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VAT Fixed establishment = permanent establishment? or, should direct and indirect tax practitioners talk to each other?

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The very recent CJEU judgement in *Berlin Chemie A. Menarini v Administra?ia Fiscal? pentru Contribuabili Mijlocii Bucure?ti* (Case C-333/20) ECLI:EU:C:2022:291, admirably examined by Giorgio Beretta last week considered the circumstances in which a subsidiary might be a VAT fixed establishment (FE) of its parent company or another affiliate.

A Romanian company supplied advertising, marketing and regulatory services to a German company primarily promoting pharmaceutical products sold by that German company in Romania. Employees of the Romanian company took orders from new wholesale distributors of medicinal products in Romania and forwarded them to the German company, and also sent invoices from the German company to its Romanian customers. The Romanian company was not directly involved in the sale and supply of the products and did not enter into commitments with third parties in the name of that company.

Related parties

Berlin Chemie highlights a challenging question that also arises in the permanent establishment (PE) context in connection with relations between affiliates, that is, does the affiliate in one state merely provide a service to the foreign affiliate in another state, or does it carry on the business of the foreign affiliate on behalf of that foreign affiliate? This question, as *Berlin Chemie* shows, is especially acute in the case of marketing activities where the dividing line between sales and the mere promotion of sales can be difficult to discern.

The related entity issue has a direct analogy with article 5(7) of the OECD and UN Model Treaties: the mere fact that one entity controls the other does not itself mean that either is the PE of the other. The existence of a PE is determined by reference to the other parts of the definition in article 5.

The relevance of control has, nonetheless, been elevated by the introduction of "closely related persons" in the 2017 Model Treaties which is now defined in article 5(8) by reference to control in relation to agency PE and fragmentation of preparatory or auxiliary activities.

Definitions

While the tax treaty definition of PE in article 5 now runs to more than 2 pages in the OECD Model, accompanied by 50 pages of OECD Commentary, the EU Principal VAT Directive

2006/112 (EC) (PVD) itself offers no definition of FE (Articles 56 and 57). Interpretation of the term has been left to the Court of Justice. Rulings of the court have been subject to modest codification in article 11 of the VAT Implementing Regulation 282/2011(IR), so that a 'fixed establishment' is:

"any establishment, other than the place of establishment of a business referred to in Article 10 of this Regulation, characterised by a sufficient degree of permanence and a suitable structure in terms of human and technical resources" "to enable it to receive and use the services supplied to it for its own needs" or "to provide the services which it supplies" (Article 11(1) and (2)).

Having a VAT identification number is not itself sufficient to constitute a fixed establishment (Article 11(3)).

Permanent establishment analogy

The language differs from the definition of physical establishment in article 5(1) of the Model Treaties but direct tax practitioners will undoubtedly recognise issues that are familiar:

- The need for an "establishment" connotes a fixed place. This is supported by the need for a "discernible structure" evidenced by the existence of human or technical resources. Here the court in Berlin Chemie departs from the requirement in Article 11 of the Implementing Regulation that both human and technical resources must combine to form the necessary structure (at [37]). While not relevant to the case before it, this statement raises the same question whether automated equipment alone can constitute a physical PE (See Commentary to Article 5(1) paragraph 122 and following).
- A "sufficient degree of permanence "is not wholly remote from the "certain degree of permanency" expressed in the OECD Commentary to Article 5(1). Thus, the structure cannot exist only occasionally (at [37]). This explained as being evidenced, for example, by employment and leasing contracts that cannot be terminated at short notice (at [41]). Like the PE counterpart, there is no real guidance on how long is sufficient and this remains contentious for both direct tax and VAT.
- The need for human and technical resources to receive or make supplies conveys that the establishment must carry on an economic activity within Article 9 of the EU PVD and resonates with the requirement to carry on the business of the enterprise for Article 5(1) of the Model Treaties.
- One of the questions Berlin Chemie raises is whether it is necessary for human and technical resources to belong to the company that has its business established elsewhere to constitute an establishment a FE. The court answers this in the negative. It is however necessary for that taxable person to have the right to dispose of the human and technical resources in the same way as if they were its own (at [41]). While the court adopts the "at the disposal of" the enterprise language of the OECD Commentary to Article 5(1) (paragraphs 9 to 12), the examples given by the court of employment and equipment leasing contracts that are not easily terminated, suggest a direct legal entitlement to the resources.

Outsourcing

The vexed question of subcontracting is raised but not resolved. The court considered that it is not necessary for the foreign enterprise to employ personnel or own the assets itself and that it is sufficient for staffing and material needs to be met via "various service providers" (at [45]). The

court's analysis of this issue, which goes to the heart of the case is somewhat unclear. It starts by saying that the Romanian company made extensive human and technical resources available to the German company (at [47]) but then says that a legal person is assumed to use its resources for its own needs. Whether the resources are at the disposal of the foreign entity is a question of the contractual arrangements between the entities (at [48]). Whether that is the case is left to the national court to decide. In my view this analysis simply begs the question as to what kind of contractual provision meets the requirements for a FE.

Direct impact on the economic performance of the foreign company

One of the key questions asked, was whether services capable of having a direct impact on the performance of the German company's economic activity, such as marketing services, in so far as those services are closely linked to obtaining orders for the pharmaceutical products sold by the German company, are relevant to the existence of a FE. Direct tax practitioners might ask whether this means are the activities preparatory or auxiliary within Article 5(4) of the Model Treaties? One might also ask if this approaches "plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" in Article 5(5).

The court addresses this key question by first distinguishing the services supplied by the Romanian company to the German company from the goods which the German company supplies in Romania. Each distinct supplies of services and goods and subject to different schemes of VAT (at [52]). The court then solves the question by saying (axiomatically) that the same resources cannot be used both to supply and receive the same services (at [54]). In my view, none of this would be necessary of clear guidance is given on when the resources are to be treated as at the disposal of the foreign entity. Confusion on that issue leads down these rabbit holes.

Quo vadis?

It is unfair to blame the judges for this. Interpretation of an undefined term such as FE by recourse to basic principles in light of increasingly complex cross-border business models is hazardous. Many of the issues raised are a matter of tax policy which is not the role of the courts as interpreters of the legislation. While a statutory definition would bring some clarity, it is of course no panacea as the definition of PE in Article 5, despite its length and longevity remains of uncertain application. It might reduce the number of cases on FE coming before the court on basic issues.

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