Analysis

The taxation of non-permanent establishments

Speed read

The rise of the digital economy has given rise to calls for additional taxes on digitalised businesses which are able to access markets without having a local physical presence. The recent US *Wayfair* case has decided that an out-of-state seller need not have a physical presence in a state in order to have 'substantial nexus' there. A UK company subject to a state or nexus tax may find that relief is not available under the relevant double tax treaty and will need to consider whether unilateral relief is available under TIOPA 2010 s 9(1). In some cases, unilateral relief may not be available and the foreign tax may only be deductible as a business expense under general principles.

Jackie Wheaton
Moore Stephens
Jackie Wheaton is an associate director at Moore Stephens. She has worked in business tax for over 20 years, providing tax advisory services to a wide range of clients, with particular emphasis on owner managed companies, trading and investment partnerships, international groups and hotels, and advises a number of clients in the property management and development sector. Email: jackie.wheaton@moorestephens.com; tel: 020 7334 9191.

The rise of the digital economy has given rise to calls for additional taxes on digitalised businesses which are able to access markets without having a local physical presence. At the same time, US states have been trying to collect taxes from businesses without a physical presence in that state, culminating in the recent US Supreme Court case of *South Dakota v Wayfair Inc.* (2018) 585 US (see '*Wayfair*: signposting a fairer way for global taxation?' (Michael Cullers & Robert O'Hare), *Tax Journal*, 20 July 2018).

US *Wayfair*

The decision in *Wayfair* has overturned a constitutional principle established under *National Bellas Hess Inc. v Department of Revenue of Illinois* (1967) 386 US 753 (*Bellas Hess*) and *Quill Corp. v North Dakota* (1992) 504 US 298 (*Quill*) that a state may not require a business that has no physical presence there to collect and remit sales taxes. The traditional justification for *Quill* was that it protected businesses from undue compliance burdens on interstate commerce. The court in *Wayfair* has overruled its previous decisions in *Bellas Hess* and *Quill* and decided that an out-of-state seller need not have a physical presence in a state in order to have 'substantial nexus' there. The conclusion of the court was that 'substantial nexus' is established when the taxpayer 'avails itself of the substantial privilege of carrying on business'.

Base erosion and profit shifting (BEPS)

The OECD's BEPS project has produced a series of reports, minimum standards and recommendations across 15 action points structured around three broad pillars; namely:

- improving coherence (i.e. smoothing the interaction between domestic laws of different states);
- tightening substance (i.e. realigning taxation with economic substance and value creation); and
- ensuring more transparency and certainty (i.e. disclosure and information exchange).

The international tax system considers whether a non-resident entity is carrying on a business through a permanent establishment (PE), i.e. has a taxable presence, in the state concerned. Digitalised businesses are able to access multiple markets across borders without the need for a substantial (if any) local physical presence. The digitalisation of business models therefore puts pressure on the current formulation of a PE.

There is a clear desire to ensure that 'non PEs' that appear to be trading in, as opposed to with, the UK are charged a 'fair' share of tax. The question of what is fair was considered by Bill Dodwell ('Assessing Amazon', *Tax Adviser*, September 2018), in which he observed that Amazon delivers substantial amounts of tax in the form of VAT and payroll taxes. Perhaps it is necessary to consider the other contributions that the company makes to the UK economy, such as enabling third parties and small and medium-sized businesses to sell via its platform in order to expand their potential market.

Double tax relief

The *Wayfair* ruling is relevant to the debate on how the international tax system can address the challenges of BEPS and the digitalisation of the globalised economy. For example, a UK company without a PE in a foreign jurisdiction but which is subject to foreign taxes such as those found in various US states will need to consider how it can claim relief for the foreign tax in its UK tax computations.

Where the same income is liable to be taxed in both the UK and another country, relief may be available under the specific terms of a double tax agreement between the UK and that other country or under the unilateral double tax relief provisions contained in UK tax legislation (TIOPA 2010 s 18). Unilateral relief is not available if relief is available under a double tax agreement (TIOPA 2010 s 25). Double tax agreements cover those taxes specified by the agreement. Nexus taxes and state taxes are not necessarily covered by a double tax agreement and in this case the taxpayer has to fall back on unilateral relief.

The general rule for unilateral entitlement to credit for foreign tax is set out in TIOPA 2010 s 9(1) which states:

> 'Credit for tax –
> a) paid under the law of the territory;
> b) calculated by reference to income arising, or any chargeable gain accruing, in the territory; and
> c) corresponding to UK tax
> is to be allowed against any income tax or corporation tax calculated by reference to that income or gain.'

The basic question asked by s 9(1)(b) is whether the income in question arose in the territory. This is considered in accordance with the principles of UK tax law, which may not be consistent with the principles of other jurisdictions, particularly in respect of the definition of a PE. The taxation laws of other countries may differ from the UK's laws in determining where the source of income is.

Many double tax agreements lay down specific rules for determining the source of income, profits or capital gains for tax credit relief purposes. The provision which is most often used in the article on elimination of double taxation says that, for the purposes of giving tax credit relief, profits, income or capital gains earned by a resident of one country, which may be taxed in the other country in accordance with the provisions of the agreement, are to be deemed to arise from sources in that other country.

These provisions override the domestic laws of each country for determining the source of profits, income and capital gains. Where income has a UK source under UK law but has been taxed in the other country, it is therefore necessary to refer to the relevant double taxation agreement to see what provisions there are for determining the country of the source of the profits, income or gains in question.

Difficulties may arise therefore where foreign tax is suffered by a UK entity which does not qualify as a PE under the relevant treaty.

Where tax credit relief is allowable under a double taxation agreement, where a UK resident carries on a trade profession or vocation, etc. chargeable to either income or corporation tax, and earns profits partly in the UK and partly in a foreign country, that part of the profits earned in the foreign country is regarded, for credit purposes, as having a foreign source.

Where tax credit relief is only allowable under the unilateral provisions, TIOPA 2010 s 9(3) states:

> 'For the purposes of sub-s (1), profits from, or remuneration for, personal or professional services performed in the territory are deemed to be income arising in that country.'

Therefore under UK rules, the place where income arises is not where the customer is based, but where the service is performed.

Case law

Yates (HMIT) v CGA International Ltd (1991) 64 TC 37 deals with the location of the source of service income in the context of unilateral credit for foreign tax and is relied on by HMRC. In this case, work was undertaken by a UK company in Venezuela and the UK. The High Court ruled that Venezuelan tax paid on income earned on consultancy work undertaken in the UK was not creditable against UK tax on that income (although tax paid on work undertaken in Venezuela was creditable). This was on the basis that the income for work done in the UK did not arise in Venezuela.

In *Yates*, it was argued that whether the income arose in a foreign country should be determined by the laws of that foreign country. However, the High Court decided that UK tax law should decide whether the income arises in the territory that imposes the foreign tax, and not the tax law of that territory. The reasons for this were to ensure consistency with other provisions in the foreign tax credit legislation and because Venezuelan law did not expressly impose tax on the ground that the income arose in Venezuela. Rather, it imposed tax 'whenever any of the causes originating such income shall occur within the National Territory'.

The court referred to the well-established UK principle that a trade is carried on where the contracts giving rise to the profits of the trade are made and where the operations take place from which the profits in substance arise. In that case, there was a clear division of the work: part of the contract was for work undertaken in Venezuela; and part for work undertaken in the UK. Venezuelan tax paid on income earned on work undertaken in Venezuela was creditable against UK tax, whereas tax paid on income earned on work undertaken in the UK was not. It was held that the amount of income arising in a territory depends on where the operations take place from which the profits in substance arise, and profits deriving from an individual transaction can be regarded as arising partly in one country and partly in another.

It was also found that the Venezuelan tax, despite being a turnover tax calculated at a rate of 25% on an amount representing 90% of the gross receipts of the business, was admissible for credit relief. This was because, on an examination of the foreign tax within its legislative framework in Venezuela, it was found to serve the same function as income tax and corporation tax serve in the UK in relation to the profits of the business.

Following this decision, HMRC amended its practice (SP 7/91, as revised). Foreign taxes are examined to determine whether, in their own legislative context, they serve the same function as UK income and corporation taxes in relation to business profits, and are thus eligible for unilateral relief. The overseas taxes which HMRC considers admissible for relief are listed by country in HMRC's *Double Taxation Relief Manual* at DT2100 et seq. and also in HMRC's *Business Income Manual* at BIM45905.

A trade is carried on where the contracts giving rise to the profits of the trade are made and where the operations take place from which the profits in substance arise

This means that a UK company that is subject to a foreign state or nexus tax may not be able to claim relief for that tax under a double tax treaty, and may also not be able to claim UK unilateral relief if the income does not arise in the foreign territory under UK rules.

Business expense

If treaty relief or unilateral relief is not available, HMRC accepts that a foreign tax on profits may be deducted as a business expense under general principles, as mentioned in BIM45901.

Conclusion

The *Yates* case gives an unfortunate result for some UK entities subject to foreign state or nexus tax that do not qualify for relief under the relevant double tax treaty as unilateral tax relief is not available under TIOPA 2010 s 9(1)(b) if it cannot be said, under UK rules, that the income in question arose in the foreign territory. Such foreign tax may be deductible as a business expense under general principles instead. This issue may become more significant as foreign states take steps to ensure that non PEs are charged a 'fair' share of tax. ■

For related reading visit www.taxjournal.com

- *Wayfair*: signposting a fairer way for global taxation? (Michael Cullers & Robert O'Hare, 19.7.18)
- Self's assessment: Amazon (Heather Self, 28.8.18)
- 30 questions on BEPS (Jill Gatehouse & Susie Brain, 29.10.15)
- Double tax relief (Robert Langston, 9.8.10)