Chapter 1

Spain: Are Activities in Vessels, Geographically Concentrated Areas and Director's Homes PEs?

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1.1. Introduction

In the judgment of the *Audiencia Nacional* (AN) of 25 April 2013, 169/2010, the main issue was whether an Estonian company (M) had a permanent establishment (PE) in Spain.[1] The controversy refers to tax years (2000-2001) in which the tax treaty between Spain and Estonia was not in force (the treaty entered into force on 28 December 2004 and was applicable as of 1 January 2005). The fact that the case refers to tax years prior to the applicability of the tax convention is not very relevant since the domestic definition of "permanent establishment" was modelled on article 5 of the OECD Model and the Spanish tax authorities as well as courts usually take into account the OECD's materials to interpret not only the PE concept in tax treaties but also the domestic definition.[2,3] This was certainly the case in the judgment by the AN of 25 April 2013. As a consequence, the decision by the AN would have probably been the same if the factual pattern of the case referred to years covered by the Spain-Estonia Tax Treaty.

1.2. Facts of the case

The Estonian company M conducted fishing activities in 2000-2001. For that purpose, it used Estonian fishing quotas. The ship was a freezing and factory vessel where, in addition to fishing, the fish were cleaned, gutted, cut into pieces and filleted. All the activities were conducted in international

1. The *Audiencia Nacional* (AN) is a central court of justice that hears appeals from the Central Administrative Court (TEAC). Decisions of the AN can be appealed before the Supreme Court of Spain.
2. This definition is included in article 13(1)(a) of the Non-Resident Income Tax Law.
3. The PE concept was first adopted in Spain by Law 41/1964, the preamble of which explained that the main goal of this norm was to adapt Spanish legislation to international standards as a consequence of the participation of Spain in the work of the OECD and the signing of Spain's first double tax treaties. The domestic concept is wider than article 5 of the OECD Model (e.g. the exceptions of article 5(4) are not recognized), but still closely resembles article 5 of the OECD Model.

waters where the final product was sold to a Spanish company (F). The fish were unloaded in Spanish ports, most likely in Vigo, although this is not clearly stated in the decision.

The Spanish tax inspector took into account the following findings of fact, some of which were obtained with the help of the Estonian tax authorities (it is not clear whether this information was obtained in the context of the tax treaty between Spain and Estonia or the EU Directive 77/799 on exchange of information, which was the EU instrument in force at that time):

– The company was set up in Estonia in January 2000 but was not regarded as a taxpayer in Estonia until 30 May 2002.

– The company had two directors; one an Estonian national, the other a Spanish citizen with a domicile in Vigo, Spain; both had powers to represent the company.

– The company purchased the freezing vessel in December 2000 from another company (N), also represented by the Spanish director of M. It appears – although again it is not entirely clear – that M entered into a charter agreement with that company until 2002. N was a resident in Spain.

– M had two bank accounts in Spain in which the authorized persons were the directors of the company. In one of the accounts, promissory notes were discounted and bank transfers abroad and expenses such as salaries or social security of employees were also charged.

– F (the company importing the fish into Spain and having contracts with M) paid invoices sent by the latter with promissory notes that were cashed in one of the Spanish accounts (there is some confusion on this issue since apparently the promissory notes were discounted in an account of N, from which account the cash was sent to the account of M).

– M made payments to Spanish companies, mostly shipping agents but also for repairs of the ship.

– The tax inspectors also took into account that the income obtained by M was not taxed in Estonia because for the years 2000-2001 the company was not a taxpayer in that country.

On those facts the tax inspectors drew the conclusion that M earned income from Spanish sources through a fixed place of business located at the domicile in Vigo of the Spanish director of the company. It seems that this place was chosen because all the mail related to the bank was sent from and received at that postal address. The tax inspectors linked the domicile of the Spanish director to all income from fishing activities obtained by M even though most of the activity did not take place within Spanish territory.

Obviously, M rejected that conclusion and appealed the decision, first, before the Administrative Tribunal of Galicia, second, on appeal, before the Central Administrative Court, prior to it bringing an action to the AN.

There are a couple of additional relevant details: (i) the attitude of the taxpayer was not cooperative at all, e.g. the taxpayer did not show its accounting books to the tax inspector and its income was therefore estimated by resorting to the so-called indirect method of calculation of the tax base and (ii) the decisions of the administrative courts (Regional and Central) were not made public and therefore they could not be consulted for a more accurate description of the facts.

The AN also considered that the following facts were proved by the company:

– All the fishing (with Estonian quotas) and processing activity took place in international waters.

– M sold all the products to F and all the sales were agreed and occurred before they entered into Spanish territory.

– M had the vessel repaired and supplied in Spain (Vigo) on several occasions by Spanish companies.

– The Spanish director of the company was resident in Vigo, Spain, and had a power to manage the Spanish accounts where (i) payments from sales of fish were deposited or promissory notes discounted and (ii) payments to Spanish suppliers were made.

1.3. The Court's decision

The AN first recalled that the notion of permanent establishment is composed of three elements: (i) a place of business; (ii) that place of business must

be "fixed" and (iii) the business of the company must be carried out at that place of business. Even though the AN did not cite the OECD Commentary on Article 5, it explained the meaning of those elements by resorting to them (it should be noted that the relevant PE definition was not that of the tax treaty between Spain and Estonia, but rather the domestic PE definition).

The AN did not analyse in detail the meaning of those three elements and limited its remarks to say that there is no coherence between the facts found and the conclusions of the tax inspectors. The AN considered that it was not proven that the domicile of the Spanish director was a place where the company carried out its business because the company did not even have at that place any material or personnel to perform the activities. The tax inspector, the AN continued, only has the acts of a person with a power of attorney-in-fact to manage bank accounts in which economic transactions were credited or debited, and that is not sufficient to affirm that the director's domicile was the place where the company conducted its business in Spain.

For the AN, from the data in the file, it could not be derived either that the Spanish director was a dependent agent.[4] First, there were no relevant data concerning whether the Spanish director entered into contracts with the company distributing in Spain the fish caught by M. The AN reasoned that the term "dependent agent",

> [I]s reserved, as the Fiscal Committee of the OECD explains, to those people that, in view of their powers to enter into contracts, involve a non-resident company in the business circle of the State of source, which requires to assess the effective authority of the agent with third parties, this authority must be referred to the business activity of the foreign company.

From this perspective, the AN added that it had not been proven that the Spanish director was a true agent of M in Spain, since the only fact that the tax inspector showed was that the director managed bank accounts where payments were made in connection with sales previously contracted in Estonia of fish caught and processed in international waters on a ship with an Estonian flag. For the AN, the director was only a manager of collections and payments. The AN attached a special value to the declaration by the representative of F (the main client in Spain) in which it was stated that all the purchases were connected with fish caught in international waters and the contracts were done in the central office of the company in Estonia.

4. It is not clear why the AN considered the issue of dependent agents in this case since from the description of facts, it seems that the tax inspector only argued that there was a fixed place of business.

1.4. Comments on the Court's reasoning

The judgment of the AN is confusing and obscure in its description of the facts, but it also shows that there are a number of issues that deserve comment and are relevant from an international perspective.

1.4.1. "Home office" as a PE

It is striking that the AN discarded the domicile of the Spanish director as a place where the business of M was conducted so lightly "because there were not material and personal means of the company in that place". It is odd to say that the Estonian company did not have any personal means in the domicile where one of the company directors lived – who was also the person with power of attorney-in-fact to manage the company's bank accounts.

As is well known, the issue of "home offices" was dealt with by the OECD in its draft, The Interpretation and Application of Article 5 (Permanent Establishment) (2011 and 2012);[5] but neither the AN referred to this document nor the OECD to an example like that considered by the AN. From the facts described in the case, it is not very clear whether the home of the director was used for conducting the business of M regularly "in circumstances where the nature of the employment clearly requires an office".[6] It is plausible, however, that the activity of a director also empowered to manage the bank accounts and other business of the Estonian company could be – with some imagination – assimilated to the consultant example in new paragraph 4.9 of the Commentary on Article 5 of the OECD Model proposed by the Revised Discussion Draft on Article 5 of the OECD Model.[7] The tax inspector probably should have shown (or provided some proof of) whether most of the activities of the company, or at least

5. Paragraph 22 et seq. of the Revised Discussion Draft on Article 5 of the OECD Model (2012).

6. New paragraph 4.8 to article 5, as proposed by the Revised Discussion Draft on Article 5 of the OECD Model (2012). This paragraph explains that a home office can be regarded as a PE if it "is used on a regular and continuous basis for carrying on business activities and is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise's business (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office)."

7. As is well known, this example refers to a consultant that is present in the territory of the source country for an extended period where most of the activities of the enterprise are carried out from an office set up in its home in that state.

an important part of them, were carried out from the home office. In this regard, the AN is right in requiring some evidence of the connection of the home of the director with the business activities of the company, since proof of this connection should be provided by the tax administration, which failed to do so.

But even if it were taken for granted that the director's home was a PE, could all the fishing and processing activities in international waters be linked with that PE? Did all the activities have the coherence required to be considered as a whole and be linked to the home of the director? That is again an issue that depends on elements of fact of whether it could be established that the ship was economically (functionally) connected with the alleged PE (home of the Spanish director). It is therefore surprising that the tax inspector decided to go down this road: even if there was a PE in the home of the director, it is not clear that all the profits for the fishing and processing activities could be attributed to the 'home', was there a connection (coherence) between the activities of the director and the fishing and processing activities apart from the fact that sales were made to Spanish clients? What was the role of the director with regard to the fishing and processing activities or sales (apart from the fact that the contracts were signed in Estonia? There are no data in the decision on this issue, as well as it is unknown whether the Estonian company had sufficient human and material resources in Estonia (or somewhere else) to manage, organize and direct the activities of the ship. In this respect, the reference to the charter agreement with the company that previously owned the ship, which was also a company associated to the director, was probably crucial, but this is not explained in detail in the decision.

It should be taken into account that the business that the director could have eventually been carrying out from home does not need to be the entire business of the company and, still, there could be a PE if the home had the relevant connection with part of the activity of the company (e.g. sales in Spain, organization of activities in Spain, such as unloads of processed fish in Spanish ports, etc.).[8]

8. *See* article 5(1) of the OECD Model (2010) and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5* para. 7 (2010), Models IBFD. *See also* J. Schaffner, *How Fixed Is a Permanent Establishment?* p. 129 (Kluwer Law International 2013).

1.4.2. Ships as PEs

Obviously, ships can be a "place of business"; the only question is whether they are "fixed" in order to be regarded as PEs. It has been assumed by different authors and courts that a ship is not normally a PE because the place of business does not remain at a particular location where it is normally used.[9] Unless ships are fixed to a place (e.g. ships permanently moored serving as museums, restaurants, hotels, etc.), they are not usually regarded as PEs.[10] As a matter of fact, it would be strange to interpret that a by nature movable element such as a ship can be "fixed" since this would be against the literal wording of article 5(1) of the OECD Model.

However, the "fixed" criterion has been relaxed (contrary to the wording of article 5(1) of the OECD Model) in order to establish a connection between the place of business and a geographical area.[11] The question is whether the fixed element is flexible enough to cover certain ship operations such as those considered in the judgment of the AN. From a comparative law perspective, there are precedents in one direction or another.[12] And, certainly, if "fixed" is not taken literally, i.e. interpreted as a link to a geographical area, it can be held that a ship (not permanently anchored or moored) can meet this requirement in certain circumstances.[13]

Interestingly, the OECD has dealt with this issue in the Discussion Draft on Article 5 (2012). The new proposed paragraph 5.5 of the Commentary on Article 5 of the OECD Model reads as follows:

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9. E.g. *see* J. Sasseville & A.A. Skaar, *General Report*, in *IFA Cahiers 2009 – Vol. 94A. Is There a Permanent Establishment?* p. 26 (IBFD 2009), Online Books IBFD.

10. *See* E. Reimer, *Permanent Establishment in the OECD Model Tax Convention*, in *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty Perspective* para. 45 (E. Reimer, S. Schmid & M. Orell eds., Kluwer Law International 2014) (citing German case law and administrative doctrine).

11. Para. 5 *OECD Model: Commentary on Article 5* (2010). On the fixed element, *see* Schaffner, *supra* n. 8, at p. 158 et seq.

12. On this case law, *see* e.g. Sasseville & Skaar, *supra* n. 9, at p. 26 (with reference to the national reports); B. Yalti, *Turkey: The Permanent Establishment Issue in Case of Movable Place of Business*, in *Tax Treaty Case Law Around the Globe – 2011* p. 129 et seq. (M. Lang et al. eds., Linde 2011) (reporting on a case where the Turkish Supreme Administrative Court ruled that yachts of a UK company operated in the territorial waters of Turkey for tourist purposes were a PE in Turkey of the UK company; in this case a Turkish travel agent also assumed certain functions on the documentation and registration of the transactions); Schaffner, *supra* n. 8, at p. 163 et seq. (where several examples referring to ships are explained).

13. *See* e.g. the analysis by Yalti, id. at pp. 139-142.

> Similarly, a ship or boat that navigates in international waters or within one or more States is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way for the purposes of determining whether paragraph 1 applies (paragraph 5 could apply, however, where contracts are concluded in such shops or restaurants are operated within a State).

This proposed paragraph and the explanation to it in the Discussion Draft basically contain a rule and an exception to it: (i) a ship is not normally a PE and (ii) depending on the circumstances, in specific cases a movable ship can constitute a PE. Does this interpretation go against the literal wording of article 5(1) of the OECD Model? Probably, the answer is yes, but after the fixed element of the PE definition was relaxed in 2003 in article 5(1) of the OECD Model by referring to the geographical connection, the new paragraph is only an application of that approach.[14] Perhaps an application that shows that the fixed element requirement is obsolete and leads to arbitrary distinctions: why should an anchored ship, oil rig, etc. be treated differently from a similar floating element? This distinction does not make any economic or policy sense and may also pose problems in terms of constitutional principles (is the fixation element relevant enough to discriminate between two taxpayers conducting the same or very similar activities?).[15] Moreover, one cannot avoid thinking whether relaxation of the geographic coherence element does not call for a reform of paragraph 5(4) and the consultant example in the Commentary on Article 5 of the OECD Model (work in different branches even if located in the same area or city is considered separately by the Commentary because of lack of geographical coherence).[16]

One cannot avoid thinking that there was some geographical, as well as temporal and commercial, coherence in the case considered by the AN: the

14. Id., citing other authors that a movable ship could constitute a PE based on para. 5.1 *OECD Model: Commentary on Article 5* (2010) and the geographical coherence of its operations.

15. Reimer, *supra* n. 10, at para. 48. In para. 55, this author argues in this regard that the "relationship or connection to a geographical area – instead of a fixed point – suffices to meet the fixation test".

16. For an extensive analysis of these problems, *see* Schaffner, *supra* n. 8, at chaps. 4 and 8 (arguing that the fixed element is obsolete and should be replaced by a reconsideration of the geographical and commercial coherence test; for this author, reinforcing that test would only require minor changes to the OECD Commentary).

ship operated in Vigo, Spain; through the port of this city, its main client was in Spain, presumably near Vigo; one of the company directors was in Vigo and he carried out, at least, some business activities there for the company.

The reasons why the tax inspector did not adopt this approach are not known, but were probably crucial for the fate of the case and the AN's decision. Would it not have been easier, and probably more natural, to connect all the activities of the ship to this PE than to the domicile of the director in Spain (or even to attract to that PE all the profits that could have been attributed to the director's home-PE)?[17] There was no evidence on whether the company and the ship had a relevant business connection with Estonia or any other place in the world. Absence of such link would have most likely revealed that the business cycle of the company took place in international waters and Spain (where there was commercial and geographical coherence: same port, one client, location of director's home), lacking any business connection with the place of residence of the company. On the other hand, if the company had sufficient activities in Estonia that were connected with the activities of the ship and the Spanish activities were simply of an ancillary nature (which does not seem to be the case), there was no reason to hold that the company had a PE in Spain.[18]

The reader may think that the discussion above forgot that for a PE to exist there must be a place of business "at the disposal of" the company within the country "through which" the company's business is carried on. Obviously, the ship was "at the disposal of" the company and business was carried on there, but was not always present in Spain, since the fishing and processing activity took place in international waters. In this author's view, the relaxation of the fixed element would also call for a parallel interpretation of the "at the disposal of" test and the requirement that business is carried out "through" that place of business. Whether that is possible as the Commentary now stands (or even with the proposals of the OECD's Discussion Draft on Article 5) is, to say the least, arguable and some consideration should be given to this issue in the current work on

17. Unless the geographical test is interpreted in a strict form (which seems to be the OECD's position), in this case it would have been difficult to argue that there were two different PEs since the activities of the director in Spain were economically and functionally closely connected with those of the ship.

18. It should be pointed out, however, that Spanish domestic legislation does not contain a clause similar to article 5(4) of the OECD Model; therefore, even auxiliary activities could be taxed in Spain if a PE was found to exist.