GLOBAL EXPANSION

The Risks of Permanent Establishment

Mitigating permanent establishment risk through a global PEO partner.

THOUGHT LEADERSHIP

GLOBAL EXPANSION

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The Threshold for Creating a Permanent Establishment

The global business environment grants endless opportunities for companies looking to expand their brand into different markets. But foreign market transition can be cumbersome and risky. The threshold for creating a Permanent Establishment (PE) is a test contained in most domestic tax laws and double tax treaties and is used to determine whether a business has enough activities in another country to create a taxable presence. These activities are subject to scrutiny by tax authorities, making it critical for a company to understand the consequences of triggering a Permanent Establishment.

Companies that outsource to a Global Professional Employer Organization (PEO) alleviate the tax and legal compliance issues that are triggered when creating a Permanent Establishment. By specializing in international employer-employee relations and possessing a stable legal presence in nearly all international markets, a Global PEO will handle salary remunerations, benefits administration, and tax withholding in compliance with the local country's legal mandate. By acting as the "Employer of Record", a Global PEO ensures every business activity meets compliance

standards and provides legal means by which a company reports taxes and is recognized in the host country, allowing a company to maintain its global presence without the fear of fines or penalties.

Companies using a Global PEO effectively streamline international expansion plans while ensuring tax and legal compliance. Throughout this report, we will analyze and evaluate the effects of triggering PE in a foreign country and consider several ways to mitigate the risk.

Methodology

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

Understanding Permanent Establishment

What is a Permanent Establishment?

Permanent Establishment (PE) refers to a taxable presence that leads to the creation of corporate income tax or other forms of tax imposed on business-related activities such as sales tax, payroll tax, and value- added tax within the tax jurisdiction or country. It is common for local taxes to arise in various forms such as employment tax, tax on profits, excise taxes, and VAT, while employee's personal taxes can also be affected.

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:

- 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 PE is created by a broader definition of employee actions, then the likelihood becomes greater since virtually any activity could result in PE.

A company should consider several factors before creating a Permanent Establishment in a foreign country.

The first is the substantiality of the tax level, which is dependent on several issues including employee activities.

Some countries will consider how much time employees spend in the country to determine revenue patterns and PE. According to the Organization for Economic Cooperation and Development (OECD), triggering a PE may cause substantial 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 with treaties such as the OECD may not qualify for tax treaty relief and end up paying significant taxes in the host country. Even if short-term assignees have been in a foreign country for less than 183 days, they will not benefit from tax treaty relief once a Permanent Establishment has been triggered in the host county.

A third consideration relates to cross- charging short-term assignees' costs to a local PE. This might prevent the use of a treaty exemption for assignment provisions that have existed for at least 183 days. Additionally, Olivier (2002) states that short-term assignees might be required to apply for 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.

- Contractor status to ensure compliance with laws that define the employment relationship between the contractor and the company.
- Intellectual property rights, which could be excluded from protection in the new country.
- The risk 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, potential indirect tax cost 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 considerations 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.

Tax-planning strategies can be used to minimize PE exposure in a foreign company through corporate restructuring, secondment agreements, inter-company agreements, and outsourcing, but a company needs to be fully aware of the risks before creating a Permanent Establishment.

Triggering Permanent Establishment: An Abbreviated World View

A core dilemma 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.

With a Global PEO

If a company decides to operate in Cape Verde and partners with a Global PEO, it will not trigger a Permanent Establishment because neither the individuals contracted nor the Global PEO holds 50% interest in the company.

With a Global PEO

If a company used a Global PEO, their employees would effectively be registered with the Global PEO and the company would not be taxed as a PE. Additionally, the Global PEO would take care of complex tax matters, such as the different rates applicable to local employees and foreign nationals, in China

Asia

China

Permanent Establishment criteria in China is very broad and inclusive of most types of business activities. China defines Permanent Establishment in four 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 that 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 income and non-Chinese sourced income in connection with the PE.

Although the tax authorities in China stated that due to the unprecedented global pandemic PE will not be triggered immediately, 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.

AN ABBREVIATED WORLD VIEW

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 even if their employee works only 25% of the time from home in Denmark it would still constitute permanent residence.

With a Global PEO

Instead of hiring directly, the aforementioned company could have outsourced the hiring of their salesperson to assess if the market was good for business. This would have removed any tax liability and compliance responsibility.