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How can the proposed changes to the OECD tax model convention in action 1 and action 7 counter the issue of an artificial avoidance of a PE status?

by

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Summary

The purpose of this thesis is to clarify how, according to BEPS action 1 and action 7, can the amendments of the "specific activity exemptions" in article 5 paragraph 4 of the OECD Model Tax Convention on Income and Capital (the model convention) counter the issue of an artificial avoidance of a PE status. The main issues that are connected to the concept of a permanent establishment are artificial avoidance of the status of a permanent establishment, the use of transfer pricing rules in order to artificially allocate the profits of a permanent establishment to low tax states and finally that some enterprises that operate within the digital economy can avoid the status of a permanent establishment due to the lack of physical presence. The common result of all of these issues is that the source state right to tax economic activities within its borders is limited. This limitation has resulted in a situation where the allocation of taxing rights can be perceived as unfair.

In order to prevent such unfair allocation of taxing rights and to ensure a fair taxation of economic activity the OECD has in the BEPS-project explored the issues of the digital economy further in action 1 and presented changes to the current rules in action 7, that would prevent artificial structures. These actions have been a topic for discussion. In the thesis these proposed changes are analysed in the light of the issues mentioned above. The conclusion from that analysis was that the changes can have a positive effect in countering artificial structures where enterprises have a physical presence in the source state. However, regarding the issues that relate to the digital economy and artificial allocation of profits between the enterprise and its permanent establishment the effect remains questionable.

1 Introduction

1.1 Background

Today's world of business consists of transnational enterprises. That is, enterprises that cross the borders of the state where they first began their business, the resident state, to explore business opportunities in another state, the source state. When performing economic activities in a source state an enterprise may be considered to have a taxable presence in that state by falling within the scope of a permanent establishment. If an enterprise is deemed to have a permanent establishment or not is decided with reference to the domestic law of the source state.[1] The permanent establishment and the enterprise will still be considered the same legal entity but the source state, will be able to tax the permanent establishment on profits that are allocated there. Usually a state only have the right to tax its residents so in this sense the concept of a permanent establishment is an exemption to the main rule. This exemption is based on the argument that the source state should be compensated for the costs that the non-resident enterprise generate for the local government, for example costs connected to infrastructure.[2] The tax claim of the source state is also based on the highly debated source principle.[3]

The fact that the profits of the permanent establishment will be taxed in the source state and then also most likely in the resident state, due to the fact that is the enterprise is liable to tax on their worldwide income there, constitutes a risk for double taxation.[4] However, in most situations this risk is limited due to the double tax treaties that states conclude with each other. These treaties requires one of the states, usually the state of residence, to exempt the income from the permanent establishment from the income that is subject to tax in the resident state or to grant the enterprise a tax credit on the tax that they have paid in the source state.[5]

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[1] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.6.

[2] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.11.

[3] United Nations, Draft Manual for the Negotiation of Bilateral Tax Treaties between developed and Developing Countries (2001), page.1 para.1.

[4] M. Kobetsky, *"International Taxation of Permanent Establishments – Principles and Policy"*, Cambridge Tax Law Series, Cambridge, 2011, page.30.

[5] OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, article 23A and 23B.

The fact that enterprises become liable to tax in a source state if they are deemed to have a permanent establishment there has led to a situation where the analysis if a permanent establishment exists or not has become a top priority for enterprise when structuring their business.[6] In order to avoid source taxation enterprises have chosen to structure their business in a way that makes it possible for them to avoid the status of a permanent establishment, a form of tax planning.[7] An example of how this is done is that enterprises claim that the business that they perform in the source state is within the scope of article 5 paragraph 4 of the model convention that list a number of situations when a business is exempt from the status of a permanent establishment.[8] Primarily, enterprises claim that the exemption for business activities that is of a preparatory and auxiliary nature is applicable.[9] By applying this exemption the enterprise opens up the door to the possibility to conduct business in a state, to a large degree, without paying taxes in that state.[10] Another possibility for enterprises to avoid the status of a permanent establishment is by fragmenting their business in many different places within the same state.[11]

Beside the artificial avoidance of the status of a permanent establishment there are other related tax issues to when a permanent establishment is deemed to exist. One of them is when an enterprise, that is part of the digital economy, conducts business in a state.[12] Compared to a "traditional" enterprise an enterprise that operates in the digital economy has the possibility of conducting business in a state without any actual physical presence in a state other than its resident state.[13] This complicates the analysis if an enterprise has a permanent establishment in a state since physical presence is one of the criteria in article 5 of the model convention for when a permanent establishment is deemed to exist. Again, the issue is that an enterprise is able to conduct business within the jurisdiction of a

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[6] R. Williams, *"Fundamentals of Permanent Establishments",* Wolters Kluwer Law International, The Netherlands, 2014, page.2.

[7] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.2.

[8] OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, article 5, para.4.

[9] OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, article 5, para.4.

[10] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* para.2.

[11] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* para.2.

[12] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* para.1.

[13] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.25.

state without that state having a claim to tax the enterprise. Instead the profits are allocated to the state where the enterprise is domiciled.[14]

The tax issues of artificial avoidance of the status as a permanent establishment and when a digital economy is deemed to have a permanent establishment has been on the agenda of the Organisation of Economic Co-operation and Development (OECD) and G20 countries for quite some time.[15] The OECD published a proposal to change the current rules in Base Erosion and Profit Shifting project (BEPS-project) action 1 and action 7.[16] The main features of the proposal are to expand the criterion of preparatory or ancillary by nature to include all the activities stated in article 5 paragraph 4 of the model convention and also to introduce a new paragraph to avoid artificial fragmentation of business activities.[17]

1.2 Aim and purpose

The purpose of this thesis is to clarify how, according to BEPS action 1 and action 7, can the amendments of the "specific activity exemptions" in article 5 paragraph 4 of the model convention counter the issue of an artificial avoidance of a PE status?

At a first glance this proposal in action 7 seem to be a suitable solution to counter the artificial avoidance of a permanent establishment. However, at a closer look a number of questions arise. The first question is if this proposal can solve the tax issues relating to the concept of a permanent establishment. The second question is if the scope of proposal might also include situations where there is no artificial avoidance.

1.3 Method and material

The purpose and main question of the thesis is not a purely legal dogmatic question since it focuses on if the proposed changes in action1 and action 7 can solve the existing tax issues connected to the concept of a permanent establishment. In order to achieve the purpose of this thesis the research will be conducted in two parts. The first part being an evaluation of the current provisions regarding how to determine if a permanent establishment exists and the current issues that are the result of these rules. The second part being a evaluation of the proposed changes in action 1 and action 7 and

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[14] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.25.

[15] D. W. Blum, *"Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?",* Bulletin for International Taxation, IBFD, June/July 2015, page.316.

[17] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.12-13.

especially how the proposal affects the artificial avoidance of a permanent establishment status.

In the first part of the thesis the current rules that applies when determine the existence of a permanent establishment is analysed from an internal perspective.[18] In order to conduct this analysis a legal dogmatic method will be used, which means that research is based on the current European and international rules, principles, doctrine, case law and literature.[19] There is no international law that governs when a permanent establishment exists, instead the starting point is article 5 in the model convention. Therefore the relevant sources are the OECD Model Convention and the associated commentaries, relevant case law from national courts and doctrine in the form of literature and articles. Regarding the cases from national courts those cases are used to view the practical issues that exists with the current criteria for when a permanent establishment is deemed to exist. The United Nation report that is referred to in the thesis is equal to the value of other literature and articles due to the fact that it is not an official document. The commentaries to the model convention, the national case law and doctrine are all used to provide the reader with understanding of what rules governs the concept of a permanent establishment and to provide the reader with a deeper understanding of the concept of a permanent establishment and the issues that relates to that concept.

The second part of the thesis concerns action 1 and action 7 of the BEPS-project. The reason for why both of the actions will be explored in the thesis is because they relate to one and other. Action 7 concerns the issues that are related to the current definition of a permanent establishment. One of the main issues to the current definition is the digital economy and this is an issue that is explored in action 1. When evaluation the actions and what value the project has as a source, such an evaluation needs to be done from several different perspectives. Since the BEPS-project isn't a proper legal source, the BEPS-project and its actions will be analysed form a political-sociological perspective in order to provide the reader an understanding of the actions taken by states, enterprises, individuals and non-governmental organisations.[20] Furthermore the BEPS-project will also be evaluated form an economic perspective with a purpose to provide the reader of the purpose behind the BEPS-project. Lastly, the empirical effect of the BEPS-project

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[18] Prof. dr. S. Douma, "*Legal Research in International and EU Tax Law*", Kluwer, 2014, page.17.

[19] Prof. dr. S. Douma, "*Legal Research in International and EU Tax Law*", Kluwer, 2014, page.18.

[20] Prof. dr. S. Douma, "*Legal Research in International and EU Tax Law*", Kluwer, 2014, page.50.

will be evaluated since that is a prerequisite to achieve the purpose of the thesis.[21]

1.4 Delimitation

In action 7 there are several proposed changes as to how encounter the artificial avoidance of a permanent establishment. One part of action 7 focuses on commissionaire arrangements and how the related rules should be changed.[22] However, the focus of this thesis is not the commissionaire arrangements but rather the proposed changes to the specific activity exemptions. Therefore it is not necessary to include the part of action 7 concerning commissionaire arrangements in order to achieve the purpose of this thesis.

This thesis is based on the concept of a permanent establishment that is found in the OECD model convention and its commentaries. Therefor the thesis will not deal the UN Model Double Taxation Convention.

One tax issue that will be dealt with in this thesis is the tax issues relating to the concept of a digital economy. There are several issues relating to this concept, for example value added tax issues. However, this thesis will focus on the area of direct taxation and therefore the issues relating to indirect taxes will not be explored further.

Another issue that will be dealt with, when discussing the different issues relating to artificial avoidance of a permanent establishment, is the artificial allocation of profits. In this section transfer prising-rules will not be extensive explained.

The thesis is based on research until 16 of May 2016 and consideration is, thus, only taken to material that is published up to that date.

1.5 Outline

Following the introduction the relevant articles in the model convention that regulate when a permanent establishment is deemed to exist will be presented in order to provide the reader with a understanding of the basic features. The fact that the reader understand the fundamentals of the concept of a permanent establishment is crucial for the following part of the thesis, where tax issues relating to the concept of a permanent establishment is described. The description of the issues will provide the reader with an overview of the problems that has triggered the BEPS-project. Therefor, following the second part, action 1 and 7 will be evaluated. Along with this

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[21] Prof. dr. S. Douma, "*Legal Research in International and EU Tax Law*", Kluwer, 2014, page.51.

[22] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.2.

part the possible tax effect of action 1 and action 7 will be presented. The thesis will then proceed with an analysis that will deal with questions that arise form analysing the current rules and the proposal in action 1 and action 7. Finally, the conclusions that can be drawn from the analysis will be presented in the last part of the thesis.

2 The current rules for determining a permanent establishment

2.1 Article 5 in the OECD model convention

As previously mentioned, the presence of a permanent establishment offers the state where such an establishment is located a claim to tax that establishment according to the double tax treaty. This type of tax claim is based on the so-called source principle. The principle itself is difficult to determine but according to doctrine the fundamental meaning is that income is supposed to be taxed where the income has its source. That is, in the state where there is a significant economic connection between the income and the state.[23] The question to be answered is when and under what rules a state can claim that an entity has a permanent establishment in that state.

The answer to this question can be found in article 5 of the model convention. Article 5 states that *"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on".*[24] This definition in article 5 lists three criteria for when a permanent establishment is deemed to exist. First, there has to be a "place of business", secondly the place in question has to be "fixed" and thirdly, the business that is carried out in the permanent establishment is the same business that is carried out by the enterprise as a whole.[25] At a first glace the criteria might seem easy to understand, however the evaluation whether a enterprise fulfils the criteria can be complex.

However, the commentaries to article 5 provide some additional explanation. The first criteria, that an enterprise has to be a place of business, attempts to define the scope of article 5. It is stated in the commentary that a enterprise is deemed to have a place of business in a state if the enterprise has any kind of premises, facilities or installations in a state and, in addition, as long as that place of business is used to carry on the business on the enterprise.[26] Furthermore, the first criteria also include an additional criterion that the place of business has to be at the disposal of the

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[23] M. Kobetsky, *"International Taxation of Permanent Establishments – Principles and Policy"*, Cambridge Tax Law Series, Cambridge, 2011, page.30.
[24] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 5.
[25] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.2. (15 July 2014), Models IBFD.
[26]OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.4. (15 July 2014), Models IBFD.

enterprise.[27] The second criterion is that the place of business has to be fixed. This criterion aims to establish the specific geographical place where the place of business is located.[28]

2.2.1 Exemption to the status of permanent establishment

In a situation where an enterprise meets all criteria in the main rule in article 5 and is deemed to have a permanent establishment in a state, the model convention offers an exemption to the main rule in article 5 paragraph 4 of the model convention.[29] If the business that the enterprise is carrying on through a fixed place in the other state is preparatory or auxiliary then that place of business is not considered to be a permanent establishment.[30] The paragraph mentions activities that are considered to be of preparatory or auxiliary nature, for example storage, display, delivery, goods or merchandise, maintenance of a stock of goods or merchandise, processing, purchasing and collecting information.[31] The exemption thereby provides the possibility for an enterprise to have a place of business in a state, a so-called host state, without having a permanent establishment in that state. A question that arises when re-viewing this exemption is what is the meaning of preparatory or auxiliary and what is the scope of the exemption?

The commentary to article 5 states a number of factors that should be taken into account when determining if the business that an enterprise performs in another state is preparatory or auxiliary. One of the most important criteria is that the business activities in the host state cannot be the same as the main business that the enterprise performs in the state of residence.[32] In order for determining if the business activities are the same in both states the commentaries states that the purpose and characteristics of the activities should be compared.[33] This criterion has resulted in numerous cases for the national courts. One example is the German Pipeline-case[34] where a Dutch enterprise transported oil in their wholly owned pipeline to customers located in Germany. Even though the pipeline ran through both the

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[27] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.4.2. (15 July 2014), Models IBFD.

[28] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.5. (15 July 2014), Models IBFD.

[29] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 5, para.4.

[30] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.21. (15 July 2014), Models IBFD.

[31] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 5, para.4, p.a-d.

[32] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.24. (15 July 2014), Models IBFD.

[33] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.24. (15 July 2014), Models IBFD

[34] The German Pipeline-case, II R 12/92, the 30th of October 1996.

Netherlands and Germany the pipeline was automatically controlled in the Netherlands. The German tax authorities claimed that the enterprise was liable to tax in Germany since the part of the pipeline that ran through Germany constituted a permanent establishment. The enterprise opposed this by claiming that since there was no installations or no employees in Germany and the pipeline was automatically run form the Netherlands they could not be seen as having a permanent establishment in Germany. The Federal Tax court came to the decision that the enterprise did have a permanent establishment in Germany and were liable to tax on the income that could be allocated there. The court based its decision on the fact that a permanent establishment can still exist even if it is automatically ran from another place according to German domestic law and the tax treaty that existed between the Netherlands and Germany. Furthermore the court found that the exemption was not applicable since transporting oil to customers in Germany could not be seen as business of an auxiliary nature since that was the same as the core business of the enterprise.[35]

Another aspect of when a place of business is preparatory or auxiliary is whether the place of business is of a commercial character. This means that the business that takes place in the host state, for example providing services, they cannot be performed for anyone else than the enterprise.[36] It should be pointed out that the fact that the businesses cannot be of similar character doesn't mean that the place of business in the host state cannot contribute to the productivity of the enterprise to a minor degree. The limitation is that the place of business cannot make profit performing an activity that the enterprise normally makes a profit from. The reason behind this limitation is that it would be proven difficult to allocate such profits to the place of business if it is not a permanent establishment.[37]

After reviewing the exemption in article 5 paragraph 4 one can see that the exemption of preparatory and auxiliary has a wide scope of application since it does not only apply to the situations listed in the article, but is applicable to all situations of that kind.[38] In the commentary to article 5 it is stated that the wide scope is one of the benefits of the exemption, that it is a business of a certain character that is exempt instead of a specific list of types of activities. Commentators also argue that the exemption is a practical rule for the states themselves due to the fact that they do not have to conduct complicated analysis of how the profits should be allocated to the

[35] The German Pipeline-case, II R 12/92, the 30th of October 1996.

[36] R.Ekkehart, S. Schmid, M. Orell, *"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.93.

[37] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.23. (15 July 2014), Models IBFD.

[38] R. Williams, *"Fundamentals of Permanent Establishments",* Wolters Kluwer Law International, The Netherlands, 2014, page.193.

place of business in cases where the nexus between the enterprise's activities and the state is not clear.[39] However, despite the perks and logic behind the exemption it has also created an opportunity for business to use artificial arrangements in order to avoid the status of a permanent establishment and therefore also taxation in the source state. This is something that will be explored further in the following chapter.

2.3 Tax issues that relate to permanent establishments

2.3.1 Artificial avoidance of the status of a PE

It is not easy to define what constitutes artificial avoidance of the status of a permanent establishment. The reason for this is that it is not clear what constitutes a permanent establishment in the first place due to different interpretations of the term in different jurisdictions.[40] But one example of tax avoidance is when enterprises reduce their taxable income by tax planning. That is, using the existing provisions available but applying them in a way that was not the intention of those provisions.[41] This is done by enterprises when they take advantage of the gaps and inconsistencies between the tax treaties and domestic law that exists today.[42]

One of theses gaps in the tax treaties is, as previously mentioned, the exemption of preparatory and auxiliary businesses. An example of how enterprises takes advantage of this exemption is that they only conduct their business within a limited period of time in order to avoid reaching the threshold for being a permanent establishment.[43]

Another structure that enterprises use to avoid the status of a permanent establishment is by fragmentation of activities. When using this structure an enterprise establishes several places of business within the same state that together form part of the core business and therefor qualifies as a permanent establishment. To avoid this status, enterprise claim that each place of business is of preparatory or auxiliary character and that no permanent

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[39] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.85.

[40] A. Martin Jiménez, *" Preventing the Artificial Avoidance of PE Status",* Papers on Selected Topics in Protecting the Tax Base of Developing Countries, United Nations, September 2014, page.13.

[41] Z. Prebble, J. Prebble, *" Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law",* Bulletin for International Taxation, April 2008, IBFD, page.152.

[42] M. Kobetsky, *"International Taxation of Permanent Establishments – Principles and Policy"*, Cambridge Tax Law Series, Cambridge, 2011, page.67.

[43] J. de Goede, D. Kaur, B. Kosters, A. Perdelwitz, *"Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention: Response from IBFD Research Staff",* Bulletin for International Taxation, June 2013, page.315-316.

establishment exists.[44] This raises the question when theses several places of business are supposed to be considered as separate places of business, and when and under what conditions they form one fixed place of business.

The key to deciding if these several places of business should be evaluated as one entity is deciding if the places of business are separated locally and organisationally.[45] When deciding this it is evaluated if the places of business are conducting complementary functions and if there is a geographical and commercial coherence between the places of businesses. The commentary to article 5 provides a few examples of what is meant by this. An example of complementary functions is when one place of business is receiving and storing goods in one place and then later distributing those same goods through another place of business.[46] Another example of when an enterprise is maintaining several places of business in a source state that should be seen as one due to the geographical and commercial coherence is a building site. This is still the case even if the work that is performed is based on several contracts.[47] A final example given in the commentaries is a situation where a painter that performs two separate jobs for different clients, but these jobs is performed in the same building. According to the test of geographical and commercial coherence this do not constitute a single place of business but the opposite, two places of business. This is because of the lack of commercial coherence since the jobs are performed for two different clients.[48]

The test if several places of business should be seen as one place of business is a complex issue. However, it is necessary in order to determine if a enterprise is using fragmentation of activities as a way to avoid the status of a permanent establishment. Some commentators argue that the geographical and commercial coherence test makes it easy for enterprises to circumvent the criteria for creating a permanent establishment, especially the geographical coherence test.[49] By circumventing these criteria the possibility for enterprises to use fragmentation of activities remains and the possibility for the source state to tax the enterprises are reduced.

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[44] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.27.1. (15 July 2014), Models IBFD.
[45] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.27.1. (15 July 2014), Models IBFD.
[46] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.27.1. (15 July 2014Models IBFD.
[47] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.18. (15 July 2014), Models IBFD.
[48] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5,* para.5.3. (15 July 2014), Models IBFD.
[49] A. Martin Jiménez, *" Preventing the Artificial Avoidance of PE Status",* Papers on Selected Topics in Protecting the Tax Base of Developing Countries, United Nations, September 2014, page.37.

2.3.2 Issues of allocating profits to a permanent establishment

If an enterprise cannot completely avoid the status of a permanent establishment then there are other structures that allow an enterprise to minimize its tax burden, for example by artificially allocating profits from the source state to the state of residence. According to article 7 of the model convention the main rule is that an enterprise is to be taxed in the state of its residence. However, when an enterprise has a permanent establishment in the state other than the residences state, the profits of that establishment is to be taxed in the source state.[50]

A problem that arise from this is how to decide how much of the enterprise's profits is derived by the permanent establishment, in other words, how to allocate profits to the permanent establishment.[51] Article 7 of the model convention states that the profits that should be allocated to the permanent establishment is the profit that it is expected to earn if it had been an independent enterprise that conducted the same or similar activities under the same circumstances as the main enterprise.[52] This approach is referred to as the functionally separate entity approach and is the authorized approach of allocation profits of the OECD.[53] When applying this approach special consideration should be taken to what functions are conducted by the permanent establishment, what kind of assets are used and finally what risks are assumed by the permanent establishment.[54]

When allocating profits to a permanent establishment this means, from a practical perspective, that importance is given to the earnings and losses that the permanent establishment generates from conducting business. When doing this it is the actual transactions that are made within the permanent establishment that is analysed. This includes transactions between related and independent enterprises.[55] The analysis is divided into a two step process where the first step is a functional analysis and where the purpose is to identify what assets that are attributed to the permanent establishment, what functions (including people functions) the permanent establishment has and also to identify the different risks that the permanent establishment

[50] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 7, para.1.

[52] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 7, para.2.
[53] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.93.
[54] OECD, *Model Tax Convention on Income and Capital,* condensed version of 15 July 2014, article 7, para.2.
[55] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 7,* para.20. (15 July 2014), Models IBFD.

has assumed.[56] The fact that the enterprise and the permanent establishment in fact are the same "person" and conduct the same business makes it difficult to identify which of the two bears which risks. However, the OECD approach provides for a solution to this problem by stating that risks are connected to the functions that are performed by the significant persons.[57] If significant persons or management perform their functions thorough the permanent establishment, that is where those risks should be allocated.

The second step focuses on the transactions that are made between the permanent establishment and related enterprises in order to evaluate if the pricing is in line with the arm's length principle.[58]According to this principle the transactions that are made between associated enterprises should be priced the same as transaction between unrelated enterprises. Evaluating a transaction and its compatibility with the arm's length principle is difficult and article 7 of the model convention do not provide detailed information on how to conduct such an evaluation. Therefor the evaluation is based on the commentary to article 7 as well as the transfer pricing rules in article 9 and the transfer prising guidelines.[59]

A question that arises is how allocation of profits between the main enterprise and its permanent establishment and the use of transfer pricing rules create a tax issue for the contracting states. The answer is that transfer pricing rules, and especially the fact that profits should be allocated to a state based on where the risks, functions and assets are, creates an opportunity for enterprises to plan where their key management should be located in order to allocate most of the profits to that state.[60]

From the issue of artificial allocation of profits another question arise and that is why profits should be allocated to the permanent establishment to begin with. Some commentator argue that, according to the source principle, profits should be allocated to the place where the value is created and therefor profits should be allocated to the permanent establishment in order for the source state to tax the profits.[61] Other commentators are critical to

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[56] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 7,* para.21. (15 July 2014), Models IBFD.

[57] OECD, *"Report on the Attributions of Profits to Permanent Establishments",* 22 July 2010, CTPA, para.15.

[58] OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 7,* para.22. (15 July 2014), Models IBFD.

[59] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.162.

[60] A. Martin Jiménez, *" Preventing the Artificial Avoidance of PE Status",* Papers on Selected Topics in Protecting the Tax Base of Developing Countries, United Nations, September 2014, page.40-41.

[61] J. Francisco Bianco, R. Tomazela Santos*, "A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need To Resolve the*

how allocation of profits is done. They argue that the rules governing how taxing rights should be divided between the state of residence and the state of source, in this context the rules in article 5, article 7 and the transfer pricing guidelines, are no longer suitable for the world of business as it looks today.[62] This issue will be explored further in the following chapter.

2.3.2 The digital economy

To begin with it is important to clarify the definition of the digital economy because a majority of people might be of the impression that a digital economy only refers to the information and Communication Technology (ICT) sector but this is not the case. The scope of the digital economy goes far beyond that.[63] It stretches from education and healthcare to retail and e-commerce. Meanwhile, the wide scope and constantly developing of technology makes it difficult to define the concept of a digital economy. At the same time, it is possible to identify particular characteristics of the digital economy.[64] The first one is mobility. The mobility of intangible assets have resulted in lower cost for enterprises acting within a digital economy since there is low costs concerning storing and producing. Furthermore, because many of the products are digital, the mobility of these products makes it easier for enterprises to establish themselves in a new market. For example, introducing their product in another state.[65] The second characteristic is network effects. This characteristic refers to the digital economy's ability to use network effect to their advantage. The network effects mean that if several people are using a product it is likely that more people will start using this product.[66] Finally, the third characteristic is the importance of data and this characteristic refers to the enterprise's ability to use data regarding the market but also the ability to use data as a way of development.[67]

There are different models that are used when structuring a business that is a part of the digital economy. For example by a physical e-commerce, a

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Source versus Residence Dichotomy", The Bulletin for International Taxation, vol.70 no.3, 2016, page.3.

[62] J. Francisco Bianco, R. Tomazela Santos, *"A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need To Resolve the Source versus Residence Dichotomy"*, The Bulletin for International Taxation, vol.70 no.3, 2016, page.4.

[63] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.11.

[64] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.11.

[65] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.11.

[66] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.12.

[67] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.13.

digital e-commerce and cloud models or multidimensional models. The first model, the physical e-commerce, can be described as the traditional digital economy where an actual physical product is sold online and distributed to customers.[68] This structure is relatively straight-forward. The same cannot be said about the second model, that is the digital e-commerce and cloud models. These structures, unlike the physical e-commerce, provide a product or service that is purely digital and in some cases customers can use the product simultaneously but at different locations.[69] The third model, the multidimensional model, is based on a model that consists of two or more dimensions. This model can be described by the following example. In the first dimension a digital service is provided to a consumer, for example a social media. In the second dimension the provider of this service sells advertising spots to other enterprises and this generates value.[70]

These models and the concept of a digital economy have resulted in a situation where enterprises can conduct a large amount of business in a state without fulfilling the criteria for a permanent establishment, since they do not require a physical presence.[71] The enterprises therefore avoid source taxation since there is no nexus between the profits of the enterprise and the source state.[72] This issue have resulted in a situation where there are divided opinions between specialists on where value is considered to be created.[73]

3. BEPS - Action 1 and Action 7

3.1 General introduction to the BEPS-project

A couple of years ago the G20 countries and the OECD member countries initiated the BEPS-project with the aim to ensure that enterprises profits are taxed where the economic activities are carried out and where value is

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[68] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.21.
[69] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.22.
[70] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.22.
[71] W. Hellerstein, ”*Jurisdiction to tax in the Digital Economy: Permanent and other Establishments”*, Bulletin for International Taxation, June/July, 2014, page.350
[72] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.1.
[73] D. W. Blum, *”Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?”,* Bulletin for International Taxation, IBFD, June/July 2015, page.315.

actually created.[74] The result of this initiative, 15 reports based on the action plan, was published on the 5th of October of 2015 and presented a number of different actions that are to be implemented in a multilateral treaty in order to reach the aim of the BEPS-project.[75]

When the BEPS-project was initially introduced by the OECD in 2013 is had three fundamental pillars, coherence, substance and transparency.[76] It is the second pillar, substance, that is the main focus of action 1 and action 7. In the case of action 1 and action 7, what referring to substance means that there should be a connection between a state's right to tax and the commercial activity taking place in that state.[77]

3.2 The purpose and proposed changes in action 1

Action 1 of the BEPS-project focuses on the issues and challenges that relates to the digital economy. The main tax issue that is related to the digital economy is the fact that an enterprise is able to conduct a considerable amount of business in a state without being subject to tax because this business is conducted in a way that doesn't require a physical presence. This issue is the result of development of the digital economy as a whole.[78] According to the OECD this issue also highlights the fact that the rules regulating the existence of a permanent establishment are no more appropriate to the digital economy and the changes that it brings to the world of business.[79]

After identifying the tax issues and challenges arising form the digital economy the question to be raised is what is a suitable solution to this issue? In action 1 there are various proposals that aim to answer this question. One proposal is to introduce a new nexus regarding the digital economy, namely that a taxable presence exists when an enterprise has significant economic presence in a state. According to the proposal in action 1 such a significant economic presence should be determined by reviewing whether an

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[74] P. Saint-Amans, R. Russo, *" The BEPS Package: Promise Kept",* Bulletin For International Taxation, April 2016, IBFD, page.236.

[75] Hendrik-Jan van Duijn, Rocco O. IJsselmuiden, *" Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?"*, European Taxation, February/March 2016, IBFD, page.78.

[76] OECD (2013), *Adressing Base Erosion and Profit Shifting,* OECD Publishing, page.10.

[77] M. Stewart, *"Abuse and Economic Substance in a Digital BEPS World",* Bulletin for International Taxation, June/July, 2015, IBFD, page.399.

[78] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.246.

[79] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.255.

enterprise has purposeful and sustained interaction with the economy of a state via technology and other automated tools.[80] When evaluating if such an interaction exists factors such as revenue, digital presence and user base should be taken into consideration.[81] Beside the proposal of a new nexus action 1 also explores a second proposal and that is to introduce a withholding tax on the transaction between the customer of one state and the seller of the other state.[82] A third proposal is to introduce an equalisation levy as a way to achieve a equal treatment of resident and non-resident enterprises.[83]

These proposals seem to be a solution to the issue that currently exists in regard to the digital economy since they provide an opportunity for a source state to tax the value that is created within its territory.[84] However, the proposals also raise questions and create issues of their own. When evaluating the proposals the OECD reached the conclusion that the BEPS related issues that are connected to the digital economy can be solved in a more effective and proportionate way by other measures in the BEPS-project. It was also pointed out that these other measures are more likely to ensure that the location of taxation and the location of economic activity and value creation will be aligned.[85] Therefore the proposals were put on hold.

As mentioned above, the possibility for enterprises within the digital economy to carry on business in a state without being taxed on that business in that state has raised the question if the rules for determining a permanent establishment should be altered to fit the model of the digital economy. In action 1 it is explained that it is important that the rules of taxation is based on real economic activity and establish a fair result in situations involving intragroup transactions.[86] It is also pointed out that there is no need for special rules for a digital economy but that it is to prefer that the current

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[80] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para.277.

[81] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* para.278-280.

[82] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* para.292.

[83] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* para.302.

[84] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* para.345.

[85] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* Paris, para.355.

[86] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.41.

rules instead is changed in order to apply to the digital economy in a more suitable way.[87]

3.3 The purpose and proposed changes in Action 7

Similar to the purpose of action 1, action 7 also targets situations where enterprises avoid the status of a permanent establishment. Action 7 focuses specially on how the exemptions in article 5 paragraph 4 and how these exemptions has created an opportunity for enterprises to artificially avoid the status of a permanent establishment. In many of these situations the enterprises will avoid taxation in total or will only be taxed at a low rate. This issue raises the question if the current rules on permanent establishments are effective and if they actually ensure a fair allocation of the taxing rights between the contracting states.[88] In the light of this issue the OECD has in action 7 proposed two changes to the current rules that aim to restore a fair allocation of taxation. These proposed changes will be presented more in detail below.

3.3.1 The modifications of article 5.4

Today the issue of artificial avoidance of the status as a permanent establishment is more relevant then ever because of the changes that are taking place regarding how enterprises operate, for example the expansion of the digital economy that is examined in the previous chapter. The fundamental issue is that previously there has been a general assumption that all the exemptions that are listed in article 5 paragraph 4 are of preparatory and auxiliary character due to the characteristics of the listed businesses. By contrast, now that same type of business activity can be regarded as a core part of the business that the enterprise conducts as a whole.

The proposal in action 7 is to modify article 5 paragraph 4 so that the criterion for preparatory and auxiliary is a requirement for that all the exemptions that are listed in the article. This is done by inserting a sub-paragraph that states that one of the specific exemptions mentioned in the paragraph only applies if *"the overall activity of the fixed place of business, is of a preparatory or auxiliary character."*[89] It is also proposed to clarify the actual meaning of preparatory and auxiliary by adding a general meaning of the term in the commentaries. There it will be stated that a preparatory place of business is an activity that is performed as part of the

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[87] European Commission, Report, *Commission expert Group on Taxation of the Digital Economy*, 28/05/2014, page.41.

[88] OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, page.35-36.

[89] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.13.

core business of the whole, but that only takes place during a sort period.[90] In addition, it is also stated in the new commentaries that auxiliary business activities refers to activities that do not form part of the core business of the enterprise but is more of a supportive activity that do not require significant part of the enterprise's assets or personnel.[91] In order to clarify the meaning of preparatory and auxiliary these general definitions are also complemented with examples of business activities that fall within the scope of the exemption.[92]

3.3.2 The anti-fragmentation rule

According to some states the modification of article 5 paragraph 4 is not the ideal change because they consider that the main issue of the mentioned article is that enterprises can fragment their places of business in a way that makes it possible for them to conduct a large amount of business without creating a permanent establishment.[93] In order to solve this issue of fragmentation of businesses action 7 purposes to introduce an anti-fragmentation rule. This rule aims to prevent a enterprise or a group of closely related enterprises from taking a cohesive business operation, that usually would constitute a permanent establishment, and splitting that business operation into several small operations in order to claim that these several small business operations are of a preparatory or auxiliary character, and therefore do not qualify as a permanent establishment.[94]

This anti-fragmentation rule raises a few questions. The first one is how this new rule is different from the current rules. The answer to this question is that the proposed anti-fragmentation rule has a wider scope compared to the current rules since it also includes closely related enterprises.[95] In action 7 the OECD claim that the anti-fragmentation rule is necessary in order to ensure that the exemption in article 5 paragraph 4 is not artificially avoided. If the scope of an anti-fragmentation rule were restricted to the places of business of one enterprise then that enterprise could fairly easily circumvent

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[90] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, proposal for paragraph 21.2. in the new commentaries.

[91] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, proposal for paragraph 21.2. in the new commentaries.

[92] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.13, proposal for paragraph 22.6.. in the new commentaries.

[93] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.13.

[94] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, proposal for paragraph 30.2. in the new commentaries.

[95] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.15.

that rule by fragmenting the business operations between it's closely related parties instead.[96] If the anti-fragmentation rule is applicable then the several parts of business should be viewed as one place of business.

The second question that arises is when enterprises are to be considered as closely relates enterprises. According to the proposed new commentaries, enterprises are considered as closely related when one of the enterprises has control over the other or when both enterprises are controlled by the same enterprise.[97]

3.4. Possible effects of Action 1 and Action 7

After reviewing the proposed changes in action 1 and action 7 this chapter will focus on the possible tax effect of the proposals. Also, if the changes are in line with the purpose of the BEPS-project, that is to ensure that value is taxed within the state of where the actual economic activity that creates value is carried out.

The proposed changes in the actions have several effects. For example, the threshold for what constitutes a permanent establishment will be lowered. This is a result of the modification of article 5 paragraph 4 that is proposed in action 7. Since all the examples that are listed in paragraph 4 will be coupled with the criteria that the business activity has to be of a preparatory or auxiliary nature less activities will fulfil the criteria for the exemption. Therefore, the business activities will be considered to create a permanent establishment.[98] The actual tax effect of a lower threshold is that a source state will be entitled to tax the profits of an enterprise since that enterprise is considered to have a significant amount of presence in the source state. [99]

Some commentators argue that the modification of article 5 paragraph 4 and the new anti-fragmentation rule are suitable and effective measures to ensure the purpose of BEPS-project. This is because the proposed changes reflect a modern business world and they prevent the situation where an

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[96] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.15.

[97] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, proposal for paragraph 38.10. in the new commentaries.

[98] Hendrik-Jan van Duijn, Rocco O. IJsselmuiden, *" Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?"*, European Taxation, February/March 2016, IBFD, page.85.

[99] Hendrik-Jan van Duijn, Rocco O. IJsselmuiden, *" Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?"*, European Taxation, February/March 2016, IBFD, page.85.

enterprise can artificially avoid the status of a permanent establishment.[100] On the other hand, other commentators argue that theses positive tax effect have a limited effect due to the fact that the modification and anti-fragmentation rule only apply in situations where the enterprise has a physical presence in a source state. Therefore the proposed changes do not solve the tax issues that are related to the digital economy where enterprises conduct business exclusively with the assistance of electronics.[101]

Furthermore it is relevant to see what possible effects that action 1 and action 7 might have on states domestic laws. It is stated in action 7 that the proposals are not aimed at changing or refining the current standards for allocation of taxing rights.[102] However, the proposed changes in action 1 and action 7, particularly in action 7, are changes that are connected to states rules of determining and allocating taxing rights and therefor it is argued by commentators that theses changes do in fact have the objective to refine such rules.[103] This constitutes a issue because the rules that regulate when a state has a right to tax constitutes is an exclusive competence of the state itself.[104] This is according to the sovereignty principle.[105]

Assuming that the proposed changes in action 1 and action 7 can solve the issues relating to the digital economy and artificial avoidance of a permanent establishment there is still one aspect left to deal with in order for these solutions to become reality, and that aspect is implementation. This is a difficult task for the OECD because the issues that the BEPS-project aims to solve need to be, as mentioned before, implemented into domestic law and in addition to that another solution needs to be introduced. This second

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[100] P. Saint-Amans, R. Russo, *" The BEPS Package: Promise Kept",* Bulletin For International Taxation, April 2016, IBFD, page.238.

[101] J. Francisco Bianco, R. Tomazela Santos, *"A change of Praadigm in International Tax Law: Article 7 of the Tax Treaties and the Need To Resolve the Source versus Residence Dichotomy",* Bulletin for International Taxation, 2016 (volume 70) no.3, page.9.

[102] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, para.3.

[103] C. HJI Panayi, *" The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposals with EU Law"*, Bulletin For International Taxation, IBFD, Jan/Feb 2016, page.98.

[104] C. HJI Panayi, *" The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposals with EU Law"*, Bulletin For International Taxation, IBFD, Jan/Feb 2016, page.98.

[105] R.Ekkehart, S. Schmid, M. Orell,*"Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective",* Kluwer Law International, The Netherlands, 2015, page.6.

solution also needs to be effective to implement.[106] The OECD's proposal for such a solution is a multilateral tax treaty.[107]

Even though this multilateral tax treaty is presented as an answer to the question of implementation, it raises numerous of questions itself. For example, how will it work? There is a wide span of possibilities, from only changing the current commentaries to replacing all existing treaties with the one treaty.[108] The OECD has chosen to an approach that allows the multilateral tax treaty to work as a complement to the existing tax treaties that states have. However, the multilateral tax treaty would focus on the specific issues that are related to the BEPS-project.[109] One of these aspects being altering the definition of a permanent establishment in line with the proposal in action 7.

On the one hand, one advantage with an alternative like the multilateral tax treaty, is that it would result in a coherent and unity interpretation of the term permanent establishment.[110] Also, the OECD argues that a multilateral tax treaty is more likely to solve the disputes between states that are inevitable to accrue in a global world of business.[111] On the other hand, commentators have pointed out that the proposal for a multinational tax treaty also has its disadvantages. For example, the fact that several states are reluctant to sign a multilateral treaty makes the treaty less effective.[112] Additionally, commentators have underlined the need for more work to be done on the proposal for a multilateral tax treaty.[113]

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[106] J. Malherbe, *"The Issues of Dispute Resolution and Introduction of a Multilateral Treaty",* Intertax, Volume 43 Issue 1, Kluwer Law International BV, 2105, page.93.

[107] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.para.7.

[108] J. Malherbe, *"The Issues of Dispute Resolution and Introduction of a Multilateral Treaty",* Intertax, Volume 43 Issue 1, Kluwer Law International BV, 2105, page.93-94.

[109] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.para.19.

[110] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.para.15.

[111] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.para.14.

[112] J. Malherbe, *"The Issues of Dispute Resolution and Introduction of a Multilateral Treaty",* Intertax, Volume 43 Issue 1, Kluwer Law International BV, 2105, page.94.

[113] J. Malherbe, *"The Issues of Dispute Resolution and Introduction of a Multilateral Treaty",* Intertax, Volume 43 Issue 1, Kluwer Law International BV, 2105, page.95.

4 Analysis

4.1 Introduction

As an introducing remark to this part of the thesis the outline of this analysis will be clarified. First, the issues relating to the current rules will be analysed in order to understand the reasons behind the issues. Second, the current nexus-approach will be analysed. Third, the consequences of action 1 and action 7 will be explored further. Furthermore the remaining issues connected to the concept of a permanent establishment will be analysed.

4.2 The current definition of a permanent establishment and related issues

The concept of permanent establishment has been a topic for discussion for a long time and the current rules regulating the concept, article 5 of the model convention, is no exemption. In this thesis it has been explained how enterprises can avoid the status of a permanent establishment in a situation where that enterprise, according to the domestic law of a state, is considered to have such a presence in that state. The avoidance is done by artificial structures and often by applying the exemption in article 5 paragraph 4 of the model convention. Therefore, the current rules leave a door open for enterprises to avoid the status of a permanent establishment. This raises the question how this can even be a possibility to begin with?

Of course it is difficult to identify one answer to such a question. There are several factors that contribute to this possibility. One example is that enterprises exploit the different definitions between states of what constitute a permanent establishment. However, the underlying issue is that development of the rules has not kept the same pace as the development on how business is conducted in the world today. A good example of this is the criteria of a physical presence in order to qualify as a permanent establishment. This criteria might make sense in a business world where an enterprise has to establish a location in a state when trying to expand it's business, but today expansion to a new market in another state do not require a physical presence. This is especially the case when it comes to business models in the digital economy.

The fact that the current rules are not always applicable due to the fact that they are not up to date with the modern business world creates a situation where the concept of a permanent establishment looses its purpose of being a threshold for taxation for a source state. This shows the flaws with the traditional nexus-approach and raises the question if it is time to move away from the traditional nexus-approach. However, before making such a

decision special consideration should be taken to what consequences a change like that would have to the legal certainty of when a permanent establishment is deemed to exist.

4.3 Dose BEPS provide a solution?

A new nexus-approach is one of the questions that the OECD dealt with in action 1. Or at least attempted to deal with. In action 1 several suggestions to an alternative nexus-approach are presented, for example that an enterprise should be liable to tax if it has a significant economic presence in a state. It can be argued that this nexus-approach would be a step in the right direction because it takes an enterprise's digital presence into account when determining if the enterprise has a taxable presence in a sate or not. On the other hand, this nexus approach would result in a situation where there would be one set of rules for the digital economy and one set for the rest of the economy.

This is not a desirable situation due to two reasons. First of all, a nexus-approach like that would make it fairly easy for enterprises within the digital economy to circumvent the rules because the criteria are specific. Second of all it is not a good idea to have special rules for the digital economy because the digital economy is not a small part of the economy as a whole. The business models that form the digital economy is the new standard for how business is conducted. Therefore it should be under the same rules as other enterprises. After looking at these different aspects it can be argued that the OECD made a correct choice by not moving forward with the new nexus approach for permanent establishment. It should also be pointed out that the proposal in action 1 is the result of two years of work. It is fair to claim that a decision of changing a nexus approach, which is a fundamental decision, should perhaps be based on more detailed information.

According to the OECD one reason why it was decided not to go further with any of the suggestions in action 1 was because the issue of determining a taxable presence for enterprises within the digital economy could be solved more efficiently by other action plans in the BEPS-project, especially the proposed changes in action 7. Yet, the suggestions that are presented in action 7 do not cover the challenges and issues of the digital economy. Those suggestions focuses on how the current rules, that has the criteria of a physical presence, can be changed in order to prevent enterprises from artificially avoiding the status of a permanent establishment. Therefore, as been pointed out by commentators, the proposed changes in action 7 has a limited effect since it do not include enterprises in the digital economy that operates completely in a digital way. This also shows that OECD:s argument in action 1, that the issues of digital economy can be better solved by the suggestions in other actions plans, can no be sustained.

Meanwhile, despite the fact that action 7 does not completely solve the tax issues relating to the digital economy, the proposed changes of a modification of article 5 paragraph 4 in the model convention and the introduction of a anti-fragmentation rule can result in difficulties for enterprises that use a artificial structure to avoid the status of a permanent establishment. The modification of article 5 paragraph 4 has two main effects. The first one being that it is clarified that in order for the exemption to be applicable the place of business has to be of preparatory or auxiliary nature. There have been divided opinions in the past about if the listed examples in the article have to be of preparatory or auxiliary nature in order to qualify for the exemption, but the modification of paragraph 4 clarifies this once in for all. It can be argued that the modification in that sense contributes to more legal certainty in this area.

The second effect of the modification of article 5 paragraph 4 is that the scope of the exemption is limited. This is because the place of business that a enterprise have in a state has to be of a preparatory and auxiliary nature. This might lead to a situation where business activities that previously would be covered by an exemption, because it was one of the activities listed in article 5, is no longer exempt because it do not pass the test of preparatory or auxiliary nature, and is instead considered to form a permanent establishment.

This effect also results in a situation where the threshold for when an enterprise is deemed to have a permanent establishment is lowered. This lower threshold can be either a blessing or a curse, depending on from whose perspective you look at the situation. From the enterprises perspective the lowered threshold is more of a curse since they become liable to taxation for the performed activities in a source state. However, from the perspective of the source state, this is a blessing since it will now be able to tax profits of activities that are performed within its territory. Activities that was not taxable before due to artificial structures.

Beside the modification of the exemption in article 5, action 7 also proposes to introduce an anti-fragmentation rule. It can be argued that this new rule might prove effective in countering artificial structures to avoid the status of a permanent establishment. This is because this rule focuses on countering fragmentation of business activities, a structure that in the past has proven effective for enterprises that wants to avoid the status of a permanent establishment. The fundamentals of these structures are that enterprises divide their business activities between several places within a state in order to claim that they all fall under the exemption of preparatory and auxiliary. The anti-fragmentation rule counters these situations by stating that all of

the places of business should be seen as one if there is a geographical and commercial coherent.

There already is a rule like this anti-fragmentation rule in the current model convention. However, this new rule expands the scope by including the places of business of enterprises that are closely related. This expansion of the scope creates a issue of its own since it is not clarified what is to be considered as closely related enterprises. This definition has to be found in the commentaries to another paragraph of the article.

The proposed change to modify the exemption in article 5 raises the question if the meaning of what constitutes preparatory and auxiliary will be different in a post BEPS-world. Since these terms are not defined in the actual article, neither the current nor the modification, this question is answered by comparing the current and proposed commentaries. By this comparison it is shown that the actual meaning of what constitutes preparatory or auxiliary business activities are the same. In a post BEPS-world the important aspect is still time-aspects and if the place of business perform activities that is the same activity that the enterprise perform as whole.

4.4 Questions that arise from action 1 and action 7

After evaluating how the proposed changes in action 7 in fact can be effective in countering enterprise's efforts to artificially avoid the status of a permanent establishment, the proportionality of these proposed changes should be evaluated. The proportionality of rules is an important aspect because rules are not allowed to go beyond what is necessary in order to ensure the purpose of the rules. The purpose and aim of action 7 is to counter the artificial avoidance of the status of a permanent establishment in order to ensure a fair allocation of taxing rights between states. As been explained above, the modification of the exemption in article 5 and the new anti-fragmentation rule do counter the artificial structures and therefore it can be argued that the suggested changes fulfil their purpose. However, it should be evaluated if the changes go beyond what is necessary in order to fulfil this purpose. One aspect that points to the conclusion that the changes are not proportionate is that there is a risk that the scope of the rule is expanded too far. Even so far that they also include structures that are not artificial. One example of this is that the new anti-fragmentation rule will also include enterprises that are closely related parties.

Even if the proposed changes would be proportionate and result in a situation where it is not possible for enterprises to use artificial structures to avoid the status of a permanent establishment there is one issue remaining. That is the issue of artificial attribution of profits. The fact that action 7 do

not deal with this issue can result in a situation where a source state will finally have a claim to tax the profits of a permanent establishment, but finding that the taxable profits being remarkably low due to the fact that the enterprise has relocated those profits to the resident state or another low tax state.

To get a greater understanding of the effects of the proposed changes in action 1 and action 7 it is interesting to look closer at the economic effects. If the proposed changes are adopted this will, as previously mentioned, give the source state a claim to tax the economic activity taking place in that state. This can result in a situation where more subjects carry the tax burden in a state and in some cases also result in an increase of revenues for the source state. The fact that a source state will have a claim to tax the activities of non-resident enterprises might also have a different effect. The fact that a enterprise will be deemed to have a permanent establishment in a state will perhaps change the enterprises decision to expand it's business to this state to begin with. This is an aspect that the OECD does not consider in action 7.

One last aspect that should be pointed out when evaluating the effect of the BEPS-project and in this case action 1 and action 7 is that the proposed changes is the result of two years of work of the OECD. It might be in everyone's, both the enterprises and the states, to go over the alternatives one more time in order to ensure that the proposed changes wont result in a less desirable situation then the one that exists today. This is especially the case regarding the multilateral tax treaty. The advantages that are presented by the OECD might be logic in theory but from a practical view the suggestion has several weaknesses. The most obvious one being states aversion to signing such a treaty. This can lead to only a few states adopting the tax treaty and in that situation the current issues will be left unaffected.

5 Conclusions

The purpose of this thesis was to clarify how, according to BEPS action 1 and action 7, can the amendments of the "specific activity exemptions" in article 5 paragraph 4 of the model convention counter the issues of an artificial avoidance of a PE status. This thesis has showed that the proposed changes in action 7 might indeed counter the issues relating to artificial avoidance of the status of a permanent establishment. It has even been showed that these changes might be quite effective for such a purpose. However, it has also been pointed out that there is a risk that the changes are taking one step too far, resulting in a situation where the new rules also targets situations that are non-artificial.

It should be pointed out that theses changes have a limited effect when trying to counter the issues relating to the concept of a permanent establishment because they only apply to situations where an enterprise has a physical presence in a state. This means that when enterprises have a purely digital business model, they will not fall within the scope of these rules. The result of this being that these enterprises will still be able to conduct business in a state without being liable to tax in that state. This limited effect highlights that the digital economy remains a problem for source states in a post BEPS business world, in the sense that the states have no foundation for a tax claim. It can also be concluded that this is not a problem that will go away any time soon. The digital economy is no longer the future. Quite the opposite, the digital economy is the normal standard for conducting business and it would be preferable that the OECD finds a solution to this problem sooner then later.

To conclude, it can be argued that the proposed changes to the specific activity exemption and the introduction of a new anti-fragmentation rule to a certain degree solve some of the issues relating to enterprises artificially avoiding the status of a permanent establishment. It is a step in the right direction, but three is still work to be done.

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