

LIUC – Università Carlo Cattaneo

International Tax Law

a.a. 2019/2020

Material Permanent Establishment

Prof. Marco Cerrato

Permanent establishment

“International legal framework”

- The 1923 Report of the Economists Group
- The 1925 Report
- The 1927, 1928, 1931, 1933 Models
- The Mexico and London Model Tax Conventions
- The OECD Model Tax Conventions
- OECD BEPS Final report on Action 7 and the Multilateral Instrument (MLI)

Permanent establishment

“International legal framework” – MLI

- Four BEPS actions propose changes to tax treaties:
 - hybrid mismatches (Action 2)
 - treaty abuse (Action 6)
 - the artificial avoidance of PE status (Action 7)
 - improvements to dispute resolution (Action 14)

Permanent establishment

“BEPS Action 7: Preventing the artificial avoidance of PE status”

- Final Report published in 2015
- Updating of the definition of permanent establishment status for anti-tax avoidance purposes
- A lot of abusive practices were put in place in order to circumvent the definition of permanent establishment provided by double tax conventions
- New art. 5 OECD MC (2017): reflects the changes provided by BEPS Action 7

Permanent establishment

“International legal framework” – MLI

- 24 November 2016: publication of the MLI following negotiations between more than 100 States
- 7 June 2017: 67 different States signed the MLI, including Italy

Permanent establishment

“International legal framework” – MLI

- With over 3,000 bilateral tax treaties, the MLI constitutes a vehicle for the quick implementation of treaty-related BEPS measures.
- Mechanics of the MLI:
 - parties may opt out of provisions of the MLI (or part of a provision in some cases) through specific provisions allowing for reservations;
 - some provisions (including the one relating to the PE) allow Parties to choose to apply one or none of two or more options;
 - where a Party selects a particular option, the option will generally apply only to the Treaties for which the other Party has chosen the same option.

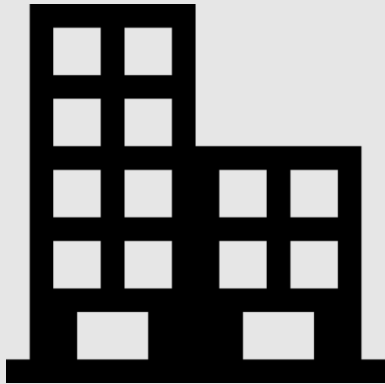
Permanent establishment

“Italian legal framework”

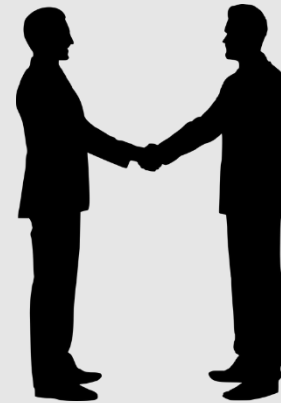
- **Legislative Decree 12 December 2003, No. 344:**
 - **Art. 162 of the Presidential Decree 22 December 1986 No. 917 (Consolidated Income Tax Act, “CITA”);**
 - **PE definition:**
 - Applies for **Income Tax** and **IRAP** (regional tax on productive activities) purposes only (not applicable for **VAT** purposes);
 - Differences and relationship with Treaties;
 - Recently amended by the 2018 Budget Law.

Permanent establishment

“Two types of PE”



VS.



«MATERIAL» PE

«AGENCY» PE

“MATERIAL” PE

Permanent establishment

“Basic rule”

Art. 5(1) OECD MC:

«*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*».

Permanent establishment

“Basic rule”

- In order for a PE to be deemed to exist, there must be a **place of business**:
 - **Fixed** from a geographical as well as a temporal perspective;
 - **at the disposal** of the enterprise;
 - through which its **business** is carried on.
- **Relation of instrumentality between the PE and the foreign enterprise’s business activity**

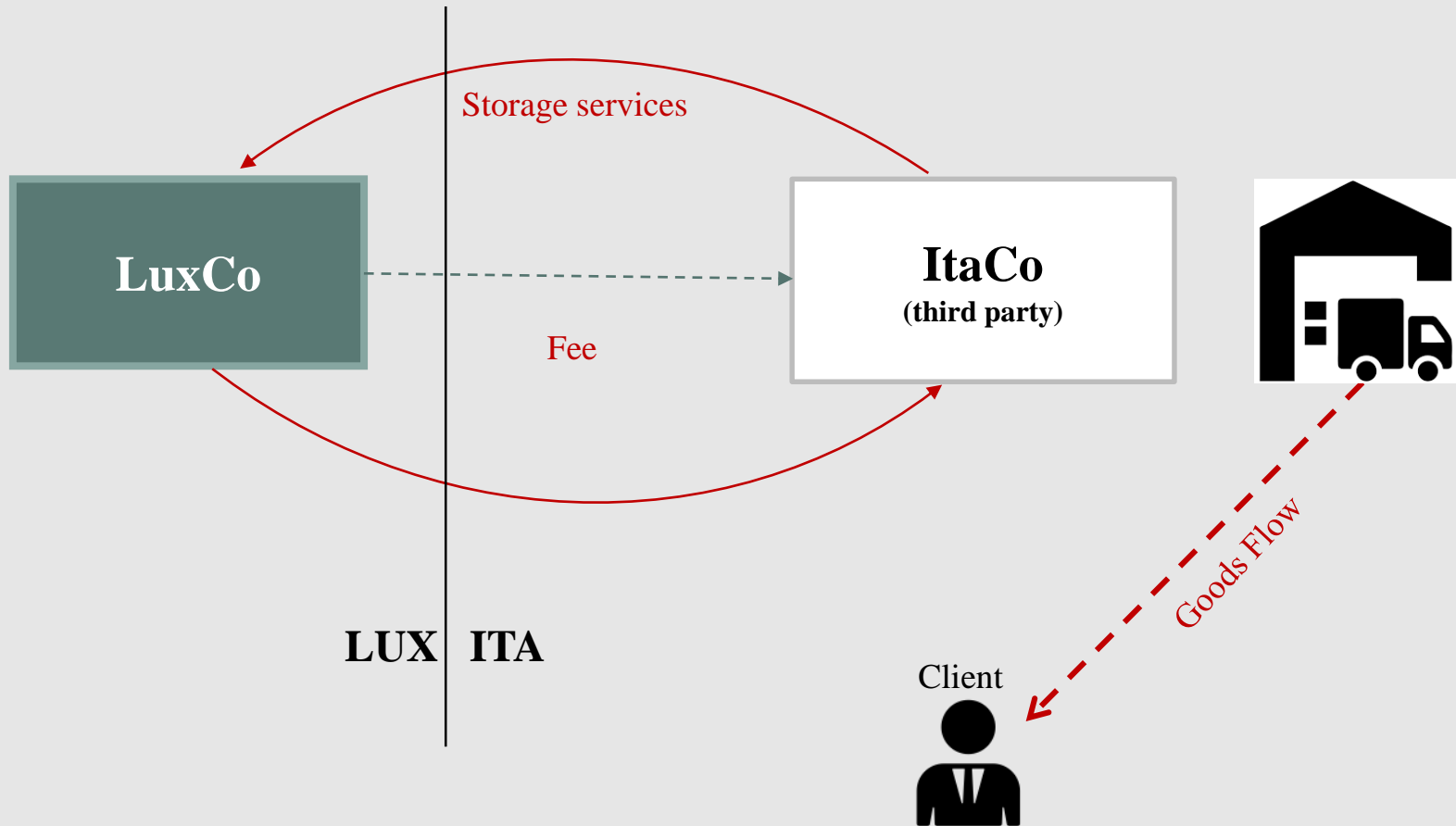
Permanent establishment

“Place of Business”

- Physical characteristics;
- Irrelevance of the human presence;
- Irrelevance of the formal legal right to use the fixed place;
- Irrelevance of the exclusive availability of the place of business by the foreign enterprise;
- **Case No. 8 of the OECD Discussion Draft:**
 - General Contractor resident in State R which carried on its business activities in State S by means of a Sub Contractor;
 - **Working party:** the place where the Subcontractor carries on its activities should be deemed to be “**at disposal**” of the General Contractor where the latter has the legal possession of the place, controls access to and use of the place and has overall responsibility for what happens at that location during that period.

Permanent establishment

“Example - Irrelevance of the formal legal right”



- LuxCo has the full right to inspect the warehouse
- LuxCo employees have badges to access to the warehouse

Permanent establishment

“Fixed Place of Business”

- Fixed place and movable activities;
- Fixed place and activities carried out within a specific geographic area (see example next slides)
- **Case No. 5 of the OECD Discussion Draft:**
 - Shop located on a ship that navigates in international waters;
 - **Working party:** There is no PE (“*unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence*”).

Permanent establishment

“Permanence”

- Fixed place and activities carried out within a specific geographic area;
- Irrelevance of the time period provided for construction sites;
- International duration vs actual duration;
- Dies a quo and termination of the PE;
- Temporary interruptions and activities repeated over the time;
- Movable and seasonal activities;
- Services and consultant industries.

Permanent establishment

“Fixed Place of Business” - OECD MC Commentary on Art. 5(1)

- An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for five years.
- In that case, given the nature of the business operations at that location, it could be considered that the **time requirement** for a PE is met due to the **recurring nature of the activity** regardless of the fact that **any continuous presence lasts less than six months**.
- The time requirement could similarly be met in the case of **shorter recurring periods of time** that would be dictated by the specific nature of the relevant business.

Permanent establishment

“Positive list” – Art. 5(2) OECD MC

- The expression "permanent establishment" includes especially (illustrative list):
 - a place of management;
 - a branch;
 - an office;
 - a factory;
 - a workshop;
 - a mine or an oil or gas well, a quarry or other place for the extraction of natural resources, including areas outside the territorial waters.
- Relationship between the illustrative list and the basic rule;
- Italian observation to the OECD MTC.

Permanent establishment

“Positive list” – Art. 5(2) OECD MC

- The list is not exclusive but it is simply illustrative.
- This paragraph contains a list, by no means exhaustive, of examples of places of business, each of which can be regarded as constituting a permanent establishment under paragraph 1 provided that it meets the requirements of that paragraph. As these examples are to be read in the context of the general definition given in paragraph 1, the terms listed, “a place of management”, “a branch”, “an office”, etc. must be interpreted in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.
- The term “place of management” has been mentioned separately because it is not necessarily an “office”. However, where the laws of the two Contracting States do not contain the concept of “a place of management” as distinct from an “office”, there will be no need to refer to the former term in their bilateral convention.

Permanent establishment

“Positive list” – Art. 5(2) OECD MC

- Italy: additional definition of PE introduced with 2018 Budget Law: a “*significant and continuous economic presence in the territory of Italy, built in such a way that it will not result in a physical presence in Italy*”.
- Redefinition of the link between physical presence of a foreign entity and its taxation.
- Introduction of forms of taxation for enterprises involved in the digital economy.
- Contrast to tax avoidance schemes put in place in order to circumvent the concept of permanent establishment.
- However, this definition has to be coordinated with double tax treaties.

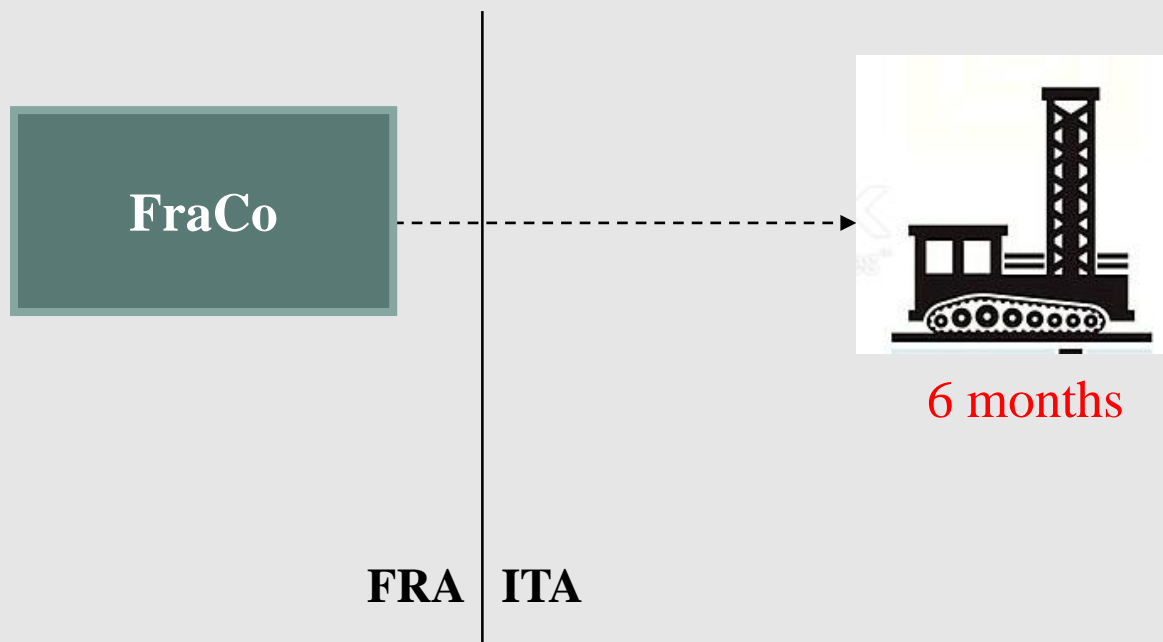
Permanent establishment

Construction, assembly or installation site

- Art. 5(3) OECD MC: *«A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months»*.
- Origin of the provision.
- Consequences of the autonomy definition and significance of the twelve month threshold.
- Offices related to construction sites.
- Peculiarity of Art. 162 CITA: duration and supervision activities.

Permanent establishment

“Peculiarity of art. 162 CITA vs. Double tax conventions”



- Art. 5(2) Italy – France DTC (1989): «The term "permanent establishment" includes especially: [...] a building site or construction or installation project if it lasts more than 12 months».

Permanent establishment

“Construction, assembly or installation site”

The term «building site or construction or installation project» includes not only the construction of buildings, but also:

- construction of roads, bridges or canals;
- renovation of buildings, roads, bridges or canals;
- laying down of pipe-lines and excavating and dredging.

Permanent establishment

“Construction, assembly or installation site”

- On-site planning and supervision of the erection of a building are covered by paragraph 3.
- States wishing to modify the text of the paragraph to provide expressively for that result are free to do so in their bilateral convention.

Permanent establishment

“BEPS Action 7”

- According to the existing provisions, a PE arises when work on a construction site lasts at least 12 months.
- In order to prevent splitting up contracts artificially into shorter periods, the OECD advocates for a principal purposes test, or a specific provision that **allows for combining the activities of the related enterprises carried out at one construction site during different periods of time**, each exceeding 30 days, when determining the duration of work.
- **MLI - Most relevant countries that have opted out:** Italy, Germany, Luxembourg, UK, Austria → no changes to the Treaties concluded.

Permanent establishment

“Negative list”

- History of the negative list;
- Relationship with basic rule, positive list, construction sites and agents;
- The use of a place of business for the sole purpose of carrying out any other preparatory or auxiliary activities for the enterprise;
- The concept of “*essential and significant part of the activity for the enterprise as a whole*”;
- The importance of the fact that the place of business carries on preparatory or auxiliary activities only;
- The importance of the fact that the preparatory or auxiliary activities are carried out for the enterprise.

Permanent establishment

“Negative list”

- The term “**permanent establishment**” shall be deemed **not to include** (Art. 5(4) OECD MTC):
 - 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**;

Permanent establishment

“Negative list”

- 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**; **(BEPS concern)**
- f) the **maintenance** of a fixed place of business **solely** for **any combination of activities** mentioned in subparagraphs a) to e), provided that the **overall activity** of the fixed place of business **resulting from this combination is of a preparatory or auxiliary character**.

Permanent establishment

“Negative list”

- **Combination of preparatory or auxiliary activities:**
 - The condition according to which **all the combined activities** are carried out **within the same place of business**;
 - The condition according to which **all the combined activities should lie within the negative list**;
 - The condition according to which **the activity resulting from such combination** has, in turn, **a preparatory or auxiliary nature**;
 - Art. 162 CITA and the Italian Treaty practice.

Preparatory and Auxiliary activities

“BEPS Action 7”

- **BEPS concerns:**

- Depending on the circumstances, activities **previously** considered to be merely preparatory or auxiliary in nature may **nowadays** correspond to **core business activities** (i.e. **digital economy**);
- **Fragmentation of a cohesive operating business** into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Art. 5(4).

Preparatory and Auxiliary activities

“BEPS Action 7”

- **Solutions:**
 - **Amendments to Article 5(4)** in order to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a “preparatory or auxiliary” character;
 - Introduction of **Art. 5(4.1)**:
 - **Anti-Fragmentation rule.**

Preparatory and Auxiliary activities

“BEPS Action 7”

- The Activities provided by Art. 5(4) should not be automatically considered “**auxiliary and preparatory**”;
- The nature of such **activities** should be **assessed** on the basis of the **overall business activity**;
- It should be ascertained whether the activities performed within the same State:
 - “*constitute **complementary functions***”;
 - “*are **part of a cohesive business***”.

Preparatory and Auxiliary activities

“BEPS Action 7”

- **Preparatory Activity**

- “...is one that is carried on in *contemplation* of the carrying on of what constitutes the *essential and significant part* of the activity of the *enterprise as a whole*.”;
- “carried on during a *relatively short period*”.

- **Auxiliary Activity**

- “...carried on to *support, without being part of, the essential and significant part* of the activity of the enterprise as a whole.”;
- “It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.”.

Preparatory and Auxiliary activities

“BEPS Action 7”

- **MLI – Art. 13:** Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions
- Requires that the activities listed in the “negative list” are deemed not to constitute a PE only if effectively preparatory or auxiliary
- Case-by-case approach
- Example Italy: no reservation on this Article

Anti-Fragmentation rule

“BEPS Action 7”

Art. 5(4.1) OECD MC:

“Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

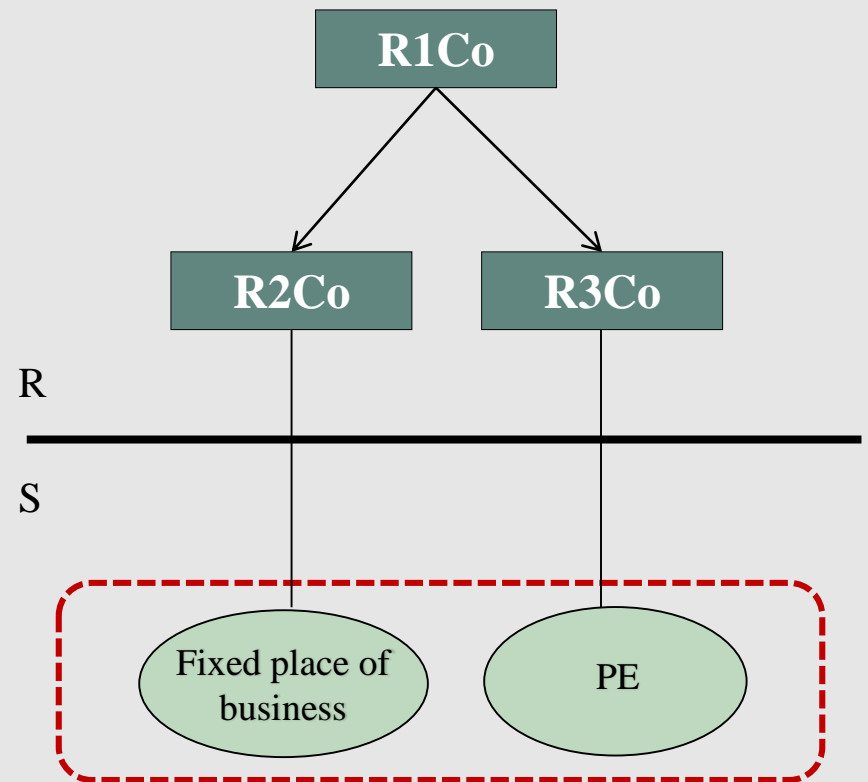
b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, ***constitute complementary functions that are part of a cohesive business operation”***.

Anti-Fragmentation rule

“BEPS Action 7” – Case 1

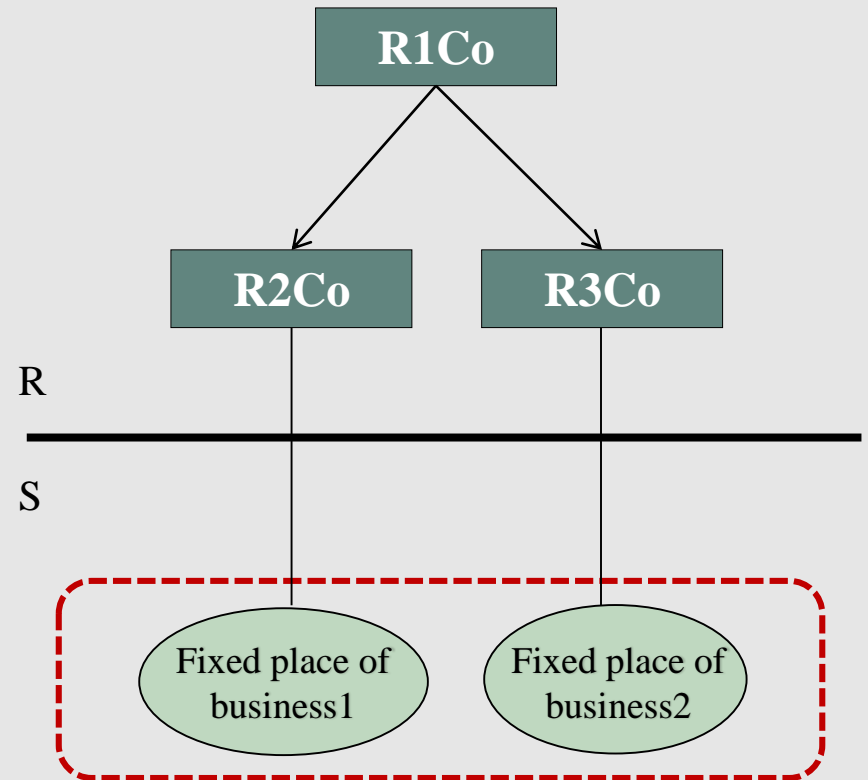
- R2Co and R3Co are two subsidiaries of R1Co resident in State R.
- R3Co has a PE in State S.
- R2Co has a fixed place of business in State S.
- The exceptions of Art. 5(4) will not apply if the business activity carried on by the fixed place of business and the PE constitute complementary functions that are part of a cohesive business operation.
- In such a case, R2Co will have a PE in State S.



Anti-Fragmentation rule

“BEPS Action 7” – Case 2

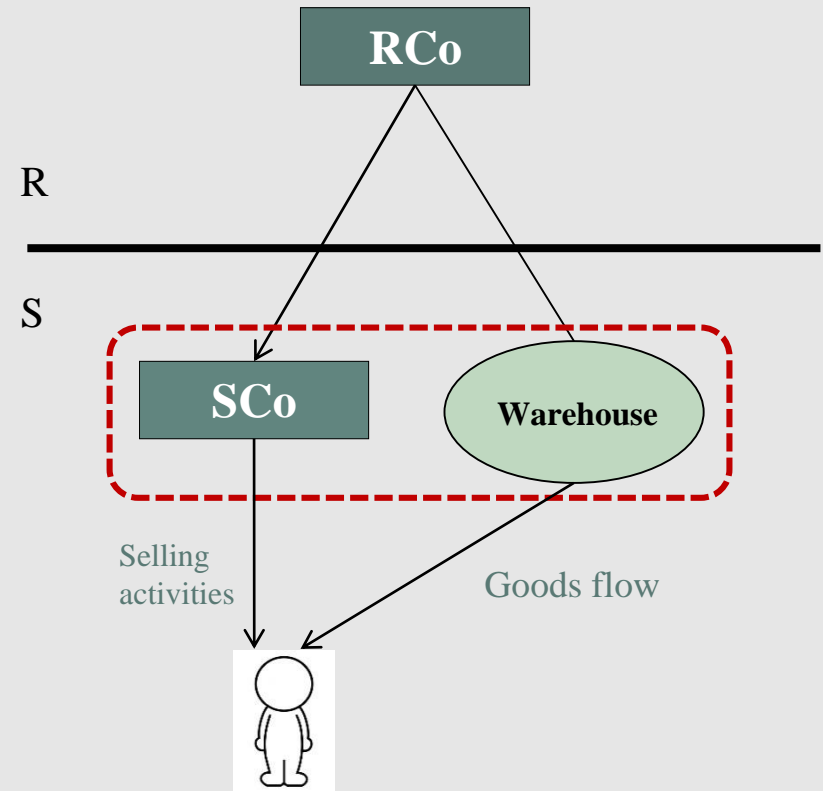
- R2Co and R3Co are two subsidiaries of R1Co resident in State R.
- R2Co and R3Co have both a fixed place of business in State S.
- The exceptions of Art. 5(4) will not apply if the business activity carried on by the two fixed place of business constitute complementary functions that are part of a cohesive business operation.
- In such a case, R2Co and R3Co will have a PE in State S.



Anti-Fragmentation rule

“BEPS Action 7” – Case 2

- RCo manufactures and sells appliances.
- SCo owns a store where it sells appliances that it acquires from RCo.
- RCo owns a small warehouse in State S where it stores items that are identical to some of those displayed in the store owned by SCo.
- When a customer buys such a large item from SCo, SCo employees go to the warehouse where they take possession of the item before delivering it to the customer.
- The exceptions of Art. 5(4) will not apply since the activities of storage carried out by the warehouse and the activity of selling carried out by SCo constitute complementary functions that are part of a cohesive business operation.



Anti-Fragmentation rule

“BEPS Action 7”

- The anti-fragmentation rule was introduced with Art. 5(4.1) following the issues outlined with BEPS Action 7 and was introduced in Art. 13(4) of MLI.

Anti-Fragmentation rule

“BEPS Action 7”

- MLI – Art. 13(4): *“A provision of a Covered Tax Agreement (as it may be modified by paragraph 2 or 3) that lists specific activities deemed not to constitute a permanent establishment shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting Jurisdiction and:*
 - a. that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a permanent establishment; or*
 - b. the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,*

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation”