

LEGISLATIVE DEFINITION OF PERMANENT ESTABLISHMENT IN UKRAINE AND ITS FEATURES

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ABSTRACT

Despite the long history of the permanent establishment concept and its importance in the context of international taxation, there is no common approach to its main characteristics because of the nature of the concept that determines the necessity to conform the provisions of domestic tax legislation to the norms of the double taxation treaties covered by international law. Each state forms the legal basis of the permanent establishment concept on its own and Ukraine is not an exception.

Considering the fact of the ratification of the Multilateral Convention to implement Tax Treaty Related Measures to Prevent BEPS (MLI) and the outdated definition of permanent establishment in the domestic legislation, there is the necessity to make changes that should bring into the conformity the national tax legislation with the international obligations in the context of regulation of permanent establishment. Nevertheless, the proposed draft of changes of the Tax Code of Ukraine has some features that should be avoided in order to ensure better regulation and accordance with widely recognized standards that are included in the OECD Model Tax Convention (OECD MTC). First, the words “permanent place” should be replaced with the words “fixed place” in the general rule on permanent establishment included in Art. 14(1)(193) of the Tax Code of Ukraine. Second, the concept of related (associated) persons should be replaced with the concept of closely related persons in the proposed draft of the Law on BEPS. Third, Art. 14(1)(193) of the Tax Code of Ukraine should be changed by the way of improvement of the provisions on permanent establishment to ensure proper implementation of Art. 10 of the MLI.

Keywords: Permanent Establishment, Domestic Regulation, Taxation, Double Taxation Treaty.

INTRODUCTION

Despite the importance of the permanent establishment concept in the context of application of double taxation treaties, its appearance is connected to the needs of the German States in the second half of 19th century (Williams, 2014). The efforts of such countries as Prussia, Saxony and the Austro-Hungarian Empire helped to develop the basic conditions for permanent establishment at the end of the century (Skaar, 1991). The further evolution of approaches to the permanent establishment concept in the context of double taxation treaties has not limited the relevance of its appropriate normative regulation at the level of domestic legislation. It results from the fact that the features of the permanent establishment concept are determined by the conventional relations between contracting jurisdictions but they are also based on the national legislative prescriptions. Hence, the features of domestic regulation might

impact on the realization of obligations as they follow from the provisions of double taxation treaties.

At the same time, the global campaign against base erosion and profit shifting (BEPS) creates the situation in which the participating states should modernize their approaches to normative regulation of the permanent establishment concept including international as well as domestic levels. It results from the recommendations of the report dedicated to the issue of preventing the artificial avoidance of permanent establishment status (Organisation for Economic Co-operation and Development, 2015).

Taking into account the global trends and the necessity to counteract the inappropriate application of the provisions of double taxation treaties by taxpayers, Ukraine is also on the way of making changes into domestic normative regulation of the permanent establishment concept.

Firstly, the changes are drafted with consideration of the fact of ratification by Ukraine the MLI in February 2019.

Secondly, the national government has declared as one of the aims of tax reform ensuring the consistency of existing double taxation treaties of Ukraine with the provisions of the OECD MTC (Cabinet of Ministers of Ukraine, 2017).

Finally, in 2018, the National Bank of Ukraine and the Ministry of Finance of Ukraine presented the draft of legislative developments to the domestic tax legislation that have to implement the international obligations recognized under the MLI (it is worth mentioning that the draft is still under discussion and is not in the agenda of national legislator as of May 2019).

These steps demonstrates that the permanent establishment concept is under the review at the domestic level by the Ukrainian authorities because its normative basis was created at the beginning of the 1990th and does not allow efficient counteraction to tackle tax evasion and tax avoidance that is serious challenge for the financial stability. Nevertheless, the permanent establishment concept has not been widely investigated by researchers in Ukraine with few exceptions especially in the context of legislative changes and its accordance with the international standards (Trachuk & Tsvetkov, 2019; Trachuk & Franchuk, 2018). Thus, there is the necessity to characterize the modern approach to normative regulation of permanent establishment and its proposed changes in the context of the international standards reflected in the provisions of the MLI and the OECD MTC.

METHODOLOGY

The methodological basis of the study is a set of general and special methods of scientific knowledge. The systematic approach is a common scientific method that is allowed for identifying issues of legal regulation of counteraction to tackle tax evasion and tax avoidance. The logical semantic method is used in the context of studying the categorical apparatus in accordance with the tasks of the research (for example, the concept of permanent establishment). The formal method is applied for formulation of proposals and recommendations on improving the normative regulation of the permanent establishment concept at the domestic level in Ukraine. A comparative legal method is used to compare the legislation of Ukraine, the recommendations of the OECD MTC and its Commentaries and the provisions of the MLI in the context of permanent establishment. Normative basis of the research is represented by the legislative acts of Ukraine, the model acts of the OECD and the international treaties that have been concluded by Ukraine.

RESULTS AND DISCUSSION

According to Art. 14(1)(193) of the Tax Code of Ukraine, the definition of permanent establishment is set out as:

“Permanent place of activity through which the business of an non-resident is wholly or partly carried on in Ukraine”

Including:

“A place of management; a branch; an office; a factory; a workshop; a construction or facilities for the exploration of natural resources; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; a stock or a building that is used for the purpose of delivery of goods, a server”.

In addition to the general rule, the Ukrainian legislator provides the list of activities, persons or objects that might result in the recognition of permanent establishment for non-resident:

1. A building site, a construction, assembly or installation object or supervisory activities in connection therewith, but only if the duration of activities connected with such site, object or activity last for more than six months.
2. The furnishing of services by a non-resident (except to the services of secondment of staff), including consultancy services, through employees or other personnel engaged by the non-resident for such purposes, but only if the relevant activity continues within Ukraine (in the framework of one project or project that is connected with it) for a period or periods aggregating more than six months in any 12-month period.
3. The residents that have the exclusive right to act in the name of non-resident (the negotiation of the substantive conditions and/or the conclusion of contracts in the name of the non-resident) that creates the civil rights and obligations for the non-resident.
4. The maintenance of storage of goods belonging to the non-resident from which the delivery of goods is made in the name of non-resident (with the exception to residents that have the status of warehouse for temporary storage or licensed customs warehouse).

There is also the negative list of examples of activities that should not result in the recognition of the permanent establishment for non-resident:

1. The use of facilities or buildings solely for the purpose of storage, display or delivery of goods or merchandise belonging to the non-resident;
2. The maintenance of a stock of goods or merchandise belonging to the non-resident solely for the purpose of storage or display;
3. The maintenance of a stock of goods or merchandise belonging to the non-resident solely for the purpose of processing by another enterprise;
4. The maintenance of a permanent place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the non-resident;
5. The assignation of natural persons at the disposal of another entity in the framework of the contract on the secondment of staff.
6. The maintenance of a fixed place of business solely for the purpose of carrying on of any other activities that has a preparatory or auxiliary character.

As one might admit, the definition of permanent establishment has its features in accordance with the general approach proposed by the OECD MTC.

First of all, the Ukrainian legislator includes the types of permanent establishment that are not mentioned in the wording of Art. 5 of the OECD MTC (for example, service or delivery

permanent establishment). Thus, it points out that the national normative regulation tends to widen the scope of permanent establishment concept in the attempt to ensure the fiscal sovereignty.

Secondly, Art. 14(1)(193) of the Tax Code of Ukraine contains provisions that are not similar in their wording with Art. 5 of the MTC OECD. As an example, it might be pointed out at the usage of the word “*resident*” in the context of agency permanent establishment that limits the list of situations that might be covered by the provisions of national tax legislation.

Lastly, the wording of Art. 14(1)(193) of the Tax Code of Ukraine does not prevent the conflict of interpretation in case of the provisions like the delineation between the basic permanent establishment and the agency permanent establishment. According to the position of the national legislator, the point is that the wording of the basic permanent establishment might be interpreted in a way that supposes the existence of fixed place of business for the agency permanent establishment.

Obviously, the existing approach in the Tax Code of Ukraine is not in accordance with the contemporary wording of Art. 5 of the OECD MTC in its version as of 2017 as well as the provisions of the MLI:

1. The wording of Art. 14(1)(193) of the Tax Code of Ukraine does not allow the inclusion in the scope of the agency permanent establishment the cases in which a person is acting on behalf of a non-resident and habitually plays the principal role leading to the conclusion of contracts that are routinely concluded by the non-resident.
2. There is no indication that a person does not have the status of independent agent if the person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related.
3. The national legislator does not include any specific provisions that are necessary for the implementation of the provisions of the OECD MTC (Art. 5(8)) and the MLI (Art. 15) on closely related enterprises.

Taking into consideration the abovementioned features of the definition of permanent establishment and the conclusion of the MLI, the Ukrainian government in the face of the Ministry of Finance and the National Bank of Ukraine proposed the draft of the Law of Ukraine titled “*On Amendments to the Tax Code of Ukraine for the Purpose of Implementing the Action Plan on Base Erosion and Profit Shifting*” that was represented at the end of October 2018 (the draft of the Law on BEPS) (National Bank of Ukraine, 2018). One of its aims is the modernization of the wording of the definition of permanent establishment included in the Art. 14(1) (193) of the Tax Code of Ukraine. Among other changes to existing legislation, it is proposed:

1. The introduction of the rules on counting the calendar months that are necessary for the application of the construction as well as service types of permanent establishment (for example, the periods of activity of non-resident is added to the calendar months if each of them is less than one month but the aggregate their duration is more than thirty days).
2. The introduction of characteristics of the person’s authorities for non-resident that might result in the agency permanent establishment (e.g., giving the instructions by the non-resident that are compulsory and are realized by the person; the existence of corporate e-mail of non-resident or its related person that is granted to the person and is used by such person for communication with the non-resident and/or the third persons that have concluded contracts with the non-resident or are planned to do that in future).
3. The clarification of the provisions on the activities that do not create the basis for the permanent establishment because of their preparatory or auxiliary character by the exclusion from the scope of the permanent establishment any combination of activities of preparatory or auxiliary character provided that the overall activity still have the same character.
4. The clarification of the provisions on the permanent establishment by mentioning that the activities of the non-resident and its related persons might be recognized as basis for the existence of their permanent

establishments in Ukraine if these activities are out of the preparatory or auxiliary character and constitute complementary functions of a cohesive business process.

5. The inclusion of the characteristics of a person that might create the agency permanent establishment of non-resident in case if such person has and habitually realizes the authorities to negotiate contract conditions that leading to the conclusion of contracts (e.g., the activity of the person is financed by the non-resident and/or its related non-residents).

Nevertheless, there are some specific characteristics of the provisions of Art. 14(1)(193) of the Tax Code of Ukraine that might be problematic in the context of their conformity with the recommendations of the OECD MTC and the demands of the MLI even in case of adoption of changes proposed by the abovementioned draft of the Law of Ukraine.

Firstly, the definition of permanent establishment contained in Art. 14(1)(193) of the Tax Code of Ukraine is worded with referral to “*permanent place of activity*”. Nevertheless, place of business has to be “*fixed, i.e. it must be established at a distinct place with a certain degree of permanence*” (para. 6 of the Commentary on Art. 5 of the OECD MTC) (Organisation for Economic Co-operation and Development, 2017). Thus, the criterion of permanency and the geographical criterion should be connected via the concept of fixed place. Taking into consideration these criteria, Reimer provides the examples of place of business that is permanent but not fixed (e.g. a business vehicle inside a car park, even if no one has applied the brakes) as well as of place that is fixed but not permanent (e.g., a scaffold fixed on the wall of a house, or a tent on a camping ground) (Reimer, 2015). As it seems, the definition of permanent establishment should be changed in accordance to the need to be in conformity with the language of double taxation treaties as well as the MLI. The difference between the criterion of permanency and the geographical criterion determines the feasibility of replacing the words “*permanent place*” with the words “*fixed place*” in the definition of permanent establishment as it is worded at the domestic level.

Secondly, the draft of the Law on BEPS proposes to introduce the concept of related (associated) persons to the definition of permanent establishment in the national tax legislation. At the same time, it has to be mentioned that the concept of related (associated) persons might be similar in some aspects but not the same as the concept of closely related persons as it is worded in the OECD MTC and the MLI. It is underlined in the separate definition of closely related persons in contrast to the associated persons as it follows from Art. 5(8) of the OECD MTC and Art. 15 of the MLI. Moreover, one might admit the provisions of the Commentary on Art. 5 of the OECD MTC that reflect the recognition of the difference between the related (associated) persons and the closely related persons: the concept of closely related persons

“Is to be distinguished from the concept of associated enterprises which is used for the purposes of Art. 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent” (para. 119) (Organization for Economic Co-operation and Development (OECD), 2015).

Nevertheless, there is the opinion that the introduction of the concept of closely related persons in the context of permanent establishments seems to be less appropriate than the concept of associated enterprises (Storck & Petruzzi, 2016). In our opinion, the Ukrainian legislator should replace the concept of related persons with the concept of closely related persons and introduce it to the definition of the permanent establishment at the domestic level in order to ensure the conformity with the provisions of the MLI and the international standards implemented in the provisions of the OECD MTC.

Finally, Ukraine has chosen to cover its double taxation treaties with the scope of Art. 10 of the MLI in the attempt to restrict the access to treaty benefits in case of so called triangular situations. One of the main criterions of Art. 10 is the comparison between the tax in the jurisdiction where the permanent establishment is situated and the tax that would be imposed in the jurisdiction where the enterprise is located to which the permanent establishment belongs if that permanent establishment were situated in the jurisdiction of residency of the enterprise. As it is underlined by Rust & Wöhrer;

"The difference in the taxable base is taken into account. Even if the tax rate in the residence state and in the permanent establishment state is the same, the anti-abuse provision for triangular cases might nevertheless be applicable if a lower taxation in the permanent establishment state results from tax exemptions in the permanent establishment state" (Rust & Wöhrer, 2016).

Besides, there are no any specific rules on the implementation of Art. 10 of the MLI neither in the Tax Code of Ukraine nor in the draft of the Law on BEPS. Obviously, the current situation should be changed by the improvement of the provisions on permanent establishment of the Tax Code of Ukraine. Otherwise, the implementation of Art. 10 of the MLI would be problematic in the absence of the specific rules in the domestic legislation of Ukraine.

CONCLUSION

The permanent establishment concept is one of the most important in the context of international taxation and the double taxation treaties. At the same time, its normative basis should be based on the provisions that are in conformity with the conventional norms as well as the domestic tax legislation. Thus, Art. 14(1)(193) of the Tax Code of Ukraine should be improved taking into consideration the global trends of tax regulation and the ratification of the MLI. Nevertheless, the proposed draft of the Law on BEPS has some features that do not allow ensuring the full conformity with the provisions of the MLI as well as the recommendations of the OECD MTC. As it follows, there is the necessity to make a few additional changes on permanent establishment in the process of improvement of domestic tax legislation. First of all, the words "*permanent place*" should be replaced with the words "*fixed place*" in the general rule on permanent establishment included in Art. 14(1)(193) of the Tax Code of Ukraine because of the difference between the criterion of permanency and the geographical criterion that have to be combined in the fixed place concept. Secondly, one might admit that the concept of related (associated) persons should be replaced with the concept of closely related persons in the proposed draft of the Law on BEPS because of the need to ensure the conformity with the provisions of the MLI and the international standards implemented in the provisions of the OECD MTC. Lastly, Art. 14(1)(193) of the Tax Code of Ukraine should be changed by the way of improvement of the provisions on permanent establishment to ensure proper implementation of Art. 10 of the MLI.

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