The Offshore Taxation Review

SPAIN: PERMANENT ESTABLISHMENT A CAUTIONARY TALE

Jonathan Miller[1]

The Scenario

For the purposes of this article,[2] the fictional company Global Plonk plc (Plonk) is an unlisted English public company. It is inevitably resident in England. For the avoidance of doubt, it should be added that its place of effective management is in England, and it does not fall to be treated in any other jurisdiction as resident there.

Plonk's business is the provision of oenological advice and services to clients, including advice on the sales and marketing of the blushful Hippocrene[3] and other winy products. Some clients require advice from time to time. Some others require Plonk's services on a continuous basis under a contract of consultancy. Included amongst Plonk's clients are three Spanish companies.

Plonk provides its advice by referring to databases which belong to it, and extracting therefrom data appropriate to the client. The databases are the property of Plonk, and are regularly updated from research conducted by or for Plonk. The services provided are perceived by Plonk to be ancillary to the advice, and most commonly consist of demonstrating how the advice may be put into practice.

Vino Colapso SA (VCSA),[4] a Spanish wine-producer, is one of Plonk's longer-term clients under an annually-renewed contract. VCSA is resident in Spain and

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2 In which all persons referred to, physical or moral, are imaginary.

3 With apologies to Messrs Keats and Wodehouse.

4 Also fictional.

has no installation or office outside Spain. The contract is current, and has been renewed twice.

Plonk, seeking to improve its efficiency for the client and at the same time protect its industrial property, decided to locate an employee of British nationality, Mr Albert Bacchus (AB), in VCSA's offices, in a room made available for the purpose by VCSA. At the time of telling this tale, AB has been working from VCSA's offices for nearly two years.[5]

AB's principal duties for Plonk are to act as operator and guardian of a portable computer and its software[6] on which Plonk's databases are held. Requests for advice from VCSA are passed directly to AB who, after consulting with head office, creates the advice for the client from the local computer, and delivers it directly to the client. From time to time, AB provides to VCSA commentary and advice ancillary to and in amplification of that produced from the database. AB may also provide the services referred to earlier.

AB is paid in sterling by Plonk under a UK contract of employment, and continues to be held current in the UK social security system. No reports of AB's presence in Spain have been made by Plonk. No tax harmonisation arrangements have been made or thought necessary. AB has no power to bind Plonk in contract. His employment title is "consultant". All invoicing of VCSA is done by Plonk's head office. Plonk has bank accounts only in the UK, and AB has no power to operate those accounts.

Following a chance examination of the situation, Plonk was advised that it was, albeit unwittingly, probably operating a Permanent Establishment (PE) in Spain. Some of the logic for this conclusion is given below.

This article concerns the potential effects of that discovery, and addresses some of the possible cures.

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5 AB is indubitably resident for tax purposes in Spain (see article on this subject in OTPR Vol 4, Issue 3, pp 177–184) and equally clearly should be declaring his worldwide income, realised gains, and wealth to Spain. It is not intended here to examine further AB's personal position.

6 Updated by modem connection with Plonk's mainframe every night.

Rep Office or PE?

In positioning AB in Spain, Plonk did not consider whether it would be creating a PE. If they thought about it at all, the directors considered that, at most, they would be establishing a representative office of Plonk in Spain. Certainly, it was not their intention to create a duty to make any reports or returns to any Spanish authority, nor to pay any tax in Spain.

It is already established that Plonk is not resident in Spain and is resident in the UK. In consequence, if no PE exists, Plonk's profits from its business activity in Spain fall under Article 7 of the UK/Spain Double Tax Treaty and are taxable in the UK and not in Spain. If, however, a PE does exist then the picture is substantially different.

Does Plonk have "a fixed place of business" in Spain? Despite the fact that AB is established in an office provided by VCSA, and not owned or rented by Plonk, the very nature and duration of AB's presence suggest that the answer must be in the affirmative. It seems also unarguable that Plonk is carrying on its business in part from that place. Prima facie, therefore, it seems that AB and his activities constitute a PE of Plonk.

Exemptions?

Article 5 of the UK/Spain Treaty is firmly based on the OECD model, and includes the usual definition. It also provides the usual exemptions, key amongst which, perhaps, are those for:

> (1) " ... use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise"; and
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> (2) " ... the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character for the enterprise."

Now, it would be entertaining to contemplate the possibility of arguing for Plonk that the information contained in the database constitutes "goods ....belonging to the enterprise". Of course, intellectual property is normally considered to be a right ("derecho") rather than a good ("bien"). Nevertheless, the fundamentally immaterial nature of the proprietary information or work requires (certainly in the case of a company, which has no equivalent of a human brain or memory) that it be recorded in some manner. In any event, recording thereof is a necessity if the

intellectual property is to be the subject of a claim for registration or other protection. Whilst the medium upon which it is recorded is not itself the intellectual property, the latter cannot be sensibly perceived, identified, examined or distinguished other than by way of the physical medium. Perhaps more to the point, in this context, it cannot be kept or stored other than on that or another medium. In short, the intellectual property is for all practical purposes indivisible from the medium on or in which it is recorded or stored from time to time. Clearly the medium itself needs to be kept or stored.

Is the proprietary information, stored on AB's computer, merchandise? Certainly it is for sale, albeit that its form may be more in the nature of raw material or work in progress than finished goods. It may perhaps be argued that the principal reason for positioning AB with his computer in Spain was precisely that of swift and convenient delivery.

I am not aware of any decided cases – and certainly the Commentaries to the OECD Model Treaty do not help me – which say whether the term "goods or merchandise" in the extract from Article 5 referred to above[7] can be taken to refer to immaterial property. If they do not, then perhaps they should. In any event, the somewhat jejune argument advanced above is unsatisfactory and insufficient for Plonk given, *inter alia*, that the computer at VCSA's premises contains, at best, a copy of the proprietary information, and not the information itself. In short, the "storage, display or delivery" exemption is of little help to Plonk.

Might the "preparatory or auxiliary activities" exemption be of more help? Certainly, Plonk believes that the services it provides are of a nature ancillary to its principal activity of providing advice to VCSA; that even though those services are largely provided by AB, the fact that he is in Spain does not alter their character as auxiliary. In order to determine whether this argument can succeed, it is necessary to consider the view of Hacienda (the Spanish equivalent of the UK's Inland Revenue).

Although there is, to my knowledge, no formal statement of practice (or equivalent) on the matter, Hacienda is known to accept that activities are merely auxiliary only provided that:

(a) The activities carried on in the fixed place of business in Spain are not, in themselves, the central activity or purpose of the foreign

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7 I have, of course, referred specifically to the UK/Spain treaty, but the reference holds good for the OECD Model, and other treaties based thereon.

company, and are clearly ancillary to that central activity or purpose.

(b) Those ancillary activities are performed solely for the foreign company, and not for other parties (such as a client company).

(c) The establishment in Spain performs only those ancillary activities.

In the case of Plonk:

(a) The duties performed by AB clearly coincide almost precisely with the core business purpose and commercial activity of Plonk. AB's duties and activities cannot be distinguished as merely auxiliary or ancillary thereto.

(b) The services provided by AB are provided to VCSA, and not to Plonk's head office.

(c) AB handles enquiries and requests for information from VCSA for Plonk, himself provides the answers from the database held by him on his local computer, and himself provides directly the "ancillary services" (Plonk's definition) of advice on implementation.

It seems, therefore, that the argument for the "preparatory or auxiliary activities" exemption also fails, on every ground.

If the full circumstances of Plonk and its establishment in Spain were drawn to the attention of Hacienda, Plonk would be held to be operating in Spain through a PE.

Taxation of a PE in Spain

Corporation Tax

In the overall, a PE in Spain is taxed much as a resident company, and is subject to the Impuesto sobre Sociedades[8] (IS). The current rate of IS is 35%, with no smaller companies rate. A PE must maintain separate accounting records of the

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8 Corporation Tax.

PE's assets[9] and the transactions effected by or through the PE, distinct from the company's accounts, in Spanish, according to the Spanish accounting standard,[10] and in the national currency.

There are rules limiting what may be deducted from the income of a PE. Of note are those prohibiting deduction for payments by the PE to its headquarters for royalties, interest, commissions, technical assistance charges, or in respect of use of assets or rights belonging to the company. Inevitably, soft-cost re-charges in respect of management and general administration expenses must meet the tests of reasonability, consistency, continuity, and rationality. They must also be reflected in the accounting statements of the PE.

Of potentially great - and indeed painful - significance, however, is the provision in Article 7 of the double tax treaty which attributes to a PE the profits which it might be expected to make if it were "a distinct and separate enterprise engaged in identical or similar activities in the same or similar conditions and dealing independently with the enterprise of which it is a permanent establishment". A probable effect would be an attribution for tax purposes to the PE, as income thereof, of all income derived by Plonk from contracts with all its Spanish clients (not merely VCSA), irrespective of whether AB played any role in servicing the other clients.

Whilst the mind of the tax planner immediately turns to seek some possible advantage from this deemed source-shifting of income, it is worth bearing in mind that, even if there were a tax advantage, the additional cost of compliance with the Spanish accounting and reporting requirements tends to be a great disincentive. In the instant case, Plonk would pay more tax, and would have to fund the increased compliance and management costs.

VAT[11]

One of the commonly unlooked for, and almost always unwelcome, effects of having a PE in Spain lies in the VAT rules. A fixed place of business in Spain (and the VAT legislation does not provide an escape for preparatory or auxiliary

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9 In Spain, a branch must be separately capitalised (i.e. a portion of the company's capital must be identified as that of the branch).

10 The Plan General de Contabilidad (General Accounting Plan).

11 In Spanish "IVA" (Impuesto sobre el Valor Añadido). The standard rate is presently 16%.

activities) becomes a VAT PE. Although, prima facie, this may not appear to be a big cash-flow issue for Plonk, it is worth noting that:

(a) it is most likely that all services provided by Plonk to Spanish clients will be deemed to have been provided by the PE, and so chargeable under the Spanish VAT regime.[12]

(b) once again, the additional management, accounting, and compliance costs will significantly increase the cost of the exercise.

PAYE[13] and Social Security

Although not strictly taxes per se, these matters are worth a passing mention. As the employer of Mr Bacchus, Plonk's PE in Spain should have registered with the labour authority as an employer.

The PE should be paying AB, and should be complying with the Spanish rules on retentions (PAYE) from AB's salary. If it has not made the retentions, and paid them over as required, then apart from any other sanction applied, the salary payments will not be deductible in calculating the PE's taxable profit.

In the case of Plonk, it may be that the PE was initially protected by the EU rules from having to register with the Social Security authority and pay the requisite contribution (30.8% of payroll) in respect of AB, given that AB is held current in the UK system. However, if Plonk did not make the required notifications[14] to the Spanish authorities two years ago, the PE would be in breach.

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12 ... which is notable for, *inter alia*, the fact that claims for repayment may only be made in the first quarter of each year, in respect of the preceding year. Such claims without fail spur a full inspection of all the tax payer's books and all tax accounts (not limited to VAT). The resource cost of this is usually high. Approved claims are slow to be repaid, and it would be an unwise taxpayer who built such repayments in to his cashflow forecasts before September of the year in question.

13 The law provides a scale of retentions from the employee's pay and benefits on account of the employee's income tax liability. The scale takes the amount of emoluments and the number of dependents as its indices. The employer has the duty to retain and pay in to Hacienda the appropriate amount. Benefits in kind must be grossed up, and the retention paid in cash.

14 Form E101 for the first twelve months of the overseas tour of duty, possibly extended by Form E102 for a further twelve months.

Effects of Discovery

If compliance failures[15] are discovered at the instance of the tax authority, the law specifies that a penalty of 50% to 150% of the assessed unpaid tax is payable. 30% of this penalty may be rebated if the assessment is agreed by the taxpayer. In addition, of course, the unpaid tax itself, and interest thereon must be paid.

If the taxpayer elects to make a voluntary "regularisation" of the compliance failure – which is to say that he spots the error of his ways, and voluntarily makes good before Hacienda drags him under the hot lights – there are no penalties. There are, however, surcharges[16] payable in addition to the unpaid tax and interest thereon. The amount of the surcharges depends on the time which has elapsed between the due and the actual dates of payment of the tax. 5% of the tax due is the surcharge where a compliance failure is rectified within 3 months of the due date, 10% for 6 months, 15% for 9 months, and 20% for 12 months or more.

In this latter context, it should be noted that a tax-year in which a compliance failure has gone unnoticed for five years from the last day on which payment should have been made, may not be reopened by the tax authority. Any activity by either party (Hacienda or taxpayer) causes the passage of time in this 5-year "proscription period" to be suspended. In a case where a taxpayer is considering voluntary regularisation, he should make a calculation of the competing risks before electing to take action. In brief, the potential cost of discovery rises with each passing year, and the temptation to crystallise the liability at a lower cost by voluntary regularisation can be pressing. Gritting one's teeth and eventually passing the five-year winning-post can be like winning the lottery (and the winnings are tax-free). It is considered poor advice in Spain not to alert those clients, whose circumstances are appropriate, to this possibility.

In Plonk's case, barely two years along the track, and in a continuum of tax-years with taxable earnings, hoping to remain undiscovered for a rolling period of five years from the close of each tax year is not a sensible option.

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15 Applies equally to direct taxes and to VAT.

16 What's in a name? Mind you, so far as the record is concerned, to have been penalised by the tax authority is a beast of entirely different colour from that of voluntarily to have paid a surcharge.

What does Plonk do now?

Assuming that Plonk wishes to continue doing business in Spain in substantially the same way, the principal options would appear to be:

(1) Do nothing.

(2) Continue as before, but with voluntary regularisation.

(3) Discontinue the branch, form a subsidiary in its place, and

  (i) either ignore the branch's past compliance failures;

  (ii) or voluntarily regularise the branch's tax affairs.

Do nothing

This has a number of superficial merits. It does not draw attention to an admittedly murky situation. As an option it is, per se, cost-free. Nevertheless, it is not to be recommended. The risks not only remain, but continue to grow, both in quantum of tax, interest and penalty, and of discovery. Plonk is not in command of its own ship and is vulnerable to chance or deliberate action by other parties. Any other consideration aside, this is not a good commercial position.

Continue the branch, with voluntary regularisation of the tax position

The considerations here are, primarily, two: what is an appropriate corporate structure; what to do about both past and future tax liabilities.

It is my judgment, formed over many years, that, for a foreign company, a branch is a cosmically inconvenient mechanism for doing business in Spain. On general grounds, a subsidiary is greatly preferable. In Plonk's circumstances, a branch is even less attractive, and a subsidiary greatly to be preferred (and in this I am considerably influenced by the *vis atractiva* of a branch, in which Plonk's other operations with Spain would be considered for tax[17] purposes to be operations in Spain conducted by the branch).

I therefore discard this option also.

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17 Including IVA (VAT).

Form a subsidiary and choose whether to ignore or voluntarily to regularise the past tax position

Formation of a subsidiary has a number of attractions. It is a separate person-at-law from the parent company. The direct operations of the parent can be distinguished from those of the subsidiary. Any problems suffered by the subsidiary can be contained at that level, and not automatically strike at the heart of the parent. The tax compliance requirements are broadly the same, but without the dreadful *cuenta de enlace*[18] required of a branch operation. The company law requirements are generally simpler to deal with. The tax rate is the same, with more open rules as to what may be deducted.[19]

I take the clear view that Plonk should conduct its business with VCSA via a subsidiary. It gives greatly increased flexibility and control. There may be other benefits also:

(1) The new operation would be fully compliant, and would be seen to be so upon inspection.

(2) Past compliance failures, if discovered, would not be those of the new sub.

(3) Those historical compliance failures (of the parent) would, indeed, be history, and not being continued. The risk of Hacienda being put on notice would be a fading one. It is entirely possible that, in such circumstances, Hacienda may decline to pursue an enquiry even if alerted to the historical situation.

Self-evidently, the question of whether Plonk plc should own up to past misdemeanours, or allow the passage of time the chance to heal all, must be a commercial one to be taken by the directors of Plonk. Extraneous matters (such as a disaffected employee, or a dissatisfied customer, or a displaced competitor) may leave finger-posts pointing at the past, which Hacienda could not ignore. In the absence of the latter, however, it seems unlikely to me that Plonk's past sins would be discovered. There would be a slightly nervous period of years until the last open year of the branch operation passed the 5-year mark. Or there again,

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18 A "linking account" in which all transactions between the Spanish branch, its head office, and any other branches are shown in full detail. The effect is, almost without exception, to reveal to Spain pretty much the whole of the company's businesses. It is normally costly and bureaucratically complex to produce.

19 Unlike the prohibition on deduction for certain payments between branch and head office, the over-riding requirement between parent and sub is the arm's-length principle.

there may be technical, moral, and even commercial satisfaction in cleaning out the sore immediately upon formation of the subsidiary.

Conclusion

Plonk plc is not alone. There are many British and other operations in Spain which are Permanent Establishments, and which the head offices regard as mere rep offices. This article is designed to draw attention to the risks. It is above all designed to illustrate the necessity for planning.