TAXABLE PRESENCE: Understanding risks for investment managers

The definition of taxable presence is under review in all OECD and many other jurisdictions. New OECD proposals enhance the risk that Investment Manager ("IM") activities create a taxable presence in an operating jurisdiction.

Although changes are not yet agreed, the direction of travel is clear; all jurisdictions will seek to broaden the scope for taxation. Investment managers should evaluate their operations in all jurisdictions to understand the risk. The most effective way to mitigate risk is to establish a robust transfer pricing policy that demonstrably recognizes appropriate profits for local activities which may deter challenges by fiscal authorities.

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Background

The international nature of investment management services, with investors, assets and staff in different jurisdictions has never been more closely scrutinised by fiscal authorities each wanting a share of global profits. A jurisdiction requires a taxable presence or permanent establishment ("PE") within its territory to claim taxing rights over a business and to attribute profits to the PE to establish a tax liability. The traditional definition of PE, contained in bilateral tax treaties, is universally acknowledged to be unsuitable for today's mobile and technologically sophisticated global business operations. The OECD Base Erosion and Profit Shifting (BEPS) project focussed on this issue and treaty changes were proposed in the Report "Preventing the Artificial Avoidance of PE Status" and the Public

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Discussion Draft "Additional Guidance on the Attribution of Profits to PEs" published in June 2015 and July 2016 respectively.

Broadening the definition of a permanent establishment

IMs are likely to have an economic presence in more than one jurisdiction, providing IM and advisory services to funds by performing a range of functions including marketing, research, strategy design and execution and risk management. The functions may be performed in one business entity in one jurisdiction, but it is commonplace for IM staff and third party agents to perform certain functions in other jurisdictions.

The OECD BEPS project now sharpens the focus on whether these functions create a taxable presence. The BEPS project proposes changes to the treaty definition of a permanent establishment ("PE"), which determines whether a taxable presence exists in a jurisdiction. Additional guidance is also proposed for the method of attribution of profit to the PE. The proposed changes are wide and complex and are likely to create additional compliance burdens and potentially additional tax costs.

Changes that may impact IMs include:

- Widening of the scope of dependent agent activities which may create a PE;
- Narrowing of the definition of independent agent potentially changing their status to dependent agent and creating a PE;
- Clarification of the definition of activities previously regarded as "preparatory or auxiliary" which may be re-characterised as core activities creating a PE.

It is important to note that both internal staff and third party agents, depending on functions, can create a PE risk. If marketing, advisory and research functions are performed by a closely controlled affiliate predominantly for the IM, the independent agent exemption is unlikely to be available and the PE risk is enhanced.

Where the broadened definition of PE is applied in a jurisdiction, activities carried out for an overseas affiliate may create a PE of the affiliate even where a separately taxable legal entity has been established in that jurisdiction. The analysis may be uncertain and some IMs may choose to establish a separate branch in addition to its affiliate in any jurisdiction where clarity is required.

It is now more important than ever for IMs to identify whether a PE risk applies in each jurisdiction where IM staff or third party agents are active. Careful review of all functions will be required with particular focus on marketing, distribution and investor relations, advisory services and research.

Marketing, distribution and investor relations

IMs routinely market and distribute funds across a number of jurisdictions. Such activities typically involve IM staff on short-term business trips and also locally based third party agents. It is not unusual for investment professionals to meet potential investors as well as marketing and investor relations staff. Historically, for an enterprise with no fixed place of business in a jurisdiction, the OECD approach was to identify a PE where a person habitually exercised authority to conclude contracts on behalf of that enterprise in the jurisdiction.

The consequence of the proposed wider definition of PE is that a PE may arise where a person habitually plays a "principal role" in negotiating contracts for an enterprise, which are then concluded without material modification by that enterprise. A PE risk would only arise where activities are repeatedly performed: isolated activity would not be relevant.

Where the fund marketing activity comprises a simple promotion of the fund, a PE risk should not arise. However, for more complex marketing activities, functions of all individuals will need to be carefully analysed to evaluate PE risk. These include who negotiates the size of the investment, fees charged, minimum investment periods and special terms, as well as where due diligence and investor relations will be carried out.

Advisory Services

Investment advisory services are routinely provided to IMs by affiliated entities and third parties in another jurisdiction. The advisor would be unlikely to have authority to conclude contracts, or negotiate terms on behalf of the IM, but it is possible that advice will be implemented by the IM substantially unchanged. IM's need to consider whether advisory services create a PE risk in the advisor's jurisdiction. Does the advisor habitually play a "principal role" in negotiating contracts for the IM, which are then concluded without material modification by the IM?

Research

Research functions support IM services and may be carried out by IM staff or third party agents in another jurisdiction. These functions are significant and will direct IM strategies, but may not always be regarded as core to the IM service. Non-core activities that are "preparatory or auxiliary" in nature are exempted from the definition of activities which may create a PE under the OECD proposals. IMs need to evaluate research activity to consider whether it forms an "essential and significant part" of their activity.

Attributing profits

Where a PE risk is identified the complex process of calculating the profits attributable to that PE will need to be considered. The OECD guidance expressly accepts that attributable profits may be zero, but the compliance requirements for registration and filing of returns takes no account of low or zero tax liabilities. The consequence may be a disproportionate compliance burden for PEs where minimal or zero tax liability arises.

Conclusion

The proposed changes are subject to consultation and the OECD is considering the comments made by stakeholders regarding potential disproportionate compliance burdens. Although the changes are under review and the detail is not yet formalised, it is clear that fiscal authorities in all jurisdictions are now more sensitised to this issue and many are likely to examine their approach to PE and seek to impose taxes where commercial activity is regarded as creating economic value. The UK "diverted profits tax" introduced in 2015 to address the "avoided PE" is an example of how individual jurisdictions can respond unilaterally. A robust transfer pricing policy will be essential to risk management. Whilst this may not directly address the PE risk it is likely to discourage a fiscal authority from challenging profit attribution to a PE where profits are fully recognised and additional material tax revenue would not arise.

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