Permanent Establishment

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Permanent Establishment

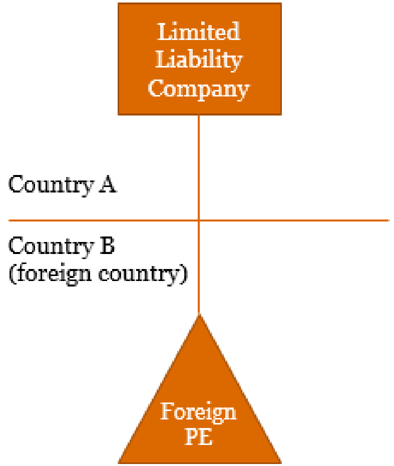
Agenda

- Introduction to Permanent Establishment (PE)
- PE and the tax treaties
- Authorized OECD approach (“AOA”)
    - Applying AOA to PEs of banks (capital allocation)
    - Applying AOA to PEs of insurance companies (allocation of investment income)
- Experiences and observations: Denmark, Finland, Norway, Sweden

Introduction to Permanent Establishment (PE)

A PE is the part of a company's foreign activity that can be taxed in that foreign country.

- OECD'S Model Treaty Convention Art. 5 and 7



PE criteria (article 5):

1. Fixed place of business
2. Dependent Agent

Tax implications of PE:

- Attribution of profits to PE to determine taxable income in home and host country
- Transfer pricing / arm's length profits of PE (article 7)
- Attribution of capital (interest expenses, investment income, etc.)

PE and the tax treaties

Allocation of taxable profits to PE is determined according to article 7 of the OECD model tax treaty.

- ***"functionally separate entity" approach***

In 2008, OECD published a "REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS"

> *"Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. [...] The focus was on formulating the most preferable approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade." (OECD 2008 report).*

The purposes of the report was to provide further guidance regarding allocation of profits to PEs via the use of the Authorized OECD Approach ("AOA").

Report updated in 2010 to reflect changes in the 2010 model tax convention with regards to PE income.

The Nordic tax treaty is build on the 2008 model tax convention – and consequently the 2008 report should be referred to for interpretation of the treaty with regards to allocation of profits.

On 22 June 2017, OECD released a final discussion drafts on the additional guidance on the attribution of profits to permanent establishments (***BEPS Action 7***). The draft provides additional guidance on the attribution of profits to permanent establishments (PEs) arising from Article 5(5) including dependent agent structures and with respect to PEs arising from the changes in Article 5(4) .The additional guidance provided in BEPS particularly concerns PE's outside the financial sector

Authorized OECD approach ("AOA")

AOA is a supplement to the "functionally separate entity" approach as referred in Article 7.

The AOA is not universally used by all countries.

The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities.

This analysis involves the following two steps:

1) Functional and factual analysis

- Identification of obligations, rights, significant people functions (and KERTs) and attribution of capital based on assets and risks
- The functional and factual analysis performed in the first step must identify the economically significant activities and responsibilities undertaken by the PE

2) Determining profits through the pricing on an arm's length basis of recognized dealings between head office and PE.

For banks and insurance companies, the allocation of assets/capital between the head office and the PE is particularly relevant for determining the taxable profits of PEs in accordance with article 7.

Applying AOA to PEs of banks

Allocation of income and expenses based on functions and risk of the PE.

> *"The key entrepreneurial risk-taking functions are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of individual risks and portfolios of risks. For a bank, the creation of a financial asset and its subsequent management are likely to be* ***the key entrepreneurial risk-taking functions*** *and so…economic ownership of the financial asset (and the income and expense associated with holding that asset, lending it out, or selling it to third parties) is generally attributed to the location performing those functions."*

Capital allocation / Interest expenses

Under the AOA, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes.

- Stage 1: measuring the risks attributed to the PE
- Stage 2: determining the "free" capital (several approaches), e.g.
  - capital allocation approaches (same debt/equity structure within all "parts" of the entity)
  - thin capitalisation approaches (free capital as if independent entity – comparability may be an issue to consider)
  - safe harbour approach (free capital according to minimum capital requirements in host country)

An appropriate adjustment may need to be made to the amount of interest expense claimed by the PE in order to reflect the amount of the bank's capital that is actually needed to support the lending activities of the PE.

"Interest rate" on debt to be adjusted/allocated can cause issues (e.g. subordinated high rate debt)

Applying AOA to PEs of insurance companies

Two important sources of income for insurers are **(1) underwriting income** and **(2) investment income.**

KERT-functions of insurance business is those activities that constitute the most important active decision-making functions relevant to the assumption of insurance risk. As a general matter, the relevant activities are those, typically falling within the category of ***underwriting activities***. However, other functions (e.g. product development, sales and marketing, and risk management) may themselves represent active decision-making functions relevant to the assumption of insurance risk.

Allocation of assets / Allocation of investment income

The insurance risk can only be assumed if reserves are established to meet the potential claims and there is surplus available to provide a cushion in the event that reserves are insufficient to meet claims. Thus, an insurance enterprise must have sufficient assets to cover both its reserves and surplus requirements. There are generally two authorised approaches to allocating total investment assets:

- **Capital allocation approach**, under which it is intended only to attribute a total amount of investment assets to the PE based on the risk it has assumed, not to identify specific assets to be so attributed.
- **Thin capitalisation approach**, in which it would attribute investment assets to an insurance PE by reference to the amount of investment assets of an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions.

Various ways to determine investment yield on allocated investment assets/the potential adjustment of income – also depending on whether or not investment assets can be identified.

No special guidelines for allocation of interest expenses due to relatively less importance-> “normal” allocation principle apply.

Experiences and observations: Finland

General observation:

- So far very limited taxation practice / case law regarding capital allocation or allocation of profits to PEs.
- Tax authorities are expected to pay more attention on the allocation going forward.
- New guidance issued by the Finnish tax authorities in June 2017 regarding income allocation to PEs.
  - The guidance confirms that OECD Guidance and BEBS Actions 8-10 Final Reports may be used as a tool to guide interpretation of the arm's length principle.
  - However, the guidance does not deal with specifics of PEs in the financial services or insurance industries.

Case law:

- The Finnish tax authorities have tried to challenge the capital allocation of Finnish branches of foreign banks by claiming that the equity of the branches was not in line with the solvency requirements applicable for credit institutions.
- Recent Finnish Supreme Administrative Court decision on allocation of shares in Finnish company (and related acquisition debt) into a Finnish branch of a Swedish company (SAC 2016:72).

Experiences and observations: Norway

Status and tendencies:

- The Norwegian tax authorities are increasingly aggressive in protecting the tax base by focusing on PEs, allocation of income and TP
  - The «lost» Herkules case from the Supreme Court
  - An attempt for «extra time in soccer»? http://blogg.pwc.no/skattebloggen/skattemyndighetene-utfordrer-pe-bransjen-igjen

Observations in the FS space

- Norwegian branches of foreign non-life insurers
  - A specific allocation rule in the Tax Act section 8-5, 4th paragraph allowing a foreing branch of a non-life insurance company to allocate income to the branch different from AOA (see prev. slides):
    - 3% of gross premium income plus the excess of net value of real estate and ten times the premium income
    - The tax authorities' view is that it is a taxable transaction to enter into the specific regime, which can be challenged
- Credit deduction at the main office in Norway for interest paid by foreign branches. The secondary act (§16-29-4provides a rule that in some cases do not allow full deduction and accordingly double taxation
  - This may be challenged based on the EEA treaty as a unjustified discrimination

Experiences and observations: Sweden

General observation:

- So far very limited taxation practice / case law regarding capital allocation or allocation of profits to PEs.
- Generally, AOA approach should be accepted by tax authorities.

Experiences and observations: Denmark

General observation:

- So far very limited taxation practice / case law regarding capital allocation or allocation of profits to PEs, but cases are pending
- Tax authorities are expected to pay more attention on the allocation going forward.
- Currently a tendency towards lowering the threshold for creating a PE in Denmark

Audit of insurance companies

- In 2014 Danish tax authorities carried out audits of the 34 Danish branches of foreign insurance companies.
- Audits was initiated following a change from indirect to direct allocation method in Danish law from 2010.
- Primary focus of audits was allocation of investment assets/income to the branches
- Article published in leading Danish tax journal (authored by the tax authorties)
- Article confirms that Danish tax authorities generally follows the AOA and the PE report.

Experiences and observations

General observation:

- Risk of no uniform approach to capital allocation / allocation of investment income **->** Disagreements on allocation of taxable profits
- Limited case law and not much guidance in OECD commentary and reports
- High risk of double taxation due to different local interpretation, principles, etc.