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Virtual Service Permanent Establishment – Kuwait Developments

Overview

Recent news that the Department of Income Tax (“DIT”) has adopted the concept of a “Virtual Services Permanent Establishment” has created further concern amongst companies doing business with Kuwait and the Gulf region generally. It closely follows the news of the Saudi tax authorities introducing a similar concept. Whilst Kuwait domestic tax law has no formal definition of Permanent Establishment (“PE”); the Virtual Services PE concept is contrary to the tax treaties Kuwait has signed, and the generally accepted international practice. In our view, the DIT will not be able to sustain this policy as it is contrary to the long term public interest of Kuwait, but in the short term, companies should consider protective measures in such areas as contractual tax clauses and how services are delivered to Kuwait.

Discussion

The DIT considers a Virtual Services PE to be created when a non-resident service provider furnishes services in connection with another person’s activity in Kuwait for a period of at least 183 days (or whatever threshold is provided by an applicable tax treaty). No physical presence or delivery within Kuwait is necessary to create a Virtual Services PE.

The consequences of this approach to the service provider and their Kuwait customers are not entirely clear. The service provider will presumably be expected to file a Kuwait tax return for the deemed Virtual Services PE but enforcement against a service provider without a physical presence in Kuwait is problematic. By law, all Kuwait contractors are required to retain at least 5% of contract payments until the service provider produces a tax clearance certificate that might now be refused by the DIT if they believe a Virtual Services PE exists. However, in practice, only Government Departments or certain Government owned entities apply the contract retention.

It is not clear if this new approach is contrary to the Kuwait income tax law and executive by-laws as they do not contain a formal definition of PE. A reasonable interpretation of the law and by-laws

would be that profits are taxable if they are derived from the rendering of services wholly or partly within Kuwait and this implies an in-country physical presence. The DIT approach does contradict both the OECD Model and UN Model Tax Treaties. The OECD Model refers to “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

It may be noted that many of Kuwait’s tax treaties follow the UN Model Tax Treaty. The DIT interpretation appears to arise from recent discussions at meetings of the United Nations Committee of Experts for Tax Cooperation regarding the services provision that is included in the UN Model Tax Treaty in Article 5 (3) (b). This refers to the “furnishing of services including consultancy services, by an enterprise”. A minority view was that “furnishing” was different from “performing” or “rendering” and did not require a physical presence in the recipient country. Although, the primary concern of this minority was “cyber-based technical services” delivered “through the network” rather than general offshore technical and consultancy services as proposed by the DIT.

However, this minority view was rejected by a large majority of the Committee of Experts and the UN continues to take the same position as the OECD that a physical presence within the country is required for a PE to exist.

The DIT approach appears contrary to encouraging foreign companies to partner with Kuwait for the supply of technical knowhow and will likely increase the cost for technical knowhow if foreign service providers pass on the liability to their customers through pricing or contractual terms.

What may companies do?

Since it is still uncertain how this new approach will be enforced, service providers should factor in the potential tax cost in their pricing or the tax indemnity clauses of a contract. In some cases, it may be possible to restructure how services are delivered to mitigate the exposure. There is also the option to challenge the DIT’s position through the domestic appeals procedure and the Mutual Agreement Procedure of a tax treaty, but both are lengthy processes with limited chances of a successful outcome.

However, we do believe that in the longer term, the DIT will have to revise this new policy in the light of criticism from major companies wishing to provide much needed technical knowhow and expert services to Kuwait and when both the OECD and UN will restate their views that physical presence is a fundamental requirement for a PE to exist.

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