

# UK changes definition of permanent establishment

March 19, 2019

## In brief

The UK Finance Act 2019, which became law on February 12, includes the legislation required to update UK domestic law to align with the UK's position on the changes to the Permanent Establishment (PE) definition arising from the OECD's Base Erosion and Profit Shifting (BEPS) project and included within the Multilateral Instrument (MLI). This effectively expands the definition of PE in the UK which — together with forthcoming changes to many double tax treaties — is likely to result in more PEs arising.

## In detail

### Implementation of the BEPS project

The BEPS project included a workstream (Action 7) focused on reviewing the PE threshold to address situations where taxpayers were setting up arrangements that were seen as intended to avoid having a PE. This work concluded in October 2015 with a number of proposed changes to various aspects of the PE definition in Article 5 of the OECD's Model Tax Convention (OECD Model) and its Commentary, including changes to both the Fixed Place of Business PE definition as well as the Dependent Agent PE definition.

In order to adopt the proposed changes to the PE definition from Action 7, changes to double tax treaties as well as domestic law changes would be required. The OECD undertook

to do this via the MLI to allow countries to modify multiple double tax treaties in an efficient way. There are currently 87 territories that are signatories to the MLI, and 21 countries have now completed the ratification and deposit process, including the UK.

As part of the process of signing the MLI, countries indicated their draft 'reservations' against any of the BEPS changes that they did not want to adopt in their tax treaties. These positions were finalized on delivery of their ratification instruments. They also indicated the options they chose to pursue where the MLI put forward alternatives. Given the PE changes were a best practice, rather than a minimum standard, countries including the UK have made or propose to adopt a range of reservations against, and options in respect of, the PE changes.

The UK currently has decided not to make the BEPS Article 5 changes, apart from in relation to the new anti-fragmentation rule described below.

### What is the OECD proposal in relation to the Fixed Place of Business PE threshold?

There are various 'specific activity' exemptions from PE status in Article 5(4) of the OECD Model. These relate to maintaining facilities for the display or storage of goods, etc. This part of Article 5 and the anti-fragmentation standard below have been revised in the 2017 update to OECD Model (and the MLI) partly to address evolving digital business models. Despite earlier proposals to make all such specific activity exemptions subject to an overall 'preparatory or auxiliary'

requirement, the Action 7 report recommends that countries clarify their approach and adopt the anti-fragmentation rule.

The option chosen by the UK is to make no clarification, and broadly to maintain the approach in Article 5 immediately prior to the 2017 update to the OECD Model. That means there is no clear requirement that each of the various specific activity exemptions be subject to this preparatory-or-auxiliary test.

An explanation of the terms 'preparatory' (emphasizing the short-term duration of the relevant activity) and 'auxiliary' (being an activity "to support, without being part of, the essential and significant part of the activity of the enterprise as a whole") also is included in the latest 2017 OECD Model Commentary, supported by new examples designed to illustrate the intended operation of these terms.

As noted earlier, the BEPS Action 7 report proposes a new anti-fragmentation standard to Article 5(4) of the OECD Model. If the anti-fragmentation rule were implemented in a treaty, the specific activity exemptions would not be available to a fixed place of business used or maintained by an enterprise if the same or a closely related enterprise carries on business activities at either the same place or at another place in the state if:

- the same or the other place is a PE (this might include a local resident company); or
- the overall activity from a combination of the activities is not of a preparatory/auxiliary character; and, in either case,

- the activities carried on (by the two enterprises at the same place, or by the same or closely related enterprise at the two places) constitute complementary functions that are part of a cohesive business operation.

#### **What does the UK legislation say?**

The new UK legislation is effective from January 1, 2019 (splitting accounting periods that straddle that date). The impact of the first batch of the UK's treaties to be affected by the MLI in this regard will be felt from April 1, 2019 (the timing depending on the date of ratification of the relevant treaty partners).

The UK legislation that contains the definition of a PE is in Section 1143 of CTA 2010. The amendments made to the UK legislation are aligned with the MLI wording in most respects, with one notable exception. This exception is that the definition of 'closely related enterprise' in the UK legislation seems potentially much broader than the definition included in the OECD MLI.

As well as a 50% investment condition, some of the alternative conditions include whether one party is able to secure the other party acts, or it is reasonable to assume that the other party acts, in accordance with the first party's wishes. This potentially means some situations where third parties are acting in a business relationship with each other at arm's length could create a PE, where the non-UK resident party is relying on the 5(4) exemptions. However, the definition of closely related would, wherever MLI Article 15 applies (and against which the UK makes no reservation), follow the standard OECD definition, which refers more generally to 'control'.

---

## **The takeaway**

---

### **What next?**

Any business that is relying on the Article 5(4) exemptions to assert that it does not currently have a UK PE should review its situation carefully to understand whether the activities of a closely related party in the UK would mean its ability to rely on these exemptions has ceased and it should be filing corporation tax returns in the UK from January 1, 2019.

---

## Let's talk

---

For a deeper discussion of how this issue might affect your business, please contact:

### Transfer Pricing

Sonia Watson, *London*  
+44 (0) 207 804 2253  
[sonia.watson@pwc.com](mailto:sonia.watson@pwc.com)

Nick Palazzo, *London*  
+44 (0) 20 780 41371  
[niccolo.m.palazzo-corner@pwc.com](mailto:niccolo.m.palazzo-corner@pwc.com)

Aleks Davydov, *London*  
+44 (0) 2072 138745  
[aleksandr.d@pwc.com](mailto:aleksandr.d@pwc.com)

### Tax Policy and International Tax Services

Philip Greenfield, *London*  
+44 (0) 7973 414521  
[philip.greenfield@pwc.com](mailto:philip.greenfield@pwc.com)

Michael Cooper, *London*  
+44 (0) 20 721 35212  
[michael.j.cooper@pwc.com](mailto:michael.j.cooper@pwc.com)

Ben Proctor, *London*  
+44 (0) 20 780 41887  
[ben.m.proctor@pwc.com](mailto:ben.m.proctor@pwc.com)

### Transfer Pricing Global, Americas, and US Leaders

Isabel Verlinden, *Brussels*  
Global Transfer Pricing Leader  
+32 2 710 44 22  
[isabel.verlinden@be.pwc.com](mailto:isabel.verlinden@be.pwc.com)

Horacio Peña, *New York*  
Americas Transfer Pricing Leader  
+1 646 471 1957  
[horacio.pena@pwc.com](mailto:horacio.pena@pwc.com)

Paige Hill, *New York*  
US Transfer Pricing Leader  
+1 646 471 5192  
[paige.hill@pwc.com](mailto:paige.hill@pwc.com)

## Our insights. Your choices.

Select 'Tax services' as your *Services and solutions* of interest to receive more content like this.

[Set your preferences today](#)

© 2019 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

#### SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 158 countries with more than 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at [www.pwc.com/US](http://www.pwc.com/US).