Permanent Establishments under scrutiny

Recently, Tax Authorities across the globe have increasingly adopted local reflexes in determining the nexus of a company in order to derive proper tax that is due and payable. The nexus of a company takes various forms such as physical place of business, the location of effective control and management, and more recently, carrying out business through a dependent agent. This in a nutshell, is the concept of a Permanent Establishment (PE).

The concept of PE is broadly defined under the Organization for Economic Co-operation and Development (OECD). The Income Tax Act in Kenya borrows its definition of a PE from the OECD.

A PE is defined as a fixed place of business in which a person/business entity carries on business for at least six months. The Finance Act, 2014, further expanded the definition of a PE to include a person's dependent agent. A dependent agent is a person who habitually exercises authority to conclude contracts on behalf of a corporation. Even with this expansion, the definition is still not as wide as the OECD definition which also includes the fixed place of business test and dependent agent test. The concept of "fixed" under the OECD extends to include any place of business with a certain degree of permanence.

PEs have been used as a tool to carry out business in different jurisdictions without having to establish tax residency status. The issue of PE is primarily one of the boundary between different governments and allocation of taxing rights between countries in relation to trading activities. This has over time led to erosion of the tax base or in some instances double taxation. Globally, various tax jurisdictions have become alive to this reality and have initiated certain reforms such asthe popular OECD Base Erosion and Profit Shifting (BEPS) Action Plan in 2013. BEPS focuses on base erosion, double non-taxation, treaty abuse, permanent establishments and transfer pricing as key areas for reform. Essentially, BEPS highlights instances where the interaction of different tax rules results in either no payment or minimal payment of tax. It also refers to situations where the tax paid in a particular jurisdiction is not commensurate with the economic value generated in that jurisdiction.

Specifically, among the proposed recommendations affecting the operation of a PE is Action Plan 7, "Preventing the artificial avoidance of permanent establishment status". This Action Plan proposes to develop changes to the definition of a PE in order to prevent the artificial avoidance of PE status through the use of commissionaire arrangements. These are arrangements known to divert profits by using a person to transact in a given state in its own name but on behalf of a foreign enterprise. This allows the foreign enterprise to sell its product without necessarily creating a PE to which such sales may be attributed for tax purposes. Since the person that concludes the sale does not own the products, he cannot be taxed on the resultant profits and may only be taxed on the remuneration that he receives for his services, i.e. a commission.

With the globalization of the world and trade, there exists several other arrangements that can potentially create a PE status. These include: business travellers and seconded employees, popular use of sub-contractors, construction assembly or installation projects, toll or contract manufacturing arrangements.

A more recent development in the United Kingdom (UK) is the scrutiny on companies that exploit the operation and use of PE to carry out business thereby artificially diverting profits from the UK. Her Majesty Revenue & Customs, which is the revenue authority in the UK, targets companies having contrived arrangements to divert profits from the UK by avoiding the creation of a UK taxable presence. In an effort to curb such practices, the UK has introduced a tax known as diverted profits tax. The tax seeks to counteract arrangements by which foreign companies exploit the PE rules and also prevent companies from creating tax advantages by using transactions or entities lacking economic substance.

Locally in Kenya, the KRA has placed emphasis on the Multi-National Corporations (MNCs) having to substantiate where the economic value in the global value chain is created. The KRA has passed tax adjustments in instances where the taxpayer is not able to support the revenue or profit generated from Kenya as being commensurate with the economic value created in Kenya.

With the above changing environment, KRA will possibly give more attention and seek to unveil the existence of PE's operating in Kenya. Going forward, MNCs should expect more scrutiny as to the nature and existence of their PE in Kenya.

Consequently, in order to avoid unpleasant PE surprises, non-residents carrying out business in Kenya should continually review their activities to assess whether they have crystallized a PE in Kenya. Upon crystallization of a PE, they should take deliberate actions to formalize their operations through either incorporating a company or registering a branch to mitigate against adverse tax implications and KRA's intervention.

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