Permanent Establishment and Secondment Agreements – Challenges of Linking Corporate and Individual Tax Issues for Global Mobile Employees

In today’s ever-changing global business arena, global mobility is increasingly common, whether in the form of formal expatriate arrangements or simply frequent international business travelers. Any type of cross-border employment or frequent travel can present a gauntlet of challenges such as immigration, cost management, individual and payroll tax compliance, relocation, and policy management. Because global mobility is often initiated by a business line or HR rather than by an employer's legal or tax departments, corporate tax issues are often an afterthought.

HR and mobility specialists know that having an employee perform services in more than one country can often trigger individual income taxes for the employee or additional payroll tax requirements for the company. But having an employee work in another country can also create exposure for the home-country entity from a corporate tax perspective. If an employee’s activity in the host country creates a “permanent establishment” (a “PE”) of the home-country entity in the host country, the employer may become subject to the host country’s corporate tax on profits attributable to activity in the host country. In many circumstances, the individual’s specific activities in the host country can have a significant impact on whether or not the home-country entity has a PE in that host country. If a PE has been created, local tax authorities may then assert that the home-country entity is liable for corporate taxes there. This can be a very costly and administratively burdensome situation for many companies.

Below, we look at the factors that taxing authorities may consider when evaluating whether a foreign multinational employer has created a permanent establishment in the United States (“US”) – and is thereby subject to US corporate income tax. Then we look at ways to mitigate exposure to this risk, including the use of secondment agreements. We do not address other corporate tax implications, such as transfer pricing, recharge, and corporate deduction issues.

Permanent Establishment (PE) evaluation

Check for treaty coverage: What constitutes a PE depends on factors that vary by jurisdiction. As a first step, you should check whether an income tax treaty between the home and host countries provides specific guidance on what creates a PE. For example, the US model tax convention (“US Model Treaty”) provides a broad-based definition of what does or does not constitute a PE for treaty partners. The primary factor is the existence of a “fixed place of business through which the business of an enterprise is wholly or partly carried on” when corporate activities go beyond “preparatory or auxiliary” activities. The most common fixed places of business include an office, factory, or workshop. The term “fixed” also implies a degree of permanence, and “place of business” is conditional on the existence of a facility or premises or even machinery or equipment where business is carried on. However, the US Model Treaty also includes provisions for construction works in progress which constitute a fixed place of business if the project or activity lasts for more than twelve months.

An employer can establish a PE if one of its employees “repeatedly” performs tasks that characterize the existence of a place of business in the host country. In some countries, courts have decided that twice is enough to establish “repetition.” Less obvious circumstances may
also fulfill the definition, such as maintaining a regularly available hotel room, a residence-based office, or an office location on site at a client.

**Authority to conclude contracts:** While a “fixed place of business” is certainly the primary factor used to define the existence of a PE in many treaties, other factors can come into play. The very activities of the individual who is working across borders can also constitute a PE. Persons whose activities may create a PE are called “dependent agents.” Typically, individuals who have and habitually exercise the authority to negotiate or conclude contracts on behalf of their home-country entity can create a PE for that entity in the host country where they are performing their services. This is the case because the individuals are not acting independently; rather, they are acting at the home-country entity’s direction.

A person is considered as authorized to negotiate or conclude contracts on behalf of a company in a host country if he or she is authorized to negotiate all elements and details of a contract in a way binding on the enterprise, even if someone outside the host country signs the contract. An agent who concludes contracts that bind the enterprise, even if those contracts are not actually in the enterprise’s name, is not explicitly exempt from the definition of PE. Lack of active involvement by an enterprise in transactions may indicate a grant of authority to an agent. Additionally, the habitual exercise of an authority to conclude contracts related merely to auxiliary activities, which are merely tangentially related to the income generating activity of the employer (e.g., advertising, accounting services, etc.), will be insufficient to create a PE to the home-country entity.

For example, an agent may be considered to possess actual authority to conclude contracts where he or she solicits and receives (but does not formally finalize) orders that are sent directly to a warehouse from which goods are delivered and where the home enterprise routinely approves the transactions. In addition, tax authorities will scrutinize the relationship between the home-country entity and the individual to establish who bears the risk of the employee’s activities and who provides the materials, equipment, or resources to perform the services.

**Objective definitions:** Some tax treaties define a PE specifically and objectively. For example, the United States – China income tax treaty specifies that a PE includes “the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for that purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.” So if a Chinese employer has more than one employee in the US working on the same project, the Chinese entity must continually confirm that the employee’s aggregate number of days of presence in the US does not exceed six months in a rolling twelve-month period – or the company will automatically create a PE in the US. Similar provisions appear in other treaties, including the United States’ tax treaty with Canada.

Treaties can also specify activities treated as exceptions that would not give rise to a PE, even if a fixed place of business exists. Generally, the common feature of these activities is that they are “preparatory” or “auxiliary.” For example, maintaining a fixed place of business solely for the purpose of gathering and distributing information, accounting, marketing, advertising, and
market research often does not constitute the core business activity of a company and would not present the risk of establishing a PE.

If no treaty exists between the home and host country, then the host country’s tax regulations will dictate whether specific actions by an employer will give rise to a PE. Under US federal income tax law, the presence of the employee of a home-country entity in the US can subject the home country entity to US branch profits or corporate income tax if the employee’s actions are deemed to create a US trade or business and there is income earned which is effectively connected to that business. The determination of whether an employee’s actions will create a taxable US presence focuses on the degree and significance of the activity of the employee in relation to the profit-making activity of the home-country entity. If the employee’s activities rise to the level of a US trade or business, the income of the home-country entity which is effectively connected to the US trade or business could be subject to both US federal income tax on a gross basis and an additional tax on remittances of branch profits.

When determining Permanent Establishment status, consider:

- Which entity is the legal employer of the employee?
- Where is the employee working?
- What kind of work is the employee performing in each location?
- How long will the employee be working in the US?
- Is company property from one country being used in another country?
- Which entities are benefitting from the services of the employee?
- Which entity or entities pay the employee’s remuneration?
- Can the employee negotiate or finalize contracts on behalf of the home entity?

Mitigating exposure of a PE

As discussed above, some cross-border employment activities can give rise to corporate tax exposure. What can you do to mitigate that risk – and educate the business leaders and global mobility specialists who are initiating international assignments? With the right tools and careful planning, you can structure foreign employment scenarios to keep from having the home-county employer inadvertently qualify as a PE in the US. However, cost-benefit analysis should always be undertaken to understand the true costs of a PE. In some cases, the presence of a PE is not an inherently bad outcome if, for example, income attributable to that PE is minimal or non-existent. In such cases, the cost of planning around a PE may be greater than the US tax cost associated with the activity.
In addition to the typical recommendations for avoiding/mitigating any PE exposure (for example, no fixed place of business, no signature of contracts locally, no negotiation to a point where the role of the home-country entity would be limited to a purely formal sign-off), several basic approaches can help:

1. **Monitor employee responsibilities:** It is prudent to restrict the ability/authority for assignees to negotiate and sign contracts and limit their responsibilities to those that do not provide the authority to make decisions that would bind the home-country entity either directly or indirectly. Assignees should instead take on advisory, consultative, and auxiliary roles.

   To mitigate the risk of creating a PE, the assigned employee should be removed as far as possible from any internal decision process of the home-country entity while working in the US when the process could result in a binding commitment for the company. If the employee must be involved in some decisions while working in the US, there should always be a supervisor outside of the US who can represent the company and who has the skill and authority to oversee the employee. The supervisor should always review the employee’s opinions and approve (or reject) what the employee suggests or recommends.

2. **Use dual contract arrangements:** Historically, employers have used dual employment contracts not only to mitigate PE exposure but also to implement individual income tax planning. This scenario may prove effective if the employee plays dual roles for the company or is maintaining some home-country responsibilities while working in the host country in a specific capacity. A dual employment contract requires that the employee has a separate contract for each country employer. This can work only where the company has an existing employer in the host country. Then, it may be possible to segregate the employee’s duties so that those that directly benefit the host country are covered under a local employment contract and any duties that benefit the home country are covered under a second agreement and not carried on in the host country. Note, though, that tax authorities are challenging these arrangements more frequently. They can be complex and may create additional risk. You should seek location-specific advice before pursuing dual employment contracts as a means to avoid PE status.

3. **Monitor frequent business travelers:** As noted above, some jurisdictions have specific timing thresholds that trigger PE. Often, these thresholds are based on the number of days that an employee or groups of employees spend in that country in connection with a specific activity. For example, the United States – Thailand tax treaty stipulates that a PE will be established if a Thailand resident company furnishes consultancy services in the US through its employees (or other personnel engaged by the Thai company) for 90 or more days within any 12-month period. So it is important not only to know the specific rules for each country where you have assignees, but also to develop a system to track and monitor these mobile employees scrupulously to keep from crossing PE thresholds accidentally.

4. **Use secondment agreements:** Secondment agreements are often an effective, efficient way to manage PE risk in cases where an employee is performing services in a host country that benefit the *host-country* employer.
A secondment agreement involves the home-country employer, the host-country employer, and sometimes the employee. In this agreement, the terms of loaning the employee from the home-country entity to the host-country entity are detailed.

While the employee may be a party to the agreement for various reasons, a secondment agreement is not an assignment letter and should not be used as one. It is customary for employers to give employees a separate assignment letter detailing the terms of a cross-border assignment. In many cases, a secondment agreement will involve only the two employing entities and can cover all employees who are on assignment to each jurisdiction.

A secondment arrangement typically includes specific terms designed to prevent the employee from creating a permanent establishment for the home-country employer in the host country. The activities of the employee in the host country are “imputed” to the host-country employer; the host-country company supervises the employee’s host-country activities. The host-country employer takes responsibility for local payroll reporting and withholding. But the home-country employer can retain long-term control over the employee (e.g. termination, salary level, etc.). In addition, the home-country employer may be able to continue to set the terms of the assignment, which could allow the employee to remain in his or her home-country benefit plans. Legal counsel should be consulted to confirm this arrangement.

It is important that payments due under the secondment agreement from the host entity to the home entity be limited to the actual costs incurred by the home-country employer, and that the payment arrangements be created as reimbursements (it may be possible to add an overhead charge in some locations). Otherwise, the host-country tax authorities could deem the home-country company to be in the business of “leasing” employees, and impute taxable profits to the home-country employer. Transfer pricing issues should also be reviewed.

In addition, to be effective, secondment agreements should be reviewed by both home-country and US tax specialists:

   a. The home-country review should confirm that the employee has a strong enough connection to the home-country employer to continue the employment relationship.

   b. The host-country review should confirm that the employee’s activities in the US, as well as his or her relationship to the home-country employer, do not create a PE of the home-country employer in the US. The host-country team can also review payments under the agreement to determine whether they are deductible in the US, and confirm that no profit will be imputed in the arrangement.

Reducing overall taxes

Many of the planning opportunities to mitigate PE exposure for the employer may adversely affect assignees’ individual income taxation. In many scenarios, individuals are exempt from taxation in the host country because they meet certain criteria under income tax treaties. One of the common criteria is that costs remain borne in the home country.
A secondment agreement normally shifts costs from the home country to the host country. In these circumstances, costs, benefits, and risks needs to be weighed to determine which is the better course of action for the parties involved. In many cases, the additional administrative burden and incremental individual income tax cost may be far less onerous than corporate tax exposure, and is clearly something that can be budgeted and planned for in advance.

Secondment agreements can be a great tool in managing corporate tax exposure in cross-border employment scenarios. Implementation is generally best when all relevant functions (Global Mobility, HR, Tax, Finance, Payroll, Legal) work together as a team.

In the current regulatory environment, where tax authorities may be seeking new sources of tax revenue, planning carefully to avoid PE status – whether using secondment agreements or not – will help manage risk and may also increase the benefit of having employees perform services in more than one location.

— Elizabeth Rosenthal (Chicago)   Stephanie Linn (Chicago)
  Director   Senior Manager
  Deloitte Tax LLP   Deloitte Tax LLP
  elrosenthal@deloitte.com   stelinn@deloitte.com