

Latest trends in identifying permanent establishment (1) 1/12/23



Director, Tax, and Head of Pan-Baltic
People and Organisation Practice, PwC
Latvia

Irena Arbidane

It has been some time since Covid-19 changed our daily lives. The resulting changes to the business environment and especially employment have become a normal part of our daily lives, as the interest in remote and hybrid work grows. This way of working allows employees to choose the place or country where they carry out their job duties. Yet this unlimited mobility may create tax risks to the employer. In this article we explore whether a company may be exposed to permanent establishment (PE) risk under certain conditions if a member of its management team works remotely. We also look at how the tax authorities of other countries have responded, in order to identify the riskiest countries.

What a PE is and how to identify PE risk

A key task in applying corporate income tax (CIT) and payroll taxes is to determine whether a company has a PE in a foreign country. This task involves analysing local and international rules.

In today's dynamic business environment, a company registered in one country often does business in other countries, such as selling goods, providing services, maintaining a representative office for marketing purposes, or transferring a key business function.

Under the OECD's 2017 model convention on income and capital taxes, a PE means a fixed place where the company carries on a business completely or partially. So the company has a permanent place of business in a foreign country that gives rise to the concept of PE: a company's permanent place of business abroad for tax purposes.

While the statutory criteria for determining a PE may vary from country to country, there are some generally accepted criteria: permanence, fixed place, and foreign business. The PE is one of the concepts governed by the OECD's double tax treaty.

DTT article 5 defines the PE as a fixed place where a company carries on a business completely or partially. The OECD's commentary on DTT allows us to establish three main elements of a PE:

- There is a place of business.
- That place is fixed.
- Business is completely or partially conducted at the fixed place.

Typical examples include a company's management seat, branch, office, factory, workshop, oil or gas extraction site. The DTT states that such a fixed place does not amount to a PE if the company uses it for certain activities, such as storage of its own goods or other preparatory and auxiliary activities. In that case we need to assess the nature of the company's business in order to determine whether its activities may be considered preparatory and auxiliary. DTTs usually prescribe special conditions for sectors such as construction.

In addition to a fixed place of business, the DTT indicates another criterion that may create a PE: the non-resident company has a person that exercises authority to enter into business contracts on the non-resident's behalf. The OECD's commentary on DTT article 5 states that it's important to assess whether the person exercises this authority on a regular basis.

For example, a Latvian company sells its goods in a foreign country or simply rents some space where its sales representatives work to promote its business. A PE will arise if they are authorised to negotiate prices and sign customer contracts.

Management signatories – PE risk

We stated above that under the international rules a non-resident company is considered to have a PE in Latvia, for example, if the company carries on its business completely or partially through a fixed place of business in Latvia.

A PE may also arise, for example, if a non-resident company's board member permanently stays in a foreign country, has a tax residence there, and is authorised to enter into contracts on the non-resident's behalf. The person is considered to be acting on the non-resident's behalf and PE risk is very high, but it's also important to assess the country's national law. In Latvia, for example, a PE will arise if the person exercises the authority to enter into contracts more than once during the tax year.

The only way the non-resident company can mitigate PE risk is having the board member make all decisions concerning the company when he's present in the company's residence country only. Contracts, too, must be signed only in the company's residence country, and this must be demonstrated to the State Revenue Service.

Having a PE will first of all affect the company's obligation to pay CIT or a similar tax. Accordingly, if a PE is found to exist, the company has to register its presence for CIT purposes, determine the part of income attributable to the PE, and pay CIT on it.

To be continued next week