AccountsCo

Will my business be taxed in the UK or abroad?

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About AccountsCo

AccountsCo is an award winning UK Chartered Accounting and Chartered Tax Advisory firm that specialises in helping non-UK nationals establish and grow businesses in the UK.

> AccountsCo - “Best UK Advisor to European Start Ups” - *Wealth & Finance International Magazine*

> AccountsCo - “Leading Advisory for Non-UK Businesses” – *Acquisition International*

The majority of AccountsCo’s professional staff are bilingual and the firm has particular expertise in the UK, Italy and France. Purpose of note

Purpose of note

Many overseas people that set up a UK company believe that it will automatically pay tax in the UK, but this is not always the case. This briefing note is about where your business will be taxed. It is an abbreviated extract from a book written by Simon Edrich “Doing Business in Great Britain” which is due to be published shortly. If you would like to order a copy please send an e-mail to info@accountsco.com.

Contents

Note summary

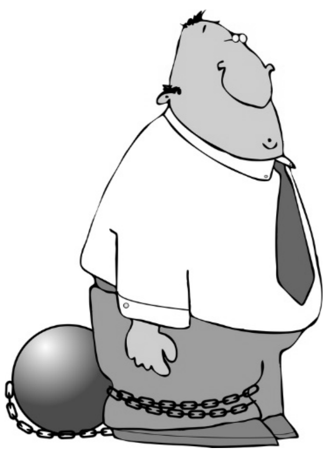
Introduction

This topic is key to understanding international tax. It's so important that it's normally one of the first things that I discuss with my clients - often even before they become clients. So, if you're considering setting up in the UK, then it's probably important for you.

The tax residency rules determine your businesses 'home' for tax

In fact, it's such an important consideration that it will often influence your other decisions, like what sort of business you set up and how you will manage it. For this reason, you really need to understand these concepts before you set your business up.

Corporate tax residency



Corporate tax residency determines which country is your businesses 'home' for tax i.e., which country it will have its primary tax responsibility in. Since different countries have different tax rates your businesses' tax residency will set how much tax it will pay.

There's another point that makes understanding tax residency important. Tax residency is an ethical, topical and emotional subject and there's a strong feeling amongst the public that businesses often stretch the rules. When this happens, there's a direct impact on a country's tax revenues. So, not surprisingly, enforcement agencies focus heavily on this area. Because of the ethical considerations and the public interest, the reputational and financial penalties associated with mistakes can be high.

Central management and control

A company incorporated in the UK isn't necessarily UK tax resident

To be UK tax resident central management and control needs to be in the UK

Contrary to common belief, a company incorporated in the UK is not automatically UK tax resident. To be UK tax resident your company's central management and control needs to be in the UK and not in some other country.

This means that if you want your company to be considered UK tax resident you and your directors need to make all the important decisions regarding your company and its operations in the UK. This can be hard to achieve, particularly for a company whose owners and managers live abroad.

Permanent establishments

Overseas establishments of a UK company will pay tax abroad

Another thing to understand is that if your company is UK tax resident it will usually still need to pay tax abroad if it has a permanent establishment in another country.

Note overview

There are 2 sections in this note
- Corporate tax residency
- Permanent establishments

This note is split up into 2 sections:

- **Corporate tax residency.** This section sets out the factors that determine where your company's home country is (where it's deemed to live for tax purposes) and thus where its primary tax obligations are.
- **Permanent establishments.** International companies often have establishments abroad, which may mean that they also have tax obligations abroad. This note discusses what constitutes a taxable establishment.

Corporate tax residency

A company incorporated in the UK is not automatically UK tax resident. To be UK tax resident your company's effective management needs to be in the UK and not in some other country. This means that the directors need to make all the important decisions regarding the company and its operations in the UK. This can be hard to achieve for a company whose owners and managers live abroad.

Another thing to understand is that even if your company is UK resident it will still usually need to pay foreign tax on its overseas operations.

Taxation of international companies

Your company's place of tax residency is not directly linked to your personal residency

Companies (and LLPs) are separate legal entities to the people that own and run them. This applies to both their legal actions and their tax status. In theory, this means that the tax residency of your company will have little to do with either your own personal tax residency or the tax residency of your company's other directors and shareholders.

Why is tax residency important?

If your company is UK tax resident it will usually pay UK tax on its world-wide income

If your company is tax resident in the UK, then it will have to pay UK Corporation Tax on its world-wide profits. The way the UK tax charge is calculated is like this. You:

- add up all the profits that your company earns from anywhere in the world;
- adjust the profits to arrive at what's known as the tax adjusted profit;
- work out the UK tax on the tax adjusted profit[1]; and
- deduct any allowances that are available for tax due or paid in other countries.

What's left is the UK Corporation Tax that your company needs to pay. It's not quite this simple, but it's a good

[1] The UK tax charge is calculated by multiplying the tax adjusted profit by the UK corporate tax rate (currently 19%).

approximation. I’ve illustrated how this would work with an example.

Example 1: UK corporate tax calculation

Mr Smith has a UK company that has businesses in the UK, Ireland and Romania. The businesses make €100, €40 and €50 thousand profits in each of the countries and the countries tax rates are 19%, 15% and 16% respectively.

Mr Smith's company's Corporation Tax calculation is shown below.

€ thousands	**Ireland**	**Romania**	**UK**
UK profits			100
Irish & Romanian profits	40	50	90
Taxable profits	40	50	190
Corporation Tax rates	15%	16%	19%
Irish tax paid (€40x15%)	6		
Romanian tax paid (€50x16%)		8	
UK tax charge (€190x19%)			36
Relief for overseas tax paid			(14)
UK tax paid			22

Domestic tax laws try to maximise tax

Each country wants to maximise the tax that it can collect

Each country has its own domestic tax law, which dictates if a company needs to pay tax in that country.

Under UK domestic law, a company is UK tax resident if it's:

- incorporated in the UK[2]; or
- centrally managed and controlled in the UK[3].

The laws of each country are different but they all aim to maximise the tax that they can collect. One way that the laws do this is by taxing a company's world-wide profits and not just the profits it makes locally. This principle: that companies pay tax on their world-wide income in their home country; is applied in most countries. The result of this is that if your company is tax resident in a high tax country it'll pay more tax than if it's tax resident in a low tax country.

Dual tax residency and double taxation

In effect, countries compete to maximise the tax that they can collect from international companies like yours. Not

[2] Finance Act 1988, Section 66.

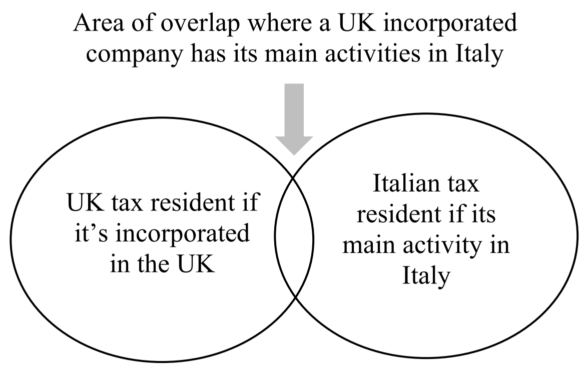
[3] Case Law: Calcutta Jute Mills Company v Nicholson (1876); and De Beers Consolidated Mines Ltd v Howe (1906).

surprisingly, therefore, the tax rules of different countries often conflict with each other.

Different countries tax laws often conflict, which can lead to dual tax residency

The result of this is that you can quite easily find yourself in a position where your company is considered tax resident simultaneously in more than one country. This can create a problem because without an international rule or agreement your company could find itself paying tax on the same profits twice. I've illustrated the concept of tax residency overlap in the figure below.

Figure 1: Overlap in tax legislation for companies



A practical example of dual residency

Let me give you a practical example of a case where the overlap of two countries domestic tax legislation can lead to dual tax residency for a company.

Example 2: Dual tax residency for a company

Alfredo has a UK company that sells goods in the UK. He manages his company from Italy.

Alfredo reads the UK rules and sees that his company is UK tax resident because it's incorporated in the UK.

Then Alfredo reads the Italian rules and sees that his company is Italian tax resident because it's administered in Italy.

Alfredo's company is dual (UK and Italian) tax resident.

Tax treaties and tie-breaker clauses

It would be unfair to pay tax on the same profits twice

It would be unfair for companies to need to pay tax on the same profits twice. That said, it does sometimes happen.

Tax treaties are bilateral agreements between two countries. Their aim is to resolve conflicts between domestic laws and to provide clarity on where and how businesses and people are taxed.

From now on in this section I'm going to talk quite a lot about tax treaties (also known as international tax treaties, double tax treaties, tax agreements and tax conventions).

Tax treaties try to provide clarity on where tax should be paid

Tax treaties

The UK has signed tax treaties with over 160 countries. They are not all the same because they are each negotiated separately. However, many tend to be based on the OECD's Model Tax Convention[4].

They contain tie-breaker clauses to resolve conflicts

Tie-breaker clauses

One way that tax treaties provide clarity on where businesses are taxed is by resolving conflicts between domestic laws. The paragraphs of the tax treaties that do this are called 'Tie-Breaker Clauses'. There are a few of these tie-breaker clauses within the OECD Model Treaty, of which Article 4 is probably the most important.

Normal tie-breaker clauses look at where effective management is situated

Article 4 of the OECD Model Treaty (for businesses)

Article 4 is the tax residency tie-breaker clause. The clause contains two sections, one that applies to people and one that applies to companies and the like. In this section I'm interested in the latter, which applies to companies and the like.

Article 4 says that if a company is deemed to be resident in two countries under their respective domestic laws then the company will only actually be resident in the country where its place of effective management is situated. The relevant part of the clause reads as follows:

> *"Where [. . a company. . .] is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated." (OECD, Model Tax Convention on Income and on Capital 2014 (Full Version), 2015).*

Most UK tax treaties contain this, or a similar, tie-breaker clause. So, it's clear that the definition and concept of Effective management is key.

[4] Some conventions are based on the United Nations (UN) Model Tax Convention. The UN Model Tax Convention is like the OECD convention.

To be UK tax resident your company's effective management needs to be in the UK

The principle of effective management

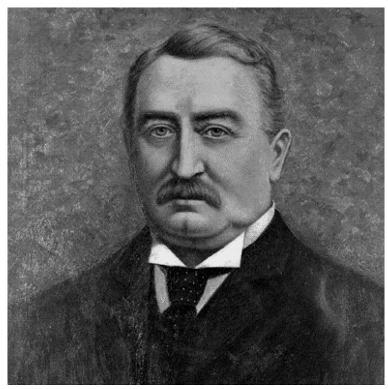
The principle of 'Effective Management' is based on a UK tax concept called 'Central Management and Control'. The roots of this are interesting, so I'll give you some history to it.

The term Central Management and Control comes from a well-known legal case heard in 1906.

Case 1: De Beers Mines v HMRC (1906)[5]

In this case, De Beers (a diamond mining company) wanted to pay tax in South Africa, rather than the UK. The directors tried to argue that it was a South African tax resident company.

Figure 2: De Beers founder - Mr Cecil Rhodes



The directors pointed out to the court that some of them lived in South Africa and that the company's Annual General Meetings (AGMs), head office, and mining operations were all in South Africa.

Lord Lorebum, who presided over the case, adjudicated that the company was UK tax resident. He noted that although the AGMs were held in South Africa most of the directors' meetings were in London and practically all the important decisions of the company were made in London. Within this case he formulated the principle of Central Management and Control.

> *"A company resides, for the purposes of Income Tax, where its real business is carried on … I regard that as the true rule, and the real business is carried on where the central management and*

[5] De Beers Consolidated Mines Ltd v Howe (1906).

control actually abides". (Judiciary T. , Decisions Summary, 1906)

Example of a dual tax resident company

Let me pull this together by giving you an example, which I've based on situations that I've encountered many times.

Example 3: Resolving dual corporate tax residency

Hugo ran a business in France. French Corporation Tax is higher than UK Corporation Tax so, to try to save tax, he set up a UK company and ran his French business through it. But he continued to manage the business from France and most of his customers were in France.

Hugo was concerned that he might not be following the rules properly, so he came to AccountsCo for advice. We told him that:

- Under UK law his company is UK tax resident because it's incorporated in the UK; but
- Under French law his company is French tax resident because its operations and main activity are in France.
- Article 4 of the French / UK Tax Treaty resolves the matter in favour of France because the company's place of effective management is in France.

We then told Hugo how to deal with this situation.

Different countries rules on tax residency

As I mentioned, different countries have different domestic rules and laws that determine corporate tax residency. That said, many countries rules are like the UK's.

Meaning of effective management

Effective management is the place where the most important decisions are made

Reading the tie-breaker clause raises the question: what does the place of effective management mean? There's no one answer to this and different countries have different views. But as a starting point the OECD states that the place of effective management is widely considered to be where the management and commercial decisions are made that are:

"necessary for the conduct of the entity's business as a whole." (OECD, Commentaries on the articles of the model tax convention, 2010).

To decide where this is, the OECD lists various factors that need to be considered, such as where the:

- meetings of the company's board of directors (or equivalent body) are usually held;
- chief executive officer and other senior executives usually carry on their activities;
- senior day-to-day management is carried on;
- headquarters are located;
- legal status of the company is governed; and
- accounting records are kept.

Examples of tie-breaker clauses

Not all tax treaties follow the OECD model tax convention. For example, the UK / Canada Tax Treaty states that when a company is a resident in both UK and Canada the two countries will need to agree on the place of corporate residence. More generally (not specifically relating to the UK) Canada has stated that it will often consider the place of incorporation to be the overriding factor in deciding corporate tax residency. The point I would like to emphasise here is that it's important to read both the tax treaty concerned and the OECD commentary before deciding on a course of action.

Directors' nationality and tax residency

I said before that there shouldn't be a link between your residence and the residence of your company . . .

. . . but for small owner managed companies there often is

Companies are separate legal entities and have separate legal identities and status to both their directors and their shareholders. So, at least in theory, the place of residence of the directors and shareholders should have little impact on their companies' tax residence. However, in practice this is not always the case and there can be quite a strong link between the tax residency of a company and the tax residency of the people that run it. This link can be particularly important for small, owner managed companies. The issue for these companies is that if the owner manager lives in one country then it can be quite difficult for him to manage it from another, and even harder for him to demonstrate that he's done this to the authorities.

Other thoughts on corporate residency

David Goldberg QC, a highly regarded barrister who I've had the pleasure of meeting, specialises in this area. Mr Goldberg wrote a very interesting article, which I've paraphrased below.

> *"There is, however, no harm in thinking about things in the bath here: thinking is not doing and*

doing is needed before there can be any management and control; if the board wants things done in the United Kingdom it needs to delegate the functions to be performed here to people here and then supervise what they do at their regular board meetings: the acts of delegation and supervision are then the acts of central management and control, and what is done here is of a lower order, in the administrative category.

Overall, the general message is this: if you want a foreign incorporated company to be non-resident, you need an active board which meets and takes decisions.

If that is inconvenient to highly important board members, they need to remember that tax mitigation requires some effort and that nothing which comes easy is worth having. Or at any rate that is my view of reality." (Goldberg, 2016).

Figure 3: Mr David Goldberg QC

My recommendations for small companies

To be considered UK resident the directors need to make all the important decisions about their company and its operations in the UK

There's no precise definition of what constitutes the place of effective management. However, in my opinion, for a company to be sure that it will be considered UK tax resident it needs to be able to demonstrate that all its acts of administration are carried out in the UK. For owner managed businesses, where the owners and managers reside outside of the UK, this means that:

- decisions must only be made during formal meetings of the Board of Directors in the UK;

- non-UK resident directors should not meet to discuss matters in their home country;
- day-to-day decisions must be made in the UK;
- there should not be any e-mails or calls back and forth between non-UK resident directors;
- the trading office and staff must be in the UK; and
- the principal activity of the company must be in the UK and not in the non-UK resident directors' home country.

In case of a tax investigation it's important that all directors' meetings and other management meetings are properly documented and that all call records and flight slips are kept by the directors so that they can demonstrate that they have managed the business from the UK.

Claiming tax treaty Relief

It may be that you're perfectly happy for your UK company to be classed as tax resident outside of the UK. For example, because the tax rate in your home country is lower than that in the UK.

Claiming Tax Treaty Relief in the UK

In this case, you will need to apply for Tax Treaty Relief under the provision of the tax treaty. This relief is not automatic. In the UK, you would apply for treaty relief on your company's UK tax return. To be successful in this application you will usually need to include a Certificate of Tax Residency for your company that has been issued by the other (non-UK) country.

Claiming tax relief in another country

Many developed countries follow a similar method to the UK. This means that to get relief in another country you will often need to obtain a UK Certificate of Tax Residency for your company, which you will need to present to your company's local tax authorities. Obtaining a UK Certificate of Tax Residency isn't always as simple as you might expect, particularly when the company just has one or two directors who live outside of the UK.

How tax residency is investigated

Tax residency inspections can be brutal

My experience in the UK is that HMRC (the UK tax authority) is reasonable and will engage in a constructive dialogue. In matters of tax residency, particularly for small companies, I've found that investigations start quite softly. HMRC seeks to understand the business by asking questions. Then, when the Inspector feels he's understood things, he will focus in on a key area. Though non-confrontational, this approach can be very effective. A simple question like: "Where were you when you negotiated that contract?" can definitively prove or disprove residency.

Other countries have other approaches to investigating tax residency. In some countries, investigations can be quite brutal: the fiscal police just turn up at the office and spend as much time as they need to go through all the company's records. This can be very disruptive. It can also be expensive in that you need to devote resources to assisting the fiscal police who can be at your office for months. Also, it raises the possibility that other matters might be identified and investigated.

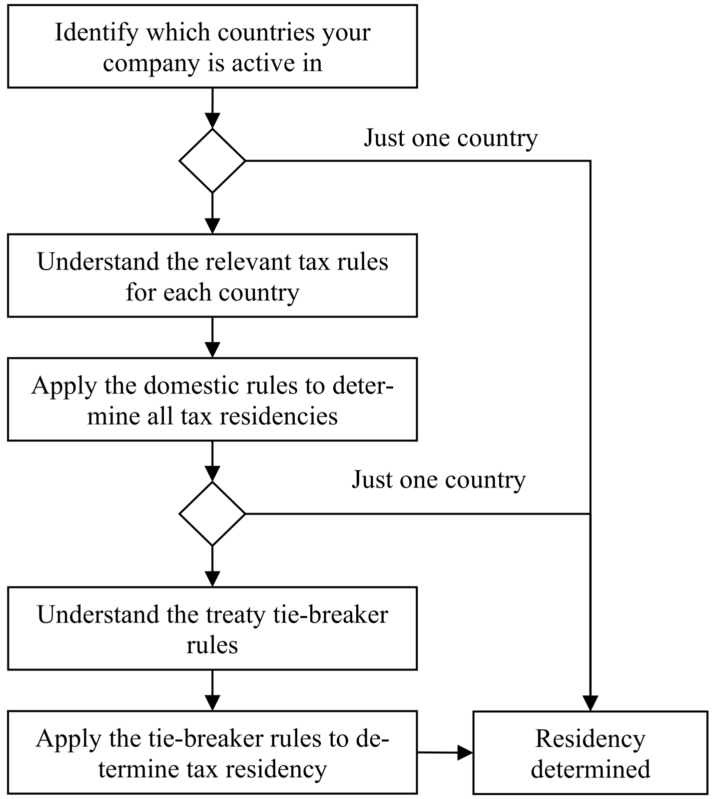
AccountsCo's approach to tax residency

AccountsCo provides advice on corporate residency

We are often asked to provide our opinion on tax residency. Our clients find this useful because it can identify procedural problems that they might have. Also, in the case of an investigation, a letter from AccountsCo can help demonstrate that the directors have done their best to get things right. This makes it harder for HMRC to bring a case for negligence, or worse still, deliberate tax evasion.

Our approach to determining residence is shown below.

Figure 4: Determining corporate tax residency


Identify which countries your company is active in
Just one country
Understand the relevant tax rules for each country
Apply the domestic rules to determine all tax residencies
Just one country
Understand the treaty tie-breaker rules
Apply the tie-breaker rules to determine tax residency
Residency determined

Legal cases and precedent

I personally find the concept of corporate residence interesting because it provides the basis of so much. So, to finish this section I've included some tax cases that show the evolution of the principles and how things now work in real life.

Case 2: Calcutta Jute Mills v HMRC (1876)[6]

This case is interesting because it's one of the first to consider tax residency, even before the De Beers case in 1906.

Calcutta Jute Mills (CJM) milled Jute[7] in India. It was an English incorporated company and its management held all important meetings in London. However, its activities were carried out in India.

One of the first UK tax case that considered the place of management was held in 1876

CJM claimed that it wasn't resident in the UK because its activities were in India. The judges disagreed and decided that the people in India were just agents that acted on behalf of the company.

Case 3: De Beers Consolidated Mines v HMRC (1906)[8]

De Beers is the most important case regarding corporate residency. It's interesting because it took the Calcutta case a step further - to cover UK incorporated companies that held meetings abroad.

In 1906 the principle was extended and the term 'Central Management & Control' developed

De Beers, a UK incorporated company with diamond mining operations in South Africa wanted to pay tax in South Africa, rather than the UK. The directors pointed out that some of them lived in South Africa and that the company's Annual General Meetings, head office, and mining operations were all in South Africa.

It was adjudicated that the company was UK tax resident. Lord Lorebum noted that most of the directors' meetings were in London and practically all the important decisions were made in London. Within this case he formulated the principle of 'Central Management and Control'.

[6] Calcutta Jute Mills Company v Nicholson (1876).

[7] Jute is a vegetable whose fibres that used to be spun into thread.

[8] De Beers Consolidated Mines Ltd v Howe (1906).

Case 4: HMRC v The Egyptian Land Company (1929)[9]

The Egyptian Land case demonstrated that incorporation, on its own, didn't demonstrate residence

In the Calcutta and De Beers cases the courts found that UK incorporated companies were taxable in the UK. The Egyptian Land case is interesting because it found that a UK incorporated company wasn't taxable in the UK.

Egyptian Land was a UK incorporated company whose activities and meetings were carried out in Egypt. It was found by the lower courts that as it was UK incorporated it was subject to UK tax. However, the higher courts reversed this decision and decided that incorporation wasn't enough on its own to constitute residence.

Case 5: HMRC v Unit Construction (1959)[10]

Unit Construction said that 'Effective Management' is where the top level of control is exercised

This case is interesting because it looked at the substance of what was happening.

Unit Construction Ltd had three African subsidiary companies each incorporated in Kenya and each with Kenyan directors. The companies' constitutions said that meetings could not be held in the UK. The directors wanted one of the companies to be considered UK tax resident because there were tax losses that they wanted to utilise in the UK.

The court found that although the day-to-day management was conducted in Kenya the boards of directors of the African subsidiaries were standing aside in matters of real importance and that real management and control was being exercised by the board of directors of the parent company in London. The presiding judge stated:

> *"The business is not the less managed in London because it ought to be managed in Kenya." (Lord Viscount 1959)*

[9] Todd v The Egyptian Delta Land and Investment Company Ltd (1929).

[10] Bullock v The Unit Construction Co Ltd (1959).

The News Datacom case distinguished between central management and control and administrative functions

Case 6: News Datacom v HMRC (2006)[11]

This is a much more modern case. It's interesting because it distinguishes between those functions that are purely administrative and those functions that constitute central management and control.

In this case, the taxpayer was a Hong Kong incorporated company that held board meetings in the UK. However, it was found that the UK Board meetings were just administrative and didn't constitute central management and control. Therefore, it was decided that the company was Hong Kong and not UK tax resident.

In the Wood case the courts found that accountants acted independently of their client

Case 7: Wood v HMRC (2006)[12]

This case sets out the principle that a board of directors that acts in the best interests of the shareholders can still be independent of the shareholders.

The case involved a tax avoidance scheme to minimise Capital Gains Tax on a husband and wife's sale of their trading company. The scheme was complicated, but in summary it relied on an offshore company being set up and controlled by trustees and accountants.

HMRC tried to tax the gain on the basis that it was really the husband and wife that were making the decisions from the UK. However, the courts found that the trustees and accountants were making the decisions independently, albeit in the best interests of the husband and wife. Therefore, the gain wasn't taxed in the UK.

In Laerstate it was decided that the substance, not the form, is important

Case 8: Laerstate v HMRC (2009)[13]

This case sets out the principle that it's not where documents are signed that's important, it's where the company's decisions are really made.

Laerstate was a Dutch company that had two directors. One director (A) lived in the Netherlands and the other director (B),

[11] News Datacom & Another v Atkinson (2006).

[12] Wood v Holden (2006).

[13] Laerstate BV v HMRC (2009).

who was also the sole shareholder, spent a lot of time in the UK but was tax resident in Germany.

B resigned as a director of Laerstate. Laerstate then purchased shares in another company, which B was a director of, and then immediately sold these to a third party. Laerstate made a profit on the sale. HMRC taxed Laerstate on the basis that its central management and control wasn't exercised by its Board in Holland but by B, who lived in the UK. HMRC said that B continued to exert influence over Laerstate even after his resignation as a director. Laerstate appealed against this decision, but this was dismissed. The tribunal stated:

> *"The test was not confined to a consideration of particular actions of the company, such as the signing of documents or the making of certain board resolutions outside the UK, if a more general overview of the course of business demonstrated that, as a matter of fact, central management and control abided in the UK." (Judiciary T. , Laerstate BV v HMRC, 2009).*

Case 9: HMRC v Smallwood 2010[14]

In Smallwood it was shown that 'Central Management and Control' was the same as 'Effective Management'

This case is important because it shows that the UK's view is that there's little difference between the place of effective management and the place of central management and control.

Smallwood established a trust to hold shares. Smallwood had the power to appoint trustees. Initially, a Jersey company acted as the trustee but in 2000 a Mauritius company was appointed as the new trustee. Shortly afterwards, the trustees sold the shares realising a substantial gain. Then, Smallwood appointed himself and his wife (both resident in the UK) as trustees.

Under the terms of the Article in the double tax agreement the trustee wasn't resident in the UK, so the gains were not taxable in the UK. However, it was decided that the trust had been set up in the UK and the scheme to appoint a Mauritian trustee was arranged and orchestrated from the UK. Furthermore, Mr Smallwood remained in the UK during the tax year. Therefore, the courts found that the trust was ultimately managed and controlled in the UK.

[14] HMRC v Smallwood (2010).

In this legal case, rent collection activities weren't found to constitute or indicate effective management

Case 10: TA.PR. v Italian Authorities (2015)[15]

This is an Italian tax case that shows how a country can use a company's activities to try to indicate where its place of effective management is situated.

The judgment concerned the tax residence of a British real estate company that had properties in the UK and Italy. Initially, it was found that the company's effective management was in the UK. However, the Italian tax Authority appealed against this stating that: 1) the shareholders were resident in Italy; and 2) the company carried out banking movements in Italy, which the Italian Authorities felt were indicative of other activities in Italy.

The appeal was rejected because the Italian High Court felt that the rent collection activities were not enough to constitute effective management. The Appeal Court also stated that the minutes of the Board of Directors meetings, which were held in the UK, provided enough proof to establish UK corporate residency.

Other cases

If you know of any other interesting cases that you think would illustrate the points in this section, please let me know.

[15] Ta.Pr. v Commissione Tributaria Provinciale di Napoli (2015).

Permanent establishments

In the last section, I talked about corporate tax residency. I noted that a company pays tax on its world-wide profits in its home country, which is called its 'Country of Tax Residence'.

There's another rule that says that if your company is tax resident in one country but has a permanent establishment in another country then it will need to pay tax in that other country. This means that international companies will usually also pay tax in those other countries where it has operations.

What is a permanent establishment?

A Permanent Establishment is a fixed place that you do business from in another country

A permanent establishment (also known as a PE or overseas branch) is a fixed place where business is wholly or partly carried on.

I'm going to discuss this definition in more detail later. But for now, let me illustrate this with an example.

Example 4: Example of a permanent establishment

Mr and Mrs Palma own an Italian company and they want to expand its operations into the UK.

The Palma's need a UK sales team and a show room and they plan to do all of the things in the UK that a business would normally do. However, they don't want to have to fly regularly to the UK, appoint directors or follow the administrative rules associated with running a company. So, they decide to set up a UK branch.

The Palma's UK branch is an intrinsic part of their Italian company. It's not a separate legal entity. Because it constitutes a fixed place of business in the UK it's classified as a Permanent Establishment.

Why are permanent establishments important?

Profits from a permanent establishments are taxed in the country it's located in

Permanent establishments are important because they need to pay tax in the country where they are located. In the example above, the Palma's need to calculate the profits attributable to their UK branch and pay UK Corporation Tax on these profits.

The profits made by your overseas establishment need to be included in your world-wide tax calculation

Taxation of permanent establishments

Earlier in this note, I explained that Corporation Tax for international companies is usually calculated in four steps:

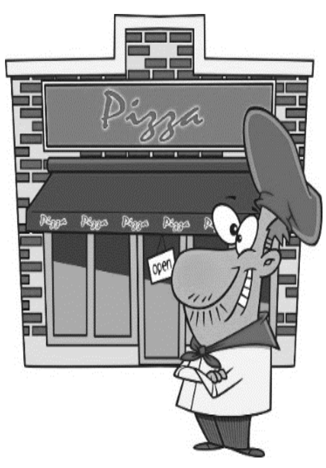
- Step 1 - add together the profits that the company earns from each country that it operates in to arrive at the company's world-wide accounting profit;
- Step 2 - adjust the world-wide accounting profit to arrive at the world-wide tax adjusted profit;
- Step 3 - work out the tax charge on the world-wide tax adjusted profit by multiplying it by the Corporation Tax rate that prevails in the country of residence; and
- Step 4 - deduct any allowances that are available for tax due or paid in countries outside of the country of residence.

What's left is the Corporation Tax that needs to be paid in the country of residence. As I said before, this is a simplification, but it serves for my purpose here.

Calculating the tax charge in the country of residence

It's important to understand this concept, so let me give you an example, which takes us to Step 3 in the calculation.

Example 5: Taxation of permanent establishments



Pizza Srl is an Italian company that has PEs in the UK and Belgium. It makes profits of €800k, €200k and €300k in Italy, UK and Belgium and pays tax in these countries at 28%, 19% and 33% respectively.

Pizza Srl pays €38k of tax in the UK and €99k in Belgium. Its tax charge, not the tax it pays, in Italy will be €364k.

€ thousands	UK PE	Belgium PE	Italian Srl
Italian profits			800
Overseas profits	200	300	500
Taxable profits	200	300	1,300
Corporation Tax rates	19%	33%	28%
UK tax paid (€200x19%)	38		
Belgium tax paid (€300x33%)		99	
Italian tax charge €1,300x28%)			364

The above example takes us to Step 3 of the above calculation: the tax charge in Italy. The tax charge isn't the same as tax paid because the company can claim relief for some of the tax that it pays overseas. Let's now look at the calculation of these reliefs (step 4 of the calculation).

Calculating relief available for tax paid overseas

Tax relief is available for tax paid overseas

The general rule is that you can reduce the tax you pay in your country of residence by the tax that you pay overseas. However, you can't always claim back all the overseas tax that you've paid. Instead, you can claim back the lower of the:

- tax paid by your overseas branch; or
- tax that the branch would have paid if it was in your country of corporate residence.

Let me show you how this would work for Pizza Srl.

Example 6: Taxation of PEs (continued from Example 5)

In Example 5, Pizza Srl paid €38k of tax in the UK and €99k of tax in Belgium. We calculated its tax charge (not the tax it paid) in Italy as €364k.

Pizza Srl can claim tax relief for all €38k of tax paid in the UK because the UK rate of 19% is lower than the Italian rate of 28%. However, the relief Pizza Srl can claim for the tax it paid in Belgium is limited to €84k. (Remember that Pizza Srl can claim relief for the lower of the tax paid by its Belgium branch or the tax that the branch would have paid if it was taxed in Italy.) The tax that the branch would have paid in Italy is calculated by multiplying the Belgium taxable profits of €300k by the Italian tax rate of 28%. The calculation is shown below.

€ thousands	**UK PE**	**Belgium PE**	**Italian Srl**
Taxable profits	200	300	1,300
Corporation Tax rates	19%	33%	28%
Tax paid in UK & Belgium	38	99	
Tax charge in Italy			364
Overseas tax relief (€38+€84k)			(122)
Tax paid in Italy			242

In total, Pizza Srl pays €242k, €38k in the UK, €99k in Belgium and €242k in Italy.

The need for a branch exemption rule

The relief can be limited, so most countries have a branch exemption rule

In the example above there are a few things worth noting. Pizza Srl:

- pays tax at 28% on the profits of its UK branch, even though the UK tax rate is just 19%;
- can't reclaim more tax than it has paid in the UK and Belgium;
- is further limited to reclaiming tax of just 28% of its Belgium profits, despite paying tax in Belgium at 33%.

These rules have some quite significant implications. For example, in this example it would be advantageous for Pizza Srl to operate in the UK through an autonomous UK company rather than a branch because, if it did this, it would pay 19% tax on its UK operations, rather than 28%. Let me extend the example to demonstrate this.

Example 7: Taxation of PEs (continued from Example 6)

Alfonzo, who runs Pizza Srl, doesn't see why he should pay 28% tax on his UK profits when the UK tax rate is just 19%. So, he decides to set up a separate, autonomous UK company. This reduces the total tax he pays from €379k to €361k.

€ thousands	**UK Ltd**		**Belgium PE**	**Italian Srl**
UK Belgium & Italian profit	200		300	800
Taxable profits	200		300	1,100
Corporation Tax rates	19%		33%	28%
Tax paid in UK & Belgium	38		99	
Tax charge in Italy				308
Overseas tax relief				(84)
Tax paid in Italy				224

Foreign branch exemption

The exemption rule means that branch profits don't need to be included in a company's world-wide income

The tax calculations above demonstrate that it can be tax advantageous to sometimes set up a subsidiary company rather than a branch.

To avoid this incentive, many countries have a foreign branch exemption rule. This rule allows the profits and taxes paid by a foreign branch to be completely disregarded when calculating tax in the country of residence. If Pizza Srl elected to use this rule in Italy the calculations would be identical to the situation described in Example 7, where Alfonso setup a subsidiary company in the UK.

Definition of a Permanent Establishment

For a PE to exist, there must be
- a place of business
- which is fixed
- through which the business is carried on

Now that we've understood the principle behind the taxation of permanent establishments we should look in more detail as to what a PE really is.

There isn't one single definition of PE that all countries have adopted. That said, there's a standard definition contained in Article 5 of the OECD Model Tax Convention.

Article 5 of the OECD Model Treaty

You may remember that tax treaties include tie-breaker clauses that settle conflicts. For permanent establishments tax treaties work a bit differently. Instead of containing a tie-breaker clause they tend to define what constitutes a PE. This definition is contained in Article 5, which says that a Permanent Establishment is a:

> *"fixed place of business through which the business of an enterprise is wholly or partly carried on." Source: (OECD, Model Tax Convention on Income and on Capital 2014, 2015).*

This is an important clause because it provides an overall definition of a PE. Breaking the clause down, it says that for a PE to exist there must be:

- a place of business;
- which is fixed; and
- through which the business is carried on.

Offices factories workshops etc.

Article 5 then goes on to list some of the things that will usually give rise to a PE, namely:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop, or
- a mine or other place of extraction of natural resources.

In its commentary, the OECD describes each of these as providing prima facie evidence of there being a PE.

Even if you don't have a fixed place of business in the UK you will have a UK PE if you have a person who habitually signs contracts in the UK

An agent that concludes documents

Article 5 also makes it clear that a PE also exists in a country if there's a person who:

> *"habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise." Source: (OECD, Model Tax Convention on Income and on Capital 2014, 2015).*

This is important because it means that a person that signs contracts gives rise to a PE in the UK even if the company doesn't have a fixed place of business. For this to apply, the person must:

- be a dependent (not an independent) agent;
- have authority to conclude contracts; and
- habitually exercise this authority.

So, for example, if you habitually sign contracts in Germany for your UK company then these acts are likely to be enough to mean that you have a German PE.

This often catches people out - You don't need to have an office in another country to have a PE. It can be enough for you, or someone else, to regularly conclude contracts in that country.

There needs to be a strong connection between a business and its location to give rise to a PE

Geographic and commercial coherency

In its commentary on the convention the OECD says that one may need to think about the 'geographic and commercial coherency' of the situation. In effect, this means that there will only be a PE if there's a strong connection between the location of a business and its operations. The OECD gives a few examples that illustrate this. I've paraphrased these below.

- **Painter works in a large office for different clients** - A painter works in a large office building for unrelated clients. The building doesn't constitute a single place of business because it's just chance that all the clients are in the same place.
- **Painter works in a large office for one client** - If instead the painter had a contract with just one client, say the building manager, then the building would be regarded as a single place of business.
- **Painter works part-time for one client** - For many years a painter spends three days a week painting a large office. The painter is performing his main

business activities in the office, which is therefore classed as a PE.

- **Salesman regularly visits a client to take orders** - A salesman regularly visits the same customer to take orders. The customer's premises aren't at the disposal of the salesman and therefore do not constitute a fixed place of business or a PE.
- **Informal arrangement to use an office** - One company has an informal agreement to use an office of another company. It's the substance, not the form, which is important and therefore, even though the agreement is informal, this would constitute a PE.
- **Haulage company uses a customer's delivery dock to offload goods** - A transportation company uses a delivery dock at a customer's warehouse every day to deliver goods to the customer. This sort of presence is too limited to constitute a PE. The business carried on needs to be substantial.
- **Director uses different rooms in a hotel** - A director uses different rooms in a hotel to conduct his business. Different locations that have geographic proximity can constitute a PE and, in this case, the hotel would be considered a single fixed establishment and, therefore, a PE.

What's not a permanent establishment

Just holding merchandise, owning a website or doing other things that are of a preparatory or auxiliary nature won't normally constitute a PE

Article 5 also describes some of the things that don't constitute a PE.

Facilities of a preparatory or auxiliary nature

Facilities that are preparatory or auxiliary to the core business aren't considered to constitute a PE. For example, the use of facilities to store, display or deliver goods don't, on their own, give rise to a PE.

Construction projects of less than 12 months don't give rise to a PE

Short-term projects

Other specific exclusions are building sites, construction sites and installation projects that last less than twelve months don't constitute a PE.

Independent agents don't give rise to a PE

Independent agent

Article 5 states that an independent agent will not constitute a PE. An independent agent is usually someone who works for more than one person and who decides himself how to carry out his work.

Final note on Article 5

Many tax treaties contain a similar definition of PE to that in the OECD's Model Tax Convention. That said, not all countries have the same definition and some countries interpret the meaning of PE in different ways.

Some of the different interpretations are described in the OECD's Commentary to the Model Tax Convention. So, when you're thinking about PEs it's important to look at both the double taxation agreement in question and the commentary before reaching a decision.

Specific examples of permanent establishments

Now let's look at a couple of specific cases that I've found can cause confusions.

Websites and E commerce

Web-sites and E commerce is a tricky area. Strictly, one needs to distinguish between the hardware (which is a tangible asset) and the software (which is not). Consider the following two cases:

- **Case 1: Website hosted by an internet service provider** - Say you have a web-site that's hosted by GoDaddy in the Netherlands. In this case, the server isn't at your disposal and so you don't have a PE in Holland.
- **Case 2: You lease a server in the Netherlands** - Now let's say you lease a server in the Netherlands and host your website on it. In this case, the server is at your disposal and you may have a permanent establishment in Holland.

Note the word may in Case 2: as you will remember, for a PE to exist the activities carried on must not be purely of a preparatory or auxiliary nature. Therefore, you would need to consider if the web-site's operations are sufficiently important to signify that business is carried on through it.

HMRC's view on websites

In the UK, web-sites don't, on their own, indicate the presence of a PE

You can see that it can all get quite subjective. Luckily, at least in the UK, things are clear. HMRC's view is that a website alone will not by itself constitute a PE. HMRC considers that it's where your trading activity takes place that's important. If your trading activity (processing, arranging fulfilling etc.) takes place outside the UK then, even if you have a UK website that generates sales, you won't normally have a UK PE.

Services

Services is a tricky area

Services is another complicated area. In most cases, profits from services performed by a resident of one country (say South Africa) in another country (say UK) will only be taxable in the UK if they are attributable to a permanent establishment in the UK. This can make the difference between being employed or trading in your own right very important. The legal case Fowler v HMRC is a great example of this.

Case 11: Fowler v HMRC (2016)[16]

A South African professional diver worked in the North Sea. HMRC tried to tax the diver on his UK earnings (note that earnings are different to profits).

The diver argued that they were not earnings because he wasn't employed. Instead they were profits from his trade. Since he didn't have a UK PE these trade profits were not taxable in the UK. The court of appeal found in favour of the diver.

[16] Fowler v Revenue and Customs Commissioners (2016).

A UK incorporated company managed from France was found to have a French PE

Legal cases and precedent

To end this section, I've jotted down a few interesting legal cases for you.

Case 12: Omnium Products v French Authorities (2012)[17]

This is a legal case that we often cite to our smaller clients. Omnium Products Ltd was a company that was incorporated in the UK by a French husband and wife. They lived in France and managed their company from France. The company purchased goods from Morocco and sold them in the UK.

The court's decided that there was a permanent establishment in France because the couple were processing orders, purchasing goods, dealing with supplier etc. from France. This decision was made despite the facts that:

- it was a UK incorporated company;
- the company had UK bank accounts;
- the contracts were signed in Morocco;
- the goods didn't pass through France;
- the company had an employee in the UK; and
- the accounts were prepared by a UK Chartered Accountant.

The couple appealed against the decision, but their appeal was rejected.

Using a client's office to work from was found to constitute a PE

Case 13: AB v South African Authorities (2015)[18]

This is a simple case that illustrates that the use of a client's office can constitute a PE.

AB LLC was a US company that provided consultancy services to a South African airline company. AB sent personnel to their clients offices in South Africa, where they worked in the clients boardroom. They used the room during the day but didn't have access outside normal working hours.

AB declared the income that it earned in South Africa in the US and paid US tax on it. The South African Revenue

[17] Cour Administrative dAppel de Versailles, 1ère Chambre, (2012).

[18] AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services (2015).

Authority felt that use of the Board Room constituted a PE and imposed penalties for failure to file a return or pay taxes in South Africa.

The South African Authorities view was upheld at appeal.

Case 14: Borax Europe Ltd v Spanish Authorities (2014)[19]

In the Borax legal case the courts looked at the substance rather than the form

This is interesting because it shows how courts try to look at the substance of the matter rather than the strict legal form.

In this case, Borax Europe imported chemicals into Europe, where it processed them before exporting the chemicals out of Europe. Borax España, a subsidiary of Borax Europe, carried on the processing activities in Spain.

Borax Europe and Borax España signed two contracts.

- Contract 1 gave Borax Europe the exclusive use of Borax España's warehouses. Thus, ownership of the chemicals remained with Borax Europe, even when the chemicals were in Spain.
- Contract 2 made Borax España an independent agent for Borax Europe. Borax España could get orders, but prices were set by Borax Europe, which also had the sole right to conclude contracts.

The Authorities taxed Borax Europe because it felt that it had a Spanish PE. Borax Europe appealed, saying that Borax España was a separate company with its own business, and anyway, even if it wasn't a separate business it was an independent agent and therefore exempt from the PE regulations under the double tax agreement. The appeal was dismissed. The court found that, regardless of the various contracts, in substance Borax Europe was conducting its own business in Spain through a PE.

Case 15: Formula One v Indian Authorities (2016)[20]

In this legal case a four-week project was found to constitute a PE

This is an interesting case, decided on by the Delhi High Court. It shows that events of even a short duration can constitute a PE.

[19] Borax Europe Ltd v General State Administration (2014).

[20] Formula One World Championship Ltd. v Commissioner of Income-tax, Delhi (2016).

Formula One World Championship Ltd (a UK company) promoted a car race in India. The UK company carried on activities in India for about four weeks. It was found that this was enough to constitute a PE in India.

Other cases

If you know of any other interesting cases that you think would illustrate the points in this section, please let me know.

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