Problems with permanent establishments

1. Introduction

> *"When there is an income tax, the just man will pay more and the unjust less on the same amount of income" – Plato*

In the modern business environment, and apparently that of Plato's time, organisations may wish to minimise their tax burden. In order to achieve same, entities may operate on a global scale and endeavour to locate taxable profits in low tax jurisdictions. The operation of business on an international scale is not always tax driven. An international presence may be required due to the nature of business undertaken. The locating of business activities through different jurisdictions can result in different authorities claiming taxing rights. The vast international network of tax treaties endeavours to eliminate the potential to double taxation. The keystone to these treaties is the concept of permanent establishment ("PE").

2. What is a PE? – a helicopter view

The concept of a PE is a fundamental idea which is intrinsic to double taxation agreements. Essentially, it is this concept which determines the right of a contracting state to tax the profits of an enterprise of the other contracting state. The existence of a PE is a minimum threshold which is required to be cleared in order for a country to tax a non residents business profits derived from sources in that jurisdiction.

The OECD Model Tax Convention is the framework typically used by developed countries when negotiating new agreements. Article 5(1) of the Model Convention provides that a PE is taken to mean:

> *"....a fixed place of business through which the business of an enterprise is wholly or partly carried on."*

The definition put forward in the UN Convention is similar to the one above. This apparently relatively straight forward definition encapsulates three requirements in order for a PE to be present, namely;

1) The existence of a "place of business",
2) The "place of business" must be of a fixed nature and
3) The enterprise being carried is required to be carried on through the fixed place of business

3. Place of Business

Typically a place of business is taken to mean any premises / facilities used for the purpose of the enterprise. Such facilities are not required to be used exclusively for the purposes of the business. However, it is possible for a place of business to exist without the presence of premises / facilities. The availability of an amount of space for business usage should suffice. Interestingly, it is not necessary for there to be a formal legal entitlement to usage of the premises / facilities. A substance over form approach is adopted.

The difficulty in determining if there is a place of business is in that it is possible for the facilities not to be at the disposal of the enterprise. This is likely to occur where, say, the sales people of the non resident entity conclude contracts at the offices of its customers. In theory it is possible, assuming all other criteria is satisfied, for a non resident to have a number of PE's in the same jurisdiction. This in itself causes its own difficulties. See section 8 below.

4. Fixed Nature

Article 5(2) of the OECD Treaty provides specific examples of what will constitute fixed places of business. Specifically included are;

1) *"A place of management*
2) *A branch*
3) *An office*
4) *A factory*
5) *A workshop; and*
6) *A mine, an oil or gas well, a quarry or any other place of extraction of natural resources."*

The provision of the above examples reinforces the belief that a physical facility is required in order for a PE to be present. It is generally accepted that it is irrelevant as to how long a non resident has been operating in a contracting state. In the majority of cases it should be apparent whether a physical presence exists or not.

The examples set out in Article 5(2) hanker to an era comprising of manufacturing and retailing businesses. The concept of a fixed place of business is not in keeping with modern businesses such as those in the service industry.

The examples provided refer to mines, oil wells etc. By nature, the work undertaken on these projects can in theory span over a vast land mass. This can give difficulties in determining a single place of business. However, it is generally accepted that mining over a spread area should constitute a single place of business. This is on the basis that the work is being undertaken in a particular geographical location. A similar situation arises in the case of acquiring the services of an "office hotel".

5. Operations carried on through the permanent establishment

In order for a place of business to constitute a PE it is necessary for the enterprise to carry on its business activities wholly or partly through it. The activity is not required to be of a permanent nature. However, it is considered necessary for the activity to be carried on a regular basis.

The current OECD Model Treaty (2008) contains what would appear to be a suttle differentiation to the PE definition. As indicated above, the current definition of PE is;

*".....a fixed place of business **through** which the business of an enterprise is wholly or partly carried on."*

This definition differs from its predecessor – the 1963 definition. This provided that a PE was:

*".... a fixed place of business **in** which the business or enterprise is wholly or partly carried on."*

The revised definition results in a wider application of the concept of a PE. In theory it is now possible for the definition to apply to any situation where business activities are carried on at a particular location which is at the disposal of the organisation.

It will be determined as to whether business is being carried on through a PE by reference to the domestic laws of the foreign jurisdiction. Each jurisdiction will have its own criteria for determining what constitutes the carrying on of business in the region.

6. Construction Sites

Article 5(3) provides that a PE will exist where:

"A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

This article is commonly adopted and provided for in tax treaties. However, depending on the treaty in question this twelve month period can be reduced to as little as three months. The twelve month duration will apply to each individual project. Difficulties may arise in determining if a project is within the twelve month timescale given that it may be difficult to identify when the project commences. It is considered that the twelve month clock begins to tick when the contractor beings their preparatory work in the foreign jurisdiction. Once work commences the project is considered to be ongoing and active until such time as it completes. The site will not be considered to cease where there are periods of temporary discontinuance. Such periods may occur due to factors beyond the contractors control e.g. weather conditions, third party agencies or indeed industrial disputes.

In order to circumvent the twelve month criteria contractors may endeavour to subcontract out elements of the project to third parties. Unfortunately, even in these circumstances the principal contractor may still have a foreign PE. The time spent by the sub contractors is taken into account in determining if the principal has a PE.

The twelve month test applies to each individual project / site. In establishing the duration of each contract and whether a PE exists, no account is taken of time spent on unconnected projects. However, a project may be regarded as a single project by virtue of its commercial and geographical unity. This can be irrespective of the fact that there may be multiple contracts. It is understandable why this provision should apply. Historically, entities would have endeavoured to circumvent the twelve month provision by splitting an overall contract amongst multiple connected parties.

The twelve month test may appear to be the most straight forward method of determining if a PE exists. However, as indicated above this test comes with its own difficulties. The fact that there is no provision for temporary absences, perhaps due to circumstances beyond the non residents control, can give rise to a PE. One would contend that this should not be the spirit of the treaty. Whilst it may be difficult to monitor and enforce it is necessary that there should be a provision to cover such circumstances.

7. Foreign Agents

An enterprise should be considered to have a PE in a foreign jurisdiction where it is carrying on business through an agent who is acting in the ordinary course of business. An agent is not taken to mean a broker or commission agent. This "acting in the ordinary course of their business" test has been the source of much confusion and criticism. While the OECD Commentary attempt to clarify the situation, in reality the position is still dependent on the legal system in each jurisdiction. In the common law jurisdictions it has been accepted that the activities of an independent agent, which are unusual for him / her, will constitute a PE. This can be the case even where the activity being performed is "normal" for the industry.

It is commonly understood that in order for the agent to give rise to a PE, the agent is required to have sufficient autonomy to negotiate and conclude contracts on behalf of the organisation. In addition to having to ability to negotiate / conclude contracts, it is necessary for this power to be habitually exercised.

In general, under many treaties the above is the position adopted in determining if an agent results in a PE. However, certain treaties provide alternatives to the ability to negotiate / conclude contracts. Under the Ireland / Japan treaty, despite an agent not having the ability to negotiate / conclude contracts, the agent may still result in the organisation having a PE. Under the provisions of this treaty if the agent retains stock in Ireland which is used to fill the orders of the Japanese organisations customers, this can result in an Irish PE. Similar provisions are in the contained in the Ireland / Pakistan treaty.

8. Multiple PE's

As indicated above, the presence of all three "ingredients" are required in order for a PE to exist. Depending on the nature of the business activities being undertaken, the "place of business" may move around. Activities which by their nature require movement between locations may still constitute a single place of business to the extent that they may be identified as a single coherent unit both geographically and commercially. The example best used to describe this is the exploration of a mine. However, where the geographical and commercial unity cannot be identified it is possible for there to be multiple PE's.

In situations where there are deemed to be multiple PE's this can result in an increased tax cost to the non resident. Neither the OECD nor UN treaties provide for the offset of losses incurred by one PE against taxable profits incurred by a related PE. This can result in the non resident incurring a higher tax liability in the foreign jurisdiction. Depending on the jurisdictions in question, this can result in a higher real tax cost to the organisation as it may not get the full benefit of credits in its home jurisdiction.

9. Negotiating Parties

The negotiating parties as defined in the treaties may expand the scope of their territoriality to include territorial waters in accordance with international law. In these instances it is possible for the non resident to be liable to tax in the contracting state on profits derived from its exploration activities. This manner of determining a PE may not be straight forward due to difficulties for the non resident to establish in whose territory they are operating. In theory

work on a particular site, e.g. extraction of oil from offshore may result in a non resident crossing over a number of territories. The non resident may have two or more PE's.

10. Outsourcing of back office services

The outsourcing of support services to cheaper jurisdictions is a common practice worldwide. However, this practice raises the issue of whether a PE is created in the outsourced jurisdiction. This issue was addressed by the Authority for Advanced Rulings in India where it handed down a ruling in the case of Morgan Stanley & Co ("MS"). MS was involved in the provision of financial advisory services, corporate lending and the underwriting of securities. MS outsourced a wide range of its support services to its group company Morgan Stanley Advantage Services Private Limited ("MS India").

It was held by the Authority for Advanced Rulings that MS did not have a PE in India. This was on the basis that MS India was not considered to be a fixed place of business. The business of MS was not considered to be carried on in India. In addition, MS would not have been considered to have an Indian PE due to the fact that MS India did not have the ability to conclude contracts on behalf of MS.

This decision is particularly important for multi-national organisations with outsourced activities in India. In India an advance ruling is only binding on the applicant (MS). However, it does have significant persuasive value and will play an important role in international taxation.

11. Electronic Commerce

It has been argued by many that the definition of PE as put forward by the OECD and UN treaties is antiquated and does not address the modern business environment. This grievance was rooted in the fact that it did not address the e-commerce society. This has now been addressed by the OECD in its current edition of the Commentary.

The presence of computer equipment at a fixed location may in itself give rise to a PE in that jurisdiction. However, it is necessary to draw a distinction between computer equipment located in a jurisdiction and the data and software used by that equipment. A website in itself would not have a fixed place of business and would not be considered a PE under the existing definition. The server though would comprise of a fixed piece of equipment and be located at a specific location. The server in itself would give rise to a PE.

Frequently, the enterprise which operates a server on which a web site will be hosted will not be the enterprise that carries on business through that web site. In these scenarios the server may not be a fixed place of business of the enterprise carrying on the trade. As a result, the operation of the website should not constitute a PE of the organisation. It is understood that often websites are hosted by internet service providers. The servers and the location of the servers are generally not at the disposal of the enterprise. As the entity does not have a fixed place of business a PE should not exist.

The consensus reached by the OECD in respect of determination of a PE for ecommerce entities is summarised as follows:

- A web site will not constitute a PE
- A web site hosting facility should not result in a PE for the entity carrying on business through the web site
- An internet service provider should not constitute an agent and give rise to a PE
- A server located in a jurisdiction for a sufficient long period of time may be considered "fixed" and constitute a PE.

The commentary issued by the OECD in respect of ecommerce is logical and is reflective of the way society now does business. It is understood that commentary received by the OECD from non OECD members has received support.

12 Conclusion

The concept of a PE is intrinsic in international taxation. It is this concept which determines the right of a contracting state to tax the profits of an enterprise in another jurisdiction. The topic has been the source of great consideration by academics and practitioners alike. Guidance produced by the OECD and UN is useful but is in no way conclusively addresses all issues. It may be contended that the concept does not properly reflect that the current business environment. The concept is not without its problems. Difficulties created include determining if there is a place of business and the possibility of there being more than one. This scenario can result in an increased tax cost due to the inability to offset losses against taxable profits. In the case of construction sites it may appear clear cut. However, the use of a time period as a yard stick can result in difficult negotiations with foreign authorities. The determination of when a project commenced may be up for debate. The fact that consideration is not given for temporary discontinues due to reasons beyond the non residents control is punitive.

Despite the above mentioned problems with the concept of a PE, it is keystone concept. It is vital in helping tax payers worldwide to determine if they will have a taxable presence. Without it, taxpayers would be operating in the dark. However, if the concept is to continue to be used it is necessary that it is a "working" definition. As the business environment in which we operate evolves so too should the concept of PE.

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