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Dependent Agents as Permanent Establishments

edited by
Michael Lang
Pasquale Pistone
Josef Schuch
Claus Staringer
Alfred Storck

Linde

Dependent Agent Permanent Establishments: Recent OECD Trends

Philip Baker QC

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I. Introduction

This brief chapter examines three recent developments related to the definition of a dependent agent permanent establishment (DAPE) in article 5 of the OECD Model Tax Convention on Income and Capital (the OECD Model), namely the revised proposals concerning the interpretation and application of article 5, which were published by the OECD in October 2012, as they relate to DAPEs;[1] the recent series of cases on commissionaire structures;[2] and the international acceptance of the new version of article 7 of the OECD Model which was adopted in 2010. To a certain degree, each of these three recent developments has become entwined with the current project of the OECD on base erosion and profit shifting (BEPS), and in the concluding remarks of this chapter, some additional material will be included with regard to that project.

II. Background Comments on DAPEs

By way of background to these three developments, it may be appropriate to offer a few general words about DAPEs. The underlying concept is that an enterprise that is resident in one contracting state may become taxable on its business profits in another (host) state even if it has no fixed place of business (falling within article 5(1) of the OECD Model) in the host state. The alternative requirement is that it be represented in the host state to a sufficient degree that the representative becomes a dependent agent. Implicit in this concept is the idea that mere representation (by a representative office, for example) in the host state, of itself, is not enough. There must be representation to a sufficient degree to fulfil the conditions in article 5(5)[3] and the representative must not come within either the exemption for "independent agents" in article 5(6)[4] or merely carrying out activities which, if exercised through a fixed place of business, would be exempt under article 5(4).[5] The 19th century origins of the permanent establishment concept would identify this type of representative with a travelling salesman or local representative of a foreign manufacturing firm who solicited and concluded orders from customers of the firm in the host state.

1 The proposals are set out in "OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)", released for consultation by the OECD on 19 October 2012. The closing date for the consultation period was 31 January 2013. Subsequently, no further steps have been taken publicly by the OECD in terms of implementing any of these proposals.

2 The French legal concept of a commissionaire has two n's, but the English spelling has one only. Hopefully, spellchecking will allow the correct version to prevail.

3 Specifically, the representative must be "acting on behalf of an enterprise and has, and habitually exercises, in [the host state] an authority to conclude contracts in the name of the enterprise [...]".

4 So that the representative is not "a broker, general commission agent or any other agent of an independent status [...] acting in the ordinary course of their business".

5 If, for example, the representative were merely storing, displaying or delivering goods, or carrying out other activities of a preparatory or auxiliary character.

It may be helpful to identify three types of representatives who may constitute DAPEs. First, what one might refer to as an "internal agent", that is someone engaged within the non-resident enterprise to represent the enterprise in the host state. The most common example of this would be an employee of the enterprise who is sent to the host state with authority to conclude contracts with customers there; directors of a non-resident company who are sent to the host state, again with authorization to conclude contracts; or, for example, partners of a non-resident partnership who may have, under the law governing that partnership, an implied authority to conclude contracts binding on the partnership or all the partners. One suspects that this is probably the most common type of DAPE and that, on a regular basis, enterprises of one state send persons engaged by that enterprise to the host state with authority to conclude contracts, which authority is then habitually exercised in the host state. Clearly, this is the paradigm, 19th century example of the travelling salesman employed by the foreign company, or the locally-based employee acting as a representative of the foreign company.

The second category are representatives who are "external and unassociated" – that is representatives who are not engaged within the non-resident enterprise, but belong to a separate enterprise which is not associated (in the sense of not being in any way under common control) with the foreign enterprise. This would cover, for example, an unassociated foreign company that is engaged to act as local agent, distributor or dealer for the foreign enterprise; it would also include self-employed persons based in or operating in the host state who were engaged by contract to represent the foreign enterprise and had authority to conclude contracts binding on the foreign enterprise.[6] Commonly, such external and unassociated representatives will be agents of independent status within the exemption under article 5(6). However, if they are not of independent status – because, for example, they are economically dependent upon the foreign enterprise – then they would constitute a DAPE. The 19th century might have seen this in the form of the independent salesman who represented a business in his home state, or a local enterprise which – perhaps alongside its own business – also took orders for a foreign company.

Thirdly and finally, the representative may be "external but associated" – that is the representative is a separate enterprise, separate from the foreign enterprise that is being represented, but is an associated enterprise in the sense of being under common control. The most common example of this would be a sister company in the same multinational group as the foreign enterprise, where that sister company represents the foreign enterprise and habitually exercises authority to

6 A good example of this would be the self-employed insurance agents in the Knights of Columbus case (CA: Tax Court of Canada, Ottawa, 2008, *Knights of Columbus v. Queen*, 10 Intl. Tax Law Rep. 827 (2008)) or the *American Income Life Insurance* case, (CA: Tax Court of Canada, 2008, *American Life Insurance Company v. Canada*, 11 Intl. Tax Law Rep. 52 (2008)), except that in those cases the self-employed insurance agents had no authority to conclude contracts binding upon the US insurance company they represented.

conclude contracts binding upon[7] the foreign enterprise.[8] This would cover the increasingly common situation where associated companies of the same multinational group represent other members of the group in their host state, but give rise to a permanent establishment only if either the premises of the company are at the disposal of staff of their foreign sister enterprises or if they have and habitually exercise authority to conclude contracts binding upon their foreign, sister enterprise and are not acting as agents of independent status.[9]

One may quite properly ask what is the point of distinguishing these three types of DAPEs. The answer becomes critical when one examines the application of article 7 and the attribution of profits to the DAPE. In the case of the *internal agent*, the DAPE is part of the foreign enterprise itself (just like a physical branch) and is therefore performing functions, employing assets and taking on risks for the foreign enterprise itself. In that situation, the attribution process can be applied to determine the profit taxable in the host state.

External and unassociated DAPEs operate at arm's length to the foreign enterprise; they receive payment for the functions they perform, the assets they employ in carrying out those functions, and the risks which they bear. As the arm's length remuneration that they are paid is taxable in the hands of the external and unassociated agent in the host state, it follows that there is no further amount which, under the arm's length principle, can be attributed to the DAPE and taxed within the host state. Any further taxation would require that one recognize the DAPE as a separate taxpayer, with different functions, assets and risks from the enterprise the activities of which give rise to the PE. This is a strange, rather shadowy concept when it is the agent itself and its activities in performing its functions that give rise to the PE.

Finally, in the case of the third type of *external but associated* DAPE, the provisions of article 9 of the OECD Model may be applicable. It is possible that, by virtue of the common control, the amount being paid to the DAPE does not reflect an arm's length payment for the functions it performs, assets it employs and risks it bears, and an adjustment to the "arm's length" remuneration may be appropriate. However, if the remuneration is at an arm's length level, that remuneration is already being taxed in the host state and there is no basis for applying the arm's length principle to adjust the remuneration to bring a further amount to tax in the host state. Perhaps putting it another way, if the second type of *external and*

7 The phrase "binding upon" is used with regard to the Commentary on Article 5 of the OECD Model at paragraph 32.1; it is now clear that the phrase "in the name of" does not mean literally in the name of the foreign enterprise, but rather means an agreement binding upon the foreign enterprise.

8 This would have been the scenario, for example, in the *Philip Morris GmbH* case, 4 Intl. Tax Law Rep. 903 (2002), had the Italian companies in fact had and habitually exercised authority to conclude contracts binding upon the German company.

9 Account must be taken here, of course, of article 5(7), under which the existence of an associated enterprise in a state does not, per se, give rise to a permanent establishment.

unassociated agent is paid at the appropriate arm's length level (given that the enterprises are at arm's length), then what basis is there for attributing to the type of *external but associated* agent a higher remuneration which is taxable in the host state? These are issues will be returned to in the discussion of the acceptance of the new version of article 7.

III. The OECD 2012 Revised Proposals on the Interpretation and Application of the Permanent Establishment Concept

It is now well established[10] that the drafting of article 5(5) and (6) reflects an element of misunderstanding between the different concepts of agency under the common law and the civil law systems of continental Europe. The point is not repeated here, but underlies some of the commissionaire cases referred to below. Even before the current BEPS project, the drafting of article 5(5) and (6) was probably overdue for an overhaul. The OECD Revised Proposals, however, address only possible changes to the Commentary and not to the text of the article itself. Three specific issues relating to DAPEs are discussed in the Revised Proposals.

First, Item 19 discusses the meaning of the phrase "to conclude contracts in the name of the enterprise" and paragraph 32.1 of the Commentary. The proposed change to the Commentary is very limited, to deal only with agents for undisclosed principals. The discussion in the OECD document touches upon commissionaire arrangements and notes that the Working Party established by the OECD agreed that it was not possible to reach a common view on the solution to these issues within the context of the existing wording of article 5(5).

Secondly, Item 20 asks whether paragraph 5 is restricted to situations where sales of goods are concluded, and paragraph 33 of the Commentary. The proposal here is to add wording to show that the type of contracts entered into by the representative are not restricted to contracts for the sale of goods but could cover, for example, contracts of leasing or contracts for services.

Finally, Item 21 discusses whether paragraph 6 (the exclusion for independent agents) applied only to agents who do not conclude contracts in the name of their principal. This touched upon the relationship between article 5(5) and (6) and the long-debated question as to whether one is an exception to the other. The Working Party concluded that the issue could not be addressed merely through changes to the Commentary.

In light of the extensive use of commissionaire structures, and the subsequent developments in the context of the BEPS project, these three discussions in the Re-

10 And is shown clearly in the chapter by John Avery Jones in Chapter 1.

vised Proposals might, perhaps, be characterized as a discussion about moving the deckchairs around on the Titanic. Clearly, the BEPS project identifies (as discussed below) that much more extensive reform is required of the agency permanent establishment provision. It is therefore not surprising that, in this context, nothing further has been publicly stated about these Revised Proposals.

IV. Commissionaire Structures and Recent Cases

Arising, perhaps, from the misunderstandings of the differences between the common law and civil law concepts of agency in the drafting of article 5(5) and (6), structures have become quite common in recent years that rely upon a form of indirect representation that is potentially outside the scope of article 5(5). Under the civil or commercial codes of certain continental European countries, a concept of commissionaire is recognized under which the appointed person indirectly represents the principal in the relationship. The commissionaire then enters into a contract with customers under which he undertakes to deliver products or services supplied by the principal to the customer. The only contract that is created with the customer is the contract with the commissionaire; under the civil law of some of those countries, the activity of the commissionaire does not create any contractual relations between the principal and the customer. Goods and services are supplied by the principal directly to the customer, but the customer's only recourse is against the commissionaire, with whom the customer has his only contract.

It is fair to say that these commissionaire structures have been widely exploited in recent years, not only in continental Europe but further afield. It has become common for foreign enterprises to be represented in a country without a DAPE, on the basis that the commissionaire does not conclude contracts binding on the principal, and has no authority to conclude such contracts. In common law countries, where there is no recognition of a separate commissionaire concept as such, "synthetic commissionaire structures" have been created utilizing the freedom of contract to achieve the same result. In many parts of the world these commissionaire structures have begun to replace more traditional, buy-sell agency arrangements. In most circumstances, it is the local company of a multinational group that acts as commissionaire with respect to the foreign principal (or entrepreneur company) which provides the goods or services supplied by the group.[11]

11 The establishment of commissionaire structures has also been encouraged not only by the possibility of having representation in a country without a permanent establishment, but also because of the ability to shift risk and to avoid controlled foreign corporation (CFC) legislation. Under the contract appointing the commissionaire, the principal may agree to keep the commissionaire fully indemnified against any risks arising from the supply of goods or services to the customer. In that case, the risk-free commissionaire receives a lower reward to reflect the fact that it bears no risk. So far as CFC legislation is concerned, because the principal provides the goods directly to the customer and there is no related party sale, the profit arising may fall outside the scope of some countries' CFC legislation.

These commissionaire structures have been challenged in the courts of a small number of countries. With one exception (which is probably not a true commissionaire structure), the taxpayer has been successful.

Undoubtedly, the leading case is the decision of the French Council of State (*Conseil d'État*) in *Société Zimmer Ltd*,[12] where the conclusion was reached that, on a strict analysis in accordance with the law, the activities of the company acting as commissionaire in France did not involve that company's having and habitually exercising authority to conclude contracts binding on its English principal. This was followed in a Norwegian law context in the case of *Dell Products (NUF) v. Tax East*[13] where the Supreme Court of Norway reached a similar conclusion that the Norwegian company acting as commissionaire did not give rise to a permanent establishment of its foreign principal. Most recently in Italy, in the *Boston Scientific International BV* case[14] the Italian Supreme Court of Cassation also held that a commissionaire structure did not give rise to a permanent establishment.

The only case that appears to go against this trend is the decision of the Spanish Supreme Court in the *DSM Nutritional Products Europe Ltd* case[15] where a permanent establishment was found to exist. However, careful examination of that case (including factual information supplied by those involved with the case) confirms that it was not in fact a commissionaire structure, but rather an unusual arrangement of dual contracts for representation in Spain.

It is understood that there is a further case concerning Dell Spain proceeding through the Spanish courts.[16]

The effectiveness of commissionaire structures has not been tested in all countries. In particular, it has not yet been tested in a common law country where the specific, nominate contract of commissionaire does not exist as such. However, assuming that the arrangements mirror those of, for example, the French commissionaire, and that the common law principle of agency for an undisclosed principal is disapplied, and the activities of the "synthetic commissionaire" do not bind the principal to a contract with the customer, the result should be the same.

12 FR: *Conseil d'État* (Supreme Administrative Court), 31 Mar. 2010, Cases 304715 and 308525, *Société Zimmer Limited v. Ministre de l'Économie, des Finances et de l'Industrie*, 12 Intl. Tax Law Rep. 739 (2012).

13 NO: *Noregs Høgsterett* (Supreme Court), 2 Dec. 2011, HR-2011-2245-A, *Dell Products (NUF) v. Tax East*, 14 Intl. Tax Law Rep. 371 (2011).

14 IT: *Corte Suprema di Cassazione* (Supreme Court), 9 Mar. 2012, Case 3769, *Boston Scientific International BV v. Agenzia delle Entrate*, 14 Intl. Tax Law Rep. 1060 (2012).

15 ES: *Tribunal Supremo* (Supreme Court), 12 Jan. 2012, Case 1626/2008, *DSM Nutritional Products Europe Ltd. (formerly Roche Vitamins Europe Ltd.) v. Agencia Estatal de Administración Tributaria*, 14 Intl. Tax Law Rep. 892 (2012).

16 At present, however, it is understood that it has not been heard by a judicial tribunal, but only by an administrative body.

The introduction of commissionaire structures in many parts of the world has allowed foreign enterprises to be indirectly represented in a territory without the foreign enterprise's having a DAPE in the territory. If the commissionaire is kept in a low-risk position, and is rewarded on a risk-free or low-risk basis, the consequence is that the host state may subject to profit tax only a small amount of the profit arising from supplies of goods or services into that territory. The issue of commissionaires is well within the scope of the BEPS project and is the subject of further comments, below.

V. Consequences of Being Deemed to Have a DAPE

As a preliminary to the discussion of article 7, article 5(5) also deals expressly with the consequences of having a DAPE. It states that the foreign enterprise "shall be deemed to have a permanent establishment in that State *in respect of any activities which that person undertakes for the enterprise* [...]" (emphasis added). Thus – in contrast, if one likes, to the fixed place of business permanent establishment – the DAPE is a deemed permanent establishment. It is also a limited deeming, as the DAPE is a permanent establishment not for all purposes, but only "in respect of any activities" which the DAPE undertakes for its principal.

This focus on the activities of the DAPE has implications for a transfer pricing approach that seeks to attribute *functions*, assets and risks to the permanent establishment. Assuming that functions and activities are synonyms, seeking to attribute to the permanent establishment any functions beyond those which are actually performed by the DAPE on behalf of its principal would seem to go beyond the scope of the wording in article 5(5). The permanent establishment exists only in respect of the activities/functions of the DAPE and not more broadly.

VI. The Acceptance of New Article 7

The 2010 version of the OECD Model contained a new version of article 7 which was designed to be fully supportive of the authorized OECD approach to the attribution of profits to permanent establishments.[17] At the time that the new version of article 7 was adopted, the Commentary to the old article 7 was amended to include a new paragraph 26, which appears to be designed to support the "two taxpayer" theory that – in the case of a DAPE – it is possible to attribute profits to the deemed permanent establishment even if it is formed by an external and unassociated enterprise or an external but associated enterprise, but in either case the

17 The history of the development of new article 7 is not central to this discussion. For further consideration, see the *Cahier de Droit Fiscal International* (2006) which considers "the attribution of profits to permanent establishments".

enterprise is rewarded on an arm's length basis. This approach is inherent in the authorized OECD approach.

In the three years since the OECD adopted the new version of article 7, only two treaties in force by June 2013 contained the new wording of article 7.[18] There were also eight further treaties pending.[19] Given that the wording of new article 7 of the OECD Model was available to be used by treaty negotiators for some time before 2010, this limited acceptance is hardly a ringing endorsement of either the new wording or the new approach to the attribution of profits to permanent establishments. This is significant to the issue of the scope of the DAPE definition; there is little point in finding a permanent establishment if there are no profits to attribute to it, or, for that matter, if the methodology for attributing the profits is so much in dispute that it causes serious uncertainty to business. In the context of recent developments relating to DAPEs, a number of OECD member countries have rejected the new approach inherent in article 7, and the new approach has been rejected by the UN Committee of Experts with respect to the UN Model.

VII. Concluding Remarks and the BEPS Project

One might draw some very simple conclusions from the discussion of recent developments. The widespread use of commissionaire structures reveals the problematic nature of the current drafting of article 5(5) and (6). The potential changes to the Commentary discussed by the OECD do little, if anything, to address these issues. Changing the definition of a PE may not, of itself, be sufficient to clarify the taxing rights of the host state; the limited acceptance of article 7 suggests that the authorized OECD approach is not widely adopted and the resulting uncertainty is undesirable as a matter of principle.

In this context, one may turn to Action 7 of the Action Plan on Base Erosion and Profit Shifting, published by the OECD in July 2013. That Action states as follows:

> Prevent the Artificial Avoidance of PE Status. Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.

There is little doubt that the current wording of article 5(5), as interpreted in the commissionaire cases discussed above, does not reflect the policy of the majority of OECD member countries. At the very least, one may assume that the BEPS project will propose the redrafting of this paragraph. In principle, the redrafting

18 These are the United Kingdom-Liechtenstein and United Kingdom-Barbados treaties.

19 These are the Guernsey-Luxembourg, Jersey-Luxembourg, Isle of Man-Luxembourg, Netherlands-Norway, United Kingdom-Norway, United States-Poland, Hong Kong-Italy and Israel-Panama treaties.

would not be particularly difficult. The mischief that is sought to be caught is the foreign enterprise that supplies goods or services into a host state through the involvement of a representative there, regardless of whether that representative has authority to conclude contracts. Thus, a redrafted article 5(5) would have the following elements:

(1) the enterprise of a contracting state supplies goods or services (including digital goods or services) in the other contracting state;
(2) the amount of business done by that enterprise in the host state is more than insubstantial;[20]
(3) the enterprise has a representative in the host state at some time during the year who is involved, directly or indirectly, in the arrangements for the supply of the goods or services (but who does not necessarily conclude contracts); and
(4) the activities of the representative cannot be regarded as merely preparatory or auxiliary.[21]

No doubt the Commentary could clarify what level of involvement of the representative in the supply of goods or services would be necessary, in order to ensure that there is no force of attraction in operation. The only difficulty then is to determine what is business that is more than insubstantial, and perhaps a financial limit might be agreed between the contracting states on a basis that would be uplifted from time to time (a solution that has been suggested with regard to service PEs).

While it is quite easy to identify the elements of a new dependent agent permanent establishment (or, perhaps, better, a "representative permanent establishment") concept, whether this would be acceptable to the OECD and G20 countries remains to be seen.

20 This element is included, as any activity that is less than substantial – say not exceeding a certain turnover level each year – does not merit the compliance costs for the taxpayer or tax authority in treating it as a PE.

21 This is the standard carve-out for activities that are preparatory or auxiliary; so, the staff of a representative office that merely supplied information and kept a watching brief over the local market would not become a PE. Clearly, a broader definition such as this would mean more reliance being placed on the "preparatory or auxiliary" exemption, which is unfortunate as the terms are far from clear. New commentary would be need on the meaning of those terms.