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Services Permanent Establishment according to the Czech Double Taxation Treaties and Czech National Legislation

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During the communist period and in the early 1990s, the Czech Republic gave only limited attention to international trade development and Double Taxation Treaties ("DTT"). After the Velvet revolution in 1989 and with the change in the economic situation of the Czech Republic, certain provisions of existing DTTs proved to be deficient and adapting them to the new circumstances appeared inevitable. As a result, the Czech Republic now intends to renegotiate the DTTs concluded during this period.

In the DTTs which were concluded after the early 1990s and mainly in recent years, the Czech Republic sought an arrangement not only as regards the conditions of the creation of a "fixed" permanent establishment, but also concerning the implementation of the concept of a "services" permanent establishment (e.g. DTT with the Slovak Republic or new DTTs with France or Austria).

The issue of permanent establishments has an important practical impact, since following the creation of a Czech permanent establishment, the income received by a foreign entrepreneur through this permanent establishment is subject to taxation in the Czech Republic and, moreover, the creation of a permanent establishment results in a related administrative burden (e.g. registration obligation, obligation to file a Czech tax return, administration related to employees of the permanent establishment in certain cases).

Permanent Establishment within the Meaning of the OECD Model Tax Convention

Conditions for the creation of a permanent establishment are usually regulated by DTTs concluded between the particular states involved and/or in their national income tax legislation, so they can vary from state to state. These differences may, and often do, result in practical difficulties and complications as far as cross-border trade is concerned. However, the majority of DTTs concluded between developed states is negotiated according to the wording of the OECD Model Tax Convention on Income and Capital ("Convention")^[1].

The Convention defines the term "permanent establishment" as a fixed place of business through

which the business of an enterprise is wholly or partly carried on^[2]. In compliance with this definition, the main condition for the creation of a permanent establishment is the existence of a place of business of the foreign entity (i.e. a facility such as premises, machinery or equipment) which is fixed (i.e. must be established at a distinct place with a certain degree of permanence). The legal relationship of the entity to the place of business is not important, i.e. it is not decisive whether the facility through which the business is carried on is in the ownership of the respective entity, rented or just left at the entity's disposal without any legal right.

Permanent Establishment in the Double Taxation Treaties Concluded by the Czech Republic – Concept of a Services Permanent Establishment

The provision on a services permanent establishment negotiated in the Czech DTTs goes further than the understanding of permanent establishments within the meaning of the Convention, as it assumes creation of a permanent establishment based on the mere provision of services in the territory of another state for a certain period (specified in the DTT), even if the business is not carried on through any fixed place of business. The tax consequences of the creation of a services permanent establishment are generally the same as for a fixed one.

This trend reflects the opinion of the Czech Republic on the issue of permanent establishments as mentioned in the Reservations on Article 5 of the Convention. The Czech Republic reserved "the right to propose in bilateral negotiations specific provisions clarifying the application of this principle to arrangements for the performance of services over a substantial period of time". Usually, in the DTTs concluded by the Czech Republic, this period is agreed as six months in any 12 consecutive months.

As a result of the above provision negotiated in the Czech DTTs, a services permanent establishment of a foreign entity on the territory of the Czech Republic may be created, for example, in the following case:

The work of a consultant performed at different branches in separate locations pursuant to a single project for training the employees of a bank, i.e. he or she moves among separate locations. (This situation is expressly addressed in the Commentary on Art. 5 of the Convention. The Czech Republic declared in the Observations on the Commentary its view that a permanent establishment may also be created if services are provided over a substantial period of time.)

It is true that cases where a foreign entity provides services in another state for a significant period without having a fixed place of business there are quite rare and usually it is possible to identify a place which can be deemed as a fixed place of business. Nevertheless, even if in these cases a permanent establishment is created anyway, the reasons for its creation understood by the Czech Tax Authorities could differ from the understanding of the Convention.

A common situation is that of employees of a parent company who are sent to its Czech subsidiary

to provide consulting or management services to this subsidiary. These employees usually have at their disposal a certain place, being an office or even just a desk, where they may perform their activities. As mentioned above, the legal rights to this place are not important, so it may be left at their disposal without any special legal act. In compliance with the Convention, if the above activities of employees show a certain degree of permanency, a fixed permanent establishment of the foreign company is created.

According to the regulation on services permanent establishment negotiated in the Czech DTTs, if these services are provided for a period exceeding six months in any 12 consecutive months (or another period stipulated in the respective DTT) they result in the creation of a services permanent establishment and the fact, whether there is a fixed place of business (certain degree of permanency) is usually disregarded.

Double Taxation Treaties Concluded by the Czech Republic Lacking Provision on Services Permanent Establishments

More serious problems may arise concerning entities from countries whose DTT concluded with the Czech Republic does not contain regulation of services permanent establishments (mainly DTTs concluded up to the early 1990s).

The national Czech tax legislation stipulates the creation of a Czech services permanent establishment of a foreign entity based on the provision of services in the Czech Republic for a period exceeding six months in any 12 consecutive months. Under Czech law, the provisions of international treaties that are binding on the Czech Republic and that have been ratified by the Czech Parliament shall prevail over national law. Moreover, Czech income taxes legislation contains analogous provision on the priority of binding international treaties. Therefore, the above national regulation on the creation of services permanent establishments is to be applied only if such a binding international treaty does not stipulate otherwise.

The issue remains whether DTTs not containing provision on services permanent establishments "stipulate otherwise" in the sense that they prevent the application of national Czech regulation of a services permanent establishment^[3]. According to the Czech Ministry of Finance (which is the supreme authority with regard to tax matters), the concept of a services permanent establishment in Czech national legislation may be applied in these cases as it is not in conflict with the respective DTTs (the list of facilities and situations to be regarded as being/leading to permanent establishments in the DTTs is only demonstrative). Consequently, this opinion is followed by the tax administrators in everyday practice, even if it is contrary to certain judgments of the Czech courts, which have confirmed that in these cases the regulation on services permanent establishment set out by Czech legislation cannot be applied^[4].

The issue of Czech services permanent establishments is complicated and it is necessary to address it on a case-by-case basis. Moreover, in the case of potential disputes with the Czech Financial Authorities, sophisticated argumentation plays a very important role. Therefore, it is highly recommendable to always consult a Czech professional tax advisor in this respect.

[1] The Czech Republic negotiates its DTTs also with regard to the wording of the United Nations Model Tax Convention.

[2] Art. 5 Par. 1 of the Convention.

[3] The Slovak Republic, whose attitude towards services permanent establishment is very similar, avoided this problem by stipulating in its national tax legislation that in the case of one-off activities, the place where the activity is performed is regarded as fixed if the respective activity is performed for a period exceeding six months in any 12 consecutive months. As a result, in DTTs lacking the regulation of services permanent establishments, Slovak tax administrators can deem a fixed Slovak permanent establishment has been created.

[4] This decision was formulated, for example, with respect to the DTT between the Czech Republic and Austria concluded on 7 March 1978. The new DTT between these states, concluded on 8 June 2006 and applicable as of 1 January 2008, already contains a special provision on services permanent establishments and stipulates a time test of six months in any 12 consecutive months.

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