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Introduction to Permanent Establishments

– Corporate perspective

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Agenda

Basics of International Taxation

- Right to tax
- Applicable rules
- Types of income

Permanent establishment (PE)

- PE concept and different types of PEs
- MTC and BEPS-related changes to PE rules
- Creation of a PE - Example of a cross-border installation project
- PE-related obligations
- Calculation of profit attributable to the PE
- Eliminating double taxation

How to manage tax in projects?

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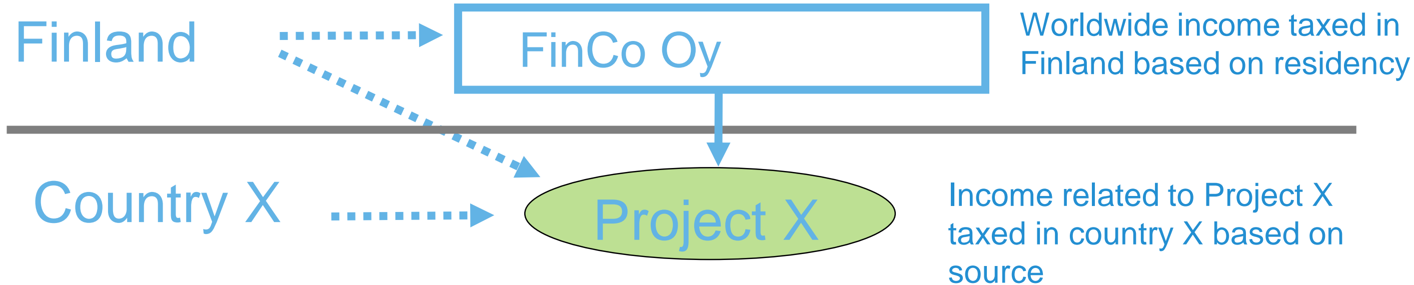
Right to tax

Countries may tax on the basis of:

- **Residency** (worldwide income of an incorporated company); or
- **Source** (income from activities within the territory)



- This may lead to double taxation (i.e. same income taxed twice)
- Rules used to avoid double taxation include:
  - Domestic tax legislation; and
  - Tax Treaties (a.k.a. Double Tax Treaty/Agreement/Convention or DTT & Multilateral Tax Conventions e.g. Nordic Tax Convention)

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Applicable Rules

Tax rules' hierarchy:

1. EU law
2. Tax treaties (e.g. DTT)
3. Domestic law

- Tax treaties as the main source of international tax law aim at avoiding double taxation, dividing taxing rights between countries and preventing tax evasion (double non-taxation).
- Tax treaty only limits the domestic law but does not create new taxing rights to countries.
- Tax treaty prevails over domestic law rule, if it leads to a more lenient taxing consequence to the taxpayer concerned and vice versa (i.e. tax treaty provides for lower tax burden than based on domestic law).
- EU law prevails over treaties, though acknowledging their role.
- EU law can play a role in establishing the legal meaning of terms not defined in DTTs, according to article 31(3)(c) of the 1969 Vienna Convention on the Law of Treaties and article 3(2) of the OECD Model Tax Convention on Income and on Capital.

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Types of Income

Tax treaties determine the rules for source country taxation and withholding tax ("WHT") rates for different types of income including:

1. Business income (only if PE – only net profit taxable)
2. Royalty & technical services (WHT on gross amount)
3. Interest (WHT on gross amount)
4. Dividend (WHT on gross amount)
5. Capital gain
6. Personal income etc.

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Permanent establishment ABCs

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WHAT is a permanent establishment?

- Taxable presence = liability to pay foreign taxes
- Double taxation (head office & branch are subject to tax)

WHY do we need to know this?

- Managing compliance in existing branches/activities
- Risk management, supply chain planning in x-border projects

HOW do we manage this?

- Training, instructing, appointing responsible parties (”Model”)
- Tools, knowledge sharing, communication with business

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Concept of permanent establishment

- Right to tax business profits of a non-resident company in the source country (project country) is determined by the PE concept.
- PE creates taxable presence for Corporate income taxation (“CIT”) purposes.
- Source country may tax business profits only if the recipient has a PE in that country. However, only for the part of profit that relates to the PE’s activities.
- Also, the country of residence may tax the foreign sourced income as part of the worldwide income of the company (i.e. both “head office” and “foreign branch” of the same legal entity).

Example: Finland-based company

- Taxing right of the state in which the PE is located does not remove the right of Finland to tax worldwide income of its residents.
- Risk of double taxation when same income is taxed abroad and in Finland.

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Definition of permanent establishment in OECD MTC

- Definition of a PE differs in each country.
- Often the local PE rule in the domestic law corresponds to the definition in the OECD Model Tax Convention on Income and on Capital (”MTC”).
- PE definition used by Finland, Norway and Sweden in their tax treaties (incl. Multilateral Nordic Tax Treaty) is also based on the definition in the OECD MTC.
  - MTC Commentary used in cases subject to interpretation.
  - Although the Commentary is not binding, it is important in understanding tax treaties that follow the OECD model.
- Some tax regimes are unpredictable and new ’Virtual/digital PE’ cases exist. As of April 2019, ‘significant economic presence’ will trigger a PE in India based on domestic law.
- PE concept may be of limited significance in a non-tax treaty situation
  - For example, all business income sourced from Finland/Norway/Sweden may be taxed in these countries despite the recipient having a PE or not in the project country.

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BEPS Project changes PE rules with a Multilateral Instrument (MLI)

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- Final report of OECD/BEPS Project Action 7 (“Preventing the artificial avoidance of permanent establishment status”) released in October 2015 included the following changes:
  - a widening of the dependent agent test to include activity of agent that "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 [by the principal]”;
  - a narrowing of the independent agent exemption not to include an agent that “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related”;
  - a tightening of the specific activity exemptions from PE status (e.g. for facilities used for storage, display or delivery of goods) to apply only where these activities are preparatory or auxiliary in relation to the business as a whole (including an anti-fragmentation test to prevent activities being split across separate legal entities); and
  - certain measures to prevent abuse of the 12 month building site PE rule.
- More than 100 jurisdictions concluded MLI negotiations implementing series of tax treaty measures to update international tax rules transposing BEPS Project results into +2000 tax treaties worldwide.
- PE Articles 12-15 of MLI partly optional.
- MLI signed at OECD 2017 → implementing dates vary by country (Finnish law in force as of 1 June 2019).

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OECD Model Tax Convention (MTC) 2017

- Updated Model Tax Convention 2017 approved by the OECD Council published on 18 December 2017.
- Updated Article 5 regarding PEs follows the changes in OECD/BEPS Project Action 7 as described.
- Finland (together with Luxembourg, Sweden and Switzerland) has reserved the right not to include the new Article 5(4.1) regarding the anti-fragmentation rule in its tax treaties.
- Finland (together with Germany, Luxembourg, Sweden, Switzerland and the United States) has reserved the right to follow
  - Article 5(5), which defines dependent agent PE (DAPE), and
  - Article 5(6), which defines independent agent

  as they stood before the 2017 update (i.e. in accordance with MTC 2014).
- Finland and Sweden reserve the right not to include the definition of closely related enterprises contained in Article 5(8).

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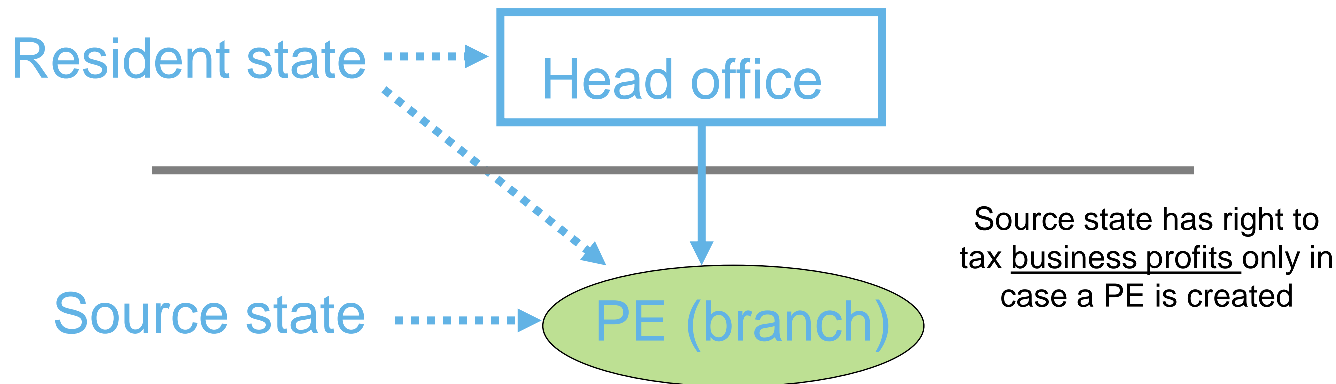
Main PE Articles in tax treaties

- OECD MTC rules are typically implemented in DTTs as following articles:
  - Article 5: creation of permanent establishment
  - Article 7: allocation of business profits



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Different Types of PEs in a nutshell

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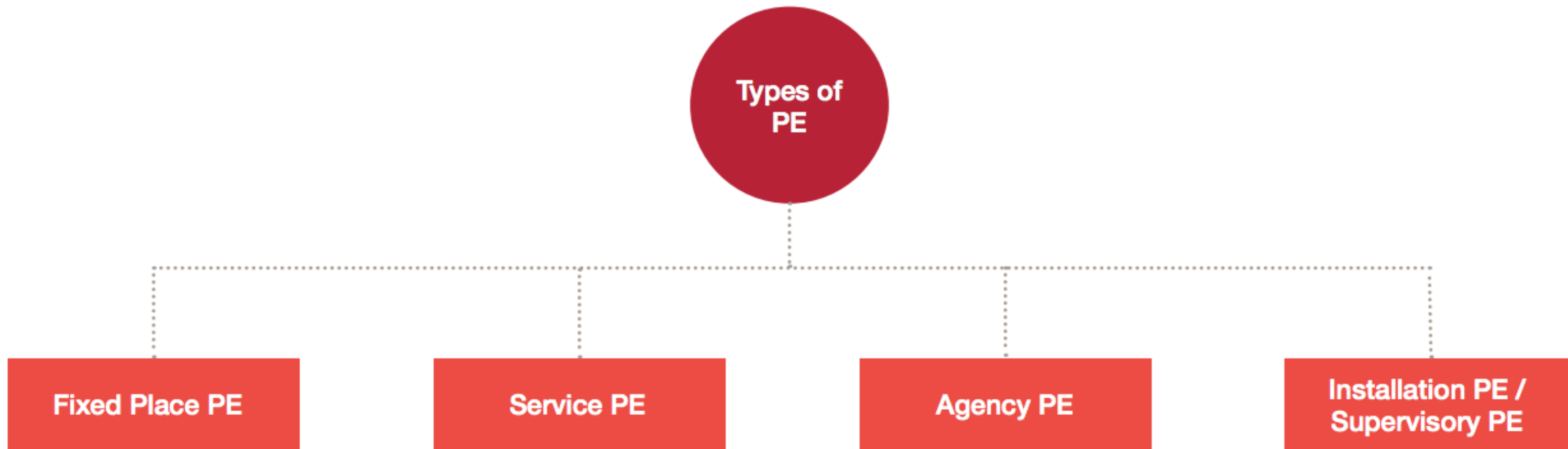

- New types of virtual PEs for certain digital activities may arise in the future (e.g. based on ’significant economic presence’)

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Different Types of PEs – General rule and Project PE

Article 5 of the OECD MTC (2017)

PERMANENT ESTABLISHMENT

1. 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.
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.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than **twelve** months.

General rule PE (paragraphs 1–2)

Project PE (paragraph 3)

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Different Types of PEs – Specific activity exemption

Article 5 of the OECD MTC (2017)

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed **not to include**:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, **any other activity**;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a **preparatory or auxiliary character**.

No PE is created for limited scope of activity of a preparatory or auxiliary character

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Different Types of PEs – Agent PE

Article 5 of the OECD MTC (2014/2017)

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person -- other than an agent of an independent status to whom paragraph 6 applies -- is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an **authority to conclude contracts in the name** of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an **independent status, provided that such persons are acting in the ordinary course of their business**.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Agent PE (dependent agent) (MTC 2014)

No PE if an independent agent (MTC 2014)

Subsidiary does not create PE by default (MTC 2017)

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Example of a cross-border installation project

- "Installation project" is not restricted to an installation related to a construction project, but includes the installation of new equipment, such as a complex machine (e.g. Servers, IoT devices).
- On-site planning and supervision are covered by paragraph three.
- 12-month test may apply to each individual site or project.
  - Some countries’ Double Tax Treaties have a 6-month period (e.g. Turkey, India, China, Latvia).
  - Calculation of time is often challenging and subject to interpretation.
- When determining the duration of the project, no account should be taken of the time previously spent by the contractor on other sites or projects which are totally unconnected with it → no “force of attraction”.
- A site should be regarded as a single unit, even if it is based on several contracts - provided that it forms a coherent whole commercially and geographically (no artificial splitting!).
- If the duration in the relevant DTT is exceeded, a PE is regarded as being created from the beginning of the project i.e. ”DAY ONE”
- For risk management purposes it may be advisable to create a PE for one party (general contractor) since the beginning of the project by registering a PE / branch to avoid multiple PEs in same country for same project.

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Example of a cross-border installation project

How to calculate the installation project PE timeframe?

When is a PE created by a site?

- OECD MTC: A site exists from the date when the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g.
  - Setting up a planning office for the construction.
  - First personnel arrive on site.

When is the site PE finished?

- In general, PE continues to exist until the work is completed or permanently abandoned.
  - Completion of work is done usually upon takeover by buyer (even if employees remain on site training buyer's personnel in using the equipment?).
  - A site should not be regarded as ceasing to exist when work is temporarily discontinued.
  - Seasonal (e.g. bad weather) or other temporary interruptions (e.g. shortage of material or labour difficulties) should be included in determining the life of a site.
  - Contractual issue: who bears the tax costs due to a delay when a PE is (retrospectively) created?
    - PE costs / tax costs – budgeted or tax credit afterwards?

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Example of a cross-border installation project

What on-site activities are included in the PE calculation?

- Planning and supervision
- Maintenance, repair, installation
- Testing (if the seller is responsible for such)
- Closing and dismantling of project site
- Activities by subcontractors

→ Separate PE may be created for subcontractors (even if the period of their activity is calculated into the length of the main contractor)

What on site activities are not included?

- Preparatory work: signing of contracts, registrations, preliminary site inspection upon negotiations etc.
- Delivery of goods to the project site.
- Planning and supervision by others than the contractor or affiliates (except artificial splitting of a contractual whole between companies in a group).

→ Estimating the facts with respect to the beginning of the project from tax perspective is a separate task!

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PE creates many obligations

- Local corporate income tax (”CIT”) liability.
- Liabilities relating to indirect taxation (VAT/GST/Sales tax etc.).
- Other registration liabilities (company/trade register, employer register etc.).
- Prepayment of payroll taxes.
- Reporting liabilities (annual corporate income tax returns, VAT returns etc.).
- Bookkeeping (local GAAP; Generally Accepted Accounting Principles).
- Auditing and reporting of annual financial statements, changes in the head office information (directors, address etc.) to local register etc.
- Employees’ tax liabilities (PE employee is subject to local tax from day one).
- Neglecting the obligations (even if ”not on purpose”) may lead to
    - Tax increases and penalties for late compliance; and
    - Interest liabilities; and

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Profit attributable to the PE – Arm's length principle

Correct allocation of profits from cross-border activities for tax purposes

- Arm's length principle applies for transfer pricing purposes
- Separate bookkeeping should be kept for the PE / branch.
- Taxable income determined in accordance with local bookkeeping and tax rules
  → taxed with local corporate income tax rate (or "branch profit tax rate").

In practice:

- Guidelines exist for a basic PE P/L model (to calculate income subject to tax)
- No allocation conflicts / discussions have taken place yet with foreign tax authorities.
- Currently applied TP methods can be used (e.g. "Benchmarked" Full Cost +markup).
- Consecutive losses trigger the interest of local tax authorities to investigate the transfer pricing
- Advance ruling may be applied for the allocation of profit to PE (prior to reporting period)
- In a retrospective PE case, allocation may be a more difficult issue.

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Profit attributable to project PE

Off-shore and on-site part

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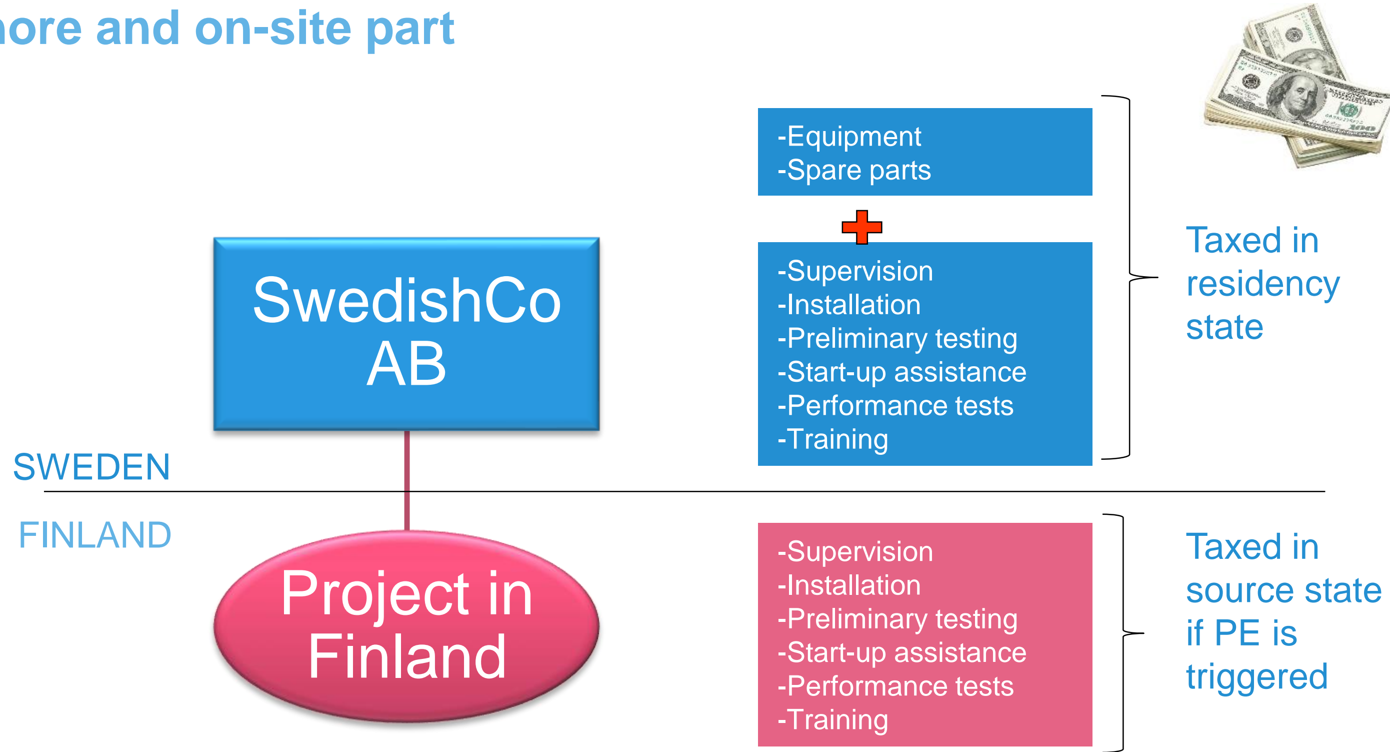

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Eliminating double taxation

How are foreign taxes paid by PEs credited?

- Depends on how double taxation is eliminated according to the DTT / domestic tax law.
- **Credit method (common):**
  - Foreign source income is taxable in country of residence, however
  - Foreign taxes are credited (deducted) against taxes payable in country of residence.
- **Exemption method (rare):**
  - Foreign source income is exempted (tax free) in country of residence (not even Revenue in the PL for CIT purposes), but
  - Foreign taxes are not credited against taxes payable in country of residence. In practise, exemption method in the DTT limits the right of Sweden to tax (e.g. Portugal, Spain).
- Usually article 22 or 23 in the DTT.

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Credit method

- DTTs only determine the credit method; calculating the actual credit is done based on domestic law in the country of residence.
- This may lead, in practise, to a partial credit only.

Domestic law / Finland (and Sweden):

- Foreign taxes may be credited against domestic Corporate Income Tax on same income
  - Foreign income needs to be taxable in Finland.
  - Overall credit of foreign income (e.g. multiple PE income and WHTs) bundled together

    → evens the tax rate differences.
- Maximum credit is the amount of foreign taxes paid by the company in the country of residence
  - It is required that the company has taxable income in Finland.
  - No tax refund in case foreign taxes exceed Finnish taxes.
- No credit is granted if the company is loss-making in the year in question. However, the foreign tax credits may be carried forward for a period of 5 years.

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Example calculation on foreign tax credit

Swedish company with branches in Norway and Finland

	Taxable profit (1000 SEK)	CIT rate in FY19 (%)	Total tax (1000 SEK)
Finnish branch	10.000	20	2.000
Norwegian branch	30.000	22	6.600
Total foreign income (taxable in Sweden with local tax rate)	40.000	21.4	8.560
Total foreign taxes paid			8.600
Tax credit* in Sweden (assuming company is not loss-making)			- 8.560
Foreign tax credit carried forward			40

*Credit method used in Nordic Tax Convention

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Foreign tax credit may not be allowed in some cases

Foreign tax paid on the same income will not be credited, if e.g.:

- Company is loss-making in the year in question.
- Company uses old tax losses / group contribution reducing its taxable income to zero (0).

  → These situations can normally be managed by tax planning
- Foreign taxes paid exceed the maximum credit (i.e. 22% in Sweden or 20% in Finland).
- Tax base difference (e.g. cash flow based taxes etc.).

  → Some planning potential exists
- Foreign tax exceeds the rate (%) agreed in the DTT or source state has no right to tax according to the DTT, but WHT has been imposed.

  → Local withholding party to be contacted, excessive tax may be received back (e.g. Brazil: Managing costs in client contracts; Taiwan: Red tape incl. application for right to get a WHT exemption in accordance with the DTT)
- Company has not applied for crediting upon its taxation or has not presented all evidence asked by the domestic tax authorities.

  → Excessive tax should be revised, contact tax authorities
- States determine the income type differently (qualification of income conflict), e.g. business income vs. other income.

  → Domestic legal process in the source country may be possible and/or potential process between the countries' Competent Authorities based on different legal basis such as DTT MAP, MLI, or the EU Tax Dispute Resolution Directive (2017/1852))
- Income is tax exempt in domestic taxation, but withholding tax has been paid abroad.

  → Not much to do as there is no corresponding tax for which to get a credit

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How to manage tax in projects?

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Managing projects – Key tax issues

- Key practical issues to plan already in the **bid/sales planning phase**:
  - Will a PE be created (nature and duration of activity)?
  - Contract structure (goods, services).
  - Tax clauses in the agreements.
  - PE vs. local subsidiary.
  - Local requirements (tax payments, WHT, registrations etc.).
  - Foreign tax crediting and possible limitations to get credit.
  - Transfer pricing documentation to support intra-group pricing between legal entities as well as head office and branch of a single legal entity.
  - Circulating relevant information (e.g. Regional tax specialists, chief accountants, Finance Partners, HQ tax, compliance and legal teams, external advisors).
- Besides corporate income taxes, indirect tax (VAT and customs), employee and employer taxes, work permit issues etc. also need to be considered.

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Managing projects – General tax information

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- Country specific tax guides available from international tax advisors incl. PwC, Deloitte, KPMG, EY e.g. for checking local CIT rates, WHT rates, other taxes, transfer pricing etc.)
- **Tax treaties** (e.g. for checking the threshold for triggering project PE):
  - **Finland:** https://www.vero.fi/fi-FI/Syventavat_veroohjeet/Kansainvaliset_tilanteet/Voimassa_olevat_verosopimukset
  - **Norway:** https://www.regjeringen.no/no/tema/okonomi-og-budsjett/skatter-og-avgifter/skatteavtaler-mellom-norge-og-andre-stat/id417330
  - **Sweden:** https://www4.skatteverket.se/rattsligvagledning/15311.html?pk_vid=84544ae0a0a68b9c15238205466e6558
- **OECD MTC** Article 5:
  - 2014: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2014-full-version/article-5-permanent-establishment_9789264239081-8-en#page1
  - 2017: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017/model-convention-with-respect-to-taxes-on-income-and-on-capital_mtc_cond-2017-3-en#page9
- **OECD MLI matching database** for projections on how the MLI modifies a specific tax treaty covered by the MLI by matching information from Signatories' MLI Positions:
  - http://www.oecd.org/tax/treaties/mli-matching-database.htm

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