Can access to foreign warehouse create permanent establishment? (3/43/19)

Companies are increasingly expanding their operations around the world by hiring staff to research the local market, negotiate contracts and prices with local customers, and conduct marketing and other activities that promote the company’s business. It is important to find out whether those activities are likely to create a permanent establishment (PE) in the country where they are carried out. This article explores recent changes to the interpretation of law that will affect future PE risk when it comes to assessing a company’s access to a foreign warehouse.

Changes to the legal framework

The OECD’s 2017 Model Convention with respect to Taxes on Income and on Capital defines the PE as a “fixed place of business through which the business of an enterprise is wholly or partly carried on.”

On 6 June 2017, Latvia and several other OECD member countries signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS). Latvia has yet to give effect to this convention and has reserved the right not to apply its article 12 to Latvia’s effective bilateral tax agreements, thereby refusing to enforce tighter requirements.

The 2017 commentaries on the model tax convention have undergone substantial changes to the PE treatment. Although these commentaries are currently not applicable to 80% of the OECD member countries, we can already identify a number of aspects that may result in companies having a PE in countries where as yet no PE risk assessment has been necessary.

In the light of these changes, it is important to assess the circumstances of your company’s activities abroad because some activities that used to be seen as preparatory or auxiliary may now be considered consistent with your company’s core business activity and create a PE.

Case study

To illustrate one of the aspects of assessing PE risk, let us look at an example.

LV SIA produces dietary supplements. SE Co, a Swedish group company, provides LV SIA with packaging services in Sweden for a fee. LV SIA rents a warehouse from a third party in Sweden for storing the finished goods as well as their packaging and instructions for use SE Co needs for providing services.

Once packaged, the goods are placed in the warehouse, which is managed but not owned by SE Co. For these services, too, SE Co receives a fee from LV SIA. Since LV SIA organises deliveries to customers, LV SIA’s staff have unlimited access to the warehouse in Sweden.

Considering only the warehouse aspect, LV SIA may have a permanent (not only short-term) physical presence in Sweden where business-related activities (storage of goods) are carried out under article 5(1) of the model tax convention:

1. LV SIA’s activities in Sweden are not considered preparatory or auxiliary if the warehouse is also

used for storing goods or raw materials owned by other group companies;
2. the company’s activities at the warehouse are not limited to storage, for example, the warehouse accommodates an office used by LV SIA’s staff when in Sweden.

To mitigate PE risk, LV SIA should consider the following steps:

1. Resigning its current third-party warehouse contract with SE Co instead, and inserting restrictions on LV SIA staff access in the warehouse management contract;
2. Renting a warehouse for the finished goods elsewhere to use SE Co’s warehouse only for storing the packaging and instructions, i.e. an activity directly linked to SE Co’s core business;
3. Sending the finished goods either back to Latvia for future supplies to other countries or directly to a wholesaler for onward supplies to end consumers. This would eliminate PE risk in Sweden while increasing the company’s costs associated with extra administration and carriage expenses.

In a similar example from the digital economy, a US company sells automobile spare parts in Japan through an online shop that has its website (in Japanese) maintained in the US. The company rents a warehouse in Japan to store the parts for fast delivery. A third-party Japanese company provides the US company with warehousing services, including delivery arrangements.

Once an online shopper has placed an order and made payment, the US company sends a request to the Japanese warehouse staff for preparing and shipping spare parts to the customer. It is important to note that this business model makes customers believe they are dealing with the Japanese, not the US company, because of the way their customer service (delivery) is organised.

In this case, too, we can identify PE risk, as the US company has a physical presence in Japan with an identifiable place of business where spare parts are stored and deliveries made. Although warehousing as such may be considered an auxiliary activity, delivery in this case is one of the activities that ensures the US company’s core business and creates PE risk. The US company should consider ways of splitting its activities in Japan (hiring subcontractors, using wholesale warehouses etc) to eliminate or mitigate PE risk.

If your company is interested in our service offerings for PE risk assessment and mitigation, please reach out to our senior tax manager Vita Sakne (vita.sakne@pwc.com) or Agate Ziverte (agate.ziverte@pwc.com).