

*An overview of some of the main trends
which can be identified on the topic of
permanent establishments.*

Permanent Establishments 2.0

At the heart of the matter



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Of companies surveyed...

89% **47%**

Are directing more attention to the issue of permanent establishments

Feel that Article 5 of the OECD Model Convention is no longer adapted to deal with the complexity of their business

63% **86%**

Agree that tax authorities have become more aggressive in assessing permanent establishments

Indicate that increased mobility triggers an increased permanent establishment risk



Tax authorities everywhere have developed local reflexes when it comes to establishing a company's nexus and getting their part of the 'tax cake'. This has significantly increased the risk of double taxation for MNCs.

Introduction

Companies are spending an increasing amount of time on managing the existence of – and the allocation of income to – permanent establishments. Often, several departments are involved in dealing with potential exposures or using some of the opportunities to structure their organisation more effectively. As tax authorities in a wide range of countries are taking more aggressive positions, companies face a larger number of disputes which they need to manage. The change in the way companies operate their businesses globally adds to this complexity and raises new questions, which were not necessarily anticipated when international law concepts were initially developed. Although there are some recent policy developments, it remains uncertain whether these will resolve the most pressing concerns.

PwC conducted an online global survey in the fall of 2012 with the participation of over 200 MNCs through 31 December 2012. The results of this survey are included in this report, which aims to give the reader an overview of some of the main trends which can be identified on the topic of permanent establishments.

When considering the questions for the survey, we started with the assumption of four major trends within many MNCs:

- **Simplification:** the reduction of the number of legal entities within a group of companies and the replacement of these entities by a single entity, which operates either directly or via local branches across its region. As we will see further on, this trend is picking up fairly slowly and (from our own experience) at a different pace from region to region.
- **Centralisation:** the combination of (a number of) activities within a physically centralized entrepreneur or principal entity. Compared to simplification – which relates more to the corporate structure – the centralisation trend relates to the operating model of an organisation. This has been an important development for many MNCs in recent years.
- **Virtualisation:** the moving away from physical centralisation and replacing it with a more virtual model, in an environment of matrix reporting and increased global mobility. This model is expected to increase within MNCs.
- **Digitisation:** the increased use of technology within organisations, which initially related in this context to the use of servers, but which – due to amongst others the growth of bandwidth – has moved into the context of cloud computing.

Each of these trends has a number of related opportunities or risks linked to the permanent establishment debate. These made it very relevant to perform the survey for which the results are included throughout this document.

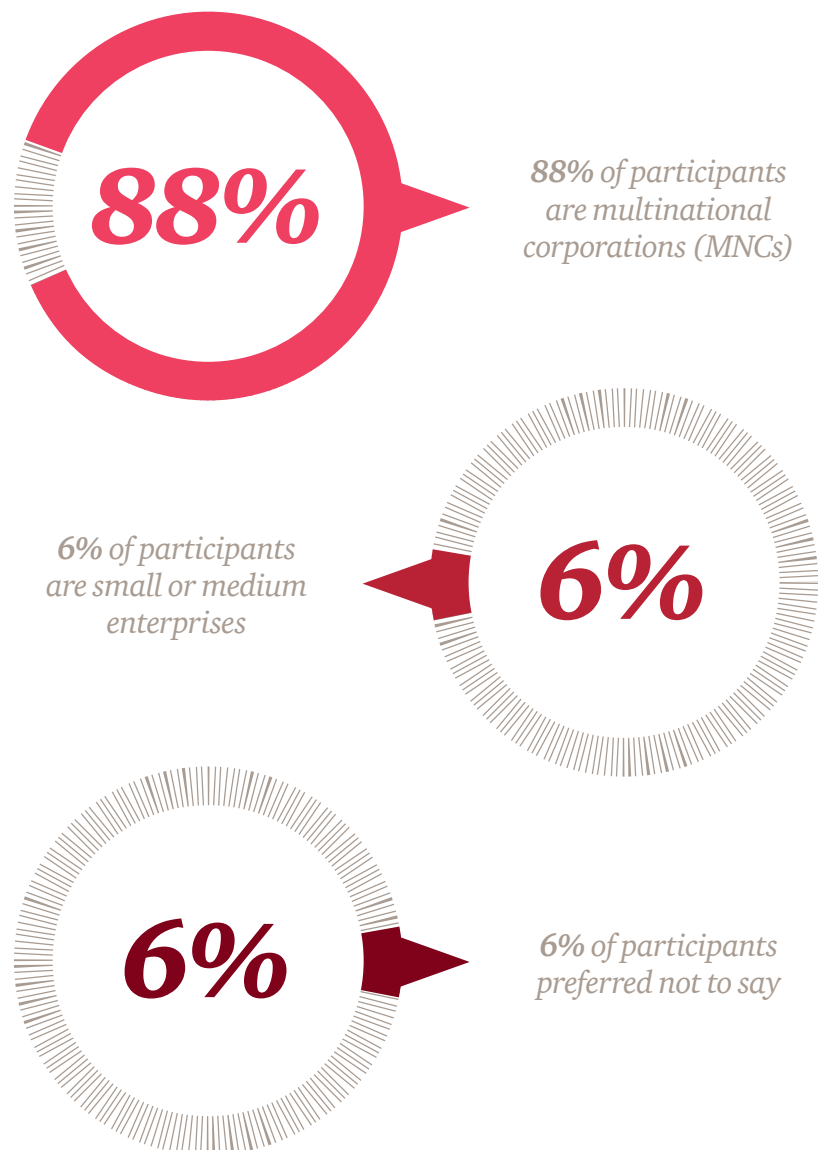
This relevance is further strengthened by the fact that permanent establishments are high on the agenda of tax authorities and government bodies around the world, which can, amongst others, be seen in various initiatives at the OECD, the UN and the EU level, as well as the increase in recent Case Law.

Methodology

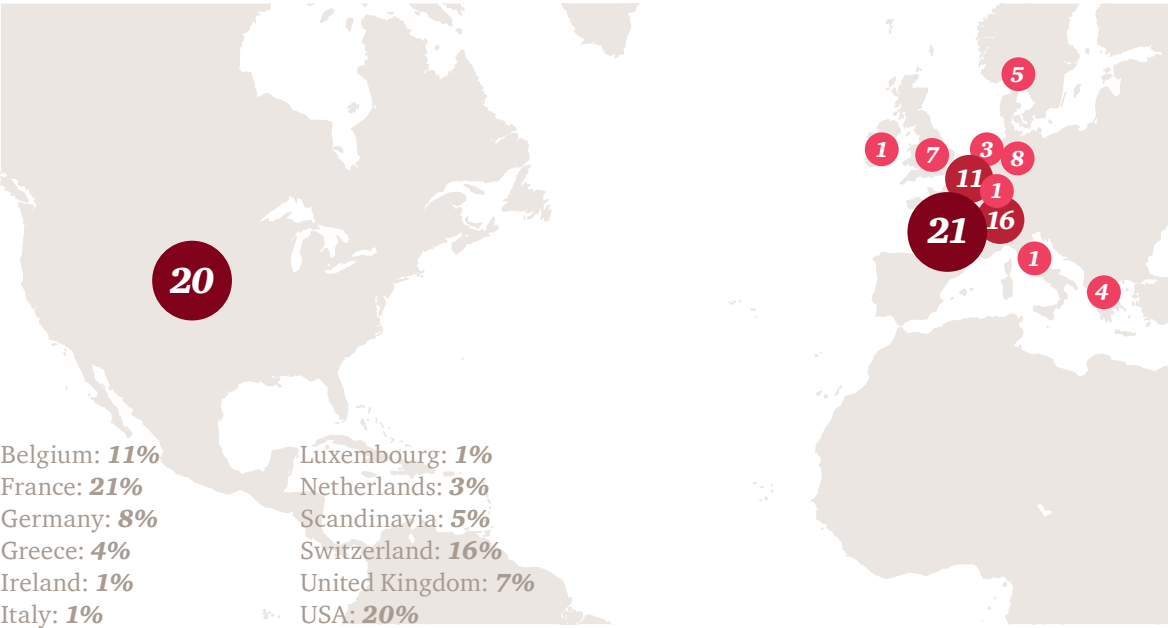
Welcome to Permanent Establishments 2.0, at the heart of the matter, which includes the findings of PwC's global informal survey of over 200 MNCs worldwide.

This report is based on detailed data gathered during a survey of over 200 companies, of which most are multinational corporations located in Europe and the United States. The participating companies operate in various and divergent industries from the automotive to real estate sectors.

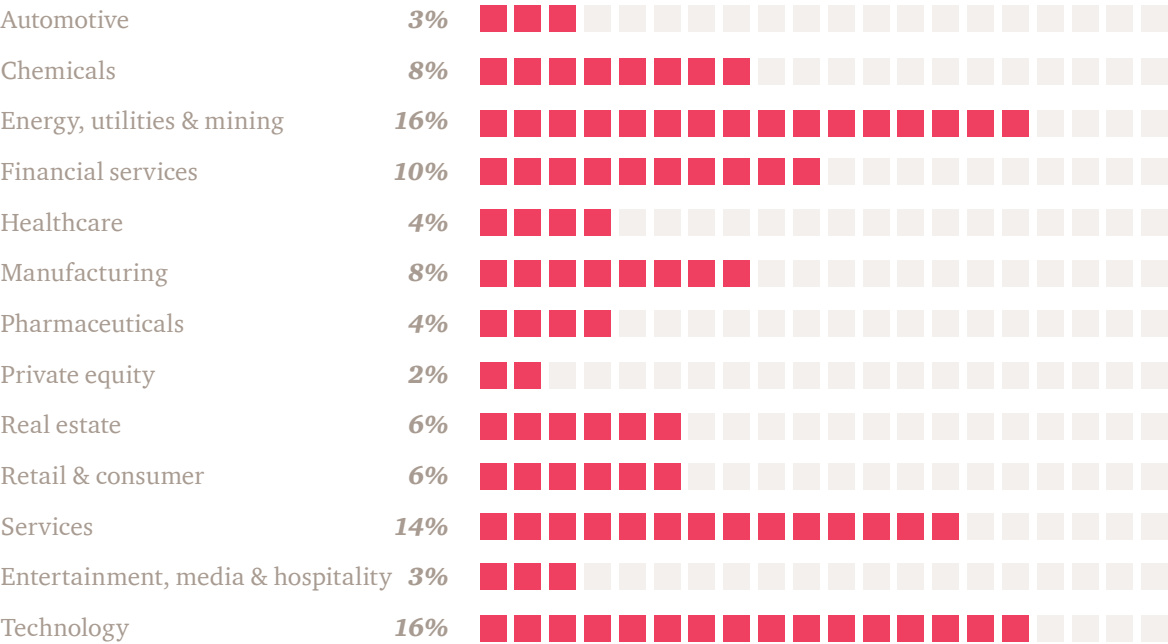
Type of participants



Location of participants¹



Sector of participants²



¹ 101 Participants preferred not to respond to this question

² 110 Participants preferred not to respond to this question

The permanent establishment risk is increased significantly by the inability of tax departments to ensure that the business side of the organisation operates in line with their guidance.

Managing the permanent establishment risk

This section deals with the awareness within company groups and how they deal with permanent establishment risk internally.

Does your group pay increased attention to the likelihood of creating a taxable presence when designing/ implementing a tax policy?

Our findings clearly show that the topic of permanent establishments is high on participants' radars, and this is fully justified. As outlined before, tax authorities everywhere are looking for additional revenue, and establishing the presence of a foreign entity in their jurisdiction can be the basis for exactly that. As we will illustrate later on, this is not a conceptual risk given the many cases under dispute either inside or outside the courts.

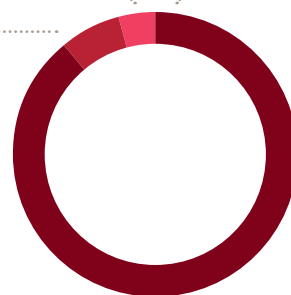
Companies therefore need to monitor the presence of potential permanent establishments actively and constantly to avoid unexpected claims. In practice, this is not always evident, as tax departments may not always be aware of how the company's business is evolving, nor whether the business teams are complying with their guidance on the matter. First question is then whether such guidance is given.

Does your group pay increased attention to the likelihood of creating a taxable presence when designing/implementing a tax policy?

Refuse/Do not know: 4%

No: 7%

Yes: 89%



Does your tax or finance department provide guidance to the operational workforce with respect to the do's and don'ts?

We noticed that most companies are guided by their tax or finance department when it comes to indicating which behaviour is or is not recommended to avoid unnecessary exposures.

This is in itself a very positive determination, as it indicates that tax or finance departments are linked in with the people in the field. This requires a mutual understanding of each others priorities, where tax is often perceived as a 'showstopper', but where companies increasingly understand that ignoring the tax side of operations may adversely impact any potential returns. Of course it then remains to be seen whether the guidance which is provided, is actually applied in practice.

Is it difficult to monitor whether other departments (e.g., sales, procurement, HR) are operating in line with your guidance on permanent establishments?

A large majority of respondents indicated to have difficulty in monitoring whether their guidance is actually implemented correctly in the field.

Here the discrepancy becomes apparent between the increased awareness within tax departments and the guidance they provide, versus their ability to keep tabs on what other departments are doing with their guidance.

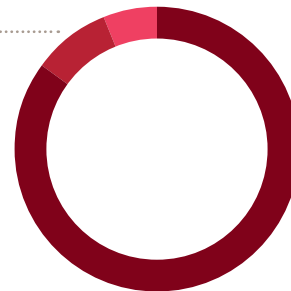
This teaches us that there is a cause for concern here, as companies are convinced they need to do more to manage the permanent establishment risk, but they equally feel that this is difficult to achieve in practice. This provides in our opinion an opportunity and a need to develop policies which can be more easily implemented and monitored.

Does your tax or finance department provide guidance to the operational workforce with respect to the do's and don'ts?

Refuse/Do not know: 6%

Yes: 85%

No: 9%

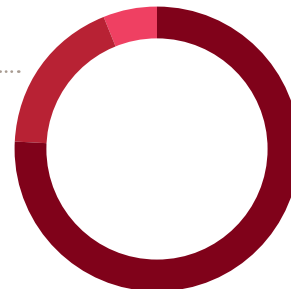


Is it difficult to monitor whether other departments (e.g., sales, procurement, HR) are operating in line with your guidance on permanent establishments?

Refuse/Do not know: 6%

Yes: 76%

No: 18%



The tax authorities' behaviour

This section deals with the level of audit activity on permanent establishments, the more aggressive nature of such tax audits and the differences among regions.

Is your group currently subject to one or more ongoing tax audits where the existence of a permanent establishment is implied?

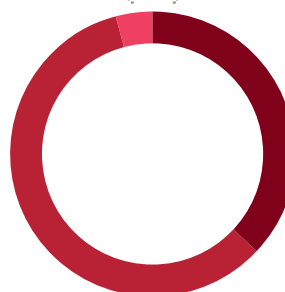
More than one third of respondents is in fact currently subject to one or more tax audits involving discussions regarding permanent establishments.

Is your group currently subject to one or more ongoing tax audits where the existence of a permanent establishment is implied?

Refuse/Do not know: 4%

Yes: 37%

No: 59%



This information confirms that tax authorities take a more keen interest in foreign companies operating in their jurisdictions and see the assessment of a local permanent establishment as a soft target to increase their revenues. This is part of a wider trend where the volume of tax audits and disputes is rising worldwide, creating an uncertain landscape for taxpayers with a significant risk on double taxation. References in this report are made to high profile cases such as Roche Vitamins [Spain] and Dell [Spain].



The majority of participants feel that tax authorities have indeed become more aggressive in assessing the presence of a permanent establishment, with only a small number actually disagreeing.

Taking the increased audit activity into account, we strongly advise companies to assess and document their permanent establishment exposures and be well-prepared for their defence in case an audit takes place. An independent audit readiness check can be a very useful tool in this respect.

Have tax authorities become significantly more aggressive in assessing the presence of a permanent establishment?

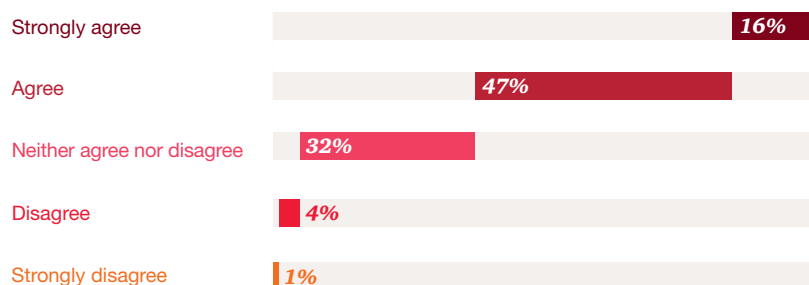
The majority of participants feel that tax authorities have indeed become more aggressive in assessing the presence of a permanent establishment, with only a small number actually disagreeing.

Aggressive audit enforcement activities and tactics are accelerating worldwide. As an example, in the US the IRS is engaging in intensive factual investigations, foreign site visits and extensive interviews of company personnel in the US and abroad. Nevertheless, as we will illustrate below, most of the challenges seem to occur in Europe.

This increased aggressiveness is also evidenced by the combination of tax inspectors and law enforcement officers to perform on-site visits (see also separate insert on France). In this respect, the use of criminal enforcement sanctions is used more and more as an effective leverage to achieve the intended results.

Furthermore, collaboration between revenue authorities has evolved into more sophisticated methods and strategies. One of the recent emerging trends is the pursuit of joint audits which involves full scale coordination between two or more countries. Joint audits represent a new era of coordinated action.

Have tax authorities become significantly more aggressive in assessing the presence of a permanent establishment?



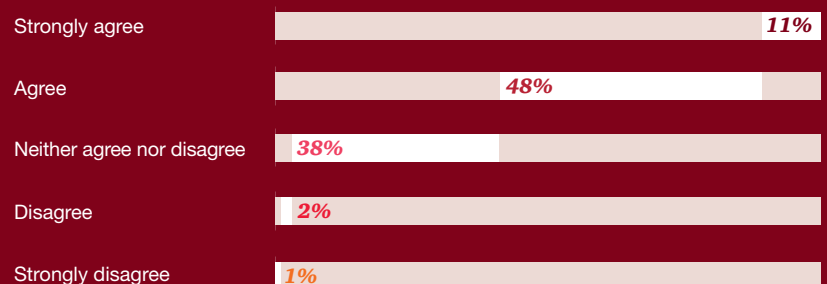
France

Microsoft was visited by the French tax authorities for what they referred to as a routine inspection. The inspection involved 67 tax inspectors and 30 police officers and lasted from dawn to well into the night. The investigation was triggered when French tax inspectors discovered invoices from Irish and US subsidiaries of Microsoft for advertising and commercial services allegedly performed in France by employees of the French subsidiary during a tax audit of another company. Microsoft is not the only IT giant to face such allegations in France, Google France was also visited by the French tax authorities.



More than half of the respondents agree that there is a high risk of contagion from the recent permanent establishment cases to other countries.

Milestone court cases such as Zimmer [France], Dell [Norway], Dell [Spain] and Roche Vitamins [Spain] have increased other countries' tax authorities' appetite to raise permanent establishment challenges.



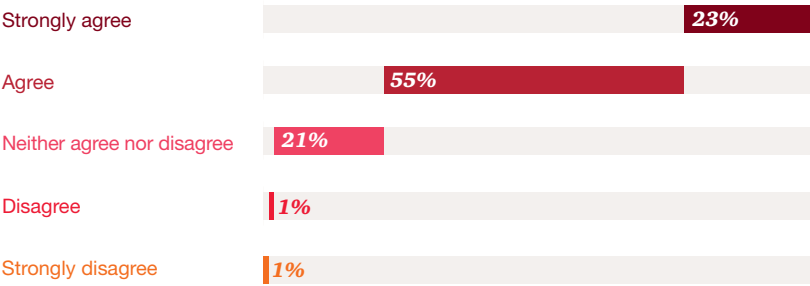
There is a clear difference in the attitude of tax authorities across countries and regions.

In most companies’ views, there is a significant difference in the attitude of tax authorities across countries and regions.

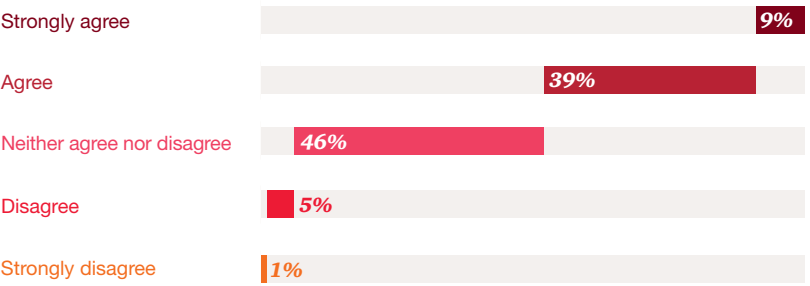
This is confirmed both by what we see in our practice and what stems from (recent) case law involving permanent establishments. There it becomes clear that there are audits in the US (see above) but little or no cases seem to occur, for example in Asia (although this is increasing). Most of the disputes to date occur around Europe, with the larger number occurring in Southern Europe.

Examples of these cases include Philip Morris in Italy (2002), Zimmer in France (2010), Dell in Norway (2011), Boston Scientific in Italy (2012), Roche Vitamins in Spain (2012) and again Dell in Spain (2012). In many of these cases, tax authorities felt that a centralised principal model still triggered a (more important) taxable presence in their jurisdiction as they argued that some of the relevant functions were performed there. This illustrates that providing appropriate substance can help companies to avoid (or win) permanent establishment disputes.

There is a clear difference in the attitude of tax authorities across countries and regions.



Tax authorities tend to focus more on the existence of a permanent establishment in case they feel the transfer pricing model cannot be challenged.



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Almost 50% of respondents feel that – regardless of the arm’s length nature of intra-group transactions – tax authorities still go after the potential existence of a permanent establishment in their jurisdiction.

This point is again confirmed by the case law we referred to above. In many (if not all) of these cases, the arm’s length remuneration of the local entity was not under discussion, but the foreign principal was still deemed to have a permanent establishment there.

The changing business environment

In this section we deal with a number of topics which relate to how changes in the way companies operate influences their exposure to permanent establishments.

Corporate simplification

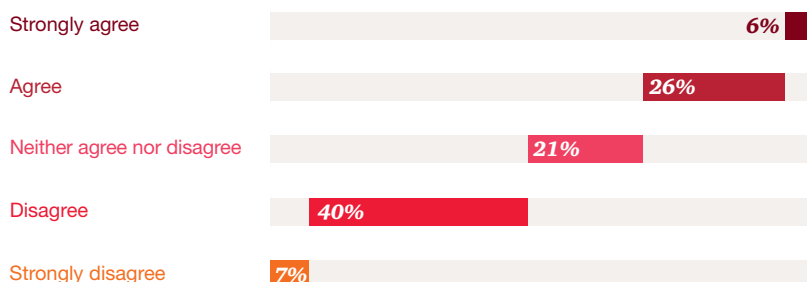
Your group is increasingly looking for corporate simplification and considers the use of permanent establishments as the better alternative.

Only 32% of respondents are currently looking further into corporate simplification.

‘Simplification’ refers here to the subject of corporate structures and how they are evolving. Many MNCs have ‘org charts’ with hundreds of legal entities, which can be an expensive way of doing business and which may, for example, complicate the flow of dividends around the group. On the other hand, there may be benefits such as the limitation of certain liabilities.

In this respect, the outcome may be influenced by regional differences, as we see companies revisiting especially their European organisation. Of course there is a framework for cross-border mergers within the EU, which facilitates this process. Still that requires companies to operate a branch model which may provide both opportunities and challenges, for example in the transfer pricing field, where some differences may occur in terms of the profit allocation between legal entities versus permanent establishments.

Your group is increasingly looking for corporate simplification and considers the use of permanent establishments as the better alternative.

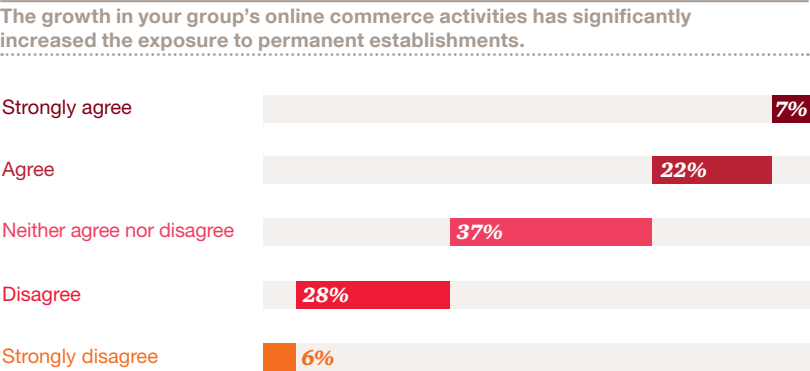


E-commerce

The growth in your group’s online commerce activities has significantly increased the exposure to permanent establishments.

Merely 29% of the companies under review recognize that online commerce activities increase the permanent establishment risk.

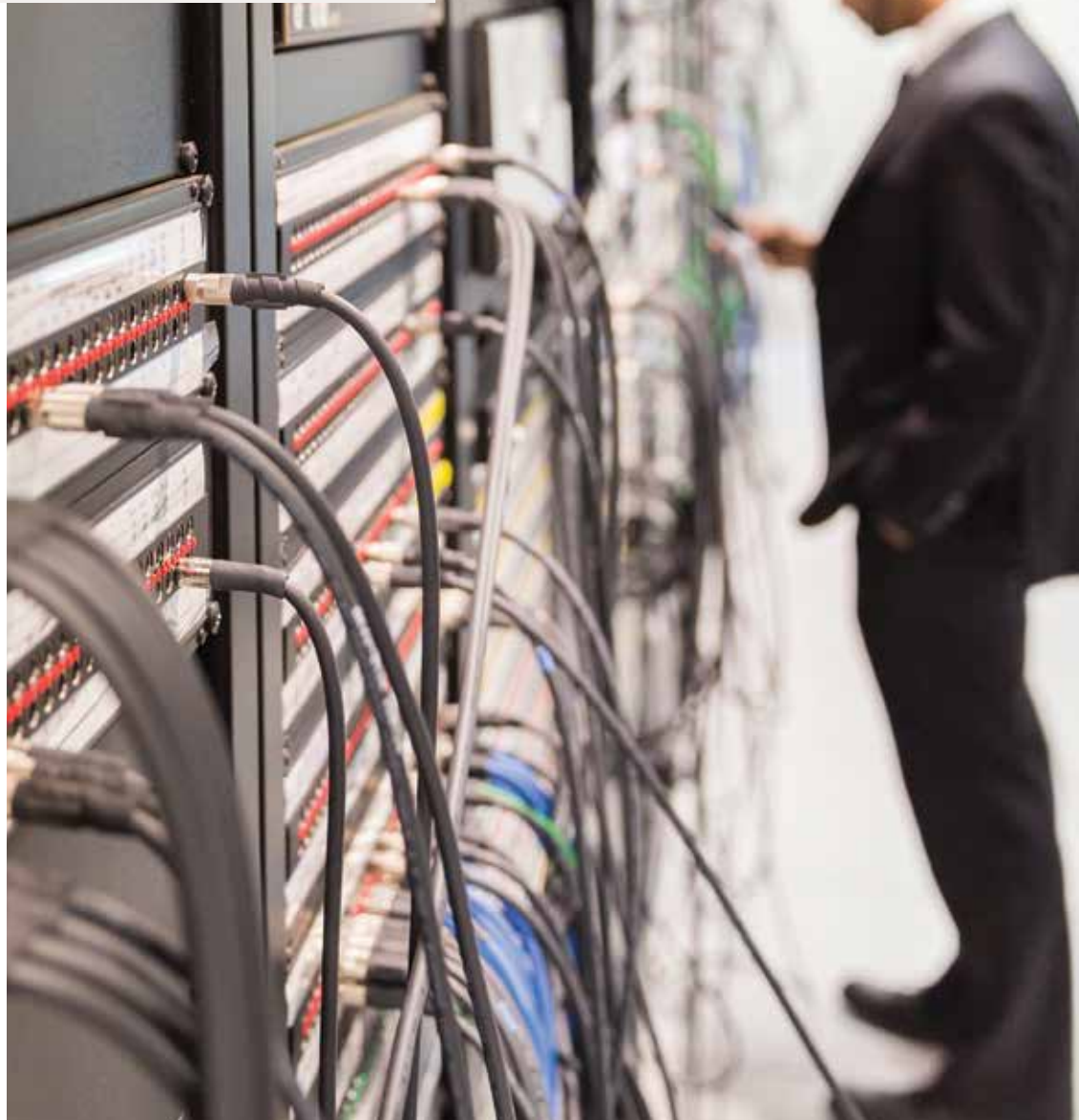
The link between ‘digitisation’ and permanent establishments has been around for over a decade, since the rise of the internet. Initially this was mainly a discussion on the server permanent establishments (so hardware driven presence), although even then some countries (such as Spain) felt that local websites (so software driven presence) could also trigger a taxable presence. More recently, this discussion has become somewhat more sophisticated with the development of cloud computing (and high speed broadband). This is especially the case as broadband now allows for the hardware (servers) to be further away from the customer (i.e. not in the same jurisdiction). These developments have sparked the discussion again on how tax authorities can access (part of) the on-line sales income generated in their territory, even without the presence of any servers.



Rapidly moving towards the introduction of the virtual permanent establishment concept?

The 2012 Spanish Dell case introduced the “online permanent establishment” concept for the first time. In line with Spain’s previous position on software driven permanent establishments, the Spanish Court ruled that an online store could qualify as an online permanent establishment, even through the server was situated outside Spain and no activity was performed through human means or assets located in Spain.

The French government announced that it will be pushing digital economy related measures, such as a virtual permanent establishment in the OECD Model Tax Convention, during the upcoming G20, at the European Union level, and the OECD meetings. These charges are targeting IT giants like Google, Amazon and Facebook. The head of the OECD’s Center for Tax Policy and Administration indicated that the French proposal links in with the work that the Committee on Fiscal Affairs is doing on base erosion and profit shifting.



“At the level of the states, there seems to be agreement that the world has changed and that international tax rules will need to be adapted. There is clearly a reflection as to whether the existing rules are appropriate or not, for the digital economy in particular, but not limited to the digital economy”

Pascal Saint-Amans

Head of the OECD’s Center for Tax Policy and Administration.

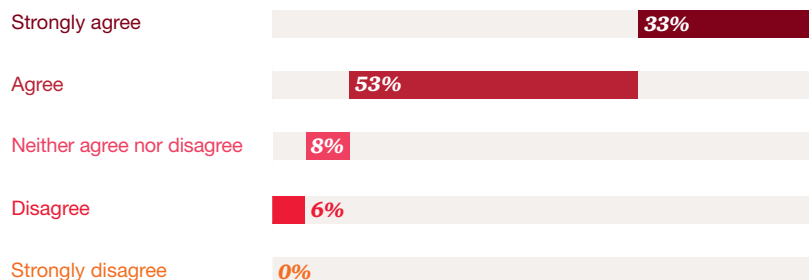
Increased global mobility

The increased mobility of people within your group implies that there is a bigger risk of permanent establishments being created

A resounding 86% of the respondents agree that this new business reality creates a bigger permanent establishment exposure.

Companies have been deploying their people across borders for decades, so in itself this is nothing new. In addition they have centralised (part of) their operations in recent years in so-called principal models, which equally caused an important movement of people (at the very least to provide for the appropriate substance). A more recent trend is that of virtualisation, where MNCs are gradually moving away from physical centralisation and tend to do this within a more virtual model, with people being scattered around and thus potentially creating taxable nexus. In addition, the increased importance of “people functions” makes it very relevant for MNCs to monitor where people are deployed and what their roles are. As mentioned before, companies often face difficulties running this monitoring function well, so more work is likely to be required here.

The increased mobility of people within your group implies that there is a bigger risk of permanent establishments being created.





Almost 69% of the respondents agree that new business realities create a bigger permanent establishment exposure.

Matrix structures

From a theoretical perspective, the existence of one or multiple permanent establishments is unavoidable as groups diversify (control over) entrepreneurial risk over various affiliates as a matter of principle, rather than having it centralised in one parent, HQ, or principal.

Almost 70% of the respondents agree that new business realities create a bigger permanent establishment exposure.

This item closely links in with the previous one on global mobility, as this mobility combined with modern technology are putting a strain on traditional tax principles. With the advent of technology, businesses are starting to take advantage of such “virtual opportunities” or the removal of barriers caused by “physical locations” to run their businesses or make decisions more effectively. This often directly conflicts with traditional tax principles and therefore confuses tax authorities. Newer notions, such as “significant people functions” (discussed in the context of profit attribution to permanent establishments) and “control over risks/ functions” (discussed as part of the OECD Transfer Pricing Guidelines) imply that value may be created everywhere people are deployed.

As a result, the presence of virtual or matrix teams will certainly increase one’s “place of management” permanent establishment exposure. Once more, MNCs should consider strengthening or building good internal governance models to set clear expectations on their staff for a defensible model in this respect. This of course, needs to be balanced with the materiality of such decisions.

Principal models

Recent business conversions (principal model) have increased your group's exposure to the creation of permanent establishments.

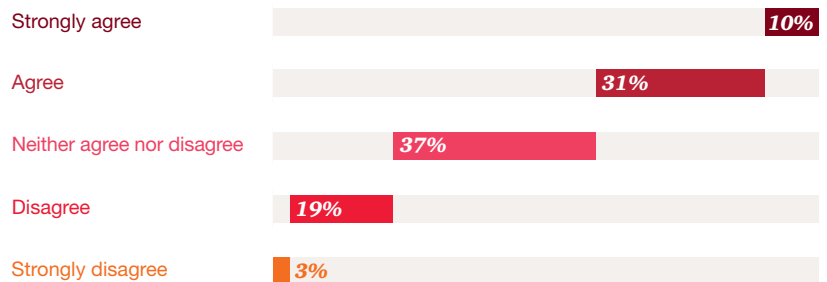
Just over 40% of the respondents believe that centralised models represent an increased permanent establishment risk.

This is a fairly low number, especially considering that most of the recent permanent establishment case law we referred to earlier involves centralised business models. Fact of the matter is that a number of permanent establishment risks are commonly associated with the principal model:

- At the level of the dependent agent permanent establishment, agents or commissionaires have traditionally been a target of permanent establishment challenges. As discussed later on, the introduction of the term “economically bound” by the Dell Norway case has certainly added new dimensions in this respect.
- A more acute area of attention is the increased attention to the fixed place of business permanent establishment:
 - “Full cycle of activity” – The Roche case has reopened the Pandora’s Box on what it means to be operationally connected or integrated. When does one enter into a full cycle of business? How does one interpret “preparatory and auxiliary” in the connection of maintenance of a stock of goods, delivery and maintenance or combinations thereof?
 - “Services” permanent establishment: Further, the differences between the OECD and UN Model Treaties, in particular on the provision of services will continue to be difficult points.
 - “Place of management” permanent establishment to which we referred above.

A key take-away is the increasing need for MNCs to ensure a consistent and reasonable approach when dealing with their tax control functions. Key points of attention will need to involve understanding where (and what) key decisions are made, where key management are located and where contracts are signed and negotiated. These will be key to defending one’s business and tax models upon audit.

Recent business conversions (principal model) have increased your group's exposure to the creation of permanent establishments.



Recent policy developments

This section deals with recent developments at the OECD and UN level and whether these will resolve the uncertainty companies are facing in the area of permanent establishments.

Is the guidance on permanent establishment up-to-date?

Article 5 of the OECD model tax treaty is no longer adapted to deal with the complexities of your business.

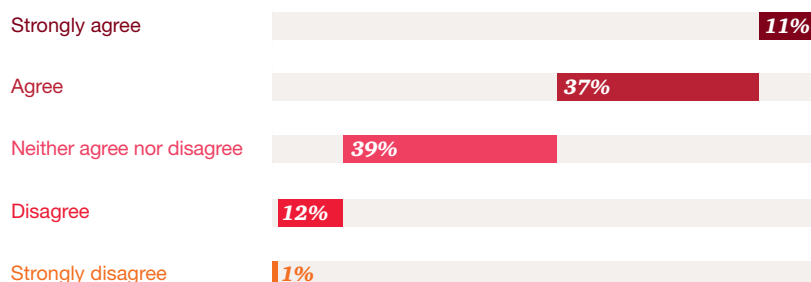
48% of the respondents feel that the current rules no longer reflect international trade and business realities or developments.

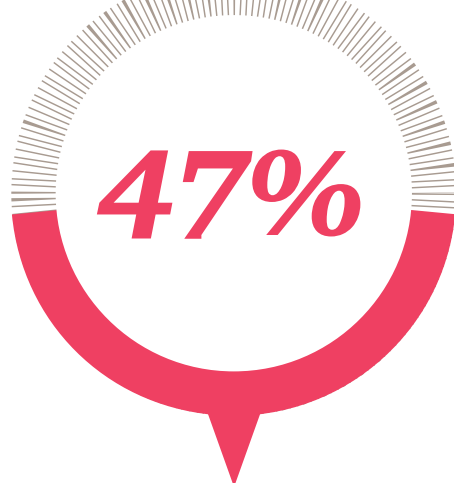
The OECD has well understood that the way in which MNCs operate has changed over time in such a way, that at least the Commentaries on Article 5 needed to be updated.

In the course of 2011 the OECD published a public discussion draft entitled 'Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention'. The discussion draft addresses 25 specific items on the basis of which amendments to the Commentaries are

proposed. Although some of these items, such as the question of whether a farm can be a permanent establishment, will be of limited importance to most MNCs, there are others which could have a significant impact on the way in which the presence of a permanent establishment is determined. The most important points of the discussion draft relate to amongst others the meaning of 'to conclude contracts in the name of the enterprise' and the questions whether it is sufficient that the company is 'economically bound' by a contract to create a permanent establishment, the 'at the disposal of' test and 'time requirements for the existence of a permanent establishment'.

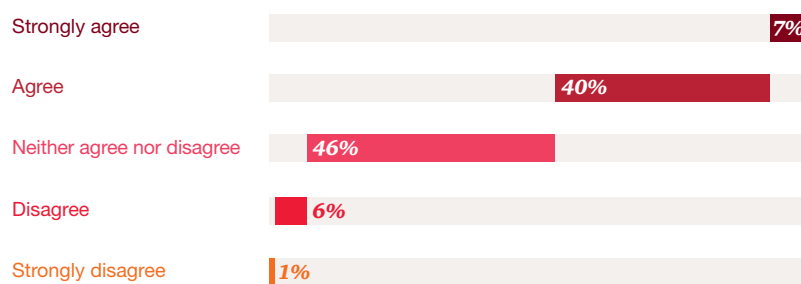
Article 5 of the OECD model tax treaty is no longer adapted to deal with the complexities of your business.





47% of the respondents are pessimistic that the current policy developments will address the concerns of MNCs on permanent establishments.

The OECD proposed commentaries on Article 5 will not resolve the current uncertainty on permanent establishments.



Do the new policy developments alleviate current uncertainty?

The OECD proposed commentaries on Article 5 will not resolve the current uncertainty on permanent establishments.

47% of the respondents are pessimistic that the current policy developments will address the concerns of MNCs on permanent establishments.

From the comments which were provided by the business community to the initial draft Commentaries on Article 5 issued by the OECD, it was quite clear that the proposals were not seen as addressing all (or even most) of the concerns.

Indeed, in line with the responses the OECD received from many business commentators (including PwC) the view is that a number of the proposed commentaries may lead to new uncertainties instead of resolving them. There are concerns regarding the meaning of the phrase 'to conclude contracts in the name of the enterprise', especially with respect to the introduction of the term 'economically bound'. The general feeling is that a lot of questions and concerns remain unanswered and untouched. The final proposal is expected to be implemented in the next update of the OECD Commentary in 2014.



Less than 30% of the companies surveyed agree with the growing relevance of the UN Model

UN Model Tax Treaty

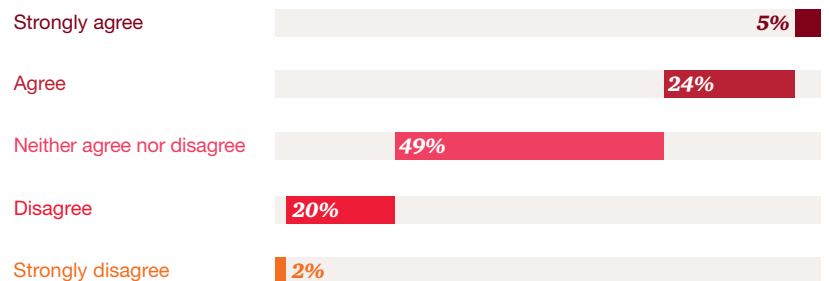
Within your group, the UN Model Tax Treaty is increasingly relevant.

Less than 30% of the companies surveyed agree with the growing relevance of the UN Model, while 49% neither agrees nor disagrees.

Nevertheless, the importance of the UN Model is increasing rapidly, especially where the BRICs countries are concerned and more in general with the developing countries which are non OECD members.

Article 5 and its Commentaries on the UN Model, deviates in a number of areas from the OECD Model wording, which stems from the fact that the OECD model is often perceived to benefit developed countries (privileging the residence state), where the UN Model is intended to benefit developing countries (privileging the source state). The barrier for creating a permanent establishment under the UN Model is thus logically lower than under the OECD Model. Examples of differences include the Service permanent establishment, the dependent agent permanent establishment, the treatment of delivery, etc.

Within your group, the UN Model Tax Treaty is increasingly relevant.



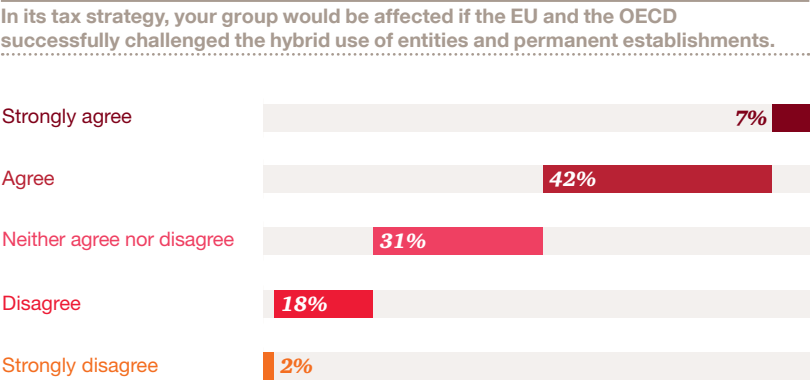
Hybrid use of entities and permanent establishments

In its tax strategy, would your group be affected if the EU and the OECD successfully challenged the hybrid use of entities and permanent establishments?

50% of the companies under review agree that they would be affected if hybrid entities and permanent establishments were successfully challenged.

This response seems to illustrate that MNCs are concerned by the OECD’s and especially the EU’s efforts to revisit the treatment of hybrid entities.

Both the EU Consultation Paper on Double Non-Taxation and the OECD Report on Hybrid Mismatch Arrangements, which were released early 2012, focus on a number of hybrid mismatches which, according to the respective bodies, should be eliminated because they create significant policy questions. Also the OECD report on Base Erosion and Profit Shifting released in 2013 focuses on hybrid mismatches and the fact that these should be eliminated. Some of the mismatches mentioned relate to entities or financial instruments, where others relate to the application of double tax treaties leading to double non-taxation, including an example where the residence state recognises (and exempts income from) a permanent establishment in the source state, whereas the latter does not recognise a permanent establishment, giving rise to double non-taxation. How these initiatives will be taken forward remains to be seen, but in the short term the suggested OECD approach of applying local general anti-avoidance rules seems more feasible than the EU view of amending the rules in the EU Member States to prevent hybrid positions from continuing to occur.



Dealing with the challenges

This section summarises the main challenges for MNCs in the field of permanent establishments and some of our recommendations in this respect

The purpose of this survey was to illustrate that, although the permanent establishment concept is a quite old one, it still is an important one and it has recently regained increased attention from tax authorities and policymakers across the globe.

MNCs seem to understand that this is and will remain an important topic in the context of their global tax policies. They actively provide guidance to their staff in the field, but struggle with monitoring how this guidance is applied in practice. This leaves a potential risk for these organisations which can best be addressed with clear governance rules and regular spot checks.

In their ever increasing search for revenue, tax authorities have clearly become more aggressive when it comes to assessing the existence of a permanent establishment in their territories, especially around Europe. Even if companies apply arm's length pricing in their dealings with group entities, this does not seem to eliminate the exposure from discussions with the local tax authorities as can be seen from quite some cases recently decided in the courts. Companies are advised to be well-prepared and to perform audit readiness checks, preferably on a country-by-country basis given the variance in approaches taken by different local tax authorities.

Considering the various business trends, there is a clear difference in what respondents deem to be important today. We were surprised that only one third of groups surveyed are looking at simplification, considering we expected that the current economic environment would push MNCs to reduce the number of legal entities in their structure, relying more on a regional presence (with or without local branches).

Also the increased role of e-commerce does not seem to concern the majority of respondents. Although this debate is widening beyond the traditional server permanent establishment concept, trends such as cloud computing and the aim of some countries to be able to tax e-commerce revenue in their jurisdiction via a so-called “virtual permanent establishment” may make this issue more relevant for MNCs going forward. More general virtualisation seems to be well-understood as an area of attention where permanent establishment exposure is concerned. Both for increased global mobility and matrix organisational models, respondents indicated a high awareness. This is less so for principal models, where there seems to be a lower concern, although most of the recent case law relates to challenges in this area. Overall, we would advise groups to pay close attention to the tax side of their changing business models, which will provide both opportunities and certain exposures that need to be managed actively.

This is - and will remain - an important topic for MNC's in the context of their global tax policies.

Finally, there are the recent policy developments at the level of the OECD, the UN and the EU (in addition to local initiatives). The OECD seems to appreciate that the traditional permanent establishment concept no longer corresponds with today's business needs. The question is whether amending the Commentaries will be sufficient or whether more fundamental changes to the wording of Article 5 will be required. What is certain, is that the OECD is no longer the only spider in this web, with the increased importance of the UN and the developing countries it represents. This will surely lead to interesting developments and it remains to be seen how the EU will be able to play a role of significance here. What is a cause for concern is that decades of efforts at the international stage to align tax systems and avoid double taxation, are more than ever at risk due to local tax authorities' initiatives in their quest for more tax revenue to balance their individual territories' books.

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