

8 MARCH 2021

Impact Of Covid-19 To Permanent Establishments

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Generally, double taxation occurs when residents of two given countries engage in international or cross-border business transactions. This is because the country in which the source of income arises normally has the right to tax that income. However, if the income is remitted to another country, it may be subject to tax again in that other country and, hence, double taxation occurs.

In order to minimise or eliminate double taxation of the same income, countries enter into double taxation agreements (DTAs). This is achieved mainly by the granting of double tax relief by the country of residence. A DTA is crucial as it makes the country attractive for international trade and investment. A DTA would also promote certainty as there are specific rules for applying taxes on international income.

By default, most Malaysian DTAs follow the Organisation for Economic Co-operation and Development (OECD) model treaty with some modifications. In interpreting the DTAs, our courts have recognised the value of the OECD Commentary as an extrinsic aid to interpretation in cases such as ***Ketua Pengarah Hasil Dalam Negeri v Thomson Reuters Global Resources* [2016] 10 MLJ 1**.

The Concept Of Permanent Establishment

Article 7(1) of the Malaysian DTAs generally provides that business profits are not to be taxed in the source country but only in the corresponding contracting country in which the business is located, unless the business has a permanent establishment (PE) in the source country. There is thus a fundamental DTA concept that business profits will only be taxable in the source country if there is a PE in the source country. The question of what constitutes a PE then arises.

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The term PE is generally defined under Article 5(1) of the Malaysian DTAs as a fixed place of business in which the business of an enterprise is wholly or partly carried on. According to the OECD Commentary, the important features of a permanent establishment are:

- (a) The existence of a place of business, i.e. a facility such as premises or, in certain instances, machinery or equipment;
- (b) This place of business must be fixed, i.e. it must be established at a distinct place with a certain degree of permanence; and
- (c) The carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

Additionally, the Malaysian DTAs generally provide that the mere presence of an independent or general agent will not result in a PE for an enterprise, unless the agent acting for the enterprise has, and habitually exercises, an authority to conclude contracts on behalf of the enterprise.

Furthermore, in general, supervisory activities in connection with a construction, installation, or assembly project will constitute a PE if it lasts more than 12 months following the OECD model treaty.

In the Indian case of ***Commissioner of Income-Tax v Visakhapatnam Port Trust (1983) 144 ITR 146 (AP)*** on the subject of PE, the High Court observed that a PE connotes the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature

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that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

Concerns Due To Covid-19

The Covid-19 pandemic has forced governments to take unprecedented measures such as implementing travel restrictions. This has raised many tax issues, including the right to tax between countries. In the context of PEs, businesses may be concerned that the displacement of employees to countries other than the country in which they regularly work could lead to the creation of a PE in those countries, thereby triggering unintended and unforeseen tax implications.

To address such concerns, the Inland Revenue Board of Malaysia (IRB) has provided guidance for taxpayers via a document titled “Frequently Asked Questions (FAQ) on International Tax Issues Due to Covid-19 Travel Restrictions”. In relation to the creation of PE for companies, the FAQ stipulates that where a company is not resident in Malaysia, the temporary presence of its employees or personnel in Malaysia will not lead to the creation of a PE in Malaysia, provided the following conditions are met:

- (a) The company did not have a PE in Malaysia before the existence of Covid-19 travel restrictions;
- (b) There are no other changes to the economic circumstances of the company;
- (c) The temporary presence of the company’s employees or personnel in Malaysia is solely due to travel restrictions relating to Covid-19; and
- (d) The activities performed by the employees or personnel during their temporary presence would not have been performed in Malaysia if not for the Covid-19 travel restrictions.

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The situation above applies to all enterprises, including partnerships and limited liability partnerships.

Commentary

Based on the FAQ released by the IRB, the exceptional change of the location where employees exercise their employment due to the Covid-19 crisis should not normally create any changes to a PE determination.

Whilst the mere fact that an enterprise having a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business, paragraph 12 of the OECD Commentary on Article 5 stipulates that the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise.

In this regard, paragraph 18 of the OECD Commentary on Article 5 states that even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual who works for the enterprise. The carrying on of intermittent business activities at a home office does not make that home a place at the disposal of the enterprise. It must be noted that it is unlikely for the enterprise to have access or control over the home office.

Furthermore, there must be a certain degree of permanency in order for a place to be considered a fixed place of business through which the business of that enterprise is wholly or partly carried on. Therefore, employees who stay at home to work remotely during the Covid-19 crisis would likely lack a sufficient degree of permanency or continuity to constitute a PE.

A related issue would be whether an employee temporarily working from home for a non-resident employer could give rise to a dependent agent PE. As

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noted above, a dependent agent will not create a PE for an enterprise unless the dependent agent habitually concludes contracts on behalf of the enterprise. In the guidance issued by the OECD Secretariat on this issue, an employee's activity is unlikely to be regarded as habitual if the employee is only working at home for a short period because of government directives.

An exception to the above is in relation to supervisory activities, where paragraph 55 of the OECD Commentary on Article 5 explains that a site should not be regarded as ceasing to exist when work is temporarily discontinued. Therefore, it would appear that the duration of any interruption of activities due to the Covid-19 crisis should be included in determining the life of a site, which will affect the determination of whether a site constitutes a PE.

Notwithstanding the discussion above, it should be noted that the IRB requires non-resident companies to keep all relevant records and documentation, for example, employees or personnel passport information, travel schedule, and work order or instructions from the employer, which must be provided to the IRB upon request. In this regard, we would caution non-resident companies to maintain proper documentation to support the fact that any temporary presence in Malaysia is solely due to travel restrictions relating to Covid-19, and that the activities performed during the temporary presence would not have been performed in Malaysia if not for the Covid-19 travel restrictions.

Authored by Ng Kar Ngai, an Associate with the firm's Tax, SST & Customs practice.

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