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Hidden or Accidental Permanent Establishments and Penalties

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Sunday, January 24th, 2016

Interest and penalty regimes place a high premium on correctly identifying the existence of a permanent establishment in the territory of a state. The failure to do so often means that there is no reporting to the tax administration by the foreign enterprise by way of registration or filing of returns. This is particularly true in a self-assessment environment (See Schwarz on Tax Treaties para 26-650). In such cases, the start of any engagement between tax payer and tax administrator is frequently very adversarial and stressful. Two recent judicial decisions show that, tax administrations are likely to press for penalties in such circumstances.

The presence of a permanent establishment in the territory of a state is the key to the door in taxing the business profits existence of a foreign enterprise. The last year has seen not only the proposed expansion in the meaning of the term in the OECD BEPS Action 7, but also the subject of frequent disputes between tax payers and tax administrations. It is a recurring theme in this blog: Agency Permanent Establishments: Commissionaires in the frame (16 December 2015); UN Model Services Permanent Establishment: What you do – not where you do it (12 August 2015); Where to draw the Line? Permanent Establishments and allocation of Taxing Rights (13 June 2015); Does the UK Diverted Profits Tax help or hurt BEPS? (11 February 2015).

Although tax treaties define permanent establishments, their administration is a domestic law matter.

Penalties for not filing returns
Recent cases that have reached the courts highlight the stakes. In *AB LLC and BD Holdings LLC v SARS* (13276) [2015] ZATC 2 (See post: UN Model Services Permanent Establishment: What you do – not where you do it (12 August 2015)), a US taxpayer was found to have a PE in South Africa. It was initially assessed for additional tax of 200% of the tax due, because of its default in rendering tax returns. The additional tax was reduced to 100% by the South African Revenue Service who accepted that there were extenuating circumstances. Default interest on the unpaid tax was also assessed.

The taxpayer's appeal against the 100% additional tax and interest was refused. Among other arguments, the taxpayer contended that it reported and paid tax in the United States as a resident on the income earned which, it maintained, showed its good faith in failing to declare and pay tax in South Africa. The South African Tax Court held that compliance in the US had no bearing on non-compliance in South Africa.

A similar argument had a very different outcome where a permanent establishment was found to

exist in France under the France-Spain tax treaty, but the taxpayer failed to register with the tax authorities or file a return in Frutas y Hortalizas Murcia SL, Conseil d'État (French Supreme Administrative Court) Decision No. 368227 on 7 December 2015. There, the French tax administration sought to apply a penalty of 80% of tax unpaid as a result of undisclosed activity. The French Supreme Court ruled that that the penalty only applies to intentional non-disclosure. Where a taxpayer contends that it has met all its tax obligations in the other state, the justification of the error must be assessed by taking into account both the level taxation in that other State and the exchange of information procedures between tax authorities of the two states.

Mistake of law v ignorance of law

In *AB LLC and BD Holdings LLC*, the taxpayer argued that it did not deliberately ignore the South African law but just misunderstood it. The Tax Court rejected this because the taxpayer had global reach, operating in many foreign jurisdictions at once. It had conducted international operations in many countries over many decades. The judge issued a stern warning to major corporations with substantial international business operations in numerous countries:

"It is a fundamental rule of business practice that a business enterprise, especially one that operates on the scale the appellant does, should familiarise itself with the taxation laws of a country in which it operates. Failure to do so would be grossly negligent, and for that reason unreasonable." (at paragraph 55)

This warning however ignores the rather more difficult issue that these cases illustrate. The taxpayer in *AB LLC and BD Holdings LLC* did not claim to be unfamiliar with the source state taxation laws. It admitted to being aware of the possibility of a tax liability in South Africa and knowing about the South Africa – US treaty. Its case was not one of ignorance of the law, but of misinterpretation of it (the definition of permanent establishment).

Uncertainty

Recent history, as shown by the OECD work, not only on the BEPS actions relating to the definition of permanent establishment, but also its project on the meaning of the term in the existing OECD Model, and judicial decisions on the term, that there is a surprisingly high degree of uncertainty, given the longevity and near universality of the concept. The decisions of various European supreme courts on commissionaires show that even where a consistent pattern of analysis emerges, there is no guarantee that all states will necessarily adopt that pattern (See post: Agency Permanent Establishments: Commissionaires in the frame (16 December 2015)).

Lowering the threshold for the existence of a permanent establishment as proposed in the OECD BEPS Action 7 Final report, as well as the introduction of new and untested expressions will do nothing to alleviate this uncertainty. The BEPS Actions to improve compliance such as Action 10 on Country-by- Country Reporting, do not help either. Indeed, the failure to identify a permanent establishment may result in erroneous reporting, and compound the problem.

Both the French and South African decisions also illustrate that the penalty regimes themselves may be more onerous than the double taxation that treaties are designed to eliminate. Fault-related penalties will always depend on specific facts if they are to be properly applied. If double taxation is a barrier to cross-border trade as the OECD identify in its introduction to the Model Convention (at paragraph 1), then such penalty regimes may have the same effect if applied aggressively in an area of uncertainty.

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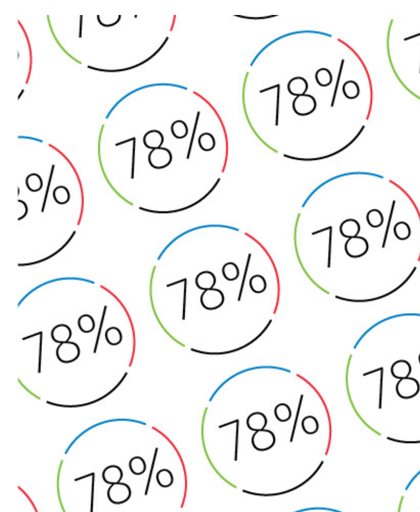

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