Tax Excellence Decoded

Permanent Establishment

Understanding the Fundamentals

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Accredited Tax Advisor (Income Tax) Ms Linda Foo shed light on complex Permanent Establishment scenarios with practical cases.

As the world moves towards regionalisation and internationalisation, it is increasingly important for businesses to be aware of the potential tax exposures arising from their international footprints, particularly in the area of Permanent Establishments (PE).

Taking time off her busy schedule to explain this concept was Accredited Tax Advisor (Income Tax) Linda Foo, Tax Partner, Deloitte Singapore. She shared her vast practical experience with the help of numerous illustrative examples at a well-received Tax Excellence Decoded session organised by the Singapore Institute of Accredited Tax Professionals (SIATP).

Concept of PE

The concept of PE is used to determine the right of a tax jurisdiction to levy tax on the profits of a foreign enterprise. Section 2 of the Singapore Income Tax Act (ITA) provides the definition of PE for Singapore domestic tax purposes. Based on this definition, if a foreign enterprise has a PE in Singapore and the PE has income accruing in or derived from Singapore or any foreign income received in Singapore, the foreign enterprise will be liable to tax in Singapore, subject to any exceptions, under Singapore's tax laws.

If the foreign enterprise engaging in cross-border transaction is a resident of a jurisdiction with which Singapore has concluded a Double Taxation Agreement (DTA), the relevant DTA would take precedence over Singapore's tax laws and determine the taxing rights on the foreign enterprise's profits.

Singapore has a comprehensive tax treaty network and has concluded over 70 DTAs with other jurisdictions. Many of these DTAs are closely aligned to the Organisation for Economic Co-operation and Development (OECD) Model Convention. For the purpose of our discussion in this article, we will be referring to the OECD Model Convention 2014 (hereafter known as the "Convention").

Article 5 of the Convention provides the definition of PE, while Article 7 of the Convention determines which jurisdiction has the right to tax the profits of an enterprise. In applying the Convention, one should first establish the existence of PE based on Article 5. If an enterprise is determined to have a PE in the other Contracting State, profits attributable to the PE could be subject to tax in the other Contracting State in accordance to Article 7. Conversely, if the enterprise is determined not to have a PE in the other Contracting State, it should then not be liable to tax in the other Contracting State unless the payments fall under other articles in the relevant DTA.

Types of PE

Broadly speaking, there are four types of PE:

1. Physical PE – Article 5(1)

"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."

A physical PE requires the presence of three key elements:

i. "Fixed" connotes a distinct location with a certain degree of permanence;
ii. "Place of business" suggests that the location should be at the enterprise's disposal;
iii. "The business of an enterprise is wholly or partly carried on" suggests the conduct of business activities.

Illustrating the above, if Company A is a tax resident in Country X but frequently sends its employee to its client's office in Country Y for business meetings where the meetings are held in any available room in the client's office, the client's office should not constitute a physical PE for Company A as it is not at Company A's disposal. While Company A may not have a physical PE, it should be noted that the company may still be liable to tax in Country Y if its activities fall within the definition of other types of PE (such as service PE). Conversely, if Company A rents a specific meeting room from its client where it carries out its normal business activities (including but not limited to business meetings), the rented room may constitute a physical PE for Company A if it is at the full disposal of the company. Company A may then have a tax exposure in Country Y.

2. Construction PE – Article 5(3)

"A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

In determining the presence of a construction PE, it is important to note that the time period applies to each individual site or project. Thus, based on Article 5(3), if a company (a tax resident in Country X) carries out two separate projects in Country Y (the first project for 18 months and the second project for six months), arguably, only the first project lasting 18 months would constitute a construction PE in Country Y and be subject to taxes in Country Y.

Companies should avoid artificially splitting up a project (which would otherwise have constituted a construction PE) into smaller projects to avoid exceeding the 12-month threshold as this may constitute treaty abuse.

3. Service PE

Service PE is not specifically covered in Article 5 of the Convention although the service PE concept is widely adopted in DTAs in the Asia-Pacific region. In essence, the concept recognises the creation of a PE through the furnishing of services by an enterprise through its employees (or other personnel engaged by the enterprise for such purpose) within a Contracting State (generally) for period or periods aggregating more than six months within any 12-month period. The threshold period(s) is typically for the same or a connected project.

It is noteworthy that the terms of service PE may vary significantly in different DTAs. For example, the Singapore-Indonesia DTA has a threshold of 90 days (instead of the usual six-month threshold in other Singapore DTAs) within any twelve-month period on a cumulative basis for all projects (instead of the more common project or connected project basis). Due to the significant differences in each DTA, it is crucial for enterprises to read the details in the relevant DTA that they wish to apply.

4. Agency PE – Article 5(5)

"… where a person other than an agent of an independent status… is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State…"

In determining the presence of an agency PE, the enterprise needs to evaluate if the agent is acting as a dependent or independent agent. Based on Article 5(5), only dependent agents acting on behalf of the enterprise, and who have the authority to and routinely conclude contracts in the

name of the enterprise, may create an agency PE for the enterprise.

Conversely, an independent agent will not constitute PE for the enterprise according to Article 5(6):

"An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

An independent agent is one that is both legally and economically independent. To be legally independent, the agent should not be an employee of the enterprise, and should be capable of acting on his own accord without taking instructions from the enterprise. To be economically independent, the cessation of business relationship with the enterprise should not create a problem to the agent's livelihood and affect the viability of his business.

To illustrate, if an agent is reliant on the enterprise as the sole source of his business income, he is likely to be considered a dependent agent and may potentially create an agency PE for the enterprise.

Exception list – Article 5(4)

It should be noted that the aforementioned analyses to determine if an enterprise has a physical, construction, service or agency PE are inconclusive. Before concluding that the enterprise has a PE, the enterprise should also consider Article 5(4) of the Convention which provides a list of activities that are specifically excluded from the PE definition ("the exception list"). The exception list generally covers preparatory or auxiliary activities.

For example, if an enterprise has a fixed place of business which constitutes a physical PE in accordance to Article 5(1), but the activity carried out (e.g. maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage) is specifically provided for in the exception list under Article 5(4), the enterprise may be deemed not to have a PE.

It should also be noted that the OECD, as part of its Base Erosion and Profit Shifting (BEPS) project, is reviewing, among other things, Article 5(4), and may narrow the exception list to address the artificial avoidance of PE exposure. As the DTAs concluded by Singapore substantially adopted the Convention, any revision to Article 5 of the Convention (including accompanying guidance and commentary) are likely to be persuasive in the interpretation of those DTAs concluded by Singapore.

Minimising tax exposure from PE

To minimise tax exposure from the presence of PE in another country, an enterprise may consider the following:

1. Monitoring the number of days present

An enterprise should actively track and manage the number of days its employees are present in the other country to avoid creating a service PE.

2. Secondment

If a service PE is expected to be created through the provision of services in the other country for an extended period of time through employees, an enterprise may consider secondment of its employees to its related entity in the other country (where available) to avoid the service PE.

During the secondment, the secondees should be legally and economically acting as the employees of the related entity, and not as proxies of the enterprise. The secondment should be formalised with valid secondment contracts, and the secondees should report directly to the related entity in the other country.

Other practical considerations

It is important for enterprises to be aware of the peculiarities of different tax authorities in administrating the PE concept. Failure to recognise the peculiarities may have adverse tax implication to the enterprises.

A foreign customer may try to withhold tax for the services received from a Singapore enterprise based on its domestic tax laws. Where there is a DTA between Singapore and the other country, and the relevant DTA provides for the relevant withholding tax to be avoided, the Singapore enterprise may inform the foreign customer that withholding tax is not applicable under the relevant DTA. However, in countries such as the Philippines, pre-application is required for an enterprise to apply DTA benefits. In this regard, if the Singapore enterprise fails to pre-apply for the DTA benefits in Philippines and as a result suffer withholding tax under Philippines' tax laws (even though it may be argued that withholding tax should not be paid under the Singapore-Philippines DTA), the Singapore enterprise will not be entitled to double taxation relief on the withholding tax suffered.

Understanding the fundamentals of PE will help enterprises to identify potential tax exposures from cross-border transactions and better manage their tax and compliance costs. With a good grasp of the fundamentals, enterprises should then focus on the peculiarities in countries where their businesses operate in. When in doubt, do consult an accredited tax professional.

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About Ms Linda Foo

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Linda has over 25 years of tax experience serving multinational and local companies including their expatriate employees in Singapore.

A graduate of the Accountancy degree and Master of Business Administration programmes from the National University of Singapore, Linda has, over the years, acquired extensive experience in personal and company tax compliance as well as Singapore and international tax consultancy and planning in the area of corporate restructuring, tax due diligence, cross-border payments, supply-chain planning, mergers and acquisitions and permanent establishment issues.

This technical event commentary is written by SIATP's Tax Manager, Felix Wong. Felix has over seven years of experience in corporate and international tax. Previously from PwC Singapore, he now leads various tax initiatives in Singapore's first dedicated professional body for tax specialists to enhance Singapore's position as a centre of excellence.