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# When does doing business in another country cross the tax line?

## A review of BEPS Action 7: Permanent Establishments

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By Seun Adu

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*"At The Palms now. They have started paying to park. Everybody inside here is walking 'fast fast'."*  
- **Chima Emerueh**

Chima's observation is a classic illustration of our tendency as humans to change our behaviour to avoid additional costs (in this case the introduction of a parking fee of only N200 at a shopping mall in Lagos). I can bet you know a friend (and maybe you are even the type) who, in order to avoid the N65 charge for making a withdrawal from another bank's ATM, will ignore the closest ATM and prefer to journey in search of his bank's ATM. Businesses are like humans. They don't want to incur costs if they can avoid it. This includes tax costs.

The focus of Action 7 of the OECD's BEPS action plan was to limit the ability of Non-Resident Companies (NRC) to artificially avoid tax in the foreign countries where they carry on business. Usually, NRCs are only required to pay income tax on the profits they make from foreign countries when they have a certain level of economic presence in those countries. This is more generally referred to as a Permanent Establishment (PE). The work on Action 7 was to block the loopholes which, the OECD believes, make it possible for NRCs that would ordinarily have PEs in foreign countries to artificially avoid creating PEs and hence avoid paying tax in those countries.

I've looked at the recommendations from Action 7 and my guess is that the biggest impact in Nigeria will not come as a result of any changes in the law. The biggest impact will come from elsewhere. Stick around and I will tell you what I mean.

## ***International trade and the origins of the Permanent Establishment concept***

Darrel Ltd. is a successful widget manufacturer based in Country D. The company will pay tax in Country D. Abolade Ltd is based in Country A and convinces Darrel Ltd that there is a big market for the widgets there. Darrel Ltd starts to export widgets to Abolade Ltd. If in addition to Country D, Country A also decides to collect income tax from Darrel Ltd on the profits it makes from the exports, the company will pay income tax twice on its export profits: first in Country D (its home country) and then in Country A (a foreign country). It will take Darrel Ltd a very short time to decide that it does not want to continue to catch, cook, and share meat that it will not even taste. This is how double taxation can discourage international trade.

In order to avoid this, the Permanent Establishment (PE) concept was developed (as far back as the 1930s) to define the circumstances under which, in our example, Country A would have a right to tax profits made by Darrel Ltd (from sales to customers located in Country A). The PE definition is designed to include only business activities which cross a certain threshold.

## ***How Non Resident taxation currently works***

Under existing PE rules, there are 2 broad ways that Darrel Ltd can become liable to income tax in Country A. First is if it carries on business through a fixed base located in Country A and second is if it carries on business through a dependent agent that is able to conclude contracts on its behalf.

Darrel Ltd will not pay income tax in Country A if it simply exports from its home country (Country D) and does not perform any activities inside Country A. Darrel Ltd will however pay tax in Country A if its employees take the products into Country A and start to sell to customers in Country A. In this instance, Darrel Ltd will have created what is called a fixed base PE in Country

A. There are a few things that Darrel Ltd's employees can do in Country A without creating a PE. These are things like having a warehouse, storing products, gathering information etc. These are referred to as the specific activity exemptions to the PE definition.

Darrel Ltd. could also be liable to tax in Country A if it gets an agent in that country to do the sales on its behalf and that agent is a dependent agent that has, and exercises the power to conclude contracts with customers in Country A. This is called a dependent agent PE.

Different countries have their own variations of these general rules. For example Nigeria has two additional conditions that will make an NRC liable to tax on its business profits. Many countries have also introduced a new category of PEs for service companies (service PEs). In the broadest sense however, most countries will only subject a foreign enterprise to tax if that enterprise has either a fixed base PE or a dependent agent PE in their country.

## ***What tax loopholes did Action 7 try to address***

I will do a quick run-down of these. If you find it a bit too abstract, don't sweat it. We will go into more details in my follow up article.

With Action 7, the OECD is trying to curb what it considers to be abuses of the current PE definitions. These are strategies that help NRCs avoid creating PEs when they should ordinarily have PEs.

First are the specific activity exemptions (I've mentioned a few of them already). These are the activities that an NRC can legitimately perform in another country without creating a PE because they are specifically exempt from the PE definition. Exemptions are troublesome. Policymakers the world over will attest to this. Make an exemption, and everyone will try to find a way to qualify for it.

When the specific activity exemptions were introduced, the belief was that these activities were not a significant part of the business activities of NRCs and as such it made sense that carrying on these activities in another country should not lead to PEs for NRCs.

Changes in the way business is done (particularly with regards to the digital economy) has however shown that some of the activities included in the exemption list have become very important aspects of some business models and it would defeat the purpose of the PE exemptions.

Then there is the issue of fragmentation. The OECD described this as tax avoidance structure where an NRC would break up a single business activity into several activities, with each activity being performed by different related parties. This would allow the NRC to argue that each separate activity qualified for a specific activity exemption. Similar to this is the practice of splitting of a single contract between several related parties to so that each party would not stay long enough in the foreign country to create a PE.

For dependent agent PEs, the major issue was the ability of NRCs to avoid a PE status because they could successfully argue that their dependent agents had not legally concluded any contracts on their behalf (recall that for an agent to create a

PE, it had to first be a dependent agent and then it had to exercise the authority to conclude contracts on behalf of the principal). The loopholes created by the uncertainties around the definition of a dependent agent were also reviewed.

The OECD put forward recommendations for blocking the above loopholes in Action 7 Paper.

### ***How will it affect Nigerian taxpayers?***

Countries that have been involved in the BEPS project will revise their double tax treaties with the recommendations from Action 7. Some countries will take additional steps and make changes to their local legislation. Although Nigeria is already making moves to adopt the changes (at least at the double tax treaty level) there is the question of whether and to what extent the changes are required. To answer this question, one would need to take a closer look at the proposed changes as well as the specific tax rules which currently apply to NRCs operating in Nigeria. We will examine these issues in my subsequent articles on the subject.

At the start of this piece, I promised to share my views on how I believe our tax system will be most impacted by the work on Action 7. I still plan to share my views; but not today.

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