

Permanent Establishment: The New Challenge (Lecture B1409 – 19.34 minutes)

The concept of permanent establishment has been around for over a century and is one of the building blocks of the corporation tax system. A permanent establishment in a country leads to a corporation tax liability and can often lead to a PAYE as well as a social security liability as well.

The Organisation of Economic Cooperation and Development (OECD) has given some useful guidelines to tax administrations regarding what does and does not constitute a permanent establishment. The relevant article in the double tax treaty is article 5 of the model treaty. Permanent establishments include:

- Places of management;
- Factories;
- Mines;
- Facilities for the exploitation of natural resources.

There are also exclusions such as:

- Warehousing;
- Preparation of goods;
- Research and development;
- Public relations;
- Assessing claims;
- Collecting goods.

For a number of reasons, the definition of permanent establishment (PE) has become more rigorous in terms of what is included and the exemptions from establishing a PE have become more circumscribed. If you look at the change to article 5 of the model OECD treaty, you will see that the exclusion for agents of independent means has been more limited and those individuals who substantially draw up the terms for contracts, even if they are rubber stamped elsewhere, will have created a PE.

Two other factors have complicated permanent establishment rules. The first is the effect of the COVID-19 pandemic which meant that workforces were dispersed, sometimes over several countries, and directors were performing duties in countries where this had not been anticipated. Most tax authorities took a more lenient view of the changes in where business activities took place and were not asserting that either the residence of companies had changed nor that a new permanent establishment had been created, so long as the company reverted to its previous patterns pre-COVID. This was backed up by OECD guidance on this point. The OECD distinguished between regular patterns and unusual ones.

The second issue is the advent of new technologies which has made it easier for employees to work remotely.

This, of course, can create its own employment tax issues. However, potentially, it also creates a challenge for the company as it may be creating a new permanent establishment. This means that small and medium sized enterprises who never had to be worried about permanent establishment rules may now find that this becomes a major issue.

There have been a number of cases both pre and post COVID which have drawn the attention of tax authorities. In particular, Denmark which has similar double tax treaties to the UK has produced a number of interesting rulings. Effectively, where one is employing someone who is setting up a sales operation in Denmark which may not be for the entire week, there is a significant danger of creating a permanent establishment. By contrast, where one engages an independent company to perform sales and marketing services, this may not create a permanent establishment.

HMRC has also recently published its own guidelines as to when it considers there may be a permanent establishment created by the actions of employees. Whilst HMRC's guidance does not have the force of law, it does create legitimate expectations and guidance which may be useful.

The guidance looks at the dilemma about whether an individual's personal plans which result in them remaining in the UK and working for longer than anticipated would create a PE for the company. The upshot of the guidance is that generally where there is a temporary stay in the UK, for example, after a holiday, this does not create a PE in the UK. However, if the stay is planned as part of say a project and involves potentially staying in the UK for a series of months every year, on a planned basis, a PE may be created. The examples are HMRC's, and this is taken from an extract of an article published in Tax Journal on 22nd September 2023.

Example 1

Juan, who works for a foreign entity in State D, comes to Brighton on holiday and stays on to work here for a total of 40 calendar days including his holiday, using the office of a UK affiliate company as a base. He enjoys the experience so much he decides to do the same thing six months later.

HMRC confirms that, in this scenario, Juan's presence would not create a fixed place of business PE because the permanence test would not be met. However, if the arrangement was expected to be an annual occurrence for Juan and/or his successors or colleagues in his team, HMRC consider that there is a possibility that the cumulative time spent in the UK could trigger a PE. This example is helpful in confirming that workdays being tagged on to holiday will not create a UK PE provided UK presence is ad hoc, rather than amounting to a committed and sustained presence in the UK.

Example 2

Francine, a French national with an English partner, joins a French company on a permanent contract which permits her to spend a fixed three-month period each year working in the UK.

In contrast to example 1, HMRC consider that Francine's presence would meet the permanence test for a fixed place of business PE because the cumulative time she is anticipated to spend in the UK over the coming few years is significant and her presence in the UK is fixed and so not random or sporadic. Whether a UK PE would be created would depend on the wider facts and circumstances, such as the nature of the activities carried out by Francine and whether the actual location used by Francine is 'at the disposal' of the business. Generally, example 2 indicates that HMRC take the view that having a contractual entitlement to spend a fixed amount of time in the UK, and this being expected over a number of years is enough to potentially meet the permanence test.

Example 3

Alexei, Luca and Sara all work for a foreign entity in State C. They come to the UK on holiday for the same part of the year with their families, staying at different addresses. They are all permitted to stay on an additional 30 days to work in the UK by their employer, using the office of a UK affiliate company as a base.

HMRC confirms that, under such an arrangement, the employees' presence would not create a fixed place of business PE because the permanence test would not be met. This example is helpful in confirming that ad hoc presence (as in example 1) will not give rise to a PE, even where the ad hoc presence takes place at the offices of an affiliated business.

Example 4

Company T has a team of staff in its Zurich office. Over the course of nine months, six staff are permitted to spend six weeks each, in turn, at an affiliate company's office in London working on a project.

HMRC considers that this scenario would meet the permanence test for a fixed place of business PE because the changing identity of the visiting personnel doesn't affect the continuity of Company T's presence in the UK. Ultimately, the test is whether the business has a PE in the UK, and the fact that each individual may not spend a significant time in the UK does not prevent a PE arising where there is continuity and permanence of presence through the company's staff generally.

The challenge of Permanent Establishment is not going away as companies and employees develop new patterns of work, they will be potentially creating Permanent Establishments in a large number of countries. Whilst HMRC's guidance is reassuring to companies who had hitherto banned their employees from extending their time in another country from a holiday to work, the guidance still leaves plenty of scenarios where unwittingly Permanent Establishments can be created in multiple jurisdictions.

What used to be a challenge for multinationals and large companies, has increasingly become a challenge for small and medium sized companies who do not necessarily have the resources to deal with this in a systematic manner.

Contributed by Jeremy Mindell