The OECD addresses permanent establishment and residency issues due to COVID-19

News Flash
China Tax and Business Advisory
April 2020
Issue 9

In brief

On April 3, 2020, the Organisation for Economic Co-operation and Development (OECD) published an analysis entitled "OECD Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis"[1] (OECD Analysis). The OECD Analysis provides guidance on cross-border tax issues arising from the COVID-19 pandemic based on an analysis of the current international tax treaty rules. These issues include whether a temporary change of work location of individuals in light of travel restrictions and various quarantine measures implemented by governments would lead to creation of permanent establishment (PE) or change in the tax residence status of the relevant corporations or individuals.

This News Flash summarises the OECD Analysis and discusses the potential tax implications that both Chinese and foreign enterprises and individuals should be aware of if they have to temporarily perform business activities or render employment services in another jurisdiction due to special working arrangement as a result of COVID-19.

In detail

The OECD Analysis

The OECD Analysis provides guidance on the application of international tax treaty rules in the following four areas:

1. The creation of PE

- Fixed place PE – The exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 pandemic, such as working from home or in a jurisdiction other than the one in which they regularly work, should not create a PE for the employer. This is because a PE must have **certain degree of permanency** and be **at the disposal** of an enterprise in order for that place to be considered a fixed place of business through which the business of that enterprise is wholly or partly carried on.

- Dependent agent PE – Employees or agents working temporarily from home and concluding contracts in their home jurisdictions on behalf of their non-resident employers or principals for a short period of time (rather than as the normal routine) because of force majeure and/or government directives are unlikely to be regarded as "**habitually** concludes contracts on behalf of the enterprise" and therefore should not create an agency PE for the enterprises.

- Construction site PE – On the other hand, the period of temporary interruption of activities on a construction site (e.g. due to a shortage of material or labour difficulties) should be included in determining the duration of the site for the purpose of ascertaining whether the site constitutes a PE. In other words, temporary interruption of activities on a construction site due to COVID-19 should not be excluded.

2. The residence status (place of effective management) of a company

Temporary relocation or inability to travel of chief executive officers or other senior executives of an entity should not trigger a change in the tax residency (place of effective management) of the entity under a tax treaty or create the issue of dual residency, especially when the tie breaker rule for dual residency in tax treaties is applied. Under the existing tie-breaker rule, the place of effective management will be used to determine the residence of a dual-resident entity for tax treaty purpose. The OECD analysis points out that all relevant facts and circumstances should be considered to determine the “usual” and “ordinary” place of effective management and not only those facts and circumstances that pertain to an exceptional and temporary period.

3. The residence status of individuals

A temporary dislocation of an individual by reason of the COVID-19 pandemic will unlikely change the individual’s tax residency when the tie-breaker rules for dual residency in tax treaties are applied.

4. Subsidised employment income of temporarily dislocated cross-border workers

The OECD takes the view that the employment income of a cross-border worker (i.e. an individual who is a resident of one state but commute to work in another state) who is temporarily dislocated and working in his/her state of residence but with his/her salaries subsidised by the government in the country of the employer (i.e. the state of source) should be attributable to the place where the employment used to be exercised by that individual before the COVID-19, as the employment income in such scenario most closely resemble a termination payment. As such, the state of source should have taxing right over such subsidised employment income.

Our observations

- The OECD Analysis does not contain any new rules or changes of the existing rules under the OECD Model Tax Convention. It simply provides an analysis of how the existing OECD rules and commentaries on applying a tax treaty should be interpreted in the exceptional COVID-19 context. In addition, the OECD Analysis only deals with corporate/individual residency issues and allocation of taxing rights between contracting parties in a tax treaty context. The domestic law of the relevant jurisdictions will apply if there is no tax treaty.
- The OECD Analysis only represents the OECD’s views, although it is influential, it is not legally binding on tax authorities of various jurisdictions. It is up to various jurisdictions to decide whether to follow these views in applying the tax treaties.
- Other than the OECD, a number of countries such as Australia, Ireland and the UK have also issued their own guidance and/or relief measures to address potential double taxation or unintended tax exposure due to exceptional and temporarily changes in working arrangement as a result of the COVID-19 situation. In Hong Kong, the Inland Revenue Department will generally follow the OECD's views and commentaries in interpreting and applying tax treaties unless they are contrary to the provisions in the Inland Revenue Ordinance.
- The OECD Analysis does not discuss Service PE as it is not included in the OECD Model Tax Convention. Generally, the period of temporary dislocation of workers after a project is concluded should be excluded in determining the duration of the project. However, it is not yet clear whether the period of temporary interruption and inability to render service in light of travel restrictions and quarantine measures due to COVID-19 during the project can be excluded.
- The OECD Analysis will not affect the tax reporting or filing obligations under the domestic law of a given jurisdiction. That is, enterprises and individuals should be mindful that even if they are entitled to a PE protection or employment income exemption in a given jurisdiction under the applicable tax treaty, their unintended presence or activities in that jurisdiction may trigger certain tax reporting or filing obligations under the domestic law of that jurisdiction. In addition, enterprises should keep sufficient supporting document as evidence of exceptional and temporary changes in working arrangement during the COVID-19 pandemic.

The takeaway

We welcome the OECD Analysis as it provides influential and useful (though not legally binding) guidance on interpreting the international tax treaty rules in this extraordinary occasion. In China, no specific rules have been released by the tax authorities regarding the PE and tax residency issues arising from the COVID-19 pandemic at this time. According to our experience, if taxpayers and the tax authorities have disputes over such cross-border issues, both sides can refer to OECD’s views and international practices in their further discussions.

In addition, non-resident enterprises with no PE and hence no Corporate Income Tax (CIT) liability in China should still follow the “self-assessment and claim" mechanism stipulated in the *Administrative Measures on Non-resident Taxpayers Claiming Tax Treaty Benefits* to enjoy treaty benefits. They are still required to file the *Reporting Form for Non-resident Taxpayers Claiming Tax Treaty Benefits*, as well as relevant CIT returns, and retain relevant supporting documents including the Tax Resident Certificate for post-filing inspection. This equally applies to individuals. We suggest non-resident enterprises and individuals carefully assess the tax implications of temporary dislocation of business activities or working arrangement in China because of the COVID-19 pandemic, and seek tax authorities’ views regarding PE and tax residency to ensure that the treaty benefits are available, and reduce the potential risk in the post-filing administration process.

On the other hand, Chinese enterprises going abroad should also pay attention to the source jurisdictions' announcement on corporate/individual residency issues, PE creation and taxing rights allocation during this exceptional period, and manage their overseas PE risk and other potential tax risks.

Endnote

1. The OECD Analysis can be accessed via this link:
   https://read.oecd-ilibrary.org/view/?ref=127_127237-vsdagpp2t3&title=OECD-Secretariat-analysis-of-tax-treaties-and-the-impact-of-the-COVID-19-Crisis

Let's talk

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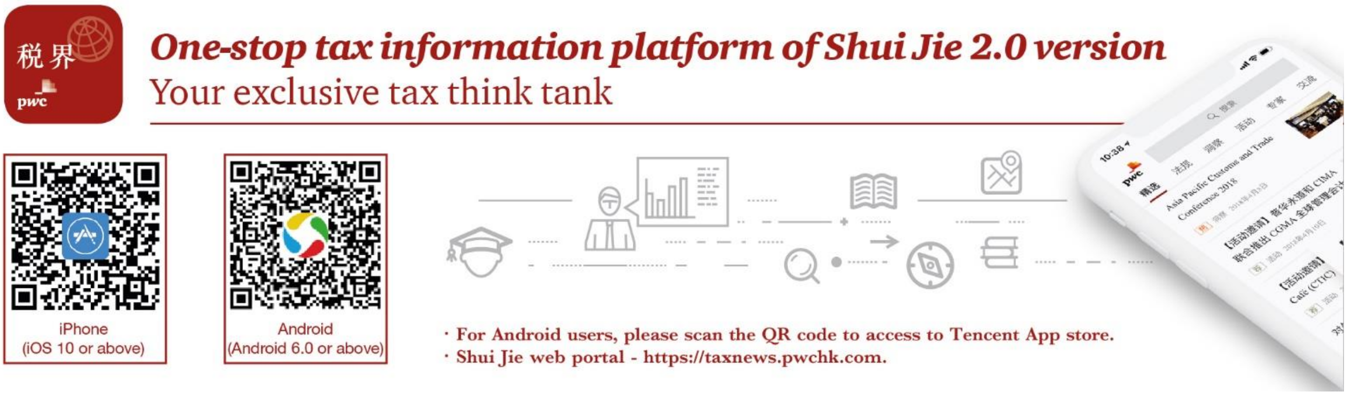

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