



GUIDE

PERMANENT ESTABLISHMENT PE



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PUERTO RICO TAX COMPLIANCE GUIDE

By Torres CPA Group
CifrasPR

Understanding the Puerto Rico tax system and its interrelation with United States is crucial for individuals and entities doing business in Puerto Rico. Puerto Rico is not a state; its a territory, with its own Business and Payroll laws and regulations.

The following White Paper is designed to give an insight Tax Issues in Puerto Rico. It provides relevant background information, which will be of assistance to organizations considering establishing business in the Island. Nonetheless, it is highly recommended to seek advice and counsel from qualified professional sources before undertaking any business.

Certain exclusions and exemptions may apply and when specific problems occur in practice, it will often be necessary to refer to the laws and regulations of Puerto Rico, and to obtain appropriate accounting and legal advice.

It is understood that the following overview does not constitute any formal rendering of either legal, accounting, tax or professional services. If legal advice or other assistance is required, an attorney, CPA or tax adviser should be consulted.

Torres CPA Group is an Advice Certified Public Accounting Firm offering Audit, Tax, Consulting and Financial Outsourcing services for over 30 years. If you require any further information or help, please do not hesitate to contact us.

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Permanent Establishment (PE) Risk

Permanent Establishment (PE) Matters

The business operations of a Puerto Rico entity are protected from U.S. taxation if those activities do not create a Permanent Establishment (PE) in the U.S.

There is always a risk that business activity in a foreign country will result in PE; and, therefore, in income tax liability. The problem with many companies is that they are not aware that their presence is triggering PE, and they are then met with unexpected tax liabilities.

Once you have established that an enterprise has a PE in a host country, they will likely need to consider the need to justify profit attributions and file tax return requirements.

Triggering Permanent Establishment

The Permanent Establishment (PE) is created by any business activity that can be viewed as having a stable and ongoing presence in another host country. As the term implies, 'permanent establishment' will be triggered by activities that reflect constant and persistent revenue creation, rather than sporadic or isolated business efforts.

Permanent Establishment risk applies when a company begins marketing goods and services within a host country's borders and derives revenue from that commercial activity.

Suppose a company is determined to be a fixed place of business. In that case, any revenue earned inside that host country qualifies to be taxed accordingly based on local tax statutes and on the amount of time the company is active as a permanent establishment.

Not every business activity undertaken in a foreign country activates a permanent establishment designation. For example, a commercial activity that lays the groundwork for trade in a country but does not create revenue typically will not classify as PE.

The following activities are excluded from the PE triggering:

Trading in derivatives - If a foreign person is not a dealer, a trade or business within the United States does not affect transactions in derivatives for the taxpayer's account, including hedging transactions.

Investing - Investing, including the active management of one's investments, however extensive, does not constitute a trade or business.

Ministerial and ancillary activities - A taxpayer does not have a USTB if only routine business stewardship, ministerial or clerical functions are performed in the United States.

Guidelines:

Any one of these can trigger Permanent Establishment and income tax or VAT, affecting the long-term return on investment in a host market.

1. Fixed Place of Business

Fixed Place of Business, address, bank account, or other physical presence

A business test's fixed place is the most common and easily identified risk and can include a branch office, factory, location for the management, or other facilities. This would also mean that the company would likely have a local entity set up and registered. More modern PE law applications are even including computer servers as a fixed place of business for digital transactions, even if there is no branch office or long-term employees in the country.

The facilities must be "at the disposal" of the enterprise. This means that despite regularly meeting at a customer's premises, those premises will not be a PE, as they are not 'at the disposal' of the enterprise.

The place of business is fixed. There must be a connection between the premises and some geographical position, as well as a 'degree of permanence' related to that location.

The business is wholly or partly carried on through that fixed place.

2. Business Activity

Activities from Staff in a host Country that directly relates to revenue creation

Naturally, employing local staff will catch tax authorities' attention, who will want to know the type of activity and number of employees. Any employee activity for PE must be habitual and ongoing, rather than sporadic or one-time visits.

For example, employing long term sales staff can trigger PE as there exists sufficient business activity under certain conditions. Usually, these will need to be more than marketing or exploratory measures, and the team will need to have the authority to conclude contracts on behalf of the company. A one-time sales visit would not be enough to trigger PE, even if resulting in a substantial deal.

3. Revenue Creation: Sales Staff Signing Contracts on Behalf of Company

The revenue creation test for PE is also triggered when staff is negotiating, drafting, and signing contracts, with most of the work occurring inside the host country over some time. This may again happen if the company uses agents or subcontractors for sales since the revenue will still flow.

4. Sufficient time frame to trigger PE under local law

5. Actual control and direction of the staff activity by the foreign entity in the host country

An entity that operates in the U.S. through a dependent agent that habitually exercises the authority to conclude contracts on behalf of the entity in the host country.

Even if an enterprise would otherwise meet the definition of a PE, certain activities are 'exempted' from applying the PE rules. If the location would be a PE, but it is used solely for an activity that has an "incidental, preparatory or ancillary" character for the enterprise, it is deemed not to be a permanent establishment.

However, there are exceptions to these general types of locations that do not constitute a PE. The exceptions are as follows:

- a) Use of a facility solely for storage, display, or delivery of goods or merchandise owned by the entity
- b) Maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery



- c) Maintenance of a stock of goods or merchandise belonging to the enterprise solely for processing by another enterprise
- d) Maintenance of a fixed place of business solely to purchase goods or merchandise or for collecting information for the enterprise
- e) Maintenance of a fixed place of business solely to carry on any other preparatory or auxiliary activity for the enterprise
- f) Maintenance of a fixed place of business solely for any combination of the activities listed above

These activities are often referred to collectively as "ancillary activities."

Triggering Activities:

An entity has many options for doing business in the U.S. without triggering a PE for tax purposes. The analysis is highly fact-specific for each case.

Sales of Inventory

Revenue from a sale of personal property, including, but not limited to inventory that is attributable to an office or other fixed place in the United States is sourced in the United States.

Revenue from a sale of personal property, including, but not limited to inventory, that is not attributable to an office or other fixed place of business in the United States is not sourced in the United States.

Revenue from the sale of inventory property that is sold for use, disposition, or consumption outside the United States where an office or fixed place of business is maintained by the taxpayer in a foreign country that materially participated in the sale, is not sourced in the U.S.

Stewardship Management Office Place

A fixed facility is not treated as an office or other fixed place of business sourced in the U.S. if the only activity conducted from the facility is general supervision or control, including top management decisions.

Employing Individuals

One of the typical ways that a host country may assign PE to a foreign company is by the presence of employees that work there. There is no hard fast rule in this area, and it will depend on factors such as the amount of time spent in the country and the specific business activities performed. Having a formal office or facility in the host country will increase PE's likelihood of being created by employee activity.

Using the 'revenue creation' model, here are some examples of where PE will likely be created by employee activity:

- An engineer on the ground servicing a contract which results in revenue to the foreign corporation
- A sales representative that is regularly concluding contracts on behalf of the company



- Customer service representatives that staff a fixed office and attend to client needs
- Withholding employee income and social security taxes
- Employing individuals who continually work inside a host country for an extended time, creating a "prolonged worksite" status
- Receiving payments from clients operating within the host country and withholding taxes; thus, signing contracts within host-country businesses and profiting from those contracts.

A few specific examples of employee activity that will likely **not** create PE are:

- Activity that is strictly marketing related, such as early negotiation of sales contacts, attending trade shows, collecting information, or otherwise testing the market
- Providing consulting or advisory services that are temporary, such as on-site IT support for occasional contracts being concluded by third parties or agents.
- Services performed by independent contractors are less likely to trigger PE.
- Sales transacted strictly over a website unless the server is physically located in-country or the revenue is traced to the host country.

Branch Office

Most branch offices will also meet the 'fixed place of business' test for PE if there are revenue-creating activities. However, a branch office could be in a host country only for customer service or sales, so it is possible that a branch could avoid PE taxation. It will depend on the following revenue creation activities:

- Habitual and revenue-creating sales contracts for goods or services concluded inside the host country, not just once or twice.
- Technical service and support that results in revenue for the company.
- Any long term, fixed branch office that offers customer service, technical support, or management-level activity.
- Long-term production of goods

Liaison Office

A liaison office is similar to a branch office but may only be a point of contact in the host country, with little or no revenue creation. For example, collecting information, advertising, and storage of goods are all insufficient to create a PE.

Sales Agents

Staff who work as sales agents and have the authority to conclude contracts on behalf of the enterprise may also be sufficient to create PE. The determining requirement is that the power must be exercised habitually, rather than once or twice. Most of the negotiation, drafting, and signing of contracts must have occurred in the host country.

Service PE

The areas of service of PE is expanding in scope and can include situations such as providing technical or managerial services in the host country. Some 'back-office services' may trigger PE in certain countries

Building and Construction Projects

Since building and construction projects are not "permanent" for the company, PE's test becomes more time-based. Depending on the country, the time of construction activity may range to trigger PE. Falling under the 'services' type of PE, consulting services, or projects pose an interesting issue where there may not be any fixed place of business typically required to create PE. The analysis for services of PE will revolve around the non-physical elements of a permanent establishment since there may be no office or branch in the country.

Individuals have a Permanent Establishment

The permanent establishment only leads to corporate taxation, so an individual working as a sole proprietor or independent contractor would not typically meet the criteria. Some host countries might impose an individual income tax for revenue earned, but that is distinct from PE.

Rental Property

Because rental properties are often a passive investment, it is unlikely that it would trigger PE unless a foreign company had many properties in the location and were conducting a leasing business.

Business Trips

Limit business activity to short business trips and avoid long assignments to employees. This assumes there is no fixed place of business or facility, and the business is solely engaged in marketing, sales, or incidental consulting.

Short term or sporadic business activity, agents, subcontractors, and secondment arrangements, these are useful issues to consider when evaluating PE matters that could avoid unintended tax liability.

One of the most common characteristics of global mobility is workers' use for brief projects in a host country that do not rely on an official site or other physical facilities. This could include consulting work, customer service, installation projects, marketing visits, or sales calls.

The criteria used most often to create PE for this type of short term business is ongoing and "habitual," rather than a one visit or sporadic activity in the host country. For example, if regular customer service or consulting is delivered from a local fixed office, it would meet both the 'habitual' and fixed place of business requirements for PE. But, a one time or occasional visit for repairs or training would lack the element of ongoing activity.

Infrequent client visits or special projects would also probably be insufficient to meet the PE definition. Installing computer hardware in a host country for a limited time would not create PE, even though the company is paid for the work conducted inside the country and could be subject to income tax.

Virtual Permanent

The traditional definitions of a permanent establishment require both physical presence and employee activity inside a host country. New criteria are being applied to e-commerce companies based on a virtual presence that generates revenue from a host country.

This may be the wave of the future as the business "nexus" tests are expanded to create permanent establishment based solely on revenue rather than physical offices or in-country staff.



Agency PE – Making Sales Calls and Concluding Contracts

The most common use of agency in business is for sales calls. Since many brief visits to a host country could be for a sales related activity, there is a question of whether a sales agent can trigger PE on behalf of a company.

In general, if the broker or agent is an independent contractor with multiple clients and only facilitates occasional sales for a single company, then it is unlikely that PE will be created.

However, if an agent concludes many contracts in a single host country for one company, this will probably fit the "habitual" definition, and PE could be created. In this instance, the agent is likely to be an employee and solidify the case for PE. The key element seems to be having the authority to finalize the contract, a measurable and direct creation of revenue in the host country; and, therefore, taxable to the company.

Subcontractors and PE

A time element of continual activity often triggers PE-based services to meet the "presence" test in the host country. This would apply to projects with a working timeline of finite duration or that may occur over multiple periods allowing for a work stoppage.

Construction and installation projects frequently use host country subcontractors to perform part of the work, but this will not insulate a company from PE. If a foreign company uses local subcontractors and directs their work, then the subcontractors' time would be attributed to the company as a general contractor for PE purposes.

Host subcontractors would be subject to the same PE criteria as any company. They would not be shielded from taxation simply because a general contractor is in charge of the overall project.

Secondment Arrangements

The use of secondment arrangements brings up PE issues for companies with global mobility programs that send employees abroad to work for a host local affiliate or entity. There is probably no real distinction for true affiliates since the parent company would continue to direct the employment and work product in the host country. This would include the ability to terminate the employment contract and control employment conditions, so the employee's activity would potentially create PE if other PE conditions were met.

However, in some cases, the host country entity will bear the risk and direct control over the employee, which would serve to create sufficient separation between the worker and parent company to avoid PE.

As an alternative, a company might use a third-party employer to act as a local employer of record. The question is whether to outsource employee on hiring impacts the creation of PE by the corporate employer.

Digital Sales and e-Commerce

An emerging but legally contested area of PE is that of revenue created through digital or virtual means. Major IT companies have escaped PE taxation based on traditional definitions, but now those criteria are being changed to adapt to the modern age of e-commerce.

Independent agent

An independent agent can be considered any one of the following:

- An importer or distributing agent
- A general sales commission agent
- A consignment agent

An enterprise of a contracting host location shall not be deemed to have a permanent establishment in the host location merely because it carries on business in that host country through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

However, when such an agent's activities are devoted wholly or almost wholly on behalf of that enterprise, he/she will not be considered an agent of an independent status if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.



Each type of agent must always be operating in the ordinary course of their business and must meet the economic and legal independence tests to protect the contracting entity from being considered running a business through a permanent establishment in the U.S.

Dependent Agent

PE arises only if there is a dependent agent that has, and regularly exercises, the authority to bind the foreign entity contractually or maintains a stock of merchandise belonging to the foreign entity to regularly fill orders.

In determining whether an agent is dependent or independent, and the agent may be related to or controlled by the principal is disregarded. There is an exclusive agency relationship between the parties. All of the facts and circumstances are considered.

Factors to consider in determining whether a person is an employee or an independent contractor are:

- Who has the authority to instruct the individual regarding how the work must be performed?
- Who controls and has responsibility for the place at which the work is performed?
- If the formal employer directly charges the remuneration of the individual to the enterprise to which the services are provided
- Who puts the tools and materials necessary for the work at the individual's disposal?
- Who determines the number and qualifications of the individuals performing the work?
- Who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered with that individual for that purpose?
- Who determines the holidays and work schedule of that individual?
- Does the individual work exclusively for the contractor?
- Who bears the risk of loss for the individual's work?

The key steps you need to take to reduce the Permanent Establishment Risk:

- Evaluate how likely it is that the Business Model and planned business activity will trigger PE.
- Review of any presence in a host country.
- Evaluate whether any activities of your enterprise fit the general definition of a PE.
- Revenue creation: test can take the form of selling goods and services locally or establishing new contracts.
- Evaluate 'dependent agents' can could constitute a PE
- Work out whether activities that would be a PE meet the 'ancillary activities' exception
- If you have a PE, review tax and compliance obligations of the host country
- Where income tax is owed, ensure you apply the correct profit attribution model.
- Review Agency and service relationships; in some cases, even providing customer service or employing agents will trigger PE if there is revenue creation.
- Review local tax laws that will likely define the type of employee activity leading to PE taxation, such as signing contracts and providing billable services.
- Tests of time duration for PE, many definitions of 'fixed place of business presence' will have a time duration when PE will kick in (i.e., six months of continuous activity)