Global Mobility Update

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Global Mobility

Tax - OECD Changes to Permanent Establishment Rules; Impact on Expatriate Arrangements

In 2012 the G20 initiated the Base Erosion and Profit-Shifting (BEPS) project, headed by the Organisation for Economic Co-operation and Development (OECD). This aimed to tackle and reduce tax planning strategies which artificially shifted corporate profits to low- or no-tax jurisdictions.

On 5 October, 2015, the OECD published the final reports setting out its recommendations in relation to BEPS. These were set out in 15 “actions”, which addressed a number of common tax planning strategies. Action 7 of the project addressed ‘Preventing the Artificial Avoidance of Permanent Establishment Status’.

The Action 7 report is highly significant in the global mobility arena, where ensuring expatriates do not create a permanent establishment of their employing company abroad is always a critical consideration in structuring an individual’s assignment overseas.

This alert summarises relevant changes coming into effect and suggests potential solutions for global mobility professionals to consider.

Double Tax Treaties and the Relevance of a Permanent Establishment

Double tax treaties are agreements between two countries which allocate certain taxing rights to prevent taxpayers from being subject to tax on the same income or chargeable gain in both jurisdictions. Generally, double tax treaties provide that a tax charge may only be levied on the business profits of a foreign enterprise if the enterprise carries on business in that state through a “permanent establishment”.

According to Article 5 of the OECD Model Tax Convention, a permanent establishment is created where:

1. there is a “fixed place of business through which the business of an enterprise is wholly or partly carried on” (e.g. a place of management, a branch or an office); or
2. an agent acts on behalf of the enterprise and “has and habitually exercises an authority to conclude contracts on behalf of the enterprise” (i.e. a dependent agent).

The activities of an agent will also not give rise to a permanent establishment if that agent is an independent agent acting in the ordinary course of his business. In addition, a permanent establishment does not include activities that are of a preparatory or auxiliary character, such as the storage or delivery of the principal enterprise's goods.

BEPS Action 7

Commissionaire and similar arrangements

The Action 7 Final Report proposed to introduce an extension to the permanent establishment definition (referred to above) to include an agent that has "the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise".

Previously, companies had attempted to limit any permanent establishment risk by including a provision in an agent's contract stating that the agent was not permitted to bind the principal. Since the agent did not have the authority to conclude contracts, this meant that a dependent agent permanent establishment was not created.

However, the Action 7 extension of the definition means that the principal enterprise will now be deemed to have a "permanent establishment" in the host state (and thus may be subject to adverse tax consequences) unless the principal enterprise materially modifies the agreement, the agent's activities are preparatory or auxiliary in nature, or the agent is an independent agent (which will normally be a question of fact save for group companies - see below).

Although this change was specifically targeted at commissionaire structures, it makes it much harder for companies to ensure a permanent establishment is not created by simply requiring expatriates not to conclude contracts in their host country, as previously was common practice.

Narrowing the scope of the independent agent exclusion

The second important change is that the definition of an independent agent has been narrowed for the purposes of the independent agent exclusion.

This exclusion provides that independent agents cannot create a permanent establishment. For example, controlled enterprises have previously claimed to be making their own decisions, independent of their controlling entity, so as to enable them to be deemed to be independent agents and fall outside the scope of the permanent establishment definition.

However, the narrowing of the scope means that a person now cannot be deemed to be an independent agent if they act "exclusively or almost exclusively on behalf of one of more enterprises to which [they] are closely related".

In the context of corporate entities, enterprises will be deemed to be closely related if one holds more than 50% of the shares in the other.

Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent BEPS

In order to implement certain of the BEPS proposals, the OECD developed a multilateral instrument (MLI) in November 2016.

The MLI enables countries to amend all of their existing double tax treaties at once, allowing them to ensure that they comply with the minimum standards provided for by BEPS in the most efficient way possible. Countries are able to dictate which treaties will be modified by the MLI, and can opt out of provisions which do not reflect a BEPS minimum standard.

The MLI was signed on 7 June 2017 by 67 jurisdictions, including most of the major international trading jurisdictions (other than the United States).

However, merely signing the MLI means very little at this stage, as its provisions will only take effect once five countries have ratified the instrument. In addition, as between two relevant countries, the provisions of the MLI will only take effect once both countries have ratified the instrument and the specific provisions.

To date, the only countries that have ratified the MLI are Austria and the Isle of Man. Once all signatories have signed and ratified the MLI, the instrument will affect more than 1,100 tax treaties internationally. However, this is unlikely to happen before 2019.

As the amendments to the permanent establishment rules referred to above do not reflect a BEPS minimum standard, signatories may choose whether or not to incorporate the relevant provisions into their treaties. Currently, a number of jurisdictions (including the United Kingdom) have reserved the right for the provisions not to apply and await consensus on the application of the rules, including clarification regarding which profits will be deemed to be attributed to the permanent establishment, prior to committing to the implementation of the provisions.

Consequently, it is important that companies check not only the status of the MLI and its ratification in their resident and host jurisdictions, but also which of the voluntary provisions countries have chosen to commit to when they sign and ratify the MLI. Where two countries party to a double tax treaty sign and ratify the MLI, but only one of those countries incorporates the new permanent establishment provisions, those provisions will not apply to the relevant double tax treaty.

Possible Solutions

The Action 7 Final Report included draft revised commentary relating to the permanent establishment rules. However, these are yet to be finalised. Whilst we await clarification regarding which provisions each jurisdiction intends to incorporate into its tax treaties, companies should now start to consider the potential impact that the implementation of the provisions may have on their business. Companies may wish to consider the following solutions, in order to limit the potential effect of the implementation of the amended permanent establishment rules:

1. Consider employing agents through entities established in jurisdictions that have not signed up to the MLI (e.g. the United States) or that have not implemented the permanent establishment provisions. Remember that the permanent establishment provisions will only apply if adopted by both contracting jurisdictions. However the corporate income tax consequences would need to be considered carefully to ensure that profits are not required to be allocated to jurisdictions with high tax rates simply to avoid a permanent establishment concern.

2. Consider changing the functions of sales teams so that the negotiation of key terms is centralised e.g. by separating the functions of marketing and sales teams where possible.
3. Consider setting up local subsidiaries and accept that additional tax will be payable via transfer pricing rules.
4. Treat the salesforce as local branches and prepare branch accounts. Historically, the allocation of tax liability has been less clear than for transfer pricing. However, significant OECD work has been undertaken in relation to the attribution of profits to permanent establishments.

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