



International Fiscal Association

 **IFA Canada | YIN WEBINAR**

Permanent Establishments: Today and Tomorrow

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Content

- Introduction
- Function of the PE concept in tax treaties
- Fixed place of business PEs
- Agency PEs
- Exception for preparatory or auxiliary activities
- Services PE Provisions
- Canada's Position on PEs
- Assessment of the PE Concept

Introduction

- This seminar will give an overview of the permanent establishment (PE) concept, how it is evolving to meet current challenges and what the future holds.
- PE concept came from work done by League of Nations in the 1920s. Global economy has changed, PE concept has stayed much the same.
- In theory, basic concept is that a business should have a minimal presence in a country before being subject to tax. This avoids compliance obligations where minimal profit would be allocated. Still relevant, issue is what the line should be given changes in global economy.

OECD Model Treaty

Article 5 – Permanent Establishment

- Paragraph 1 – “fixed place of business” through which the business is carried on
- Paragraph 2 – specific examples of PE (place of management, branch, office etc.)
- Paragraph 3 – building site, construction or installation project only PE if lasts more than 12 months
- Paragraph 4 – “auxiliary and preparatory” activities do not create PE
- Paragraph 5 – agency PE, dependent agent with authority to contract that is habitually exercised
- Paragraph 6 – exception from agency PE for independent agent acting in the ordinary course of business
- Paragraph 7 – Control of one company by another not in itself a PE

UN Model

Article 5 – Permanent Establishment

Based on OECD Model but some notable differences:

- Paragraphs 1 and 2 – same as OECD
- Paragraph 3 – construction, assembly or installation project or supervisory activities only PE if last longer than 6 months, paragraph (b) services PE
- Paragraph 4 – same as OECD
- Paragraph 5 – agency PE broader than OECD (paragraph (b) stock of goods)
- Paragraph 6 – insurance PE
- Paragraph 7 – independent agent exception more limited
- Paragraph 8 – same as paragraph 7 OECD

Canadian domestic law

- PE concept used to allocate income between provinces (Reg.400 definition)
- Also used in a variety of other ITA provisions (e.g. S.16.1, 18(5), 34.2(1), 56.4(1), 100(1), 107(2.001), 112(2) etc.) (Reg.5906(2) and 8201 definitions)
- GST/HST – potential trap, PE concept used but not as important

Relevance of Commentaries

- Both OECD and UN publish detailed commentaries to the models
- Useful extrinsic aid often referred to by Canadian courts where wording of treaty is the same or similar to particular model and neither treaty party has made observation
- Always consider what version of commentaries is relevant (may not always be most recent: *Prevost Car*)

Function of the PE Concept in Tax Treaties

- Sets the threshold for taxation of cross-border business profits between treaty partners
 - OECD Art 7(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.

Function of the PE Concept in Tax Treaties

■ Throwback Rules

- OECD Art. 10(4), 11(4) and 12(3): “Throwback” to Article 7 (Business Profits) from the dividend, interest and royalties articles where recipient has PE in payer jurisdiction and amount is effectively connected with PE
- OECD Art. 21: Income not dealt with in any other Article of a Treaty is taxable only by the country in which the taxpayer is resident, subject to a “throwback” to Article 7 (Business Profits) if the taxpayer carries on business through PE

Function of the PE Concept in Tax Treaties

■ Taxation of Capital Gains

- OECD Art. 13(2): Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

Function of the PE Concept in Tax Treaties

■ Employee Remuneration

- OECD Art. 15(2): remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
 - a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and

Function of the PE Concept in Tax Treaties

■ Employee Remuneration (cont'd)

- b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
- c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

Function of the PE Concept in Tax Treaties

■ Nondiscrimination

- OECD Art. 24(3): The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
- Note: the second sentence of the nondiscrimination clause in the Can-UK Treaty slightly varies from the OCED model

Fixed Place of Business PEs

- OECD Article 5(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.

Fixed Place of Business PEs

Elements of the PE Definition

■ Geographical Aspect

- Place of Business → premises, facilities, installations
 - OECD Art. 5(2): place of management, a branch, an office, a factory, a workshop, and a mine, well or quarry
 - OECD Commentary 2014:
 - Used for carrying on a business (exclusive use not required)
 - Owned, rented or otherwise available
- Fixed → established at a distinct place

Fixed Place of Business PEs

Elements of the PE Definition

■ Time Aspect

- Fixed → indicates a degree of permanence
 - Not of a purely temporary nature
- OECD Commentary 2014:
 - Examine the nature of the business (e.g. short duration of activities taking place regularly over longer period of time)
 - Business set-up period excluded, provided activities during this period are substantially different than operational activities
 - Temporary interruptions do not cause business of PE to cease
 - Note: 12 month threshold for construction and installation projects

Fixed Place of Business PEs

Elements of the PE Definition

■ Connection Between the Place and the Business

- Enterprise must carry on business through the PE
- OECD Commentary 2014:
 - Place where business activities are carried out must be “at the disposal” of the enterprise
 - Mere fact space is at enterprise’s disposal is sufficient for PE
 - No formal legal right to use the place is required
 - Mere presence of enterprise at location does not mean location is at the disposal of the enterprise
 - PE may exist where enterprise has at its constant disposal certain premises situated in business facilities of another enterprise
 - But, note: *Dudney* decision

Fixed Place of Business PEs

Elements of the PE Definition

■ *Dudney case*

- FCA held that an independent contractor’s right to use the premises of his client was limited and insufficient to constitute a fixed base. Relevant factors included:
 - Actual use of premises
 - The legal right to use the premises → limited to normal office hours and for purposes of performing services required by contract
 - Degree to which premises were objectively identified with the individual’s business → no dedicated office, office directory listing, letterhead or business cards
- Now addressed by “Services” PE concept in Can-US Treaty

Fixed Place of Business PEs

Elements of the PE Definition

- Connection Between the Place and the Business
 - OECD Art. 5(4): Exceptions relate to fixed place of business PEs engaged in activities of preparatory or auxiliary nature → does the activity of the fixed place of business itself form an essential and significant part of the activity of the enterprise as a whole?

Fixed Place of Business PEs

Construction Sites

- OECD Art. 5(3): A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
- Based on OECD Commentary 2014, includes:
 - Construction or renovation of buildings, roads, bridges, canals
 - Laying of pipe-lines, excavating, dredging
 - Construction installation projects and special equipment installation projects
- Based on CRA guidance, also can include:
 - Decommissioning and demolition projects

Fixed Place of Business PEs

Construction Sites

- Temporal Considerations (OECD Commentary 2014):
 - 12 month test applies to each individual site or project
 - Site is regarded as a single unit, even if based on several contracts
 - Site begins to exist when contractor commences work (including preparatory) in the country where the construction is to be established
 - Continues to exist until work is completed or permanently abandoned
 - Seasonal or temporary interruptions included in determining life of site

Fixed Place of Business PEs

Multiple Places

■ Commercial and Geographical Coherence

- Where business activities occur at multiple locations, is there a single “place of business”?
 - OECD Commentary 2014: Yes, where in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business
- OECD Example: A large mine within which activities may move from one location to another constitutes a single geographical and commercial unit
- Often relevant in construction and installation project context

“Agency” PEs

- Generally, under the OECD Model (2014) and many Canadian tax treaties (e.g. Canada-US treaty) an enterprise may have a PE in a state if a person acting in the state on behalf of the enterprise has, and habitually exercises, in that state an authority to conclude contracts in the name of the enterprise
 - UN Model Treaty: also applies where the person habitually maintains in the state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise
- Colloquially, the provision generally applies to “dependent agents” of a foreign enterprise
- There is an important exception for certain “agents of independent status”

“Agency” PEs

- OECD Commentary (2014):
 - Contracts must relate to operations which constitute the “business proper” of the foreign enterprise
 - May include contracts that bind the foreign enterprise even if not actually in the name of the enterprise
 - “Authority to conclude contracts” may include authority to negotiate all elements and details of a contract even if contract signed outside the state
 - “Habitually exercise” an authority: determination of extent and frequency necessary to meet this criterion depends on the nature of the contracts and the business of the foreign enterprise

Changes Pursuant to BEPS Action 7

- BEPS Action 7 dealt with “artificial avoidance of PE status”
- Expanded Art. 5(5) now covers a person acting on behalf of a foreign enterprise in a state who, in doing so, “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”
 - Intended to address situations in which the conclusion of a contract directly results from the actions performed by the person even though (under the relevant domestic law) the contract is not considered “concluded” in that state

Changes Pursuant to BEPS Action 7

- Rule expanded to cover contracts that are:
 - For the transfer of the ownership of, or for the granting of the right to use, property owned by the enterprise or that the enterprise has the right to use, or
 - For the provision of services by the enterprise
- This is intended to include contracts that bind the “agent” but effectively create obligations to be performed by the enterprise
 - E.g., “commissionaire” arrangements

Exception: Agent of Independent Status

- OECD Model, Art. 5(6) (2014):

“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 independent status, provided that such persons are acting in the ordinary course of their business.”

- Similar provisions exist in Canadian treaties, e.g. Canada-US treaty, Canada-UK treaty

- UN Model Treaty: agent will not be independent where its activities are devoted wholly or almost wholly on behalf of an enterprise on conditions which differ from those that would have been made between independent enterprises

Exception: Agent of Independent Status

- OECD Commentary (2014):
 - Agent must be independent of the principal “both legally and economically”
 - Agent must act in the ordinary course of its business when acting on behalf of the enterprise
- Case law (e.g., *AIL*), CRA and OECD Commentary set out factors relevant to determining whether an agent is independent

Changes Pursuant to BEPS Action 7

- BEPS changes expand the express conditions of the independent agent exception:
 - The agent must carry on business in the state as an independent agent;
 - The person must act for the foreign enterprise in the ordinary course of that business;
 - If the person acts “exclusively or almost exclusively” on behalf of one or more enterprises to which it is “closely related”, the exception will not apply

Specific Activity Exemptions

- Art. 5(4) of the OECD Model (2014) exempts certain activities from PE determination:
 - a) The use of facilities solely for the purpose of storage, display or delivery of goods 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

Continued...

Specific Activity Exemptions

- Art. 5(4) of the OECD Model (2014) exempts certain activities from PE determination:
 - 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 of a preparatory or auxiliary character
 - f) The maintenance of a fixed place of business solely for any combination of these activities, provided that the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character

“Specific Activity Exemption”

- Art. V(6) of the Canada-US treaty also contains a list of specific activity exemptions, but:
 - One exemption contains the phrase “preparatory or auxiliary character”: “advertising, the supply or information, scientific research or similar activities which have a preparatory or auxiliary character” (Art. V(6)(e))
 - A combination of activities need not be of a preparatory or auxiliary character to be exempted (except as required by Art V(6)(e))

“Preparatory or Auxiliary”

- OECD Commentary (2014):
 - Decisive criterion: does the activity of the fixed place of business in itself form “an essential and significant part of the activity of the enterprise as a whole”?
 - In general, where a fixed place of business has a general purpose that is identical to that of the whole enterprise, it will not be engaged in a preparatory or auxiliary activity

Changes Pursuant to BEPS Action 7

■ Two alternatives:

- Each of the specific activities is expressly subject to the condition that they are of a preparatory or auxiliary character; OR
- If a state considers that the specific activities are “intrinsically” preparatory or auxiliary, the state may instead rely upon the new “anti-fragmentation” rule:
 - The anti-fragmentation rule aggregates the activities of an enterprise and its closely related enterprises in a state for the purpose of determining whether or not the “specific activity exemptions” may apply

■ Added commentary/examples on the exemptions

Anti-Fragmentation Rule

- Generally, the “specific activity exemptions” would not apply where:
 - Activities are carried on by an enterprise or two “closely related” enterprises, whether at the same place or different places in the state;
 - One of the places where such activities are carried on constitutes a PE of the one enterprise or the closely related enterprise OR the overall activity that results from the combination of such activities is not of a preparatory or auxiliary character;
 - Such activities constitute “complementary functions” that are part of a “cohesive business operation”

Services PE Provision

- Extensive services can often be performed in a country without a fixed base or dependent agent (ie. *Dudney*)
- Services PE provisions deem PE to exist where services performed exceed certain time and/or revenue related thresholds even where no fixed base or dependent agent
- More recent expansion to PE concept to deal with growing importance of services in global economy

Services PE Provision

OECD Model

- No Services PE in text of OECD Model, not proposed under BEPS changes
- But OECD Commentary to Article 5 para. 42.11 to 42.48 provides example of services PE provisions contracting states could include if they choose (added in 2008)
 - Requires presence in source state and taxation based on net profits, not gross withholding
 - Similar to Services PE provision in Canada-US Treaty

Services PE Provision

UN Model

■ Article 5(3)(b) of the UN Model:

“The term “permanent establishment” also encompasses:

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.”

Services PE Provision

Canada-US Treaty

- Introduced in fifth protocol, overrides *Dudney* case
- Article V(9), two tests for Services PE:
 - Paragraph (a) individual performs services for 183 days or more in a 12 month period AND more than 50% of business revenues consist of income derived from those services
 - Paragraph (b) services provided for 183 days or more in any 12 month period, same or connected project AND customers are either residents of other State or have PE and services provided in respect to that PE
- Similar to OECD commentary version

Fees for technical services

- Controversial topic in developing countries; perception that technical fees used for base erosion
- Traditionally, would be considered business profits and no source taxation without PE
- New Article 12A of UN Model will allow gross withholding source taxation of technical services fees even where no services actually performed in source state

Canada's Position on PEs

- In general, Canada follows Article 5 of the OECD Model, with some exceptions
 - Reservations with respect to offshore activities and reference to “exploration or exploitation” in Art. 5(2)(f)
 - No observations on Commentary on Article 5
- Exceptions:
 - Special provisions for services
 - Use of substantial equipment in treaties with Australia and New Zealand
 - Offshore activities

Offshore Activities

- Article V(4) of the Canada-US treaty:
“The use of an installation or drilling rig or ship in a Contracting State to explore for or exploit natural resources constitutes a permanent establishment, if, but only if, such use is for more than three months in any twelve-month period.”

Special Provisions for Services

- Several Canadian treaties contain special provisions dealing with services:
 - Many treaties still contain Article 14 for independent personal services
 - Several treaties with developing countries contain Article 5(3)(b) of the UN Model: furnishing services in a country for more than 183 days
 - Article V(9) of the Canada-US treaty
 - Some treaties contain provisions dealing with technical services

Special Provisions for Technical Services

- Article 12(4) and (5) of the treaty with India:
“fees for included services” treated as royalties if services are “ancillary and subsidiary” or “make available technical knowledge, experience, skill, know-how, or processes or consist of the development and transfer of a technical plan or technical design”

Special Provisions for Technical Services

- Article 12A of the treaty with Mongolia:
 - technical fees arising in a state are subject to tax in that state at a maximum rate of 5 percent
 - technical fees are payments in consideration for services of a technical, managerial or consultancy nature
- Similar to new Article 12A of the UN Model

Canada's Position on the BEPS PE Changes

- BEPS PE changes:
 - Article 5(4) restricted to preparatory or auxiliary activities (alone or together)
 - New anti-fragmentation rule in Article 5(4.1)
 - Article 5(5) extended to agents playing the principal role leading to the conclusion of contracts
 - Article 5(6) excludes person who acts exclusively for a closely related person
 - New anti-contract splitting rule

Canada's Position on the BEPS PE Changes

- Canada has reserved its position on all the articles of the MLI, other than the minimum standards, including the PE changes
- This does not mean that Canada will not agree to these changes in bilateral negotiations
- Canada has agreed to the changes at a political level
- PE changes will be included in the 2017 update to the OECD Model
- Canada is unlikely to try to cherry-pick treaties (i.e., provisions will be standard in most treaties)

Allocation of Profits to PE

- If there is a PE, must determine allocation of profits
- One criticism of BEPS lowering of PE threshold is that minimal income may be allocated, frustrating theoretical basis of PE concept
- BEPS project released discussion draft on allocation of profits to PEs caught under expanded version
- Closely related to BEPS work on transfer pricing principals

Fundamental Policy Issues

- PE definition establishes a threshold for source country taxation of a nonresident's business profits
 - Resident of one state taxable by the other state only if resident carries on business through a PE in the other state and only to the extent of the profits attributable to the PE
- PE definition allocates tax revenues between source and residence countries
 - Lower threshold means more source country tax
 - Higher threshold means less source country tax

Fundamental Policy Issues

- Most countries have interests as both a source country and a residence country
- Interests vary vis-à-vis each treaty partner (e.g., Canada-US, Canada-Barbados)
- However, PE rules are relatively uniform
- Special rules in the UN Model for developing countries

Fundamental Policy Issues

- Does PE definition make sense?
- No!
- Doesn't deal appropriately with services or the digital economy
 - No fixed place of business or agent is necessary
- Many internal inconsistencies
- Easily avoided until BEPS changes are implemented

Fundamental Policy Issues

- History of the PE definition in the OECD Model shows few changes have been made since the beginning
- Instead, changes to the Commentary have attempted to expand the PE definition through interpretation
- BEPS changes are largely tinkering at the edges of the PE definition

The Future of the PE Definition

- Article 12A of the UN Model shows the abandonment of the PE concept for services
 - Also, Australian and UK Diverted Profits Taxes and India's Equalization Tax
- A different threshold for the taxation of the digital economy seems likely
 - Withholding tax on payments for digital goods and services
 - Substantial economic purpose test: sales of digital goods or services in excess of a \$ threshold