

LLM Programme International and European Legal Studies
International and European Tax Law

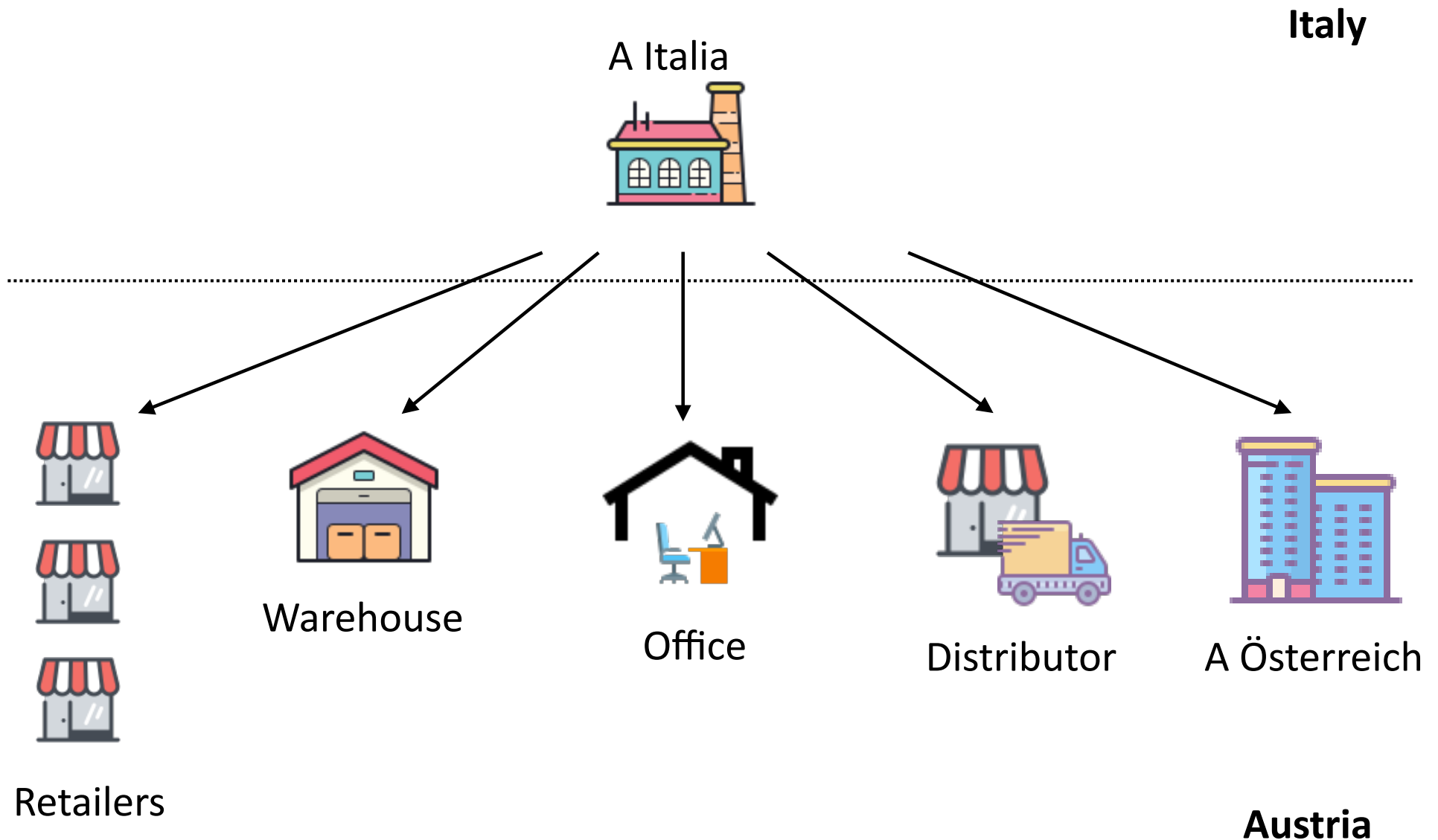
3. Taxation of cross-border activities

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International and European Tax Law

Case study



Taxation of cross-border activities

Concept

- Tax object: income from cross-border business activity
- Source vs residence taxation
- Extent of cross-border involvement:
 - ♦ Minimum involvement: direct sales or services
 - ♦ Maximum involvement: local company
- Tax implications
 - ♦ Direct sales: taxation in residence state
 - ♦ Local company: taxation in source state (state of incorporation)
- Legal basis
 - ♦ Direct sales: tax treaties (Art. 7 OECD Model)
 - ♦ Local company: domestic law

Taxation of cross-border activities

Concept

- Problem
 - Various forms of intermediate involvement
 - Which state has the right to tax?
- Solution: Permanent establishment (PE)

Taxation of cross-border activities

Concept

- General rule: OECD Model

ARTICLE 7

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

Taxation of cross-border activities

Permanent establishment

- Definition: "a fixed place of business through which the business of an enterprise is wholly or partly carried on" (Art. 5 (1) OECD Model)
- Terminology:
 - ♦ Permanent establishment (English)
 - ♦ Établissement stable (French)
 - ♦ Betriebsstätte (German)
 - ♦ Μόνιμη εγκατάσταση (Greek)

Taxation of cross-border activities

Permanent establishment

- What it is:
 - ♦ a tax term
 - ♦ a fiction for tax purposes
 - ♦ a non-resident's business presence in a particular country that is of a sufficient level to justify that country's taxation of the attributable profits
- What it is not:
 - ♦ a civil/company law term
 - ♦ a company form
 - ♦ a legal person
- Not to confuse with a branch
 - ♦ A branch is always a PE, a PE is not always a branch

Taxation of cross-border activities

Permanent establishment

- PE is a threshold:
 - ◆ Demarcation line between
 - short-term and permanent activities
 - Minimum and maximum involvement
 - ◆ Justice vs. practicality
- Tax consequences:
 - ◆ Source state is entitled to tax
 - taxation similar but not identical to a resident
 - ◆ Resident state is also entitled to tax
 - It must however provide relief from double taxation

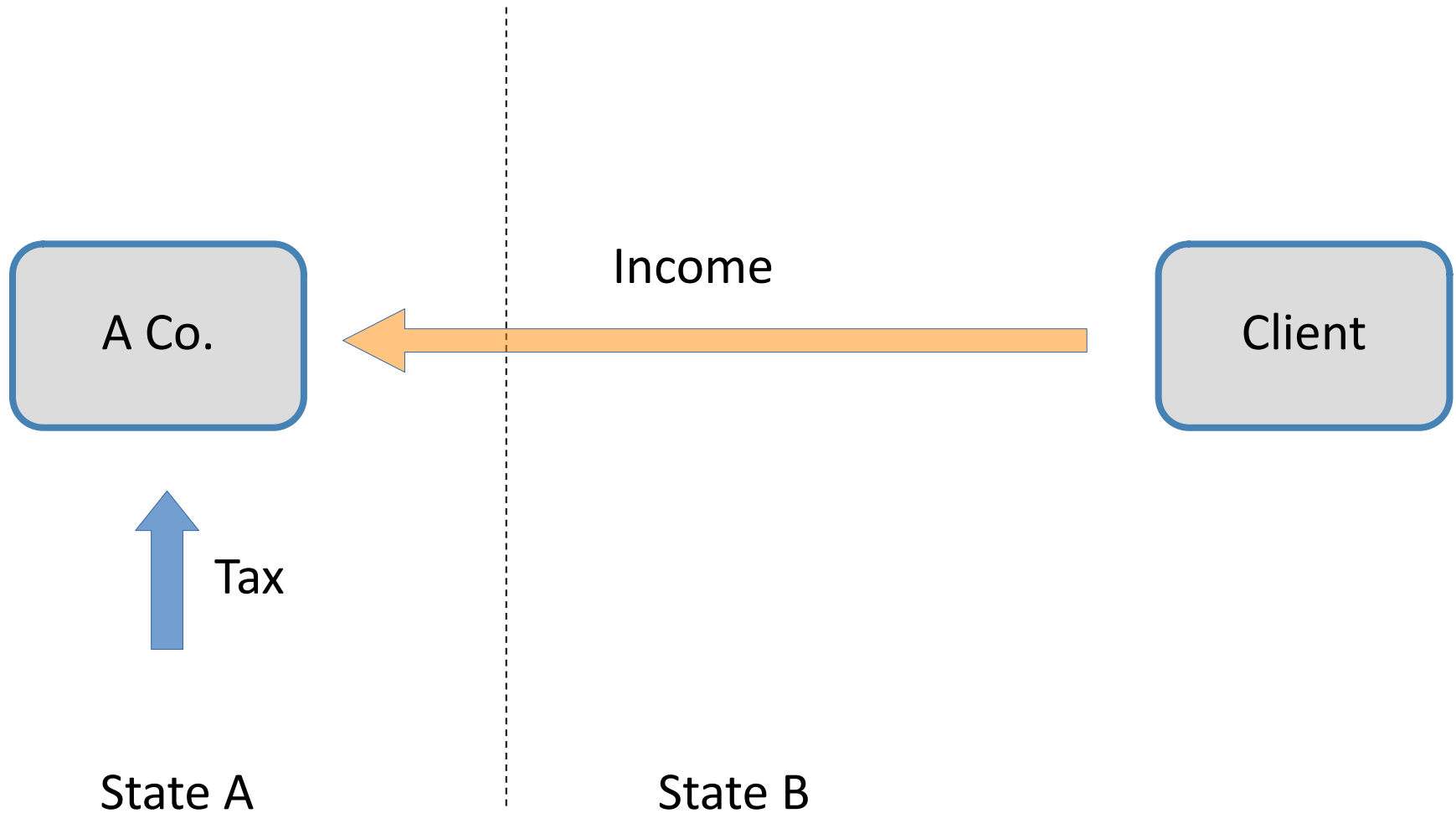
Taxation of cross-border activities

Permanent establishment

- Objectives
 - Assigning tax revenue to the source state
 - Not unconditional source taxation
 - Elimination of double taxation
 - Neutrality of PE in the local market
- Functions
 - Allocation of taxing rights
 - Determination of taxable income

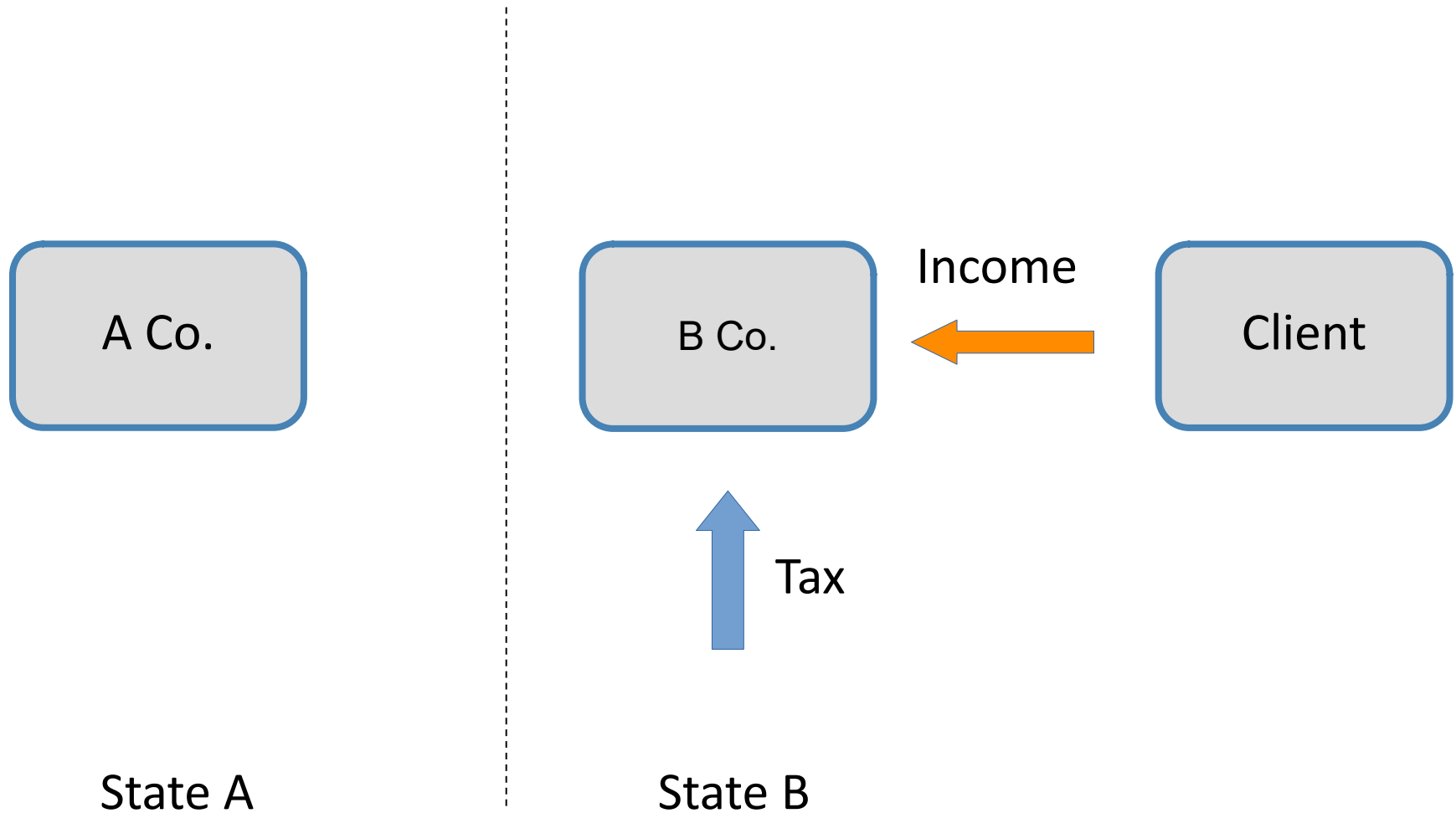
Taxation of cross-border activities

Direct sales



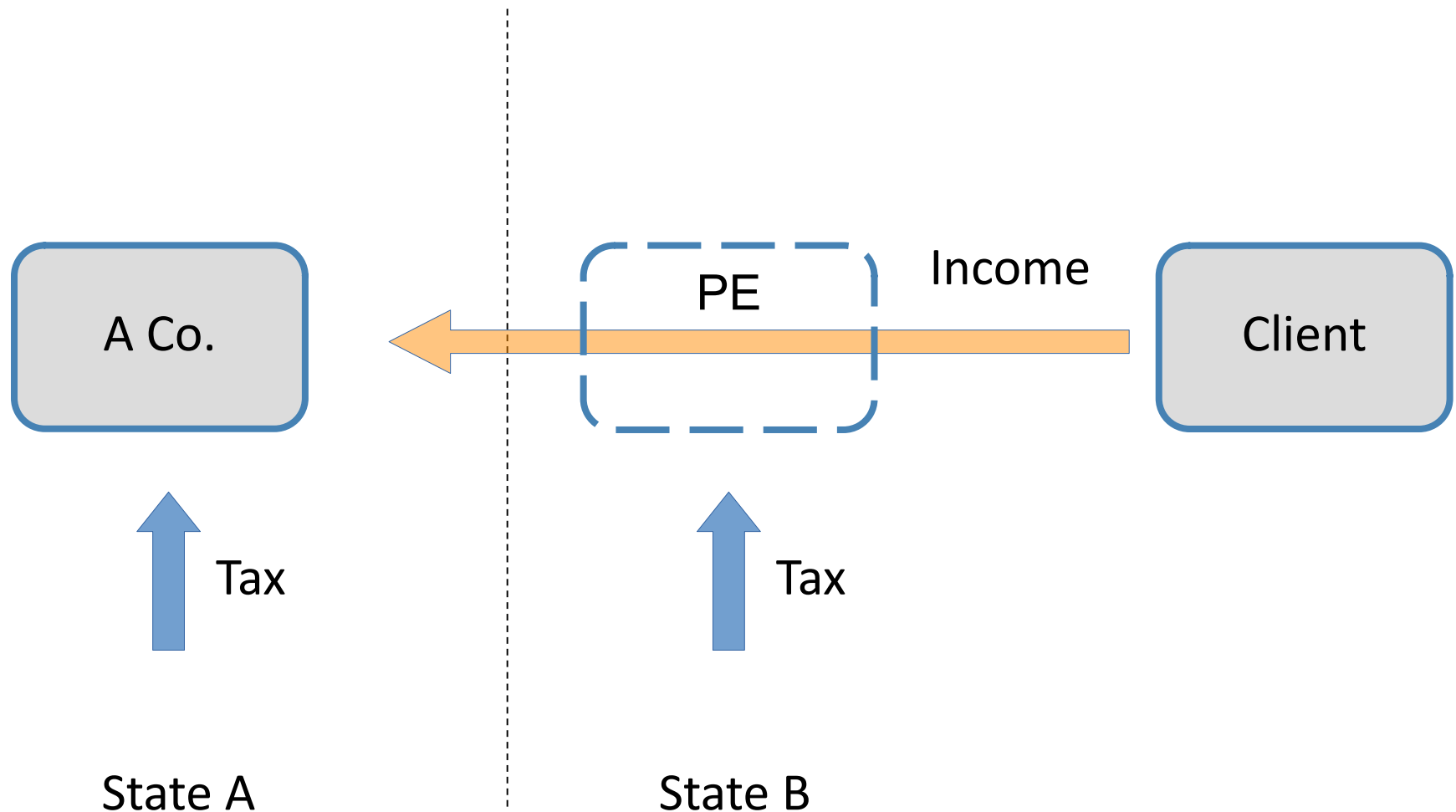
Taxation of cross-border activities

Subsidiary



Taxation of cross-border activities

Permanent establishment



Taxation of cross-border activities

History

- The concept originates in the 19th century in Germany
- The modern concept dates back to 1928 (Model Convention by the League of Nations)
- The concept was adopted by the OECD Model (Art. 5) in 1963
- 2015: BEPS Action 7 "Preventing the Artificial Avoidance of Permanent Establishment Status"
- 2017: modifications in the definition

Permanent Establishment

Definition

- Term defined by Art. 5 (1) OECD Model
- Structure
 - General definition
 - Examples
 - Positive list
 - Negative list
- Two situations
 - Physical presence: Fixed place of business
 - No physical presence: Agent
 - Dependent agent: PE
 - Independent agent: No PE

Permanent Establishment

Definition

- General definition

"the term "permanent establishment" means a **fixed place of business** through which the **business** of an enterprise is wholly or partly **carried on**"
- Elements
 - Place of business
 - Fixed
 - Carrying on of business
- Not an element: productive character

Permanent Establishment

Definition

- "Place of business"
 - ◆ Premises, facilities or installations
 - ◆ Amount of space
 - ◆ Owned, rented, occupied (even illegally)
- Examples
 - ◆ Plant owned and used exclusively by a supplier or contract-manufacturer
 - ◆ Salesman meets customer
 - ◆ Parent company's office in a subsidiary
 - ◆ Delivery dock
 - ◆ Home office

Permanent Establishment

Definition

- "Fixed"
 - ◆ Link to a specific geographical point
 - ◆ Distinct place
 - ◆ Coherent whole commercially and geographically
 - ◆ Not necessarily fixed to soil
 - ◆ Equipment
 - ◆ Duration
- Examples
 - ◆ Mine
 - ◆ Office hotel
 - ◆ Trader stand
 - ◆ Painter working on different projects
 - ◆ Ship in international waters
 - ◆ Satellite

Permanent Establishment

Definition

- "Business carried on"
 - ♦ Wholly or partly
 - ♦ In it or through it
 - ♦ Business character
 - ♦ Duration
 - ♦ Setup time
 - ♦ Legal form
- Examples
 - ♦ Industrial, commercial or scientific (ICS) equipment
 - ♦ Capital
 - ♦ Roaming telecommunications agreements
 - ♦ Automatic equipment

Permanent Establishment

Definition

- Art. 5 (2) OECD Model: Positive list (examples)
"2. The term “permanent establishment” includes especially:
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources."
• Positive list: not exhaustive

Permanent Establishment

Place of management

- Not necessarily an “office”
- Extraction of natural resources
 - Not exploration

Permanent Establishment

Construction site

- "3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."
- Construction
 - ♦ Not limited to buildings
 - ♦ Also roads, bridges, canals
 - ♦ Renovation
 - ♦ Laying of pipe-lines
 - ♦ Installation of equipment
- Twelve-month test
 - ♦ No previous time by the contractor
 - ♦ Building site: single unit
 - ♦ Abuse: Fragmentation
 - Aggregate time (splitting up of contracts in shorter timeframes)
 - Projects (splitting up in several contracts)

Permanent Establishment

Fragmentation

- Example

A non-resident construction firm, Company A, is contracted to build a row of three houses in X Avenue in State X by Developer B in the year 20X0. Construction starts in January 2020 and is finished by October 2020. Company A is also contracted with Developer C to build another four houses in X Avenue. Construction on these starts in June 2020 and finishes in May 2021.

Company A ↔ Contractor B



Company A ↔ Contractor C



X Avenue

Permanent Establishment

Definition of a PE

- Art. 5 (4) OECD Model: Negative list (exceptions)
 - use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
 - maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
 - maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
 - the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
 - maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
 - maintenance of a fixed place of business solely for any combination of activities mentioned above,
- Exceptions apply only if the listed activities have a preparatory or auxiliary character

Permanent Establishment

Definition of a PE

- Preparatory or auxiliary character test
 - ♦ Whether the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole
 - ♦ No preparatory or auxiliary activity, when general purpose is identical to the general purpose of the whole enterprise ("core business test")

Permanent Establishment

Definition of a PE

- Par. 4: List of exceptions
 - ◆ Examples
 - Warehouse
 - Spare parts
 - Cables and pipelines
 - Logistics
 - Management office

Permanent Establishment

Definition of PE

- Agents
 - ◆ individuals or companies
 - ◆ Resident in the source state

Permanent Establishment

Agent

- Dependent agent
 - ◆ Criteria
 - a person acting on behalf of an enterprise;
 - habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
 - these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.
 - ◆ No PE, even if the aforementioned conditions are met
 - Independent agent
 - Preparatory or auxiliary character

Permanent Establishment

Agent

- Independent agent
 - ♦ Criteria
 - Legal and commercial independence from the enterprise
 - Note: this can be manipulated
 - Subject to detailed instructions or to comprehensive control by the enterprise
 - Entrepreneurial risk
 - Other activities that are related or unrelated to the agency business
 - Extent of the obligations vis-à-vis the enterprise
 - Number of other clients represented by the agent
 - Agent skills, e.g.
 - network of contacts
 - local market knowledge
 - expertise in local government rules and regulations, etc

Permanent Establishment

Agent

- Examples
 - ♦ An agent routinely takes orders from customers and passes them to the enterprise, where they are formally approved
 - Scrutiny by the enterprise → no PE
 - "Rubber stamping" by the enterprise → PE
 - No or minimal intervention by the agent → no PE
 - Negotiations of details in a binding matter by the agent → PE
 - ♦ Aftersales services by the agent → PE
 - It does not belong to the business activities of a commission agent

Permanent Establishment

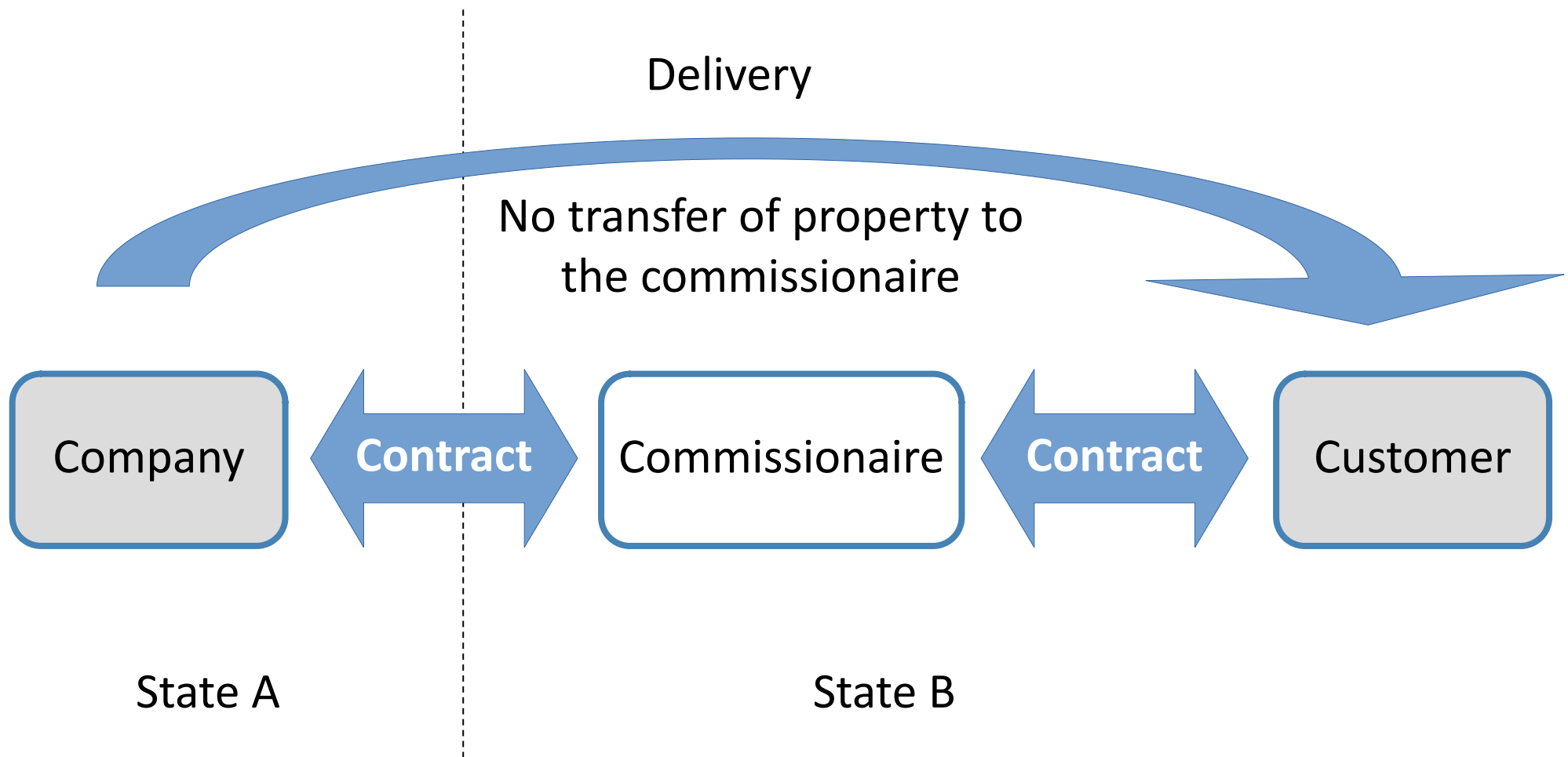
Prevention of abuse

- 2013 BEPS Action 7 (Base Erosion and Profit Shifting)
 - ♦ 2015: Final Report "Preventing the artificial avoidance of Permanent Establishment ("PE") status"
 - ♦ Focus on updating the definition of PE in Article 5 of the OECD model tax treaty
 - ♦ Objective: prevention of the artificial avoidance of PEs where there is significant activity in a country
 - ♦ 2017 amendments to Art. 5
- Issues
 - ♦ Commissionnaire arrangement
 - ♦ Fragmentation of activities between related parties
 - ♦ Artificial avoidance of PE status through the Specific Activity Exemptions

Permanent Establishment

Commissionaire arrangements

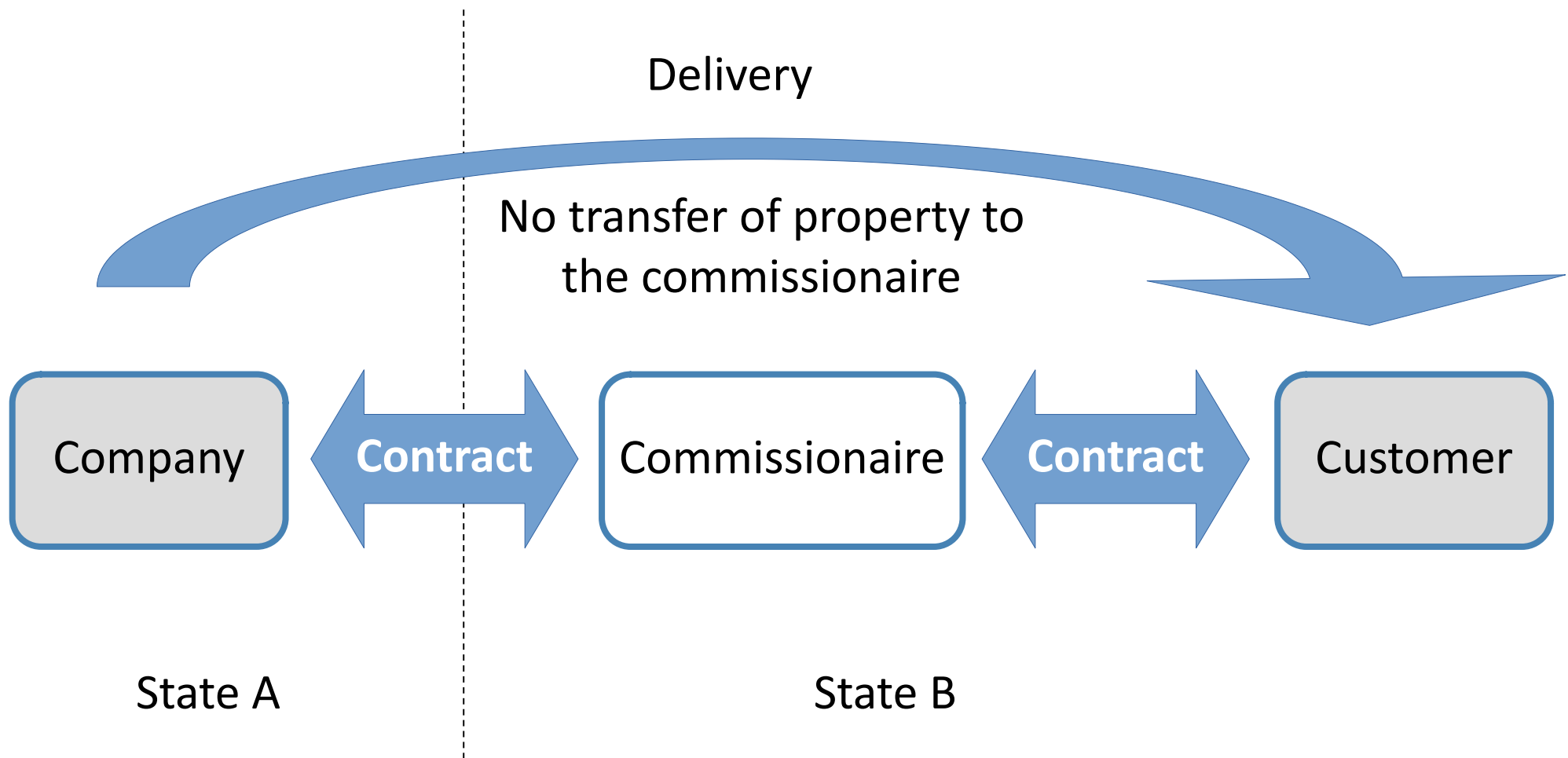
Commissionaire arrangement → previously no PE



Permanent Establishment

Commissionaire arrangements

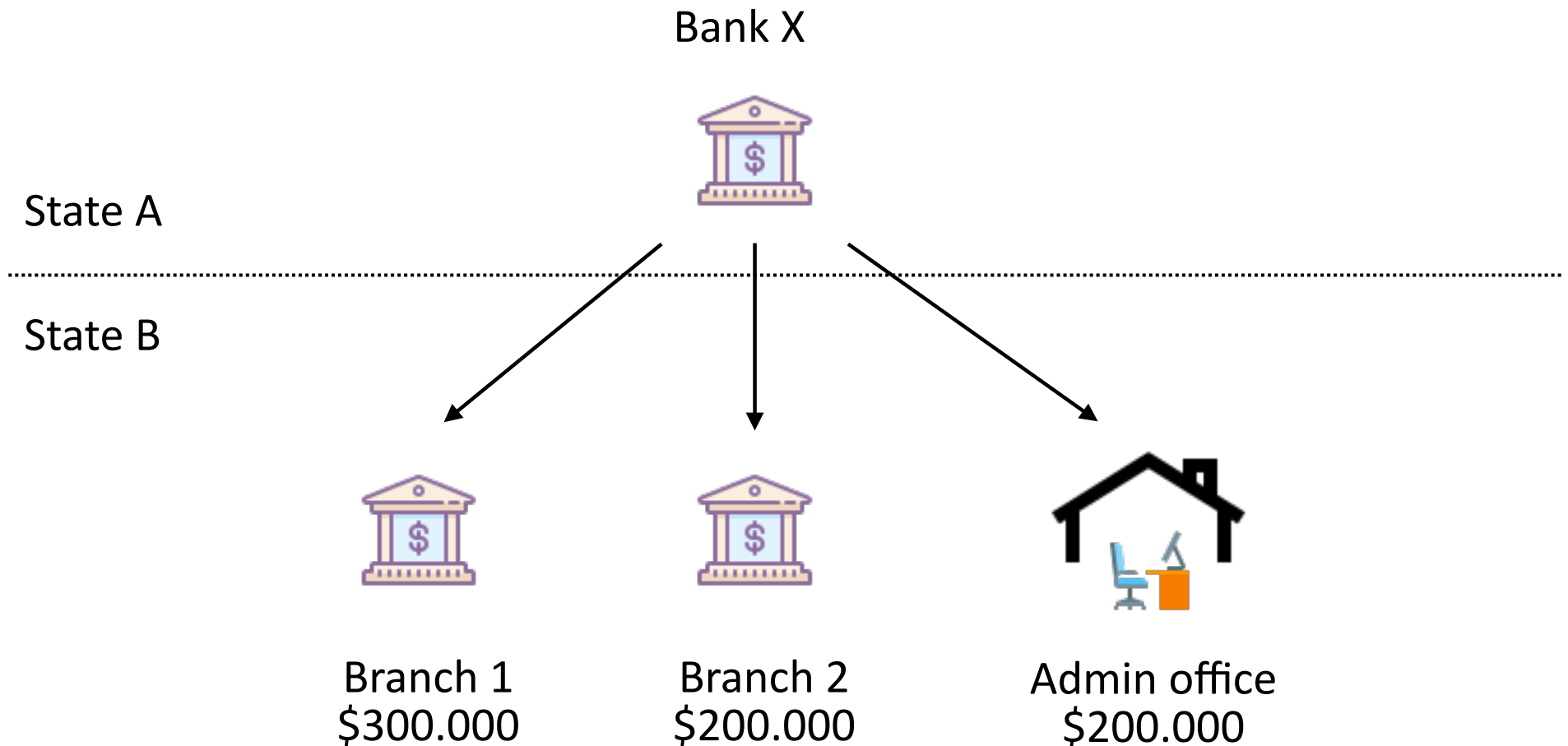
Commissionaire arrangement → now undisclosed agent → PE



Permanent Establishment

Fragmentation

Anti-fragmentation rule: Examination of the overall activity



Permanent Establishment

Dependent agent status

- Until 2017: a person will be a dependent agent (and thus create a PE) if he has, and habitually exercises, authority to conclude contracts in the name of the enterprise.
 - ♦ Opportunity to avoid PE status by carefully controlling the powers and functions carried out by staff or other persons
 - ♦ Most notable example: Google
- As of 2017: If a person is authorized to negotiate all details and elements of contracts in a binding manner in a particular state, then there is a PE, even if the contracts have to be signed by Head Office.

Permanent Establishment



Royalties



Bermuda
Black Hole

Bermuda (management)
Ireland (incorporation)



Netherlands

Double
Irish



Dutch
Sandwich

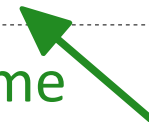
Ireland



Greece



Income



Permanent Establishment

Dependent agent status

- Google case: in many EU countries the authorities raised the question of a PE
 - France
 - Tax authorities assessed Google claiming the existence of a PE in France on the basis of a dependent agent
 - French courts overruled the assessment, holding that Google France's activities did not constitute a PE because Google France does not have the legal authority to conclude contracts in the name of Google Ireland
 - Greece
 - Tax authorities: same reasoning as in France
 - Athens Administrative Court of Appeals 4817-9/2019:
 - ➔ There is a PE
 - ➔ Google Greece's activities have auxiliary or preparatory character, but they belong to the core activity
 - The case is currently pending before the Council of State

Permanent Establishment

Definition of a PE

- It does not qualify per se as a PE (Art. 5 (7) OECD Model)
 - A subsidiary
 - An associated company

Permanent Establishment

Attribution of profits to PE

- 2-step approach
 - ♦ 1st step: existence of a PE
 - ♦ 2nd step: allocation of profits between company and PE
- General rule: The state of the PE is not entitled to tax all profits but only profits attributable to the PE
- Article 7 (2) of the OECD Model:

profits attributable to a PE are: "the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."

Permanent Establishment

Attribution of profits to PE

- Authorised OECD Approach (AOA): functionally separate entity
 - ♦ Determining the PE profits in comparison with independent third parties
 - 1st step: Functional analysis
 - 2nd step: Allocation of part of profits of the enterprise to the PE
- Alternative approach: relative business activity
 - ♦ allocation of total profits of the enterprise to the PE according to predefined factors (e.g. assets, capital, employees, etc.)

Permanent Establishment

Attribution of profits to PE

- A car manufacturer sells cars abroad through a local branch (PE)
 - ♦ Manufacturing cost is €1m and turnover from sales is €1,2m
 - ♦ Profit is €200k
- AOA
 - ♦ What would be the profit of an independent seller?
 - ♦ For instance, €50k
 - ♦ Therefore, €50k is taxable at the PE state
- Alternative approach
 - ♦ Overall profit is €200k
 - ♦ For instance, the Headquarters have 100 employees, PE has 20 employees (5 to 1)
 - ♦ Therefore, €40k is taxable at the PE state

International and European Tax Law

Case study

