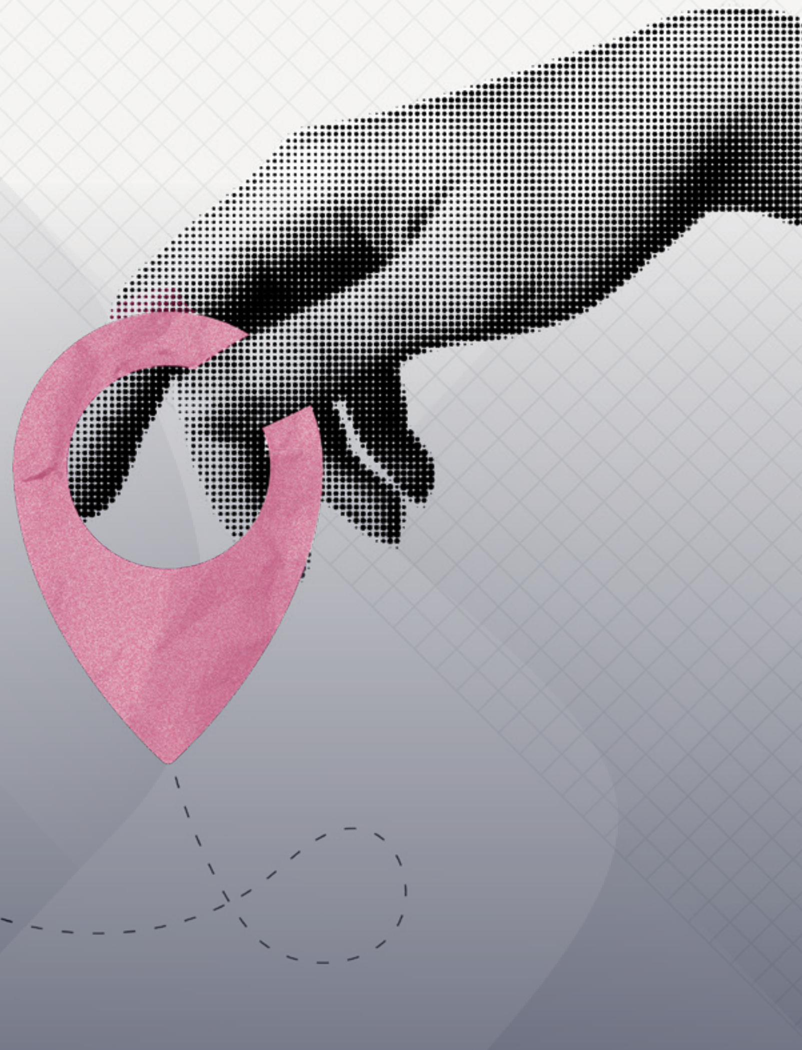
The Dangers of Permanent Establishment

How to minimize permanent establishment risk with a Global Employer of Record

THOUGHT LEADERSHIP



GLOBAL EXPANSION

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INTRODUCTION

The global business world offers companies exciting opportunities to expand into different markets. However, entering these markets can be challenging and risky.

Before launching into a new country, companies must understand the impact of creating a Permanent Establishment (PE.) One that comes with significant tax obligations that can restrict a business's expansion before it starts.

This guide will not only outline what the risks of Permanent Establishment are but also demonstrate why working alongside an Employer of Record (EOR) can be a game-changer for global expansion.

Learn the effects of triggering PE in a foreign country and discover how to mitigate the risks through proven strategies.

Methodology

This report was created using various corporate reports, government agency information, one-on-one interviews, and open-ended questionnaires.

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WHAT IS PERMANENT ESTABLISHMENT?

Permanent Establishment (PE) is when a business has a presence (physical office, factory, or level of activity) that makes it subject to taxes in a specific country. This could include taxes on things like sales, and payroll. Different types of taxes can apply, such as employment, VAT, and profit taxes, affecting both the business and its employees.

Requirements for Permanent Establishment

Many jurisdictions use ‘revenue creation’ by employees to test whether a Permanent Establishment will be created. This is a narrower approach than simple employee presence:

- If PE is only created by standard revenue creation, then activities like marketing, temporary sales activity, and arm’s length transactions would not likely trigger PE.
- If a broader definition of employee actions creates PE, then the likelihood becomes greater since virtually any activity could result in PE.

The Consequences of Triggering a Permanent Establishment (PE)

A company should carefully weigh several factors before creating a PE in a foreign country.

The level of taxation, especially related to employee activities, is a crucial aspect. Countries often assess revenue patterns and Permanent Establishment based on how much time employees spend there.

According to the Organization for Economic Cooperation and Development (OECD), triggering a PE can lead to significant taxes, including income tax on profits, employment tax, payroll tax, corporate tax, and other excise duties.

Another consideration is tax implications for employees in a foreign country. Short-term assignees may not qualify for tax treaty relief, resulting in substantial taxes in the host country. Even if they have been there for less than 183 days, once the PE is triggered, they lose the benefit.

A third factor to consider is the allocation of costs for short-term assignees'. This could impact the use of a treaty exemption for assignment provisions that have existed for at least 183 days. Additionally, Lynette Olivier states that short-term assignees may need to seek tax equalization as protection from additional tax costs.

Companies should also consider:

- Contractor status to ensure compliance with laws that define the employment relationship between the contractor and the company.
- Intellectual property rights could be excluded from protection in the new country.
- The risk is that a business will grow too quickly and not be sustainable.

By not properly managing PE risks, a company could suffer from:

- A damaged reputation.
- Unfunded and corporate tax liabilities.
- Increased audit frequency.
- Indirect tax costs when improper VAT registrations have been made.
- Interest charges and penalties.
- Non-compliance with reporting obligations such as social security and payroll, regulatory issues, immigration, and more.

Additionally, triggering a Permanent Establishment varies depending on the country.

As an example, triggering PE for a POE in a treaty-based company such as OECD might have different implications compared to a non-treaty-based company.

Strategic tax-planning methods, such as corporate restructuring, secondment agreements, and outsourcing, can help reduce PE risks in a foreign country.

However, it's critical for a company to fully understand the potential dangers before establishing a Permanent Establishment.

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TRIGGERING PE: A SUMMARIZED GLOBAL VIEW

A key issue companies face is understanding when a Permanent Establishment will be triggered so they can make informed decisions regarding business activity and potential taxation.

There are a few accepted baselines for PE, but those become broader as 'business activity' is interpreted in new ways. Companies need to explore how PE is triggered before entering new global markets.

AFRICA

Cape Verde

Cape Verde amended its income tax law definition so it clearly states that a company will not be deemed to have a Permanent Establishment if it manages activities through a broker or intermediary.

ASIA

China

Permanent Establishment criteria in China are very broad and inclusive of most types of business activities.

China defines Permanent Establishment in 4 separate areas:

- Fixed place Permanent Establishment
- Construction site Permanent Establishment
- Agent Permanent Establishment
- Service Permanent Establishment

China has become the most focused Asian country when it comes to Permanent Establishment enforcement. During the pandemic, several employees being seconded from the US found themselves stuck in China and unable to return to the US.

An example of this is Chinese nationals employed by US companies who were asked to work from home. Under normal circumstances, this would trigger PE status in China, increasing the American company's Chinese Corporate Income Tax (CIT) from 10% to 25% of all Chinese-sourced and non-Chinese-sourced income in connection with the PE.

Although the tax authorities in China stated that PE would not be triggered immediately due to the unprecedented global pandemic, they failed to explain if the threat was removed completely.

Technically after 183 days, as dictated by OECD, and the 6-month allowance given by authorities, there is no guarantee that US companies will not be charged with the higher tax.

EUROPE

Europe continues to be the most aggressive in pursuing Permanent Establishment claims against foreign companies.

Notably, France, Italy, and Spain have all won recent PE disputes, which have encouraged other European countries to raise Permanent Establishment challenges, especially around virtual business activity.

Realistically, a country attempting to attract investment and business activity might take a more relaxed attitude toward PE, while a country with an established history of foreign investment may be stricter in the application of corporate tax rules.

Denmark

The two examples below illustrate how easy it is to trigger a Permanent Establishment in Denmark.

A Swiss company looking to enter the Danish market hired a Danish salesperson to work from their home office. The Danish authorities determined that the home office was enough to constitute a Permanent Establishment, hence the Swiss company was liable for taxation.

Danish tax authorities issued binding guidance to a German company that stated that even if their employee works only 25% of the time from home in Denmark, it would still constitute permanent residence

France

The Supreme Court in France has determined inter-alia, which means there will be no Permanent Establishment in cases where there is a commissionaire. A commissionaire executes contracts in their name but on behalf of their principal. For clients, a commissionaire acts as a distributor and never takes legal title on the product acquired by the client.

Germany

To trigger a Permanent Establishment in Germany, it is essential to have a facility that, although can be used by other persons, must be of the taxpayer. If a person working for a company relocated to Germany and has an 'office space'—an internet connection and a phone will suffice—then they may create a Permanent Establishment for the business.

Portugal

To trigger a Permanent Establishment in Portugal there must be a fixed place of business or a dependent agent. If the company carries out activities through a broker, general commission agent, or other independent agents acting in the normal course of business, the agent will not trigger Permanent Establishment.

Luxembourg

PE law in Luxembourg is triggered if a foreign company has a permanent representative and a fixed premise as the headquarters. No revenue creation is required.

United Kingdom

Permanent Establishment in the UK is defined as a company presence to carry out trade, and includes 2 primary types:

- A fixed place of business, such as an office, a factory, or shop; or
- A dependent agent, executing contracts on behalf of the foreign company.

UNITED STATES OF AMERICA

In the US, trade or business requires activities that are continuous, regular, and considerable, whereas occasional and incidental activities are not deemed sufficient to create a taxable presence. Once the presence of an agent has been established, the independence and dependence are investigated by the IRS to determine if:

- An agreement between the agent and foreign principal exists, as well as economic control over the agent due to the exclusive nature of the principal relationship.
- An absence of business risk. If an agent's income is based on the income generated by executing contracts, this indicates the presence of business risk.
- Tax planning documents such as slide decks, internal correspondence, tax research, memos, or opinions are reviewed.

Permanent Establishment rules in many jurisdictions reflect the OECD guidelines, however, there may be significant local differences or no legal definition of a Permanent Establishment. As such, companies with employees who regularly work outside of their home country must obtain appropriate local advice to manage PE risk.

Monitoring risks should be an ongoing process and clear guidelines must be implemented to enable companies to track their position appropriately.

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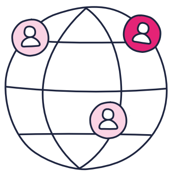
MITIGATING THE RISK OF PERMANENT ESTABLISHMENT

For companies willing to navigate the creation of a PE on their own, several steps can be taken to help internal teams mitigate risk including:

- Conducting full-scope reviews with relevant individuals to drill down into operational practices.
- Assessing the challenges and methodology of each business unit and their approach to governance against current tax standards applied by the business.
- Documenting policies, procedures, and processes applied in each territory and business line.
- Improving internal control frameworks and identifying opportunities for tax efficiency.
- Reducing the risk of unexpected tax payments by minimizing errors including interest charges and penalties.
- Making relevant disclosures to tax authorities showing appropriate measures were taken to manage PE issues.

It is important to remember that a major issue that many companies face is being unaware that their presence is triggering PE, which leads to unexpected tax liabilities.

To help mitigate the risk of unintentionally triggering PE, a company can:



Lessen the Risk with a Global EOR

A Global Employer of Record (EOR) eliminates the risk of creating a Permanent Establishment because it operates as the Employer of Record (EOR) for a company by controlling its operations and employee functions. It also assumes the company's HR-related responsibilities, such as payroll, benefits, and tax remittance.

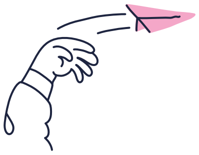
By specializing in international employer-employee relations and possessing a stable legal presence in nearly all international markets, a Global EOR will handle salary remunerations, benefits administration, and tax withholding in compliance with the local country's legal mandate.

It ensures that every business activity meets compliance standards and provides a legal means by which a company reports taxes and is recognized in the host country. This allows a company to maintain its global presence without the fear of fines or penalties.

Companies using a Global EOR effectively streamline international expansion plans while ensuring tax and legal compliance.

Engage Local Partners

One of the best ways to mitigate the consequences of PE risks is to engage local partners or experts who can advise on the host country's laws.

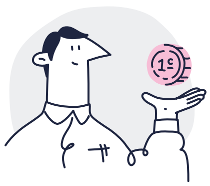


Limit Overseas Business

Another approach is to limit business activity to short business trips and avoid sending employees on long assignments. This solution assumes there is no fixed place of business or facility and ensures that the business is engaged solely in marketing or consulting.

Conduct Due Diligence

The company may mitigate the risk of triggering a PE by performing due diligence. The company should also have a specific tax compliance team that will mitigate the risk of unexpected tax payments and assist in making the relevant disclosures to tax authorities.



Mitigate Through Auxiliary Tasks

If a company relegates only auxiliary tasks to the foreign country such as preparatory work that does not lead to any revenue generation, a PE would not be triggered. The burden of proof will rest on the company to prove that the activity is indeed auxiliary.

However, the risk is still present, and the courts may determine that there is a PE, and the company would need to pay interest on the unpaid tax.

Manage Through a Subsidiary

There are many tax-related advantages associated with having a subsidiary company. The foreign subsidiary will be operating independently from the parent company, hence it has responsibility for its liabilities and assets and will be perceived to be a legal entity that is distinct for regulatory and taxation oversight from the parent company, eliminating the PE risk.

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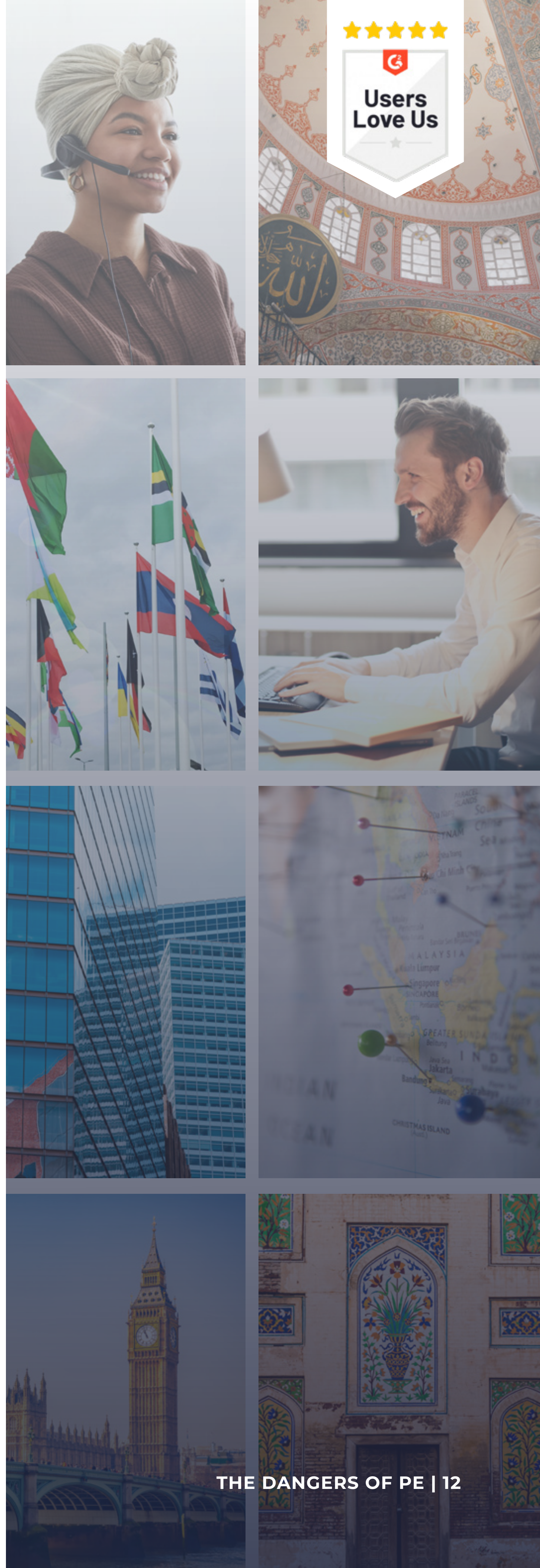
MINIMIZE EXPANSION RISKS WITH A GLOBAL EOR

Today, the safest way for a business to expand into another country is by partnering with a Global EOR partner.

The complexity and ever-changing tax landscape in different countries have made employers extremely vulnerable to PE risks and exposure to punitive taxation if unaware that a PE is created.

A Global EOR removes the initial commitment factor and allows companies to determine if the move is economically sound.



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