Ask an expert

Service PEs and 'other personnel'

Francisco Alvarez Silva
Senior manager, Milestone Tax

Email: **francisco@milestonetax.com**
Tel: **020 7534 7180**

Article 5(3)(b) of the United Nations Model Convention states that a non-resident will have a service permanent establishment (PE) in the source state, if it furnishes its services thorough employees or other personnel. However, can employees of another organisation be considered 'other personnel' of a non-resident? The OECD Commentary (at paras 42.21 and 42.22) provides some insight, but there is no guidance from the UN as to what is considered 'other personnel'. Consider, for example, a local hotel owner who engages an offshore management company to manage the hotel's day to day operations for a percentage of gross revenue. According to the management agreement, the local owner shall be the employer of all local staff to carry out day to day operations; however, the offshore manager will be granted full control over such staff, including selection, dismissal, direction, supervision and setting remuneration levels. Should such staff be considered 'other personnel' of the non-resident for furnishing its day to day management services in the source state?

The problem in this case is not so much one related to the concept of service PE, but rather whether the source state's domestic laws would allow the formal employment relationship to be questioned for tax purposes. It is to some extent the same reasoning behind the 'economic employer' concept that the OECD developed, in relation to the exemption for short-term employment in art 15(2) of the OECD Model Convention (see the OECD Commentary at paras 8.2–8.28).

Article 5(3)(b) of the UN Model Convention regards the furnishing of services by a foreign enterprise, through employees or other personnel engaged by it for such purposes, as a deemed PE. The provision is a substantial deviation from the OECD Model Convention, insofar as it allows source taxes to be charged on the profits without the foreign enterprise having a PE in the source state.

The term 'other personnel' included in art 5(3)(b) is undefined in the UN Model Convention, so recourse should be had to domestic law under the general rule of interpretation in art 3(2). It is, therefore, a matter of the domestic law of the state of source to determine the meaning of the term 'other personnel', provided that its context in the particular double tax treaty (DTT) does not require otherwise. Should the context require that an autonomous meaning of the term be sought, it is not clear what interpretative value could be attributed to any guidance found in the Commentaries to the OECD Model Convention, since the concept of a service PE is a deviation from the OECD Model Convention on which the Commentaries are based.

However, please bear in mind that some states' domestic laws may rely upon a substance over form approach to determine the nature of services being rendered by individuals (the local staff) to a person other than their formal employer (the local hotel owner).

In this case, the services performed by the local staff are directly supervised and controlled by the offshore manager company; and the services rendered by the local staff constitute an integral part of the business activity of the offshore manager company (provision of management services). Together, these facts could be used by the source state to challenge the formal employment agreement entered into between the foreign entity and the local hotel owner.

Should such a challenge succeed, the services rendered by the local staff would be considered to have been rendered under a contract of service, instead of under a contract for services. Provided that the 183 days test is met, the foreign management company would have a service PE in the source state.

Where does this leave us?

To conclude, the employees or personnel formally employed by the local hotel owner should not constitute a service PE for the foreign management company under art 5(3)(b) of the UN Model Convention, provided that the formal employment contract is not questioned for tax purposes. However, the application of domestic rules based on a substance over form approach may lead to a recharacterisation of the services as having been rendered in an employment relationship.

It follows that the services rendered by the foreign management company would have been rendered through a PE in the source state. The question then would be determining the appropriate amount of profits that could be allocated to the service PE. Recent Indian cases may provide good insight on this matter (see the Indian Income Tax Appeal Tribunal, *Linklaters LLP v Income Tax Officer –International Taxation, Ward 1(1)(2), Mumbai* ITA Nos. 4896/Mum/03, 5085/Mum/03). ■

Next week: A UK resident individual owns 100% of the share capital in a UK holding company, which in turn owns 100% of a UK trading company. He reduced the capital of his holding company by one third (partly because he thought he would pay less tax), for which he received £1m. The funds for this reduction arose from accumulated profits in the trading subsidiary which were paid up to the holding company as a distribution. How should this capital reduction be reported on the individual's tax return?