Permanent establishment today

Professor Robert Anthony,
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The issue today as to what defines a permanent establishment is not as easy as it was

Yes we have the OECD model which is a standard for many countries with minor modifications but is this today really workable as a document? Certain countries are concerned as to the applicability of their tax treaties. This means the tightening by countries to counter abuse by tax planners. This results in amendment by way of agreed modifications to existing treaties. An example is the latest amendment between Singapore and France which has recently been completed.

Proper corporate governance is necessary to justify certain holding entities. These need to have real substance. In Luxembourg, this is a real presence on behalf of the company by an office with staff. Certain countries consider that their current treaties in force are adequate, with meetings in the country concerned without the necessity of a permanence. Italy is litigating where it can, but the results are far from clear. A real activity today needs a more clear definition in a tax treaty to be applied. The issue of a permanent establishment can also be interpreted differently in countries like Germany even without a contract being signed in the country.

The G20 are putting on pressure to eliminate the abuse of low tax jurisdictions, however new opportunities are being created like Hungary. They have lowered their corporation tax rate to 10 percent in competition with Ireland and Cyprus. The UK still is seen as an interesting place to establish one's holding entity.

In summary the issue seems to be whether domestic countries will accept holding companies' tax treaties where there is nothing more than a letter box. Some countries as mentioned previously are now negotiating to amend their treaties to ensure this doesn't apply and others simply decide they don't need to or don't care. Case law is obviously important when looking at this. When is a company a resident or non-resident company? Treaties don't normally apply to non-resident companies. In order to understand better some Geneva Group International (GGI) offices have contributed their latest developments as outlined below.

"Substance over Form" in selected countries

France

Prof. Robert Anthony

The French supreme High Court (Conseil d'Etat) has ruled that a UK company providing a training centre for race horses to professionals in France, does not have a permanent establishment since:

1. there is no staff in France except a guard, and
2. even if the training centre has all the different rooms that are needed for such an activity (bedrooms for stable-lads, paddocks, forge, saddle room, forage barn and so on), their equipment was not provided by the UK company.[1]

Germany

Oliver Biernat

A recent decision of the German Supreme Tax Court[2] ruled that a foreign company is active if it maintains business operations that are adequate to its business objective. This decision is in line with, for example, German anti-treaty shopping provisions for non-active companies. So, for example, Sec. 50d Para. 3 of the German Income Tax Law denies treaty benefits to a non-resident company if persons participate in the company who would not be eligible for the tax relief if the income accrued directly to them and

1. there are no economic or other relevant reasons for the foreign company to be involved or
2. the foreign company does not generate more than 10 percent of its gross earnings from its own business activity per fiscal year or
3. the intermediate company does not maintain business operations that are adequate to their business objective (own staff, office space, communication equipment etc.).

All existing non-German holding companies that do not fulfil the substance requirements should be re-checked by an expert in international taxation.

India

Ashish Bairagra

The Indian government has recently given 'substance over form' the required attention. In the Finance Act, 2011, passed in April 2011, a new Section 94A was introduced in the Income-tax Act, 1961 which states that if an Indian Tax Assessee (individual / entity) fails to explain the 'source of the source' of the funds it has received from an individual / entity in a notified jurisdiction, the entire receipt can be taxed as Income in the hands of the Assessee. This together with the pending US$ 2.5 billion tax litigation in the 'Vodafone'[3] case highlights the importance given to 'substance over form' from an Indian tax perspective.

Italy

Dr. Sergio Finulli, Carlo Dalla Libera and Ugo Girardi

In Italy as a consequence of recent Supreme Court decisions,[4] the Tax Authorities moved from a formalistic approach and can now disregard a transaction carried out with no real economic reason and for tax advantage purposes only.

Moreover, the risk of being audited as a result of commercial relationships with "tax haven" countries dramatically increased following the new reporting requirements introduced in 2010, related to transactions with "tax haven" countries which included transactions with very common business counterparties like Swiss companies.

In order to simplify actual non-co-ordinated anti-avoidance domestic rules new lists are going to be released by Tax Authorities replacing as a criterion "lower taxation" with "co-operation with foreign Tax Authorities".

Mexico

Marco Motta Aispuro

The need to ensure that tax law provisions are applied according to a substance over form principle has recently led the Mexican Congress to the adoption of rules which main purpose is to avoid taxpayers carrying out artificial acts to reduce or lessen their taxable basis and consequently their tax payments. Additionally, in recent times isolated precedents have been issued by Circuit Collegiate Tribunals of the Judicial Power[5] stating that the interpretation of tax regulations must go beyond literal expressions or formal statements and must even take into consideration the economic nature of the regulated events.

It is really important to point out that this criterion of substance over form essentially applies in the interpretation of provisions that define the taxable event or its elements (tax subject, tax object, tax basis and tax rate). Nonetheless, when it comes to the interpretation of other tax provisions, what we see in practice is that tax authorities normally prioritise form over substance.

Singapore

Doris Foo

Apart from general anti-avoidance tax provisions in the Income Tax Act, there are no specific tax provisions or regulations dealing with "substance over form".

On the issue of tax residency, a company is tax resident in Singapore if the control and management of its business is exercised in Singapore. Having a permanent establishment in Singapore is not sufficient to establish tax residency. In practice, the Singapore tax authorities would refuse to confirm Singapore tax residence status where the taxpayer entity is either:

1. A nominee company which is not the beneficial owner of the income derived from the treaty country. A nominee company is defined as a company that is formed for the purpose of holding shares on behalf of the beneficial owners of the shares.
2. A company where 50 percent or more of its shares are held by shareholders who are not residents of Singapore, and which is an investment-holding company with purely passive sources of income or receiving only foreign-sourced income. An exception would be where such a company can furnish the reasons for setting up tax residence in Singapore. In particular, the Singapore tax authorities would favourably consider the following factors:
   a. board of directors' meetings are held in Singapore, and
   b. presence of other related companies (tax resident or with business activities) in Singapore; or
   c. have at least one director based Singapore who holds an executive position and is not a nominee director; or
   d. have at least one key employee (e.g. CEO, CFO, COO) based in Singapore.

Likewise when reviewing double tax relief claims by entities claiming to be tax resident in a tax treaty country (particularly a low tax jurisdiction), the Sin-

gapore tax authorities may review if the entities have substance in the countries where they claim to be tax resident.

Spain

Santiago Lapausa

On December 23, 2010 the Supreme Court examined whether two construction projects could be treated as a permanent establishment of a non-resident entity in Spain, in light of Article 5 of the Spain-Italy tax treaty signed in 1978, according to which construction or assembly work taking more than twelve months will be deemed a permanent establishment (Supreme Court No. 7413/2010, December 23, related to "Dolomiti Rocce Sucursal en España"). The appellant signed two construction contracts with the government, in which it undertook to perform a project in various phases. The first contract, executed in 1994, lasted fewer than 12 months, while the second one lasted more than 12 months.

The dispute brought before the Supreme Court lies in the fact that, while the appellant contended that there were two different projects and therefore it did not have a permanent establishment until 1995, The Supreme Court ruled in favor of the inspectors, stating that the determining factor is that the work to be performed, in its various phases, required a single structure (given its uniformity) and a single organisation, not two separate contracts, and therefore the length of the work took in all of the phases of the project in question and the Italian company had a permanent establishment in Spain since 1994.

A tax haven is defined for the purpose of the anti-abuse provision as any territory which does not have a personal, corporate or non-resident income tax similar to those levied in Spain. Jurisdictions with which Spain has concluded an exchange of information agreement (either within a Double Tax Treaty or as a separate arrangement) are excluded while the agreement is in force.

The new definition of tax havens for those jurisdictions not included in the 1991 black list comes from the 2006 Anti-fraud Prevention Act. The Tax Office considers an organisation based in a tax-free country or territory as resident in Spain when its main assets, directly or indirectly, consist of assets located or rights that are fulfilled or exercised in Spain, or when its main activity is carried out therein, unless it accredits that its direction and effective management take place in that country or territory, and that its incorporation and operations have a valid economic motivation and substantive business reasons other than the simple management of securities or other assets.

UK

Stephen Edwards, Graham Busch and Henry Charles

UK courts are increasingly taxing the commercial substance of a transaction rather than its legal form. However, in a recent tax avoidance case (*HMRC v Mayes [2011] EWCA Civ 407*) in which an income tax deduction was claimed following certain transactions involving life policies, the courts found in the taxpayer's favour despite the contrived artificial nature of the arrangements and the clear tax avoidance motive. Does this case mark a move back to form over substance? It seems unlikely – the legislation concerning life policies is largely formulaic in nature and therefore the courts took the view that the issue of commercial substance was extraneous to this case. The message here is to continue to ensure your structures have commercial substance where required by the legislation but also to recognise that a more legalistic approach can be successful in the right circumstances.

USA

Steven Cantor, Stanley Ruchelman and Robert Simon

Taxation in the US generally attaches to an entity based on the specific activities performed in the US as opposed to the form used to conduct such business. Thus, absent OECD treaty protection, any non-US person that conducts a trade or business in the US through an office, factory, store workshop, mine etc. will be subject to income tax in the US. Where an officer or employee is physically present in the US, taxable business activity would accrue to that business if such individual exerts substantial, continuous and regular managerial or operational control over the enterprise through some US physical location. The mere execution of a contract would not be sufficient to create taxable nexus. In addition, with the US check-the-box regulations which permit most taxpayers to elect to be treated either as a corporation or an unincorporated entity, the actual form of doing business is generally irrelevant.

While the US does not tax non-US entities directly on their income (unless they are doing business in the US), several States are following the California lead and are moving towards requiring US corporations doing business in their state to consolidate non-US parent or subsidiaries that are in the same or related business as the domestic US entity (unitary businesses) irrespective of the fact that such non-US entity is not directly engaged in a trade or business in the US. Such entities may be able to avoid this result by electing to exclude such non-US entities ("Waters Edge Election"). The decision as to whether or not to

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make this election must be evaluated for each group and for each state to determine the most tax-efficient position.

Venezuela

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The interpretation of the tax law is made in accordance with its economic meaning; contracts and/or legal entities can be disregarded if they are clearly inappropriate to the economic reality of the business. Tax authorities are becoming stricter with respect to jurisdictions where low or no tax rates are applicable, especially, in order to ensure transparency in tax issues. The Supreme Court, based on the principle that substance prevails over form, ruled against HIDECA (2/3/1999), a company devoted to oil services that set up an agro-industrial company in order to avail itself of tax rebates by virtue of new investments. However, there are still a few cases where that trend has been followed and one can still observe cases where the substance is clearly absent and no objections have occurred so far. However, the law is clear: any structure should have a solid commercial substance.

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NOTES

[1] Conseil d'Etat July 31, 2009, Sté Overseas Thoroughbred Racing Stud Farms Limited

[2] BFH (German Supreme Tax Court) dated October 13, 2010, Aktenzeichen (file reference) I R 61/09, clarifying that a foreign company is an active company if it maintains business operations that are adequate to their business objective. In the case a German insurance company established an Irish daughter company, performing reinsurance business and just paying 10% tax on income in Ireland. Operational management was performed via a "management agreement" by another corporation in Ireland. The court decided that the Irish Ltd. is active.

[3] www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/telecoms/8430422/Vodafone-challenges-2.5bn-Indian-tax-bill.html

[4] The Case Law references are: Case Law "Cass., SS.UU. n. 30055/08 and n. 30056/08" related to dividend washingCase Law "Cass., SS.UU. n. 30057/08" related to "dividend stripping". All three are dated December 23, 2008."Cass., SS.UU." is the Corte di Cassazione, Sezioni Unite, the Italian Supreme Court.

[5] Reference Epoch: Nine

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