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Tax Treaty Developments: Permanent Establishment and other Issues

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Tax Treaty Developments: Permanent Establishment and other Issues

Agenda

- Permanent Establishment Developments
 - Recent commentary changes
 - Contentious issues
 - Future work
 - Risk management
- Profit Attribution to Permanent Establishments
 - Recent commentary changes
 - Methodology used
 - FIN 48 considerations in light of changes

Tax Treaty Developments: Permanent Establishment and other Issues

Agenda (cont)

- New Royalty Characterization Rules
 - Software distributors
 - Royalties vs. other payments
 - Future work
- U.S. Treaty Developments
 - Status and significant provisions of new and pending treaties
 - Effective dates of new provisions
 - Limitation on benefits article
 - Zero percent withholding on dividends
 - Mandatory arbitration

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Recent Commentary Changes

- Deemed PE for cross–border services
 - Exception to normal “fixed place of business” rule
 - Two tests
 - individual present for more than 183 days and over 50% of enterprise’s gross revenue attributable to individual; or
 - enterprise performs services exceeding 183 days in aggregate for same or connected projects

Recent Commentary Changes (cont)

- Services performed by separate enterprise can be attributed to principal
 - Principal supervises, directs or controls the manner in which services are performed
 - How broadly can that be interpreted?
 - OECD response to comments
 - notes “some risk” it “could be misinterpreted” to apply to typical subcontractor arrangements
 - meant to describe a *de facto* employment relationship
 - could review later

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Recent Commentary Changes (cont)

- Art. 15(2) provides individual tax exemption for stays of fewer than 183 days, and costs borne by nonresident employer
- Proposed changes would allow persons to be deemed employee of local enterprise
 - Applies if services constitute an integral part of the recipient enterprise's business
 - Would override legal employment arrangements
- Art. 15(2) Commentary changes not adopted
 - Still under consideration
 - Likely will reemerge at some point

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Recent Commentary Changes (cont)

- Prior changes seemed to reduce the PE threshold
 - Commentary text suggests 6 months as the standard
 - Also several examples added, including “painter example”
 - PE found to exist when painter spends 3 days a week, for two years, in building of its “main client”

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Recent Commentary Changes (cont)

- Germany has filed three Observations to the Commentary
 - Objects to painter example on grounds of absence of control over premises
 - Objects to implications that recurrent activity can outweigh requirement of certain minimum degree of presence
 - Objects to economic nexus as a factor
 - Cautions that Art. 5(5) contract concluding agents also must have a degree of permanence

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Recent Commentary Changes (cont)

- India also actively making Observations
 - Filed 27 positions or Observations on Art. 5 and its Commentary, including:
 - Tangible or intangible property under lease can create a PE
 - List of Art. 5(2) examples (including “place of management”) can be *a priori* PEs
 - Mere participation in negotiations can constitute authority to conclude contracts

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Recent Commentary Changes (cont)

- Website alone may be a PE
- Website hosted on a server can be a fixed place of business
- Services PE not limited to services performed in the source state
- Asserts that gross-basis tax is not inappropriate way to tax services
- Asserts that outsourced telephone technical support can create a PE

Recent Commentary Changes (cont)

- Thoughts on all the Observations
 - One of the purposes of OECD is to foster consensus
 - India not a member yet, but has Observer status
 - Observations are useful to signal where tax authorities stand
- A greater tolerance for non-consensus positions seems to exist
 - Services PE rules is principal example

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Recent Commentary Changes (cont)

- OECD reports frequently signal divergence of views
 - In most cases the parties aren't named
- So where is this going?
 - Less consensus?
 - More transparency?
 - Hopefully not less consensus and less transparency

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Contentious Issues

- Art. 5(5) agents which have and habitually exercise an authority to conclude contracts in the name of the enterprise
 - Commentary includes agents who conclude contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise
 - Also states that a person who is authorized to negotiate all elements and details “in a way binding on the enterprise” exercises the requisite authority

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Contentious Issues (cont)

- Common issues
 - Electronic contracting
 - Multiple review levels
 - Term sheets

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Contentious Issues (cont)

- Use of contractors
 - Various forms of fixed place of business theory are being asserted
 - Agency
 - Right to be at premises
 - Note reference in services PE discussion
- Could apply to a wide variety of contexts

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Contentious Issues (cont)

- Place of management
 - Listed as an Art. 5(2) example
 - Requires FPOB or is it standalone?
 - Commentary says FPOB required, but Italy lodged Observation to the contrary
- Control over premises
 - Nature of control
 - Duration

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Contentious Issues (cont)

- Business restructurings
- Electronic commerce
- Anti–abuse provisions of domestic law

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Contentious Issues (cont)

- OECD Global Forum—September 2008
 - 120+ governments in attendance
 - 4 PE case studies
 - Contractors
 - Food service subcontractor for oil platform
 - Contracting authority
 - Commissionaires
 - Contract manufacturing
 - Business restructuring to turn supplier into a contract manufacturer
 - Electronic commerce
 - DVDs supplied from offshore through website accessible via in-store kiosk

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Future Work

- OECD to take a new look at the PE standard
 - Scope of project currently not clear
- Business restructuring project
 - Split into transfer pricing and PE elements
 - PE part still to be heard from
- Art. 15(2) likely to reappear
- Further Commentary fine tuning to be expected
 - Including in response to national jurisprudence
 - *Philip Morris* case, for example

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Risk Management

- Be alert to emerging issues
- Review contract conclusion processes
- Review contractor relationships
- OK to rely on “the transfer pricing defense”?
- Plan prudently in light of the overall risk level of the structure

Profit Attribution to Permanent Establishments

Recent Commentary Changes

- Reconsideration of this issue began with a Discussion Draft in 2001
- A 2008 Report was issued titled “Report on the Attribution of Profits to Permanent Establishments
- The essence of this report has now come to rest in the commentary to Article 7 of the 2008 Model Treaty

Profit Attribution to Permanent Establishments

Recent Commentary Changes (cont)

- The Commentary contains a detailed two step methodology for determining the profits attributable to a permanent establishment
 - The PE is treated as a distinct and separate enterprise with relevant traits (functions, risks, etc.)
 - Arms-length pricing for the PE's dealings are determined.

Profit Attribution to Permanent Establishments

Recent Commentary Changes (cont)

- The commentary generally rejects the general force of attraction approach that some countries historically applied
- The Model treaty requires that these principles be applied by each country in order to avoid double taxation – although local book/tax differences can still cause taxable income differences
- Transfer pricing contemporaneous documentation is noted as a “useful starting point” in this determination

Profit Attribution to Permanent Establishments

Recent Commentary Changes (cont)

- The commentary related to the attribution of “free capital” drew comments from a number of countries, including the United States, Japan, and Germany – each of these countries generally did not agree with the approach and reserved the right to apply domestic law
- The United States commented that it reserves the right to tax income attributable to a permanent establishment in the United States, even if the income is deferred until a period after the permanent establishment ceases to exist

Profit Attribution to Permanent Establishments

Methodology Used

- In the first step, the permanent establishment is provided with the relevant characteristics of a distinct and separate enterprise and a determination is made as to the type of enterprise the PE may be classified as
- This step starts with a functional and factual analysis, the significant “people functions” are identified

Profit Attribution to Permanent Establishments

Methodology Used

- This step continues with the attribution of economic risks, ownership of assets, and free capital to the PE based on where functions are performed
- In general, the shifting of risks and assets to the PE may be accepted only if the relevant functions have correspondingly shifted

Profit Attribution to Permanent Establishments

Methodology Used

- Transactions with third parties are attributed to the PE where justifiable
- A determination will need to be made on a case by case basis as to whether dealings between a PE and its home office have taken place and should be recognized

Profit Attribution to Permanent Establishments

Methodology Used

- The second step involves determining arm's-length prices for the PE's activities
- A good starting point for this analysis is contemporaneous transfer pricing documentation, the same as would be done for a separate enterprise

Profit Attribution to Permanent Establishments

Methodology Used

- The new commentary does not make any changes to the treatment of royalties and management charges between the PE and the home office – none are generally allowed
- An in the past, an allocation of R&D costs and costs attributable to the management of intellectual property may be allocated between the PE and home office if appropriate

Profit Attribution to Permanent Establishments

Methodology Used

- No deduction is allowed for internal interest (i.e. between the PE and the home office) due to the assumption that the PE should have a certain level of “free capital”
- The PE may have interest attributable to third party borrowings

Profit Attribution to Permanent Establishments

Methodology Used

- In the case of an agency PE, a functional analysis is the starting point in determining the profits to be attributed to the PE – the functions of the agent will be the functions of the PE and the risks and assets related to such functions will be drawn by those functions into the PE
- The result of this approach is that the PE profits may exceed an arm's length fee paid to the agent – this is a contested area

Profit Attribution to Permanent Establishments

Methodology Used

- The commentary confirms that costs attributable to a PE should be deductible in the PE country, regardless of any domestic law specifically addressing PEs that disallows a deduction for home office expenses
- Other more generic domestic law, such as thin capitalization rules or expense disallowance rules applicable to both domestic and foreign taxpayers, is not limited by the model treaty

Profit Attribution to Permanent Establishments

FIN 48 Considerations

- Permanent establishment risk is a common FIN 48 issue
- In measuring PE risk for FIN 48 purposes, the OECD commentary needs to be considered
- Transfer pricing analysis and documentation may be required in order to properly assess the risk of profit attributable to the PE
- This may be particularly important in the case of an agency PE

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Software Distributors

- Art. 12 Commentary, para. 14.4 added in response to position that resellers of software copies exercise copyright right of distribution
 - Spain, Italy, Philippines and others took this position
- States that even if reseller exercises that right, payments for copies still business profits
- Includes digital delivery

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Software Distributors (cont)

- Also includes software “subject to minor customization for purpose of its installation”
 - Customization issue likely to be a major one in the future
- Mexico, Spain and Portugal amend their Observation
 - Adopts 14.4 only for standardized software, with no right to customize
 - Italy will address 14.4 cases in light of all facts, including “rights granted in relation to acts of distribution”

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Other Art. 12 Commentary Changes

- Various changes that narrow the scope of royalties
 - Payments for obtaining exclusive distribution rights are not royalties
 - Payments “for the use of, or the right to use” a design, model or plan are not royalties unless design etc. already in existence
 - Granting rights to reproduce plans etc. without performing additional work results in royalty
 - Payments for know-how (i.e. royalties) relate to payments for information concerning previous experience, not for new information developed at the request of the payer³⁶

Other Art. 12 Commentary Changes (cont)

- Some potentially significant new language introduced distinguishing alienations from royalties
 - Payments for “full transfer” of “an element of property” constitutes capital gain or business profits
 - Contemplates that limited period or limited geographic scope transfers could qualify

Other Art. 12 Commentary Changes (cont)

- Plenty of analytical ambiguity
 - Commentary references national IP law relevant to the property
 - Also references national law on definition of alienation (not clear whether this means IP or other law)
 - Then gives basic rule: “alienation of rights that constitute distinct and specific property” does not give rise to royalty

Other Art. 12 Commentary Changes (cont)

- This test has not been subject to public comment
- OECD receptive to further industry comments on these rules

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U.S. Treaty Update

Treaties pending exchange of instruments

Germany Protocol	<ul style="list-style-type: none"> •Signed 6-1-2006 •Entered into force 12-28-07 	<ul style="list-style-type: none"> •0% WHT on dividends •Updated LOB article •Triangular PE provision •Mandatory arbitration
Belgium Treaty	<ul style="list-style-type: none"> •Signed 11-27-2006 •Entered into force 12-28-07 	<ul style="list-style-type: none"> •0% WHT on dividends •Updated LOB article •Triangular PE provision •Mandatory arbitration
Finland Protocol	<ul style="list-style-type: none"> •Signed 5-31-2006 •Entered into force 12-28-07 	<ul style="list-style-type: none"> •0% WHT on dividends •0% WHIT on royalties •Updated LOB article •Triangular PE provision •Mandatory arbitration
Denmark Protocol	<ul style="list-style-type: none"> •Signed 5-26-2006 •Passed by Senate •Awaiting signature by President and exchange of instruments 	<ul style="list-style-type: none"> •0% WHT on dividends •Updated LOB article •Triangular PE provision

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U.S. Treaty Update

Signed and Submitted to US Senate

Iceland Treaty	•Signed 10-23-07	•5% dividend WHT tax •Updated LOB article •Triangular PE provision •Mutual Agreement Provision allows for presentation of cases to either CA
Canada	•Signed 10-23-2007	•0% WHT on interest from unrelated parties •Phases out WHT on interest from related parties •5% source country tax on dividends received by companies, including fiscally transparent •Residence article that impacts hybrid entities •Creates PE for service business after 6 months for project or connected project •Mandatory arbitration

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U.S. Treaty Update

Effective Dates of New Provisions

Germany Protocol	<ul style="list-style-type: none">•For WHT, January 1, 2007•For other taxes, January 1, 2008•Grandfather clause available to have the old treaty in effect for 12 months from the date that the protocol would have entered into force.
Belgium Convention	<ul style="list-style-type: none">•For WHT, amounts paid or credited on or after February 1, 2008•For other taxes, January 1, 2008•Grandfather clause available to have the old treaty in effect for 12 months from the date that the protocol would have entered into force.
Finland Protocol	<ul style="list-style-type: none">•For WHT, for amounts paid or credited on or after February 1, 2008•For other taxes, January 1, 2008•For zero rate on dividends effective for income derived on or after January 1, 2007
Denmark Protocol	<ul style="list-style-type: none">•For WHT, for amounts paid or credited the first day of the second month following the date the Convention enters into force•For other taxes, the year following the year in which the protocol enters into force

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U.S. Treaty Update

- Limitation on Benefits Article
- Residents of a Contracting State are entitled to the benefits of the Treaty if the resident is:
 - An individual
 - A Contracting State or political subdivision
 - An entity established for a certain purpose (religious, charitable, scientific, etc.)
 - A company if it meets one of the following:
 - Publicly Traded Test or subsidiary of publicly traded
 - Ownership/Base Erosion Test
 - Derivative Benefits Test
 - Active Trade or Business Test
 - Competent Authority Test

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U.S. Treaty Update

Limitation on Benefits Article

- Publicly Traded generally means regularly traded on stock exchange in the same economic zone
- Ownership/Base Erosion test means that the company is owned 50% or more by residents of either Contracting State and the company does not pay out more than 50% of its gross income in deductible payments to persons who are not residents of either state

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U.S. Treaty Update

Limitation on Benefits Article

- The derivative benefits provision applies when 95% of the voting power and value of shares are owned by seven or fewer persons that meet certain criteria (EU residents, resident of a party to NAFTA, etc.) and the base erosion test is met
- Active trade or business test means that there is a substantial trade or business in the resident state and the income is derived in connection with that trade or business

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U.S. Treaty Update

- Zero Percent Withholding Tax on Dividends
- The zero percent withholding tax on dividends applies when the recipient is a company that:
 - Has owned directly or indirectly 80% or more of the voting power of the distributing company for the 12 month period ending on the date entitlement to the dividends is determined, and
 - Satisfies certain provisions of the limitation on benefits article (publicly trade, ownership/base erosion/active trade or business, derivative benefits clause)

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U.S. Treaty Update

Mandatory Arbitration

- In place to increase the effectiveness of competent authority procedure, as without the arbitration provision, there may be no incentive for the competent authorities to reach agreement
- If the competent authorities cannot reach agreement, arbitration proceedings generally begin on the date two years after the commencement date of the case

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U.S. Treaty Update

Mandatory Arbitration

- Certain conditions must be met for the case to be eligible for arbitration, but these conditions are often met
- All concerned parties need to agree to the confidentiality provisions
- The arbitration is “baseball” arbitration under which each competent authority submits its proposed resolution and arbitration board chooses one or the other