



Permanent Establishment And BEPS

When is a company subject to taxation in the UK? Broadly, when it is incorporated or managed and controlled in the UK, deals in UK land, generates profits from UK property or when an overseas company has a permanent establishment in the UK.

This article considers recent recommendations in respect of the definition of a permanent establishment. The other circumstances giving rise to taxation in the UK are broad areas that are beyond the scope of this article's consideration.

A Permanent Establishment

Currently, UK tax legislation regards an overseas company as having a permanent establishment (PE) if:

- There is a fixed place of business through which its business is carried out
- An agent in the UK habitually exercises authority to do business on its behalf

Prior to 1 January 2019, a company which only carries on preparatory or auxiliary activities (such as storing the company's products, or purchasing goods) in the UK will not have a permanent establishment. However, following the OECD's recent base erosion and profit shifting (BEPS) report this is not necessarily the case.

If a PE exists, the profits of that establishment are effectively calculated at an arm's length basis and taxed in the UK. It is important to note that, in calculating its profits subject to taxation in the UK, no deduction is allowed for royalties or interest paid by the PE to any other part of the non-resident parent company.

The rules therefore seek to prevent a foreign controlled entity siphoning profits from the UK without bearing the associated corporation tax.

It should be noted that even if a company has no permanent establishment it would still need to consider whether it was subject to taxation in the UK under other legislation – such as the diverted profits tax.

BEPS and International Concerns

Historically, many tax planning strategies sought to exploit discrepancies in tax rules to shift profits from an area of high taxation to one with little or no tax charge on those profits. This was often undertaken in a form where little or no activity was actually undertaken by the company in the locality. Key to this

planning were attempts to ensure that no permanent establishment arose in the country where the profits are generated.

The Organisation for Economic Cooperation and Development (OECD) and the G20 group of countries refer to this type of tax planning as Base Erosion and Profit Shifting (BEPS). The BEPS initiative seeks to counteract these advantages by ensuring that the jurisdiction where the profits are created has the right to tax them.

As part of this initiative the OECD published a number of recommendations to amend the definition of a permanent establishment in the model tax convention. The UK has currently reserved against the majority of the changes in respect of habitual agents and double taxation agreements. However, the new anti-fragmentation rule was implemented by the Finance Act 2019, with effect from 1 January 2019.

Changes to UK legislation - The Fixed Place of Business

As discussed above, historically there has been an exemption for companies carrying on a preparatory or auxiliary activity. The OECD has recommended that this be amended by the introduction of an anti-fragmentation rule.

As a result of this rule activities performed by different related parties must be combined when assessing whether the activities may be regarded as preparatory.

This is potentially highly significant. Consider an online retailer: typically, it would be necessary to operate a warehouse overseas where goods owned by the

business are stored for dispatch to customers. Under the current definition, in isolation, this would not represent a fixed place of business provided no other activities are undertaken in the UK. However, considering the warehouse as part of the combined activities of the entire enterprise is an entirely different matter - under the anti-fragmentation rule these activities are very much those of a permanent establishment.

Possible Future Changes

The second recommendation, which has not yet been adopted by the UK, is in relation to the *habitual agent*.

If implemented, the definition of a dependant agent will be amended from a person who *habitually concludes contracts* to one who *habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*.

This is a significant broadening of the scope of the definition, and effectively erodes the defence that an agent is independent of the company on the basis that they act for many other businesses. The breadth of the new definition would introduce significant scope for HMRC to interpret the definition and associated activities.

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Article Key Points Title Key Points

Article Key Points Content

- Non-UK companies with a permanent establishment in the UK are subject to UK corporation tax on the profits of that establishment.
- The organisation for economic cooperation and development has issued recommendations that changes should be made to the definition of a permanent establishment
- The changes significantly broaden the definition of a permanent establishment.
- With effect from 1 January 2019, the UK implemented part of the recommendations with respect to the fragmentation of operations
- The UK does not currently intend to implement the changes to the definition of a habitual agent.

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