# COLLEGE OF LAW

## Permanent Establishment Rules under Ethiopian Income Tax Law: Analysis of Artificial Avoidance of Permanent Establishment Status.

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**Thesis Approval Page**

# Haramaya University College of Law

## Program: International Economic and Business Law

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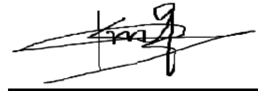

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**Nuru Beyene**

## DEDICATION

I dedicate this thesis to my loving mother, Adde Habiba Cire, and the memory of my late father, Obboo Bayan Assaboo.

## Acknowledgement

First and for most, I would like to thank the Almighty God, for his endless help and generosity in giving me the courage and strength all through the course of my studies and writing this thesis, without Thee I never see this bright day of my greatest achievement.

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## LIST OF ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| **Art** | Article |
| **ATAF** | African Tax Administration Forum |
| **BEPS** | Base Erosion and Profit Shifting |
| **DTAs** | Double Tax avoidance Agreements |
| **ETR** | Effective tax rates |
| **ETRN** | Ethiopian Tax Research Network |
| **EMoR** | Ethiopian Ministry of Revenue |
| **EIC** | Ethiopian Investment Commission |
| **FDI** | Foreign direct investment |
| **ITP** | Income tax Proclamation No. 979/2016 |
| **ITR** | Income Tax Regulation No. 410/2017 |
| **GDP** | Gross Domestic Product |
| **LOB** | Limitations on benefits |
| **MoFED** | Ministry of Finance and Economic Development |
| **MoT** | Ministry of Trade |
| **MNEs** | Multinational Enterprises |
| **MC** | Model Tax Convention |
| **MCs** | Model Tax Conventions |
| **OECD** | Organisation for Economic Cooperation and Development |
| **OECD-MC** | OECD Model Convention |
| **PE** | Permanent Establishment |
| **Para** | Paragraph |
| **TP** | Transfer Pricing |
| **TC** | Thin Capitalization |
| **UN** | United Nations |
| **UN-MC** | UN Model Convention |
| **WTO** | World Trade Organization |

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**Abstract**

*The PE concept is arguably one of the most fundamental concepts in international tax law. It is used in the tax treaty, among the other things, as a mechanism of allocating tax base between contracting states concerning non-resident enterprises business profits. The recent OECD BEPS Action Plan called for a review of PE definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition; such as commissionaire arrangements and similar strategies, specific activity exemptions, splitting up of contracts, and strategies for selling insurance in a state without having a PE therein. The purpose of this study is to examine and review the current Ethiopia's PE rules and standards and determine its adequacy in curbing the artificial avoidance of PE status. To properly meet study purpose, the research used doctrinal and analytical methods. Both secondary and primary sources have been used to deal with the questions of the study. Semi-structured depth interviews, conducted in person with purposively selected relevant individuals and officials working in the relevant institutions is also another tool used for obtaining detail information which will help to the deeper and more profound understanding of the existing legal underpinnings on prevention of artificial avoidance of PE in Ethiopia. The findings of this study have demonstrated that, both Income Tax Proclamation and Regulation contain no the definition of important terminologies, which are necessary for determining whether a non-resident's activities in Ethiopia are sufficient to create a PE. In particular, Ethiopia's income tax law does not define what constitutes "same or connected project", as well as the "elements of the definition of PE concept". Besides, incompatibility of service PE to properly establish the taxable presence of service business, Ethiopia's tax law, contains no contextualised specific provision on the insurance PE. On point of this, "the same or connected project" requirement that has been adopted in the Proclamation and Regulation, to address artificial avoidance of PE through splitting-up of contracts also contributes towards making the Project and Service PE threshold high. Based on the findings, the study recommends that the definition of important terminologies should be revamped to ensure that they adequately enable revenue authority as well as taxpayers to determine when a PE exists. Ethiopia should also adopt the contextualized standard for the taxation of insurance business, and for the determination of 183 days in case of project and service PE to effectively curb artificial avoidance of PE. To ensure that non-resident enterprise's operation in Ethiopia would be viewed as a whole and not merely on an individual project level; the application of 'the same or connected project' requirement should be limited only to determine the activities performed by related persons. To make service PE more effective Ethiopia should also consider, reducing the service PE threshold or impose withholding tax for the taxation of service business, through the re-negotiation of older treaties or signing of additional protocols, to effectively address tax avoidance strategies of furnishing service in a source state without having a PE.*

**Keywords:** Permanent Establishment, Artificial Avoidance of PE, commissionaire arrangements and similar strategies, specific activity exemptions, splitting up of contracts, insurance PE, service PE.

# CHAPTER ONE

# BACKGROUND OF THE STUDY

## 1.1. INTRODUCTION

In an increasingly interconnected world, international tax law has significant importance in facilitating cross border trade and investment, by allocating international tax base between states, preventing double taxation, tax avoidance, and tax evasion.[1] "Permanent Establishment" (PE), is one of the fundamental concepts in the international taxation, that deals with the allocation of taxing rights between states with respect to business profits.[2] It is the concept that determines the right of a source state to tax the business profits of non-resident enterprise in its jurisdiction.[3]

Though records on the early origins of the PE concept are limited, it appears from the literature, the concept of PE traces its roots in the middle of the 19th C in the German Empire to prevent double taxation among the Prussian municipalities.[4] Formally, term PE was codified in Prussia in 1891, culminating with the German Double Taxation Act of 1909, to prevent the double taxation of income within the German federation.[5] In 1889, the first bilateral tax treaty, to prevent double taxation, including the concept of PE, was concluded between the Austro-Hungary and Prussia, marking the first time usage of the Concept in international tax law.[6] It was later adopted by the League of Nations in 1928.[7] Since then, an extensive network of Models tax Conventions such as Mexico and London, and bilateral tax treaties was gradually established, incorporating the Concept of PE. Particularly through the influence of currently prominent Model Conventions (MC); Organization for Economic Cooperation and Development (OECD-MC) and United Nation (UN-MC) the Concept of PE is persisted. It can thus be said that the concept of PE is as old as Double Tax avoidance Agreements (DTAs) themselves.[8]

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[1] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en. p.7. (Hereinafter, OECD (2013), *Action Plan on BEPS).*

[2] Vogel, K. (2015). *Double Taxation Conventions*: *A Commentary to the OECD, and UN Model Conventions, With Particular Reference to German Treaty Practice*, p. 15-19. (Hereinafter, Vogel, K. (2015).

[3] Ibid.

[4] Kobetsky, Michael (2011). "*History of tax treaties and the permanent establishment concept*". *International Taxation of Permanent Establishments*. pp. 106–151. (Hereinafter, Kobetsky, Michael (2011)),

[5] Kobetsky, Michael (2011). pp. 106–151.

[6] Ibid; https://sites.google.com/view/austriaprussiataxtreaty1899, accessed on 10/01/2021.

[7] Kobetsky, Michael (2011). pp. 106–151.

[8] J. Eisenbeiss (2016). *BEPS Action 7: Evaluation of the Agency Permanent Establishment*, Intertax, 44(7), pp. 490.

With minor exceptions, MCs and DTAs use residence criteria to establish the minimum nexus for taxing a non-resident person or enterprise.[9] However, where residence fails to exist, the source state may end up without getting any revenue from the transactions that has had significant and substantial economic connection with its territory. Consequently, the concept of PE has been evolved as a basic requirement (i.e. as an extension of source principle, and as an exception to the residence principle), to grant limited right of taxation for the source state.[10] The PE concept, therefore presented a form of international equity in that it provided a reasonable compromise between the interests of residence country and source country.[11]

The term 'permanent establishment' is defined in Article 5 of both the OECD and UN MCs, and Art 4 of Income tax proclamation 979/2016, with a series of threshold tests; Art 5 of both OECD and UN MCs defines PE, as a fixed place of business through which the business of an enterprise wholly or partly carried on.[12] And Art 7 of the same, provides that, profits of an enterprise of a contracting state shall be taxable only in that state (residence state) unless the enterprise carries on business in the other contracting state (source state) through a PE situated therein. The PE is, thus, a tax concept that indicates a particular level of business activity in the Source State. In other words, in the absence of a PE in source state, non-resident enterprise shall not properly be regarded as participating in the economic life of that source state to such an extent that it comes within the jurisdiction of that source state's taxing rights.[13] The PE, therefore, plays a very crucial role in determining economical nexus between business profits and the contribution of countries involved in the profit-making process and in allocating taxing rights thereon.[14]

However, despite the effects of globalization, the current concept of PE in international tax system still reflects the principles and structures developed in early Twenty Centaury.[15] The PE concept was evolved in a world economy, in a time when there existed a significant correlation between economic activity and physical presence and international communication was slow.

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[9] Reimer, Ekkehart (2015). Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective, Kluwer, p. 11.

[10] R. L. Williams(2014). *Fundamentals of Permanent Establishments*, Den Haag: Kluwer Law International, p. 23

[11] Oguttu & Tladi, (2009). *E-Commerce: A critique on the Determination of a 'permanent Establishment'* for Income Tax Purpose from a South African Perspective, pp. 76.

[12] Similar Definition has been provided under Art 4(1) of Income Tax Proclamation 979/2016.

[13] UN MC, Commentary on Art 5. para. 22.

[14] OECD BEPS Project (2015). *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7, Final Report*, OECD Publishing, Paris. p. 9. (hereinafter OECD BEPS, *Action 7* - (2015), *Final Report*),

[15] Skaar, A. (1991), *Permanent Establishment: Erosion of a Tax Treaty Principle*, Kluwer, p. 109.

Thus the fixed element of a '*permanent*' physical establishment was the most reliable taxable nexus, as its appearance was critical to conduct business in another state.[16] Nonetheless, new business models and advanced value chains alter both the idea of a physically present PE and the assumption that trade consists of physical goods.[17] It follows that some of the principles which were fundamental in drafting the first MC —*especially fixed place of business*— may no longer be relevant in the modern economy as the structures and operational procedures of multinational enterprises (MNEs) have significantly changed.[18] Thus, it can be contended that the PE concept does not properly reflect the present business environment.[19]

OECD base erosion and profit shifting (BEPS[20]) action plan affirms that, in an increasingly interconnected world, national tax laws and international tax systems have not always kept pace with global corporations' fluid movement of capital, and the rise of the digital economy.[21] It also notes that, over the time the current PE rules have revealed weaknesses that create opportunities for BEPS and contributed to the MNEs exploitation of the rules so to generate double non-taxation, with negative effects on the fairness and integrity of tax systems.[22] Artificial avoidance of PE is one of the common tax avoidance strategies that are currently used to circumvent the existing PE definition.[23] OECD BEPS Action seven, and UN MC Commentary, provides the list of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition, such as 'commissionaire arrangements', 'specific activity exemptions', 'splitting up of Project contracts', and 'selling insurance in a source state without having a PE therein'.[24]

As the business environment becomes more complex and evolves, it is necessary that the PE concept must become dynamic and multi-faceted to reflect current reality with clearer and more updated standards.[25] Accordingly, different initiatives have been proposed to alleviate the gaps

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[16] Schaffner, J. (2013), *How fixed is a Permanent Establishment?* Kluwer Law International.
[17] Arnold, B. (2003), *The Taxation of Business Profits Under Tax Treaties*; Canadian Tax Foundation, pp. 81-84.
[18] Hellerstein, W. (2014), "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments", *Bulletin for International Taxation* vol. 68, n. 6, p. 346 ff.
[19] Ibid.
[20] BEPS refers to tax planning strategies that exploit gaps and mismatches in national and international tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.( OECD (2013), *Action Plan on BEPS,* p.10.)
[21] OECD BEPS, *Action 7* - (2015), *Final Report,* p. 9.
[22] OECD BEPS, *Action 7* - (2015), *Final Report*. p. 9.
[23] ibid, p. 9.
[24] Ibid, p. 9.
[25] OECD BEPS (2013), *Action Plan on BEPS* and OECD BEPS, *Action 7* - (2015), *Final Report*.

and frictions occurring in the international tax arena as the general and PE concept in particular in order to enable countries protect their revenue bases. In this regard, the guidance produced by the OECD, and UN MCs is useful in addressing some of the crucial issues related with artificial avoidance of PE, but is in no way conclusive to address all issues related with PE.[26]

Coming to the context of Ethiopia, the government has undertaken several reforms to improve tax policy and modernize revenue administration in recent years. In this respect, efforts to conform to the changing business practice and to counter arrangements intended to avoid taxable presence has been shown by amending the old Income Tax Proclamation 286/2002 and Income Tax Regulation 78/2002. The revised Income Tax Proclamation No. 979/2016 (ITP) and Income Tax Regulation 410/2017 (ITR), has made a substantial change to the PE definition and also introduced some technical provisions significant to counter arrangements intended to avoid taxable presence. Nevertheless, significant challenges remain; common challenges include determining if there is a place of business, the issues surrounding the compatibility of the service PE and the introduction of insurance PE rule, and the issue of the taxation of digital economy or e-commerce harmonization with PE concepts. These problems related with PE rules in Ethiopian tax law, open the room for the artificial avoidance of PE and leads erosion of Ethiopia's tax base. Against the background of the foregoing premise, this study aims to assess the adequacy of Ethiopia's PE rules in properly establishing and protecting Ethiopia's tax base under current cross-border transactions and multinational business activities. In particular, the study determines the adequacy of the current PE threshold under income tax law in addressing the artificial avoidance of PE status. In that the paper analysis relevant discussions related to the concept of PE in the context of Ethiopia's and international MCs, and examine them to explore unsettled issues, unclear concepts, and the points that need further analysis or additional attentions.

## 1.1. STATEMENT OF THE PROBLEM

The notion of PE is one of the fundamental concepts in the treaty-based international tax law. Nearly all double taxation treaties use the PE threshold to establish taxing jurisdiction over a non-resident's business activities.[27] The cumulative effect of Art 5 and 7 of both OECD and UN MCs, shows that source state cannot tax the profits of non-resident enterprise unless it carries on

[26] Ibid
[27] Kobetsky, Michael (2011). pp. 106–151.

its business through a PE situated therein.[28] Thus, PE is the tax allocation concept that determines the right of a contracting state to tax the profits of an enterprise of the other contracting state. However, taxation of MNEs through PE have significantly challenged and very complicated due to the tax avoidance strategies used by MNEs in the wake of globalization and technological advances.[29] Artificial avoidance of PE is one of the common tax avoidance strategies that are currently used by the MNEs to circumvent the existing PE status.[30] OECD notes that 'BEPS' constitutes a serious risk to tax revenues, tax sovereignty and tax fairness.[31] Notably the UN committee of experts on international tax matters also affirmed that tax avoidance had an impact on the developing countries domestic resource mobilization, resulting in forgone tax revenue and higher costs of tax collection.[32]

Although there are abundant circumstantial evidence that, MNE's tax avoidance as the general and artificial avoidance of PE status, in particular, are widespread and that they result in the erosion of Ethiopia's tax base, due to absence of reliable data and comprehensive study on the matter, it is difficult to reach a solid conclusion about how much this actually occurs in Ethiopia. OECD provided the list of six categories of indicators for BEPS, to assist in tracking the scale and economic impact of BEPS over time.[33] From among the list provided by OECD, the important one in determining the scale of BEPS in developing country like Ethiopia includes, 'FDI figures as compared to GDP' and 'Effective tax rates (ETR) of large MNE affiliates relative to non-MNE entities with similar characteristics'.[34] The study conducted by *Mascagni and Mengistu* (2016), shows that, FDI contribution to Ethiopia's GDP is minimum compared with the FDI figures.[35] In addition, the study notes, ETR of large MNEs relative to non-MNE entities with similar characteristics, are very low.[36] On point of this, the tax revenue in Ethiopia is still lower than the average for comparator groups such as low-income economies or sub-

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[28] Ibid
[29] OECD BEPS, *Action 7* - (2015), *Final Report*. pp. 9.
[30] Ibid, pp. 9.
[31] OECD (2013), *Action Plan on BEPS,* p. 5.
[32] UN-Handbook on *Protecting the Tax Base of Developing Countries*, (2015) pp. 9.
[33] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 BEPS, Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241343-en, pp. 41-71.
[34] UN-Handbook on *Protecting the Tax Base of Developing Countries,*(2015a), pp. 9.
[35] Giulia Mascagni and Andualem Mengistu, (2016), *The Corporate Tax Burden in Ethiopia: Evidence from Anonymised Tax Returns*, ICTD Working Paper 48. www.ictd/en/publications, p. 6.
[36] Ibid.

Saharan African countries.[37] Ethiopia's tax-to-GDP ratio averaged only 12% between 2010 and 2017, below the 15% generally deemed necessary to fund adequate public services.[38] All this suggests that Ethiopia is may well be more vulnerable to erosion of the corporate tax base. And generally highlights the urgent need for a stable and reliable means of domestic revenue mobilization to the Ethiopia's development. Thus, curtailing MNEs' tax avoidance is of significant importance because it erodes the already limited tax base.[39]

Furthermore, the Ethiopian government recently unveiled "Home Grown Economic Reform" agenda, which, "aims to propel Ethiopia into becoming the African icon of prosperity by 2030."[40] The success of this Reform including the third face of Growth and Transformation Program, the implementation of UN 2030 Agenda for Sustainable Development and the African Union's Agenda 2063 depend heavily on Ethiopia's ability to generate and mobilize public resources for universal public service provision. Ethiopia placed domestic revenue mobilization at the center of establishing an enabling framework to ensure the successful achievements of these Goals, which include strengthening tax structures, coverage and administration; improving fairness, transparency, efficiency and effectiveness of tax systems; and curtailing illicit financial flows in order to build fiscal legitimacy.[41]

Having concluded DTAs with several countries, Ethiopia has adopted various anti-tax avoidance measures including measures to counter artificial avoidance of PE status. In this regard, the revised ITP 979/2016 and ITR 410/2017 have introduced some provisions aimed to counter artificial avoidance of PE status, such as: the artificial splitting of projects: artificial split of single service projects: replacement of subsidiaries by commissionaire arrangement. The Revised ITP 979/2016 also incorporated new provisions on Service PE.[42] It has also excluded provisions on specific exceptions to PE which were part of the old ITP 286/2002.[43] Furthermore, the PE

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[37] https://pmo.gov.et/initiatives/, accessed on March 7, 2020.
[38] https://pmo.gov.et/initiatives/, accessed on March 7, 2020.
[39] Durst, M. (2014). *Beyond BEPS: A Tax Policy Agenda for Developing Countries*, ICTD Working Paper 18, Brighton: International Centre for Tax and Development, pp. 23.
[40] https://pmo.gov.et/initiatives/, accessed on March 7, 2020.
[41] https://pmo.gov.et/initiatives/, accessed on March 7, 2020.
[42] Income Tax Proclamation 979/2016, Article 4(2)(c); the same provisions was not included in the repealed Income Tax Proclamation 286/2002.
[43] Article 2(9(b) of the Income Tax Proclamation 286/2002 used to exclude specific activities from constituting PE which are corresponding to Article 5(4)( a-e) of the UN MC 2008.

provisions of ITP 979/2016 and ITR 410/2017, have demonstrated elements of the recommendations made in the OECD BEPS Action 7 final report.

However, despite all these reforms of the PE threshold, to safeguard Ethiopia's tax base, we could still notice gaps related to the current PE threshold in Ethiopian income tax law; One, the current PE threshold under ITP does not cover all current business models that have an economic nexus to the Ethiopia such as business models emerged by the digitalization of the economy. Two, problems related with determining if there is a PE, as both ITP 979/2016 and ITR 410/2017 contains no definition of the important terminologies, which are necessary for determining whether a non-resident's activities in Ethiopia are sufficient to create a PE. In particular, Ethiopia's tax law does not define what constitutes the "same or connected project" "*fixed place of business" and "effective place of management* and *place of management",* which are the important point in determining whether a non-resident's activities in Ethiopia are sufficient to create a PE. The lacks of definition leads to the usage of subjective test criteria by the tax authorities to determine the status of the non-resident enterprises. This undermines the principle of certainty in the taxation system of the country by enabling tax authorities to deem PE situations for non-resident enterprises in an unpredictable way, while at the same time leading to artificial avoidance of PE.

Three, the "same or connected project" requirement that has been adopted in the ITP 979/2016 and ITR 410/2017, to counter artificial avoidance of PE through splitting-up of contracts contributes towards making service and project PE threshold high. Since as per this requirement the calculation of days-of-work threshold (i.e.183) will be viewed on a project-by-project basis, in determining time spent, unconnected sites or projects are totally precluded. In other words, non-resident that may be present in Ethiopia rendering services/working on the construction, on multiple unconnected projects and deriving significant profits from Ethiopia, may not be subject to tax merely because those projects are unconnected and individually undertaken for a period of less than 183 days in a twelve-month period. Therefore, the inclusion of the "same or connected projects" requirement reduces the effectiveness of the service and construction PE and makes this threshold even more unattainable.

Four, lack of contextualised specific provision on the insurance PE that reflects the peculiarities of the insurance business; would also open the room for the artificial avoidance of PE status. Due to the nature of insurance business, in most cases non-resident insurance companies do business through an independent agent without having 'fixed place' of business in source state.[44] This could make difficult the taxation of non-resident insurance companies through PE rules provided under Art 4 of ITP 979/2016. In order to obviate this possibility, Article 5(6) of UN MC, provides specific contextualised definition for insurance.[45] However, Ethiopia's PE threshold both under ITP and ITR contains no such kind of contextualized specific provision for the taxation of insurance business, which would open the room for the artificial avoidance of PE.

Five, although service PE provision has been dealt with in Art 4(2(c) of ITP, due to unique nature of this business model the current Ethiopia's service PE threshold is not always compatible to properly establish the taxable presence of service business. As a result of technological advancement and globalization the provision of service has been rendered very short duration while still resulting in a substantial profit for the enterprise. Certain countries take cognizance of this fact and have lowered the threshold for a services PE in their DTAs to 90-days within twelve months, while others adopted withholding taxation for the service business.[46]

Thus, based on the foregoing premises and the magnitude of cross-border transactions, it is imperative to undertake some analysis to identify the gaps and propose regulatory reform that Ethiopia should make to establish sound footing for the tax system and to protect its tax base from erosion and unnecessary exploitation, in particular to addresses effectively the problem of artificial avoidance of PE, to ensure an efficient and effective taxation of cross border business..

## 1.2. LITERATURE REVIEW

PE is one of the hottest topics on the taxation of MNEs as it is more susceptible to tax avoidance. Artificial avoidance of PE issues arise directly from the existence of loopholes, as well as gaps,

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[44] OECD (2015), *Action 7 - Final Report*, *para. 5 pp, 27.*

[45] Article 5(6) of UN MC

[46] See for example South Africa's double tax treaties with Lesotho (Art 5(3(b)) June 2016), Swaziland (Art 5(2(h)) June 2005), Oman (Art 5(3(b)) January 2004); and India's Double tax treaty with Canada (Art 5(2(i)) August 1997), USA (Art 5(2(i)) January 1991), and UK (Art 5(2(k)) October 1993).

frictions or mismatches in the interaction of countries' domestic tax laws.[47] The OECD acknowledges that the current definition of a PE is not sufficient to address tax avoidance strategies in the changing international tax environment, as its standards are ineffective in equitably allocating taxing rights between source and residence States.[48] It called for the review of PE definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition.[49] It identifies the root causes for the artificial avoidance of PE status and notes on a combination of coordinated tax planning strategies leading to artificially avoid PE. In particular the OECD Action Plan on BEPS provides certain common tax avoidance strategies that are currently used to circumvent the existing PE definition, such as commissionaire arrangements and similar strategies, specific activity exemptions, splitting up of contracts concerning Project PE and service PE, and strategies for selling insurance in a source state without having a PE therein.[50] As a means of addressing tax avoidance challenges, among the others, OECD adopted Action Plan seven, that specifically aimed at addressing artificial avoidance of PE status. However, OECD's proposal tilts towards the interests of its member states, whom are mainly capital-exporting countries, thus, lacks focus on tax avoidance issues that are of priority concern to developing countries.[51]

*Glenn* provides that, due to their limited capacity and capital-importing nature, developing countries such as those in Africa are more susceptible to the artificial avoidance of PE, since the PE rules and proposals are generally developed by advanced economies, they favours capital-exporting countries.[52] *Vogel* also notes that, PE concept is designed to limit source countries' tax jurisdiction over foreign businesses, and so it generally works in favor of residence countries.[53] Despite the fact that most of African countries are victim of tax avoidance, due to limited economic and administrative capacity of most of African nations there has been very little research done so far in the area of tax avoidance mainly sponsored by the UN Economic Commission for Africa (UN-ECA) and the African Economic Commission (AEC).[54] For

[47] OECD (2013), *Action Plan on BEPS,* p. 7-13
[48] OECD (2015) *Action 7 Final Report,* p, 9.
[49] OECD (2015) *Action 7 Final Report,* p, 9.
[50] ibid.
[51] Annet Wanyana Oguttu (2017), *Tax BEPS in Africa – Part 2: A Critique of Some Priority OECD Actions from an African Perspective***,** ICTD Working Paper 64
[52] Glenn (2014) '*Transfer Pricing and Defining the Most Challenging BEPSs Action Items*.
[53] Vogel, K. (2015). p. 15-19.
[54] UN-Economic Commission for Africa (2018). Base Erosion and Profit Shifting in Africa,

example the study conducted by the UN-ECA provides that, African countries are victims of tax avoidance, and thus they should have to review the efficiency and effectiveness of their current tax laws, outlining their priorities, and find customized African solutions to the tax avoidance issues which are pertinent to Africa.[55] Similarly, the study conducted by African Tax Administration Forum (ATAF) holds the view that Africa must come up with customized solutions to protect its own tax base, to assist African countries and groups of countries in similar positions to ensure domestic resource mobilization.[56]

Coming to the Ethiopia, very limited number of research has been done so far; the information received through interview from Federal Revenue Authority main Office and MoFED, shows that, unlike advanced economies there is no established methodologies and institutions to collect and analyze data on the tax avoidance and the actions to address it in Ethiopia. This is mainly relates with lack of capacity and lack of government-sponsored studies on the tax avoidance issues in Ethiopia.[57] Accordingly the researcher identified only one Article related with the area of the study. The article was written by *Alemu Balcha Adugna*, and published in the Bahir Dar University Journal of Law; titled "*Major Problems Associated with Rules on Permanent Establishment under Ethiopian Income Tax Law*".[58] This Article provides a general overview of major problems related to the current PE threshold under Ethiopian law. It lists out some of the major problems, such as problems related with the taxation of digital economy, artificial avoidance of PE status, lacks of definition some terminologies and confusion between taxation through residence and PE due to vagueness of the definition of place of management and effective place of management.

When it comes to the artificial avoidance of PE status, *Alemu's* the paper does not address all the problems related with artificial avoidance of PE status under Ethiopian law. In particular, *Alemu's* paper does not address the problems related with insurance PE under the current Ethiopia's PE rules and problems related with compatibility of the current Ethiopia's service PE threshold in properly establishing the taxable presence of service business. Moreover, *Alemu's* paper does not address problems the "same or connected projects" requirement (provided under

[55] UN-Economic Commission for Africa (2018). Base Erosion and Profit Shifting in Africa,
[56] https://www.ataftax.org/
[57] Interview with Ato Bochu Sentayehu, Senior Legal Expert at MoFED (MoFED, 13 September, 2021).
[58] *Alemu Balcha Adugna* (2018). Major Problems Associated with Rules on Permanent Establishment under Ethiopian Income Tax Law, *Bahir Dar University Journal of Law, 9(1), 115-116.*

amended ITP and ITR) posed on the effectiveness of service and construction PE. From the above discussion it can be understood that, the issue of artificial avoidance of PE has not properly studied under the Ethiopian income tax framework, and thus this area is open for further research. In an attempt to fill this gap, this study exclusively deals with the issue of artificial avoidance of PE status and assess the adequacy of current Ethiopia's PE threshold in curbing Artificial Avoidance of PE status.

## 1.3. OBJECTIVES OF THE STUDY

### 1.3.1. GENERAL OBJECTIVES

The general objective of this study is to examine and review the current Ethiopia's PE rules and standards and determine its adequacy in curbing the artificial avoidance of PE status.

### 1.3.2. SPECIFIC OBJECTIVES

2. To discuss and analyze the concept PE and its significance in general and appraise circumstances under which it is artificially avoided.
3. To examine the adequacy of the current Ethiopia's PE rules and standards in curbing the artificial avoidance of PE status.
4. To propose the legal changes that should be considered and employed in formulating an effective PE regime for Ethiopia.

## 1.4. RESEARCH QUESTIONS

The study is guided by the following research questions;-

1. What is the role of PE in the international taxation and how is it artificially avoided?
2. Do the current PE rules and standards in Ethiopian income tax law adequately curb artificial avoidance of PE status?
3. What legal changes should be considered and employed in formulating an adequate and sound PE regime for Ethiopia?

## 1.5. SIGNIFICANCE OF THE STUDY

The issue of BEPS as the general and preventing the artificial avoidance of PE, in particular, is in its early stage in Ethiopia. As this study assesses the adequacy of the current Ethiopia's PE rules in preventing artificial avoidance of PE status, its findings form strong base to strengthen Ethiopia's tax legislation as the general and PE provision in particular, for the prevention of artificial avoidance of PE status in Ethiopia.

International tax has paramount importance in facilitating cross border trade and investment. Ethiopia's National Development Program requires that the country develops fiscal and economic policies that encourage FDI and technological transfer to foster economic growth. One of the priorities of Ethiopia's tax system as the general and tax treaty, in particular, is, therefore, attracting foreign investment. The study has been done taking into account these objectives of the National Development Program so that the proposed suggestions do not undermine the country's broader economic development objectives.

As the study strives to analyze the most esoteric concept of international tax law within the context of Ethiopia, there might be imperfections in the precision with which study questions has been addressed. Thus the study will help to initiate new ways of engaging in research for scholars and will provide a platform for further research into BEPS provisions in Ethiopia.

## 1.6. RESEARCH METHOD

The research is predominantly based on doctrinal and analytical methods. As the study assesses the adequacy of the current PE threshold under Ethiopian tax law on preventing artificial avoidance of PE status, through legal analyses and interviews of relevant respondents, this approach is suited for the collection and analysis of relevant data to properly respond research questions and also helps to improve the validity of the findings. Accordingly, the relevant international and national legal instruments including the existing literatures and laws have been analyzed. Taking in to consideration the availability of data and nature of research questions, the study also used the international trend for more insightful understanding of the issue at hand, to examine the gap, and provide useful guidance for the improvement of Ethiopia's PE rules and standards in order to formulate an effective PE regime.

Both secondary and available primary sources have been used to deal with the questions of this study. In particular, Ethiopia's tax legislations, relevant bilateral tax treaties signed by Ethiopia, and UN and OECD MCs have been used as a primary source. The OECD website have also been used as secondary sources for obtaining recent information and explanatory notes on the BEPS, along with the relevant books, scholarly articles, journals, documents, and internet sources. Finally, all the collected data has been consolidated, analyzed, interpreted, and judged qualitatively to make meaningful analysis and conclusion about the adequacy of Ethiopia's PE rules in curbing artificial avoidance of PE status.

### 1.7. Limitation of the study

The major limitation of this study relates with the absence of cases on the issue of artificial avoidance of PE and the absence of practice on some aspects of the taxation of MNEs through PE as well as lack of sufficient and reliable data over tax avoidance in general and artificial avoidance of PE status in particular in Ethiopia. The absence of cases, practice and reliable data generate a limitation of its own in conducting this type of research in the Ethiopian context. The researcher tried to minimise the effect of this limitation by using different hypothetical cases. Another limitation of this study relates with a lack of adequate research. The concept of PE is a somewhat obscure area of international tax law and no extensive study has been produced on the subject in Ethiopia making conducting study on issue of artificial avoidance of PE in Ethiopia's context a great challenge.

### 1.8. SCOPE OF THE STUDY

This study tries to addresses adequacy of the current Ethiopia's PE threshold in curbing artificial avoidance of PE status. The concept PE covers several issues which are too bulky to be considered within this study, therefore the issue of taxation of digital economy i.e. e-commerce and PE is outside the scope of the study. Since the issue of taxation of digital economy is too bulky in nature and complex, it requires separate and independent deep analysis, thus, it's excluded from the scope this study for the sake quality of the study. Accordingly the Ethiopian tax system will be analyzed with especial emphasize on the issue of artificial avoidance of PE.

## 1.9. ORGANIZATION OF THE STUDY

To appropriately respond research questions and meet research objectives, the study is organized into four chapters. The first chapter deals with background of the study, statements of the problem, literature review, research question and research method. While the second chapter deals with general overview and conceptual foundations of the study in general. The third chapter deals with the issues of artificial avoidance of PE within the context of Ethiopian tax law. It assess the adequacy of PE rules under Ethiopia's income tax law in curbing artificial avoidance of PE status, and tries to explore the unsettled issues, unclear concepts, and the points that need further analysis or additional attentions within the context of Ethiopia's income tax law. The fourth chapter concludes the whole body of the study and advances options that specifically aimed at addressing the problems and gaps identified in the chapter three of the study. It specifically deals with the proposals and legal changes that should be considered and employed in formulating an effective PE regime capable of addressing artificial avoidance of PE status for Ethiopia.

## CHAPTER TWO

## GENERAL OVERVIEW AND CONCEPTUAL FRAMEWORK OF THE STUDY

### 2.1. INTRODUCTION

Taxation of non-resident business income is one of the fundamental issues of international tax law. Allocation to tax jurisdiction over business income takes place based on various nexus principles.[59] Generally the source principle, nationality principle, residence principle, or a combination thereof is taken as the starting point. Countries often base their tax laws on the combination of these principles to have a balance between giving up taxation rights and harming international business. The concept of PE is nexus principles used in the DTAs, among other things, as a mechanism of allocating tax base between the contracting states concerning business profits of non-resident enterprises.[60] In accordance with Art 7 of both UN and OECD MCs, the existence of PE in a tax jurisdiction determines the right of source state to tax business profits of the non-resident enterprises in its jurisdiction.[61] Art 5 of both the UN and OECD MCs provides criteria for the existence of a PE, the fulfillment of which implies the existence of legitimate and substantive business activities within the foreign tax jurisdiction. This means when the PE threshold existed, enough nexus to the source country exists and the source country receives taxing rights.[62] As this study deals with the issues of artificial avoidance of PE within the context of Ethiopia's income tax law, to better address the issue of artificial avoidance of PE status, it is imperative first explore the concept of PE in general, in order to have a broad understanding of the concept of PE. Thus, in line with objectives of the study and research questions, this chapter explores discussions related to the concept of PE; such as the definition of PE, the nexus requirements for the taxation of non-resident business income, the concept of tax avoidance and artificial avoidance of PE and the concept of business profit.

### 1.2. Nexus Requirement for the Taxation of Non-Resident Business Income

The state may only tax non-resident business income, when a qualifying connection exists between the state and non-resident business income. This qualifying connection is labelled the

[59] S. Gadzo. (2018). *The principle of* '*Nexus or genuine link' as a keystone of International Income Tax Law:* A Reapparaisal,46, Intertax, Issue 3, pp. 194-209.
[60] R. L.Williams (2014). *Fundamentals of Permanent Establishments*, Kluwer Law International 2014, p. 23
[61] Kobetsky, Michael (2011). pp. 106–151.
[62] R. L.Williams (2014). p. 23

'*nexus*'.[63] In general context countries base their tax jurisdiction over non-resident business income on the combination of various nexus principles, in particular, source principle, origin, and nationality principle.[64] The nationality principle is used to allocate taxation rights on business income of individuals and legal persons based on the criterion of citizenship. Nevertheless, the nationality principle is criticised, since it does not properly reflect the link between the source of the income and the taxing state.[65] And most of tax issues related to nationality could better be addressed by the different nexus principles, especially the residence principle. The source principle is a concept, which grants taxation rights to the state where the income is generated. The source state standard has been used for a large variety of situations, that it would include the origin, territoriality and *situs* principle.[66] The source principle is the most appropriate criterion under the sovereignty principle; the fact that it fosters the international competition, the ease of administration since the relevant tax authority is located closer to the source of income, led to the wide international acceptance of this principle.[67]

Based on the foregoing premises, when an enterprise decides to carry out cross-border transaction, most of time, they implement it in three basic fashions, parent-subsidiary, short time activities or PE structure.[68] Parent-Subsidiary structure will be created when an enterprise establishes subsidiary with different legal personality under the law of the host country to compete on the foreign market. In such case subsidiary will be tax resident and as a result fully liable to tax in that host country. In case of PE structure, an enterprise participates in the transaction by establishing a business facility (branch, factory, shop etc.) which is not incorporated under the law of hosting country and leads to the existence of a PE as a part of the enterprise.[69] Short-time activities on other results when a company participates in the transaction without incorporation under the law of the host country and lack character of geographical or duration permanence and therefore it is carried out without the existence of residence and a PE. These activities do not evoke the taxing right of the host state and the state of residence has

[63] S. Gadzo. (2018). pp. 194-209.
[64] S. Gadzo. (2018). pp. 194-209.
[65] Kemmeren (2001). *Principle of Origin in Tax Conventions: A Rethinking of Models*: Tilburg University, p. 28-30.
[66] Kemmeren (2001). p. 28-30.
[67] Kemmeren (2001). p. 28-30.
[68] R. Ekkehart (2015). *Permanent Establishments, in A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (edited by: Reimer, Schmid, Orell), Kluwer, pp. 3-4
[69] R. Ekkehart (2015). pp. 4-5.

exclusive taxing right on the basis of worldwide taxation. AS it can be seen, not every cross-border business activity evokes the taxing rights of the host state. The presence of the enterprise in the host state must meet certain nexus rules to be liable to tax in that host country.[70]

## 1.3. Analysis of the Concept of Permanent Establishment

### 1.3.1. Objectives of the Concept of PE

The PE concept is arguably one of the most fundamental concepts in international tax law. It is used by the contracting states, among the other things, as a mechanism of allocating tax base between themselves concerning non-resident enterprises business profits.[71] However, the underlying economic theory, policy objective and legal reasoning behind the PE concept, is still argumentative for the scholars. In this regard, to have better understanding of the current problems of the PE (including artificial avoidance of PE) it's indispensable to refer to the historical evolution of the concept PE, since without historical perspective; it is not easy to fully comprehend the present problems of PE as the general and artificial avoidance of PE in particular.

The 1923 League of Nations Report (of the four economists) on Double Taxation indicated double taxation constituted serious challenge to the international trade and investments. This report marked a significant change in international taxation; the central idea that double taxation hinders international trade and investment, initiated a change in the international taxation, when the League of Nations report, proposed a move to resident-state taxation.[72] And the concept of PE since then introduced as an exception to residence-state taxation, and, as such, it has remained from the 1928s until today.[73] The justification behind the endorsement of the residence taxation as a general rule, and the PE as an exception were neither concretely explained in the League of Nations materials nor later in the UN and OECD MCs documents.[74]

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[70] Castro, F.M (2012). *Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy*, In: Global Bus. L. Rev. 125, pp. 126.
[71] R. L.Williams (2014). p. 23
[72] Skaar (1991), pp. 80.
[73] Skaar (1991), p. 82.
[74] Skaar (1991), p. 82.

In fact the UN and OECD MCs document indicates that the PE concept is supported by policy and administrative considerations. Commentary on the UN and OECD MCs, explains that the reason for the PE threshold is to encourage businesses to undertake preparatory or ancillary operations in a source state that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that source state.[75] Besides, PE avoids increased compliance that pose unnecessary administrative burden on enterprises and tax administrations;[76] i.e. an enterprise, whose activity in the source state does not reach PE threshold, is relieved from compliance and administration costs in source state which would be disproportionate to the minor business presence of the enterprise and tax authorities will be relieved from difficult identification and audit of non-residents with minor presence.[77] In other words until an enterprise of one state sets up a PE in another state, it should not be regarded as participating in the economic life of that another state to such an extent that it comes within its taxing jurisdiction.[78] Thus, not every cross-border activity leads to tax liability, i.e. when the PE threshold is not met, income arising from the source state is considered not intimately connected to the economy of the source state, and thus, residence state receives taxing rights.[79] In general context the analysis of the definition of a PE 5 both the OECD and UN MC reveals that the objective of the concept of PE is the identification of criteria for the existence of legitimate and substantive business activities within the foreign tax jurisdiction.

However, scholars argue otherwise; for e.g. J. Carlos, provides that the main objective of the PE concept is to delimit the right of a source state to tax the revenues obtained in its territory by an enterprise resident in another state. According to him PE concept raises not only a tax issue, but also a question of tax sovereignty and of fair division of the right to tax.[80] In the same vein Vogel, provides that, PE concept is designed to limit source countries' tax jurisdiction over foreign businesses, and so it generally works in favor of residence countries.[81] *Glenn* also provides that, since the PE rules and proposals are generally developed by advanced economies,

[75] UN MC Commentary on Article 5 para.
[76] UN MC Commentary on Art. 5 para. and OECD MC commentary on Art 5, para. 133.
[77] R. Ekkehart (2015). pp. 12-13
[78] UN MC Commentary on Art 5 para 132 OECD
[79] UN MC Commentary on Art 5 para 132 OECD
[80] J. Carlos (2012). *A Tributação dos estabelecimentos estáveis*, Porto: Vida Económica, pp. 184– 185.
[81] Vogel, K. (2015), *Double Taxation Conventions*: A Commentary to the OECD, and UN Model Conventions, With Particular Reference to German Treaty Practice, pp. 15-19.

they favor capital-exporting countries.[82] Skaar, also consubstantiates the same, he provides the fear of industrialized countries to give up revenue in favour of source countries was driving force behind the position adopted, first, by the League of Nations and later on by the London, UN and OECD Models.[83]

Be that as the case may, the elimination of double taxation was a main concern in international taxation, thus in order to promote cross-border trade and investments, there was the feeling that relief for the double taxation should be split between source and residence countries, i.e. in some cases resident country gave relief for taxes paid abroad, and so the source country also could give up its rights, provided reciprocal treatment was granted to their businesses.[84] In other word, the principle of international justice or fair allocation of tax revenues requires states to share tax revenue based on some threshold such as the case of PE. The PE is thus, adopted to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates, or whether the country of residence should be entitled to tax these cross border profits. The PE therefore constitutes an element of the distribution between states of sovereign power to tax.[85] Besides, PE establishment has policy objective of ensuring capital import neutrality between the different forms of business establishments.[86]

Therefore, a mixture of economic theory, administrative convenience and political interest explain the reason behind the resident taxation as a rule and PE as an exception in the current international taxation system. Thus, in the absence of a PE, the business profits derived in the source country by a non-resident are exempt from tax there and are taxable only in the country of residence. Once a PE is established in the source country, source state acquires the right to tax the business profits attributable to the PE. In such case, the residence country avoids double taxation either through exemption of the business profits attributable to the PE in the source sate or through providing a credit for the taxes paid in source state.[87]

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[82] Glenn (2014) '*Transfer Pricing and Defining the Most Challenging BEPSs Action Items.*
[83] Skaar (1991), p. 82.
[84] Carroll, M. (1939), "*Prevention of International Double Taxation and Fiscal Evasion: Two Decades of Progress under the League of Nations*", Geneva: League of Nations, p. 6-7.
[85] A. Carlos (2016). *Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment,* Kluwer International Law, EC Tax Review, 5-6, 296-311, p. 301.
[86] A. Carlos (2016). p. 12
[87] Articles 23A and 23B of the UN and OECD, Model Tax Convention.

### 1.3.2. The Components of the Definition of the Concept of PE

The term PE is defined in Art 5 of both the OECD and UN MCs by a series of threshold tests, such as *permanency* (for fixed place of business PE), *days-of-work* (for Project and Service PE), *habitually* (for Agency PE). Art 5 of UN MC provides the terms, conditions and requirements for a PE in nine paragraphs. Taking into consideration essential characteristics, terms, conditions, and requirements in the definition of PE, we can classify PE into four different types; (1) Physical PE, which includes Fixed Place PE and Construction PE, (2) Service PE, (3) Agency PE and (4) Insurance PE. All types of PE has relatively different conditions and requirements, such as 'permanency-test' (for fixed place of business PE), 'days-of-work' threshold (i.e.183 for construction and Service PE), 'habitually' requirement (for Agency PE), and etc.; each of which shows degree of non-resident's involvement in the commercial life of the host country. By taking into consideration the definition of PE in Art 5 of both the UN and OECD MC, for the purpose of this study the detail discussion on the types, essential characteristics, terms, conditions and requirements of PE will be made below.

#### 1.3.2.1. The Physical PE

Generally, there are two sets of Physical PE; Fixed Place PE and Project PE. Art 5(1) of UN MC deals with *Fixed Place PE*, with series of tests and 5(3) UN MC deals with another subset of Physical PE, the *Project PE*, by replacing 'permanency test' requirement under Fixed Place PE with specified time period.

##### 1.3.2.1.1. Fixed Place PE

Article 5(1) of UN MC reads as follows:

> "*"Permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."*

Similar definition has also been adopted under OECD MCs. The UN-MC Commentary describes that, Article 5(1) of UN-MC gives a general definition of the term 'permanent establishment' which brings out essential characteristics of a PE in the sense of the Convention, i.e. a fixed place of business.[88] This is relatively straightforward, which encompasses three basic requirements in order for a Fixed Place PE to exist, viz. (1) the existence of a place of business;

[88] UN Commentary on Art 5, para. 2.

(2) this place of business must be of a fixed; and (3) an enterprise must carried on its business through this fixed place of business. The detail analysis of each of the three requirements, with their characteristics and conditions will be made below.

1. **Definition of Place of Business**

The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose.[89] For a place of business to exist, premises, installation, facilities, etc. are not always required, it can exist simply where an enterprise has a certain amount of space at its disposal. Moreover, it is immaterial whether these places are owned or rented or otherwise at the disposal of the enterprise.[90] Most importantly no formal legal right to use the place is required, since the actual control over a place is established based on the evidence from facts and circumstances, through substance-over-form doctrine.

Article 5(2) of UN MC sets forth the non-exhaustive positive list of examples, each of which can be regarded, *prima facie*, as constituting a place of business, including: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.[91] These lists of examples are should be interpreted in such a way that such places of business constitute PE only if they meet the requirements of paragraph 1 of Art 5 of UN MC.[92]

In general context, a place of business covers any location used to carry on the activities of the enterprise. However, Article 5(4) of both UN and OECD MC specifically excludes some places of business with a degree of permanence from being considered as a PE. The exclusion covers activities that are, in general, preparatory or auxiliary in character to the main business activity. These, includes:

- ✓ The *use or maintenance* of fixed place of business, ***solely*** for the purpose of *storage, display or purchasing* of stock of goods or merchandise belonging to the enterprise; or
- ✓ The *use or maintenance* of fixed place of business *solely* for the purpose of collecting information belonging to the enterprise: or

[89] ibid
[90] ibid para. 3.
[91] Income Tax Proclamation 979/2016 Art 4(1).
[92] OECD Commentary on Art 5, para 46.

- ✓ The *maintenance* of a stock of goods or merchandise belonging to the enterprise **solely** for the purpose of *storage or display*; or for the purpose of processing by another enterprise;
- ✓ The *use or maintenance* of fixed place of business *solely* to carry on any other activities of preparatory or auxiliary character belonging to the enterprise.[93]

These exclusions, in general, apply only if the activity of the fixed place of business is limited to a preparatory or auxiliary character. The reason behind the exclusion is due to these activities are considered as incidental and supplementary to the basic underlying profit-making activities, so that they are so remote from core income producing business activities of an enterprise.[94] Article 2(9(b) of repealed ITP 286/2002 have also provided similar list of exclusions. Nonetheless, these lists of exceptions has given rise to abuses due to difficulty to distinguish between activities which have a preparatory or auxiliary character and those which have not, thus, amended ITP 979/2016 have excluded these lists of exceptions.

**2. Definition of the term 'Fixed'.**

Fixed place PE can be deemed to exist only if non-resident enterprise carries on business within specific geographical point with a certain degree of permanency.[95] The term 'fixed' thus, connotes two important tests, a fixed geographical location (locus test), and a degree of permanency of the activities (duration test).[96] These two aspects of 'fixed' place of business are therefore, inherently important to constitute PE.

**Location Test;** in the normal way the place of business requires the availability of a physical location where the business is situated, i.e. it demands, a specific *situs*.[97] But this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands.[98] What matter is, the existence of physical objects that are used for carrying on a business of an enterprise.[99] Where the nature of the business is that it is dispersed among the

[93] Article 5(4) of UN MC.
[94] OECD commentary on Art 5, para 58.
[95] UN Commentary on Art 5, para 6.
[96] UN Commentary on Art 5, para 6.
[97] OECD Commentary on Art 5, para 21.
[98] ibid
[99] Arvid A Skaar, ( 2005). *Commentary on Article 5 of the Model Treaty: The Concept of Permanent Establishment*, IBFD, pp. 13.

districts, ‘commercial and geographic coherence’ will be used when determining the location test. This means a place of business will be determined in light of the nature of business, thus, a particular location within which the business activities are dispersed will be identified as constituting a coherent whole commercially and geographically with respect to that business.[100]

**Duration Test:** Although no a specific minimum threshold has been set, in majority cases PE can be constituted if the place of business has a certain degree of permanency, *i.e.* if it is not of a purely temporary nature.[101] The determination whether the place of business meets the test of permanence is made against the background of all circumstance constituting each individual case.[102] Although it depends on the nature of business activity, in most cases purely temporary nature activities will not give rise to a PE, since they lack the criterions of certain degree of permanency, for a business enterprise to have a genuine link or substantial economical connection to the source state.[103] But, if the nature of the business is such that it will only be carried on, for short period of time or exclusively in that country, it may constitute a PE despite the fact that it existed, in practice, only for a very short period.[104]
Generally, a Fixed Place PE begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. It ceases to exist with the disposal of the fixed place of business or with the cessation/termination of any activity through it.[105]

### 3. Definition of the “Carried on Through” Expression

In addition to above constituents, another important requirement for fixed place PE to exist is, the non-resident enterprise should carry on its business wholly or partly *through* a fixed place of business.[106] The ‘*Carried on through*’ expression is the ‘*business activity test*’ condition, which requires the existence of a specific kind of *connection or precise link* between the place of business and the *business activity* of non-residents enterprise. The *links* between the *fixed place* and *business activity* will therefore, fulfill the requirements of ‘*carried on through*’ expression to

[100] OECD Commentary on Art 5, para 22.
[101] OECD Commentary on Art 5, para 28.
[102] S. Gadzo. (2018). *Nexus requirements for taxation of non-residents’ business income: a normative evaluation in the context of the global economy*. pp. 321, IBFD, https://www.ibfd.org/.
[103] Arvid A Skaar, (2005). pp. 13.
[104] OECD Commentary on Art 5, para 28.
[105] UN Commentary on Art 5 para.11.
[106] UN Commentary on Art 5 para. 7.

constitute PE.[107] Apparently, the determination of whether the foreign entity business is being carried on *through* a PE will be made by reference to the relevant facts, circumstances, duration, nature and character of business activities of an enterprise. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.[108] In the same vein an internationally operating trucking company, such as internationally operating railroad companies and bus companies, that makes use of tracks/roads in other countries, will be considered to be carrying on business "through" the tracks/roads at their disposal.[109] Thus, the words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.[110]

#### 1.3.2.1.2. Project Permanent Establishment

Art 5(3a) of UN MC, provides that a building site, construction, assembly or installation project or supervisory activities in connection therewith, constitutes a PE only if it lasts more than six months,[111] or twelve months in the OECD MC. Some scholars have taken the position that, the Project PE as an extension of PE definition and not as part of the *Fixed Place PE* provided in Art 5(1) of UN-MC.[112] But, the majority of scholars and both UN and OECD MCs Commentary provides that, *Project PE* is a special subset of the *Fixed Place PE* provided in Art 5(1) of both UN and OECD MC, with specified time duration requirement.[113] In other words, Art 5(3) of both UN and OECD MC, consubstantiate the '*permanence test'* requirement of *Fixed Place* PE in Art 5(1) of both UN and OECD MC, into an effective fixed time requirement.[114] The UN MC Commentary stresses that, in fact where *Project PE* exists for six months, it will in practice

[107] Tiiu Albin (2012). *Problems with Permanent Establishments: Problems in Determining Permanent Establishment on the Basis of Article 5(1) OECD MC,* https://www.ttn-taxation.net › pdfs › TiiuAlbinEssay, pp. 13.
[108] OECD Commentary on Article 5, para 20.
[109] Van, R, K. (April 2011). "*New Sources of Tax Revenue for Transit Countries: Can a (Rail) Road Qualify as a Permanent Establishment*?" pp. 25.
[110] OECD Commentary on Article 5, para 20.
[111] Article 4(3) of income Tax Procalamation 979/2016. provides more than 180 days.
[112] Ribeiro, J, S. (2009). *Outline of Article 5 of the OECD Model Convention*, 1(115) JURISPRUDENCIJA, pp. 295, 300. See also Reimer, E. (2015). *Permanent Establishment in the OECD Model Tax Convention, In A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, Kluwer, pp.72.
[113] UN Commentary on Art 5, para. 7. see also Hans, P. (2005). *The Relationship Between Article 5, Paragraphs 1 and 3 of the OECD Model Convention*, In INTERTAX, 33(4), 189.
[114] Hans, P. (2005). pp. 193.

almost invariably also meet the requirements of Art 5(1) of UN-MC, i.e. '*permanence test'* requirement.[115]

In-addition to what has been listed in the Article 5(3a) of UN-MC, both the UN and OECD MCs Commentary broadly interpreted the scope of *Project PE*, by providing non-exhaustive list of other project related activities, such as, the construction or renovation of roads, bridges or canals, buildings, the laying of pipe-lines, excavating, dredging and also the installation of new equipment or machinery in existing building as well as on-site planning and supervision.[116]

**Determination of six month duration;** the UN MC Commentary provides that the time calculation starts from the date on which the contractor begins his work, including any preparatory work, in the source state and it continues to exist, in general, until the work is completed or permanently abandoned.[117] The six month threshold has given rise to abuses due to different factors that affects time determination, such as 'splitting-up of single project contract', 'projects dispersed among various locations', 'temporary interruption of project work due to force majeure' and others. Hence, Art. 4(2) of ITR and UN, and OECD Commentary provided guidance as the determination of six month threshold.

Concerning, 'splitting-up of project contract' OECD MC commentary provide that, an enterprise (general contractor) which has undertaken the performance of a comprehensive project, may attempt to evade the time test standard, by subcontracting the whole or parts of the project to other enterprises (subcontractors) owned by the same group.[118] In such case, in determining time period, the time spent by the sub-contractors shall be taken into account as being time spent by the general contractor, despite compartmentalization of the work through subcontracting amongst multiple connected parties.[119] The same has been provided under Art. 4(2) of ITR 410/2017, provided that the activities of such a closely related enterprise are connected with the activities carried on by its closely related enterprises.[120] Thus, connected projects shall be regarded as a single unit, provided that they forms a *coherent whole commercially and*

[115] UN Commentary on Art. 5 para. 7.
[116] OECD Commentary on Art 5 para. 50.
[117] UN Commentary on Art. 5 para. 11.
[118] OECD Commentary on Art. 5 para. 52.
[119] OECD Commentary on Art. 5 para. 52.
[120] Art. 4(2) of Income Tax Regulation 410/2017.

*geographically*, irrespective of the fact that the activities are based on *several contracts* or orders have been placed by *several persons*.[121] Concerning 'projects dispersed among various locations' OECD Commentary provide that since it is the very nature of a construction or installation project activity to be relocated, continuously or from time to time, at various locations within a country, as the project progresses, in determining time spent, activities performed at each particular spot forms part of a single project irrespective of its relocation.[122] Concerning temporary interruption of project work, OECD Commentary provide that, the project term will not be considered to cease when work is temporarily discontinued, even due to factors or abnormal circumstances beyond the control of an enterprise.[123] Thus, temporary interruptions should be included in determining the life of the project or a site.

#### 1.3.2.2. Service Permanent Establishment

Due to technological advancement, the capacity to provide services across the border without using a '*fixed place'* of business in the source country has improved notably. Moreover, to avoid any risk of PE, in most cases, the MNEs could perform the services by contracting with 'independent agents'.[124] In the absence of a fixed place of business within the meaning of Art 5(1) or a dependent agent, within the meaning of Art 5(5) of UN MC, profits from services could remain taxable only in the state where the enterprise is tax resident. To obviate this possibility, the UN MC under its Art 5(3b) devised new and specific rules for a characterization of a Service PE. Art 5(3b) of UN MC provides that, furnishing of services, including consultancy services, by a person, including through employees or other personnel engaged by it for such purpose, shall constitute PE, if activities of that nature continue for the same or a connected project for a period or periods aggregating more than six month in the UN MC.[125] Next to insurance PE, the services PE concept is perhaps the most noteworthy contribution to tax treaties provided by the UN model. OECD MC does not contain provision on Service PE and insurance PE. In this regard, the OECD takes the position that these businesses models should continue to be treated the same way as other types of business activities.[126]

[121] OECD Commentary on Art. 5 para.51.
[122] OECD Commentary on Art. 5 para. 52.
[123] OECD Commentary on Art. 5 para 55.
[124] Wichmann, M., (2018). p. 201-204.
[125] Art 4(2(c) of Income Tax Procalamatio 979/2016.
[126] OECD Commentary on Art 5 para. 132.

Like the agency PE, service PE is also regarded as a 'deemed PE', because the non-resident does not need to have an actual establishment in the host state so that no fixed place of business are necessary. But, unlike agency PE, the status of the person through whom the enterprises furnishes services is irrelevant it can be employee or any other personnel. The prominent condition as discussed above is *days-of-work test*.[127]

For purposes of determining the aggregate period of 183 days or six month, for the application of the Service PE rule, the overall period shall be counted based on the total number of days the services are rendered in the source state. The UN Commentary points out, that, those measures to counteract abuses in *Project PE,* in particular the anti-contract splitting rule, would apply equally in cases of service PE too.[128] Thus, concerning splitting-up service of contract; the UN Commentary provides the same guidance provided under Art 4(1) of ITR 410/2017, which provides that the duration of service shall be determined by aggregating the periods during which services are carried on in a source state by "closely related enterprises", provided that the activities of such closely related enterprise in that source state are connected with the activities carried on in that source state by its closely related enterprises.[129] The same rule applies concerning the provision of service among various dispersed locations, in determining time spent, service provided at each particular spot forms part of a single project irrespective of its relocation.[130]

#### 1.3.2.3. Agency Permanent Establishment

Art 5(5) of both UN and OECD MCs provide an additional type of PE concept, an Agency PE that does not require the existence of a fixed place of business in the source state.[131] An Agency PE provides an alternative test of PE, in other word, if it can be shown that the enterprise has a PE through physical presence, it is not necessary to show that an enterprise would fall under Agency PE.[132] As per Art 5(5) of UN MC, an Agency PE exists when a dependent agent acting on behalf of a non-resident enterprise (principal);

[127] Wichmann, M., (2018). p. 201-204.
[128] UN Commentary on Art 5 para. 11
[129] UN Commentary on Art 5, para. 11.
[130] UN Commentary on Art 5, para. 12.
[131] Art 4(4) of Income Tax Proclamation 979/2016.
[132] OECD Commentary on Art 5, para. 100.

- ✓ habitually concludes contracts (or habitually plays the principal role leading to the conclusion of contracts) in the name of principal for the;
  - ➢ transfer of the ownership of property owned by the principal or property that the principal has the right to use; or
  - ➢ granting of the right to use on property owned by the principal or property that the principal has the right to use; or
  - ➢ Provision of services by the principal.
- ✓ Or habitually maintains a stock of goods or merchandise from which it regularly delivers on behalf of the principal. [133]

Unlike OECD and UN MCs, Art 4(4) of ITP, does not require conclusion of contract in the name of principal by an agent, it provides less stringent requirement of "regular negotiation of contract" on behalf of the principal by a dependent agent. From the reading of Art 5(5) of UN-MC one can simply deduce the following conditions that must meet for an agency PE to exist;

- ✓ A person must be a dependent agent;
- ✓ A person must acts on behalf of an enterprise;
- ✓ A person habitually concludes contracts on behalf of the principal, or
- ✓ Maintains a stock of goods from which it regularly delivers on behalf of the principal.

**1. Dependent Agent**

In principle, the person that can create a PE on behalf of a non-resident enterprise should have to be a dependent agent. Where a person acts on behalf of an enterprise in the course of carrying on it's a business as an independent agent such enterprise is deemed not to have PE Art 4(4 & 5) of ITP. The UN Commentary provided subjective test criterion such as, instructions, control, and risk assumption, to determine the status of the person acting as an agent.[134] Accordingly, where the person's activities for the enterprise are subject to detailed instructions or comprehensive control by an enterprise and an enterprise assumes entrepreneurial risk; such person can be regarded as dependent of the enterprise.[135] To the opposite, a person who acts autonomously, for

[133] Article 5(5) of UN MC
[134] UN Commentary on article 5, para. 30.
[135] UN Commentary on article 5, para. 30.

a number of principals, in the ordinary course of his business, can be regarded as independent agent. Thus, he is not subject to significant control or detailed instructions from the principals as to the conduct of the work. Moreover, independent agent is responsible to his principals for the results of his work, i.e. he bears risk and receives reward through the use of his entrepreneurial skills and knowledge.[136]

While this criterion provides a relatively well-known test based on agency law, they are not always conclusive and determinative. All the relevant facts and circumstances of each case need to be taken into account to determine the status of agent's relation with the principal.[137] OECD BEPS Action Plan seven, provided that, "…in many cases *commissionnaire* arrangements and similar strategies were put in place primarily in order to erode the taxable base of the state where business activities took place."[138] Through such an arrangement, a non-resident enterprise is able to do its business in a source state without having a PE there; since the person that acted on behalf of enterprise is deemed not have dependent agent status.[139] Therefore, it was found necessary to supplement criterion with a test focusing on substantive activities taking place, in order to address such strategies and cases where the person's relation with the principal is clearly manifest the existence of dependent agent status although the relevant rules of agency law may provide otherwise.

Through this, substance over a form doctrine, "*legality and economic"* independence conditions used to distinguish independent agent from dependent (that were used before 2017 update) and statements like "*broker, general commission agent or any other agent of an independent status"* which were provided before 2017 update in Article 5(7) of UN MC has now been deleted. This means, persons acting on behalf of principal are not required to qualify as an agent under civil law.[140] Accordingly, as per Article 5(7) of UN MC, independent status is less likely to exist, by taking into account all the relevant facts and circumstances;[141]

[136] UN Commentary on article 5, para. 30.
[137] UN Commentary on article 5, para. 30 and OEDC para. 111,
[138] OECD BEPS, *Action 7* - (2015), *Final Report para. 8 p 15.*
[139] OECD BEPS, *Action 7* - (2015), *Final Report para. 5 p 15.*
[140] A. Skaar. (2009). *Is there a permanent establishment*? In: Cahiers de droit fiscal international, V. 94(a), pp.50.
[141] UN Commentary on Art 5, para. 30.

- ✓ IF independent agent acted exclusively or almost exclusively on behalf of only one enterprise (or closely related group of enterprises) over the lifetime of that business or over a long period of time.
- ✓ If the principals act in concert to control the acts of the agent in the course of his business on their behalf.
- ✓ If the activities of the independent agent are unrelated to the ordinary course of its business.
- ✓ If independent agent seeks approval from the principal for the manner in which the business is to be conducted.
- ✓ If independent agent acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of her employer or a partner acts on behalf of a partnership.

**2. Conclude contracts**

Habitual conclusion of contracts by an agent acting on behalf of an enterprise is also additional condition provided under Art 5(5a) of UN MC, for an Agency PE to exist. Nonetheless since "conclusion of contract" provides well known test based on contract law, this test is highly susceptible to the abuse through aggressive tax planning arrangements. [142] Due to this, both the UN and OECD MCs Commentary supplemented the criterion with a test focusing on substantive activities taking place, in order address, cases where the conclusion of contracts is clearly the direct result of the activities of an agent though the relevant rules of contract law provides otherwise.[143] Accordingly, when an agent negotiates in a source state all elements and details of a contract in a way binding on the enterprise, he can be said concluded the contract in the source state on behalf of an enterprise even if that contract is signed by another person outside that State.[144] The precedence of 'substantive over a form' doctrine is also reinforced in the Article 5(5) of both the UN and OECD MCs, according to which, the person who "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" can be said, concluded the contract in the source state on behalf of an enterprise.[145]

[142] Commentary on Article 5, para. 23 OECD Para 23 & OECD 87.
[143] Commentary on article 5 para. 98 see also J Sasseville, A. Skaar. (2009). p. 52.
[144] UN Commentary on Article 5, para. 23 & OECD 87.
[145] Article 5(5) of UN and OECD MCs

3. **On Behalf of Enterprise**

A person is deemed acting on behalf of an enterprise, firstly, when enterprise is directly or indirectly affected by the activities of that person. This means agent's activity on behalf a principal should have to create rights and obligations that are legally enforceable between the principal and the third parties with which an agent acted.[146] The reference "on behalf of principal/enterprise", thus, shows that, that contract will be performed by the enterprise as opposed to the person that acts on behalf of the enterprise.[147] However, just like any other test, this test is also susceptible to the abuse, for e.g. there are situations where an agent who was in fact dependent, but represent himself as acting on his own behalf.[148] In order to obviate this possibility, the test is reinforced with substantive over a form doctrine. This means, taking into account all the relevant facts and circumstances of each case, the binding effect of the contract for the principal must be examined from an economic point of view, focusing on substantive activities taking place in one state rather than a legal one.[149] Thus, contracts that do not legally bind the principal to the third parties but that relate to the transfer of the ownership of (or to grant right to use over) property owned by the principal or the property that the principal has the right to use; or that relate to the provision of services by the principal shall be taken as contracts concluded on behalf of an enterprise.[150]

Secondly, a person is deemed acting on behalf of an enterprise, when it involves that enterprise to a particular extent in business activities of the state concerned.[151] This latter requirement is emerged from the underlying basics of PE concept (which requires the existence of substantial degree of economic connection) based on the 'activity related' approach to determine what extent of agent's activities would activate the deeming rule (agency PE).[152] This is reinforced, through "Regularly/habitually" requirement, which reflects that the person acting on behalf of enterprise should repeatedly conclude contracts and not merely in isolated cases.[153] This means, that the presence which an enterprise maintains in a source state should be more than merely

[146] Ibid
[147] UN Commentary on Article 5, para. 24, & OECD 94
[148] UN Commentary on Article 5 UNMC para. 25.
[149] OECD Commentary on Art 5 para. 98 see also J Sasseville, A. Skaar. (2009). p. 52.
[150] UN Commentary on Art 5, para. 24, & OECD 92.
[151] UN Commentary on Art 5, para. 23, & OECD 86, and S. Gadzo. (2016). pp. 48.
[152] UN Commentary on Art 5, para. 23, & OECD 98, and S. Gadzo. (2016). pp. 148.
[153] UN Commentary on Art 5, para. 23, & OECD 98.

transitory for an Agency PE deemed to exist. Since it is not possible to lay down a precise frequency test, the "*habitually/regularity*" of conclusion of contract should be determined on the basis of the commercial realities of the situation.[154] In other word, the extent and frequency of activity necessary to conclude that the agent is "Regularly/habitually" concluding contracts will depend on the nature of the contracts and the business of the principal.[155] Simply "*Regularly/habitually*" requirement consubstantiates, '*degree of permanence'* requirement in Article 5(1) or *'fixed time'* requirement in Article 5(3) with repeated activity related requirement. Be that as the case may, in order to satisfy the deeming rule and create an agency PE, the nature of the activities of a person acting on behalf of enterprise, should have to closely tie up the activity of the enterprise with the economic life of source state.[156] To sum up, activities referred to in Article 5(5) of both UN and OECD MCs covers activities relating to business operations of the enterprise. Thus, activities relating to internal operations only do not constitute PE.[157]

#### 1.3.2.4. Insurance PE

As per the definition of the term "permanent establishment" under Art 5 of UN-MC a non-resident insurance company business profits, may be taxed in the host state, if it has a fixed place of business within the meaning of Art 5(1) or if it carries on business in the that host through a person within the meaning of Article 5(5).[158] OECD Action Plan notes that due to the nature of the insurance business, foreign insurance companies do business in a source state, without meeting either of the above requirements.[159] In cases of Article 5(1), in most cases non-resident insurance companies do business through a person without having 'fixed place' of business. In cases of Article 5(5), since insurance agents generally have no authority to conclude contracts; it could be difficult to meet the conditions of agency PE.[160] OECD stresses that in this situation it is conceivable that, these companies do large-scale business in the source state without being taxed on their profits.[161]

[154] UN Commentary on Art 5, para. 23, & OECD 97.
[155] UN Commentary on Art 5, para. 23, & OECD 98.
[156] UN Commentary on Art 5, para. 22.1 & 22.2.
[157] UN Commentary on Art 5, para. 23. & OECD, 97.
[158] UN Commentary on Art 5, para. 27, Art 4 of Income Tax Proclamation, 979/2016. also provides the same.
[159] OECD BEPS, *Action 7*, (2015), *Final Report* para. 5 p 27.
[160] Commentary on article 5, para. 28.
[161] OECD BEPS, *Action 7* - (2015), *Final Report* para. 5 p 27.

In order to obviate this possibility, Article 5(6) of UN MC, provides that, an insurance enterprise shall be deemed to have a PE in the source state if it collects premiums in the territory of that source state or insures risks situated therein through a person.[162] Here like agency PE, the person through whom the non-resident insurance enterprises carry on business should be dependent agent within the meaning of Article 5(7) and the same test discussed under agency PE above, would be used to distinguish independent agent from dependent one. But, unlike agency PE, there is no requirement of conclusion of contracts by such agent on behalf insurance enterprise. Moreover no '*habitually*' requirement i.e. the number of clients is irrelevant, thus merely isolated or transitory cases can constitute PE. In other word, no condition of fundamental basics of PE concept, that requires, substantial degree of non-resident's involvement within the economic life of source state, if it is to be regarded as maintaining a PE. Thus no auxiliary or preparatory activity exclusion and PE is deemed to exist irrespective of the short duration of business activities. However, the loose nature of a rule does not properly address the core nature of insurance business. For e.g. due to the nature of the insurance business, the ease with which persons could represent insurance companies on the basis of an "independent status" makes it difficult to distinguish between dependent and independent insurance agents.[163]

### 1.4. The Concept of Business Profit

The concept of PE in Art 5 and the allocation rules laid in Art 7 of both OECD and UN MCs are applicable to business profit. Therefore it is crucial to clarify the scope of business profit and determine which items of income are covered by this concept. The term profit is not defined either in the UN or in the OECD MCs. Both UN and OECD MCs commentary defines the profit as every item of income which is derived from business activity.[164] In some circumstances, (in the situation lack of a special provision) conflict may arise between Art 7 and other Articles of the UN MC (or OECD MC) in terms of categories of income which belong to one of the other distributive rules but which also fall within the wider scope of business profit. To address these collisions between the allocation rules, Art 7 (4) of OECD MC or Art 7(6) of UN MC, makes clear that in case of items of income which are dealt with separately in other Articles, the

[162] Article 5(6) of UN MC. However, ITP 979/2016 does not contain such kind of specific contextualised provision for the insurance business.
[163] UN Commentary on article 5, para. 28.
[164] OECD Commentary on Article 7, para. 71.

provisions of those special Articles have precedence over Art 7. This limitation of the scope of Art 7 precludes the possibility of collision between the allocation rules of Articles applicable to special items of income and those items of income which are dealt with Art 7.

However, some of these other articles give precedence to Art. 7 in respect of income attributed to PEs. These rules are referred as PE proviso and can be found in the allocation rules related to dividend (Art. 10), interest (Art. 11), royalty (Art. 12) and other income (Art.21) of both UN and OECD MCs.[165] According to the PE proviso, Art 7 is applicable instead of these articles if the income earned by a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividend is a resident / in which interest arises/ royalties arise through a PE situated therein and the holding/ debt-claim/ right of property in respect of which the payment is made is effectively connected with such PE.

Recently the scope of Art 7 has been expanded in the OECD MC; firstly, payments for the use of or the right to use, industrial, commercial, or scientific equipment (ICS equipment) have been deleted from the definition of royalty under Art 12 of OECD MC. As a result, income from the leasing of ICS equipment is considered as business profit and falls within the scope of Art 7. Secondly, Art 14 has also been deleted from the OECD MC which dealt with income from professional services and other activities of an independent character. This Article was meant to cover independent professional services, such as scientific, literary, artistic, teaching activities, activities of lawyers, engineers, architects, and etc., i.e. the activities of high professional nature.[166] Similar to Art 7, of OECD this Article also gives exclusive taxing rights to the state of residence unless the taxpayer carries on those activities through a fixed base in the other state.[167] OECD commentary provides that, the elimination of Article 14 reflected by the fact that there were no intended differences between the concepts of PE, as used in Art 7, and fixed base, as used in Art 14, or the allocation rules linked to these concepts. The deletion reflected that fact and as a consequence, income earned by professional services or other activities of an independent character falls under Art 7.[168] However, some countries consider that the nature of Art 7 is not sufficient to warrant deletion of Art 14, as differences in meaning exist between the

[165] Michael Lang (2013). Introduction to the Law of Double Taxation Conventions, Linde, Vienna, pp. 102-103.
[166] Reimer, Ekkehart (2015). pp.113-114
[167] Ibid. p. 114
[168] OECD Commentary on Article 7, para. 77

"fixed base" (Article 14) and "permanent establishment" (Article 5), concepts. In view of these differences, the removal of Article 14 and reliance on Articles 5 and 7 will, or at least may, in practice lead to a reduction of source State taxing rights. Considering the differences of views in this area, differences which could not be bridged by a single provision, the UN MC retained Article 14 on the basis that, although Art 7 and 14 are based on the same principles, it's better that concept of PE should be reserved for commercial and industrial activities.[169]

## 1.5. The Concepts of Artificial Avoidance of Permanent Establishment

To understand artificial avoidance of PE status, it is important first to explain the concept of tax avoidance and tax planning. Tax avoidance is the act of using legal methods to minimize one's tax liability. In other words, it is an act of using loopholes and gaps in tax laws and exploiting them within legal parameters, so as to pay less tax.[170] The tax avoidance is different from tax evasion which is illegal and entails the non-compliance with the tax laws and includes activities that are deliberately undertaken by a taxpayer to free himself illegally from the tax which the law charges upon its income.[171] Under Art 125 of Federal Income tax administration proclamation 983/2016, tax evasion is serious crime punishable with a fine of birr 100,000 (One Hundred Thousand Birr) to 200,000 (Two Hundred Thousand Birr) and rigorous imprisonment for a term of three to five years imprisonment. To curtail tax evasion, tax authorities resort to criminal prosecution and investigation, on the other hand, since tax avoidance is legal act, it can only be prevented through amendments of the laws (addressing gaps and loopholes that opens the rooms for the exploitation) and through anti-tax avoidance provisions in domestic tax laws and DTAs.

Artificial avoidance of PE is one of mechanisms of tax planning strategies employed by the MNEs to circumvent the existing PE definition so as to avoid paying tax in the source state. In 2012 the G20 countries expressed their concerns about aggressive tax planning strategies employed by the MNEs and urged OECD to address this issue at an international level because unilateral measures proved not to be effective.[172] Then work has been started by the OECD under the aegis of addressing Base Erosion and Profit Shifting (BEPS). BEPS covers tax planning strategies which make use of gaps and mismatches in the DTAs and national tax systems in order

[169] UN Commentary on Article 5, para. 15.1.
[170] OECD (1987). *Issues in international taxation No 1: international tax avoidance and evasion*.
[171] Meyerowitz *Meyerowitz on income tax* (2009) in par 29.1;
[172] OECD (2013) Action Plan on BEPS, pp. 11, 32

to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity carried on by the enterprise. OECD released its report on BEPS in 2013, by identifying tax avoidance strategies which are available to MNEs under the current system and principles of international tax law.[173] When the OECD started identifying BEPS strategies, it stumbled upon tax avoidance strategies concerning PEs. In order to counter tax avoidance strategies concerning PEs, the OECD prepared Action plan seven on artificial avoidance of PE status. In the end of 2015, final versions of Action 7 which addresses artificial avoidance of PE status in a comprehensive manner have been prepared.[174] As discussed in the previous section, DTAs generally provide that the business profits of a non-resident enterprise are taxable in a host state only to the extent that the enterprise has in that state a PE to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in source State.[175] OECD BEPS Action Plan seven, called for the review of PE definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition.[176] The Action Plan identifies the root causes for the artificial avoidance of PE status and notes on a combination of coordinated tax planning strategies leading to artificially avoid PE, such as commissionaire arrangements and similar strategies;, specific activity exemptions;, splitting up of contracts concerning Project PE and service PE;, and strategies for selling insurance in a source state without having a PE therein.[177] OECD report shows that, these strategies are commonly used in tax planning by MNEs and have been challenged in national courts on multiple occasions.[178] Based on the foregoing premises, for the purpose of this sub-section the detail discussion on the types and essential characteristics of artificial avoidance of PE will be made below.

[173] OECD (2013) Action Plan BEPS, pp. 11, 32.
[174] OECD BEPS, *Action 7* - (2015), *Final Report, executive summaries.*
[175] OECD BEPS, *Action 7* - (2015), *Final Report, executive summaries.*
[176] OECD BEPS, *Action 7* - (2015), *Final Report p. 9.*
[177] OECD BEPS, *Action 7* - (2015), *Final Report* p. 9.
[178] OECD BEPS, *Action 7* - (2015), *Final Report* p. 15

#### 1.5.1.1. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

*Commissionnaire* arrangement is defined as an arrangement through which a person (called commissionnaire) sells products in a source state in its own name but on behalf of a foreign enterprise that is the owner of the products.[179] Through such an arrangement, a non-resident enterprise is able to sell its products in a source state without technically having a PE, to which such sales may be attributed for tax purposes and without, therefore, being taxable in that source state on the profits derived from such sales.[180] Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Commissionnaire arrangement is used by the foreign enterprises to circumvent *Agency PE*. A foreign enterprise that uses a *commissionnaire* arrangement does not have a PE because it is able to avoid the application of Art 5(5) of the OECD MC. For Art 5(5) OECD MC to be applicable a person in another state (i.e. an agent) must have the formal ability to conclude contracts *in the name of the non-resident* enterprise, which is avoided by using a commissionaire arrangement.[181] The structure became popular in the 1990s[182] and, has been appraised by many tax advisors for many years, since it allowed an enterprise to reduce their tax exposure from sales activities.[183] MNEs use mostly as a commissionaire related enterprise or a subsidiary with much lower remuneration. Although the remuneration for the services provided by related enterprise or a subsidiary subject to at arm's length, since a commissionaire typically assumes less risk and performs fewer functions than a distributor (i.e. dependent agent), the remuneration that must be paid by the principal will be much lower, which will have greater impact on the taxable amount, and consequently an enterprise could potentially reduce its tax exposure significantly.[184]

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[179] OECD BEPS, *Action 7* - (2015), *Final Report* p. 9.
[180] OECD BEPS, *Action 7* - (2015), *Final Report* p. 9.
[181] L. Parada (2013) '*Agents vs. Commissionaires: A Comparison in Light of the OECD Model Convention,* Tax Notes International,72, 1, pp. 62.
[182] D. Morgan (1997). "*Selling out the centre", International Tax Review*, p. 30.
[183] J.B. Darby (2006). "*Commissionaire Arrangements are an Important Tool in International Tax Planning*", Practical European Tax Strategies, 8, 7, pp. 2.
[184] J.F. Avery Jones & D.A. Ward (1993). *Agents as Permanent Establishments under the OECD Model Tax Convention*, European Taxation, p. 156.

Besides commissionaire arrangements, the OECD specifically targets the artificial avoidance of *agency PE* status by other similar strategies. With *Similar strategies* the OECD targets persons who typically operate as mere *sales representatives or marketing agents.* This involves situations where contracts that are substantially negotiated in a source state are not concluded in that source state because they are finalized or authorized abroad or the situations where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Art 5(5) of OECD MC apply even though it is closely related to the foreign enterprise on behalf of which it is acting.[185] Here in the case of '*similar strategies' sales agent* (*marketing agent*) has no the authority to sign contracts for its principal or the principal itself signs the contract, with the sales agent merely acting as an intermediary –i.e. a sales representative or 'marketing agent.[186] According to general principles of agency law, if a person acts as a mere sales representative or marketing agent it does not have the authority to conclude contracts for its principal, neither legally nor de facto.[187] Essentially, the functional capacity of an agent is stripped down, and as per Art 5(5) of OECD MC shall not constitute PE.[188] To combat the artificial avoidance of the PE status through *commissionaire arrangements* or *similar strategies* (marketing agents), the OECD proposes in BEPS Action 7 an amendments to the words of Art 5 of the Convention, in particular, the wording of Art 5(5) of OECD MC, the details of which has already been provided hereinabove under section of Agency PE.

#### 1.5.1.2. Artificial Avoidance of PE Status through the Specific Exceptions

Besides commissionaire and similar arrangements, the OECD BEPS project specifically targets artificial avoidance of PE status by exploiting the specific activity exemptions of Art 5(4) OECD MTC. Art. 5(4) of provides the list of exceptions according to which a fixed places of business PE is deemed not to exist where a place of business is used solely for activities that are listed in that provision. When the exceptions were first introduced, the activities covered by the exceptions were generally considered to be of a preparatory or auxiliary nature.[189] Since then, due changes in the economic environment and way that business is conducted, depending on the

[185] OECD BEPS, *Action 7* - (2015), *Final Report* p. 9.
[186] A. Pleijsier (2015). "*The Agency Permanent Establishment in BEPS Action 7: Treaty Abuse or Business Abuse?*" Intertax (Vol. 3), No. 2, p. 148.
[187] R. L.Williams (2014). pp. 255.
[188] R. L. Williams (2014). pp. 255
[189] Holmes, K. (2007). *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application,* IBFD, p. 156.

circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities.[190] The OECD expressed concern that the lists of exceptions were being used by multinational enterprises to conduct a very high volume of trade in a country through *fragmentation* of cohesive business activities into several small operations, in such a way that every 'fragment', or small part operation, could seem to only be engaged in preparatory or auxiliary activities that benefit from the exceptions of Art 5(4).[191] To obviate these possibilities the UN and OECD MCs modified their Art 5(4) through introduction of new anti-fragmentation rules, to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.[192] Moreover, OECD BEPS action seven provides the guidance that clarifies the meaning of the phrase "preparatory or auxiliary" using a number of examples. The proposed *anti-fragmentation rule* also precludes the application of exceptions if the several activities carried on by the same enterprise or by closely related enterprises at the same place or at different places constitute complementary functions that are part of a cohesive business operation and the overall activity cannot be considered as preparatory or auxiliary or one of these places creates a PE for an enterprise.[193]

#### 1.5.1.3. Artificial avoidance of PE status through Splitting-up of Contracts

Artificial avoidance of PE status through splitting-up of contracts relates with the situations governed by Art 5(3) OECD MC concerning projects PE. In practice, six month or (twelve month under OECD MC) threshold has given rise to abuses; it has sometimes been found that enterprises divided their contracts up into several parts, each covering a period less than six months and attributed to a different company which was, however, owned by the same group in order to abuse the time threshold so that they each cover a period less than the prescribed time limit, thereby avoiding PE status through such artificial arrangements.[194] To illustrate this point through an example;

[190] OECD BEPS, (2015), Action 7, Final Report, pp.28.
[191] Ibid
[192] OECD BEPS, (2015), Action 7, Final Report, p. 28.
[193] OECD BEPS, (2015), Action 7, Final Report, p. 28.
[194] OECD BEPS, (2015), Action 7, Final Report, pp. 42.

*RCo is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract.*[195]

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract is to abuse the time threshold so that they each cover a period less than the prescribed time limit, thereby avoiding PE status through such artificial arrangements.[196] The OECD BEPS Actions provides two possible solutions to counter these kinds of abuse. One of them can be found in BEPS Action 6 (titled: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances). This is the Principal Purposes Test (PTT). According to that rule if one of the principal purposes of a transaction or structure is to obtain treaty benefits, these benefits shall be denied excepted when the grant of these benefits is in line with the object and purpose of the provision of the treaty.[197] The other possible countermeasure is the amendment of the Commentary related to the calculation of threshold for Construction PE. According to that rule, the different periods (which exceed the 30 days) spent on a building site or construction/ installation project by *closely related enterprises* engaged in *connected activities* in terms of the building site or construction/installation project have to be aggregated when the duration requirement is calculated.[198] Furthermore the Commentary provides guidance with regard to the determination whether the activities performed are *connected or not*. Relevant factors can be, the persons who concluded the different contracts, the relationship between the contracts, nature of work and the change of employees performing of the work or the lack of that change.[199]

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[195] Extracted from OECD BEPS, (2015), Action 7, Final Report, pp. 42.
[196] OECD BEPS, (2015), Action 7, Final Report, pp. 42.
[197] OECD BEPS, (2015), Action 7, Final Report, pp. 42.
[198] OECD BEPS, (2015), Action 7, Final Report, Commentary para. 18.1
[199] OECD BEPS, (2015), Action 7, Final Report, Commentary para. 18.1

# CHAPTER THREE

## Analysis of Ethiopia's PE Rules in Addressing Artificial Avoidance of PE Status

### 3.1. Introduction

As demonstrated in the previous chapter, despite the reforms made to the PE definition by the amended ITP 979/2016 and ITR 410/2017 to counter arrangements intended to avoid taxable presence; and the incorporation of new provisions on Service PE, we could still notice gaps linked to the current PE concept in Ethiopian tax law. This chapter deals with the problems related with the current Ethiopia's PE rules and standards in curbing the artificial avoidance of PE status. The chapter examines PE rules in the Ethiopian tax law in light of common tax avoidance strategies (discussed under chapter two) that are used to circumvent the existing PE status, such as commissionaire arrangements and similar strategies, specific activity exemptions, splitting up of contracts concerning Project PE, and discusses problems linked to the current PE rules in Ethiopian tax law, to explore the unsettled issues, unclear concepts, and the points that need further analysis or additional attentions, and determines whether, the current PE threshold in Ethiopian legal framework adequate enough to properly establish and protect tax base under current cross-border transactions and multinational business activities.

### 3.2. Concerning Artificial Avoidance of PE Status through Commissionnaire Arrangements and Similar Strategies

In order to address artificial avoidance of PE status through *commissionaire arrangements* and *similar strategies*, the amended ITP 979/2016 and ITR 410/2017 supplemented the agency PE criterion with a test focusing on substantive activities taking place. One of the major conditions for the existence of agency PE both under OECD and UN MC is habitual conclusion of contract by an agent on behalf of the principal, here (**one**) unlike the UN and OECD MCs that uses "conclusion of contracts", Art 4(4) of ITP 979/2026 provided only "negotiation of contracts" on behalf of the principal as a condition to give rise to agency PE.[200] Art 4(4) of ITP reads as follow;

[200] Income Tax Proclamation No.979/2016, Art. 4(4).

*"When a person, other than an agent of independent status acting in the ordinary course of his business, acts on behalf of another person (referred to as the "principal"), the first-mentioned person shall be an permanent establishment the principal if the person;*

*(a) regularly negotiates contracts on behalf of the principal; or*

*(b) maintains a stock of goods from which the person regularly delivers goods on behalf of the principal"*

Instead of '*conclusion of contract'*, the amended ITP provides less stringent requirement - "*regular negotiation of contract*". This is important to cover situations where the conclusion of a contract directly results from the actions of an agent who convinced the third party to enter into contracts with the principal, though, under the relevant law, the contract is not concluded by that agent in the Ethiopia. This provision shows a strong stance taken to avert any possibilities of artificial avoidance of PE through commissionaire arrangements. Since the phrase "*conclusion of contract*" provides a relatively well-known test based on contract law, the situations where, under the relevant law governing contracts, a contract is considered to have been concluded by agent, it is highly susceptible to the abuse through aggressive tax planning arrangements of *commissionaire arrangements* and *similar strategies*. However, Since Article 4(4) of ITP does not relies on the formal *conclusion of contracts* in the name of the foreign enterprise, but on the agent's role in the *negotiation of contracts*, it is an important milestone to address *commissionnaire* arrangements used by the non-residents to circumvent PE status.

Instead of extensive usage of subjective test criterion to determine the status of the person acting on behalf of non-resident enterprise like UN and OECD MCs, which actually leads to unnecessary confusion and uncertainty; ITP 979/2016 provided only "*negotiation of contracts*" that actually minimize the room for subjective test criterion and avoid controversial discussions between the tax authority and non-resident enterprises, while at the same time ensures certainty and predictability in the taxation system of the Country and decreases administrative costs. Because, here regardless of whether the contracts are concluded in the name of principal or agent, the focus is on the agent's role in the negotiation of contracts and not the formal act of signing or concluding the contract.[201] This is aimed to cover the situation where an agent may

[201] Technical Note- Income on Tax Proclamation No. 979/2016, p. 26.

conclude contracts on his own name rather than in the name of principal, but under contractual arrangements between the agent and the principal, title to the goods passes directly from the principal to the customer. Therefore, the exclusion of '*conclusion of contract*' does not lead to artificial avoidance of PE status, since the '*negotiation of contract*' that precedes the conclusion of the contract has already been taken as a condition for the creation of PE.

**Two**, Art 4(4(b) of ITP provides that, where a person maintains the stock of goods, from which he regularly delivers on behalf of the principal, he shall constitute PE for that principal, even if he does not habitually negotiates contracts on behalf of the principal, since delivery facilitates sales of the product and thereby the earning of profit in the Ethiopia. This is aimed to address artificial avoidance of PE through other '*similar strategies'* (such as *sales agent/marketing agent*) situations where *sales agent/marketing agent* who was in fact dependent, but represent himself as acting on his own behalf. **Three**, as demonstrated in the previous chapter, in principle, the agent that can create a PE on behalf of a non-resident enterprise should have to be dependent. Due to this requirement sometimes '*related enterprises*' undertake certain secret dealing in a way that enables them to artificially avoid PE status through commissionaire arrangements. To obviate this possibility, Art 4(5) of ITP 979/2016 reinforced an "*independent agency status*" test with 'substantive over a form doctrine'. This means, taking into account all the relevant facts and circumstances of each case, the status of an agent will be examined from the point of view of his relationship with the principal, focusing on substantive activities taking place rather than a legal one. In this regard Art 4(5) of ITP 979/2016 provides that where an "*agent of independent status*" acts solely or principally for another person to whom he '*commercially and financially relates*' he will constitute PE.[202] This is aimed to cover, situations where an agent who was, in fact, dependent but represent himself as acting on his own behalf. The searcher appreciates the steps taken by the amended ITP 979/2016 to counter artificial avoidance of PE through commissionaire arrangements and similar strategies.
However the problem is that almost all of Ethiopia's DTAs uses the old OECD approaches (that were used before 2017 update) to determine *agency PE*. e.g. China (Art 5(5&6)), Turkey (Art 5(5&6)), UK (Art 5(6&8)), Netherland (Art 5(8&9)), Ireland (Art 5(5&6)), Singapore (Art 5(5&7)), UAE (Art 5(5&6)), Kuwait (Art 5(5&6)), etc. the situation that render the anti-

[202] Income Tax Proclamation No.979/2016, Art. 4(5).

avoidance measures taken under Art 4(4&5) ITP 979/2016 less effective and opens the room for the artificial avoidance of PE. Because as per Art 48 of ITP 979/2016 if there is any conflict between the terms of a tax treaty having a legal effect in Ethiopia and the ITP (except Article 48(3) and part Eight of ITP) the tax treaty shall prevail over the provisions of ITP.[203] Taking into account this possibility, to ensure the optimal effectiveness of PE regime under ITP, this anti-avoidance measures will have to be backed up through DTAs reforms; through the re-negotiation of older treaties, or the signing of additional protocols.

### 3.3. Concerning Artificial Avoidance of PE Status through Specific Activity Exceptions

Similar with the UN and OECD MCs, Art.2 (9) (b) of repealed ITP 286/2002, was also provided the lists of exceptions according to which a PE is deemed not to exist where a place of business is used solely for activities that are listed in that provision.[204] Since the lists are tended to open the room for artificial avoidance of PE status through *specific activity exemption* and *fragmentations of activities* between related enterprises; unlike the UN and OECD MCs that modified their Art 5(4) through the addition of a new sub-paragraph (4.1) to Art 5, to counter miss exploitation of the exceptions, the amended ITP 7979/2016 totally avoided the lists exceptions that do not constitute PE. The avoidance of the lists of exceptions is the important milestone taken by the ITP to eliminate any opportunities that enable the MNEs to artificially avoid a PE status through specific activity exemption and fragmentations of activities between related enterprises.

First, although relatively detail definition of the PE concept, has been made by the OECD and UN MCs, and several other multilateral, bilateral, treaties and domestic tax regimes. The broad meaning of the terms used in the PE concept, the fulfillment of the requirements, and the facts and circumstances of each case, made the PE concept, extremely complex, difficult, and debatable for taxpayers and tax authorities to precisely determine when a PE actually exists for a certain enterprise.[205] For this reason, the addition of a new sub-paragraph like UN and OECD MCs will broaden the definition of the PE concept and evoke further difficulties and complexities within already perplexed PE concept, such as how to draw the line between

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[203] Income Tax Proclamation No.979/2016, Art. 48.
[204] See Art.2 (9) (b) of repealed Income Tax Proclamation No.286/2002.
[205] Reimer, E. (2015). p. 187.

activities that are tenable to the exception and those which are not. Secondly, the PE threshold is one of the most abused concepts of the international taxation regime. Especially OECD notes that the lists of exceptions are easy to manipulate,[206] thus, the introduction of a new exceptional provision could create additional challenges and difficult interpretive issues and factual determinations for tax authorities and taxpayers, which is an undesired administrative burden including considerable costs. Thus, the writer argues that here nothing defeats the principal purpose of taxation and the motive of Ethiopia to attract FDI since the intention of the law is to avoid possibilities of tax avoidance and is not to improperly levy tax on non-resident enterprises.

Here also similar to the artificial avoidance of PE through Commissionaire arrangements, the problem is that almost all of Ethiopia‘s tax treaties included the lists of exceptions; e.g. China (Art 5(4)), Turkey (Art 5(4)), UK (Art 5(5)), Netherland (Art 5(7)), Ireland (Art 5(4)), Singapore (Art 5(4)), UAE (Art 5(4)), Kuwait (Art 5(4)), etc. this situation renders the exclusion under ITP meaningless and opens the room for the artificial avoidance of PE. Thus, to ensure the optimal effectiveness the exclusion of the lists of exceptions, it should have to be backed up through DTAs reforms; through the re-negotiation of older treaties, or the signing of additional protocols.

### 3.4. Concerning Artificial Avoidance of PE status through Splitting-up of Contracts

As demonstrated in the previous chapter, artificial avoidance of PE status through splitting up of contracts is also another means used by the MNEs to circumvent the existing PE status. Just like OECD and UN MCs, Art 4(3) of ITP 979/2016 also provides that “A building site, or a construction, assembly, or installation project, or supervisory activities connected with such site or project shall be PE only when the site or project or activities continue for more 183 days.”[207] The same holds for the *services PE*, as Article 4(2(c) of the same, provides that the furnishing of services, including consultancy services, by a person, including through employees or other personnel engaged by the person for such purpose, but only when activities of that nature continue for the same or connected project for a period or periods aggregating more than one hundred eighty-three days in any one year period.[208] Here the major challenge that creates the possibility for artificial avoidance of PE through splitting up of contract relates to the

[206] OECD BEPS*, Action 7 - 2015 Final Report*, p. 9.
[207] Income Tax Proclamation No.979/2016*,* Art.4(3).
[208] Income Tax Proclamation No.979/2016, Art. 4 (2) (c).

determination of 183 days-of-work threshold. To obviate the possibility of artificial avoidance of PE status through splitting up of contract, Art 4(2(c) of ITP 979/2016 and Art 4 of ITR 410/2017, provided for the "*the same or connected project*" and "*related person*" tests.

To this end concerning *Service PE*, Art 4(1) of the ITR 410/2017 provides that in determining whether a person exceeds the 183-day period specified in Art 4(2)(c) of the ITP 979/2016, account shall be taken of a "*connected project*" of the person or of a "*related person*".[209] The same applies to the construction PE, as Art 4(2) of the same provides that when a person performs activities referred to in Art 4(3) of ITP 979/2016, any "*connected activities*" conducted by a "*related person*" shall be added to the period of time during which the first-mentioned person has performed activities for the purpose of determining whether the 183-day period is exceeded.[210] Accordingly, in determining time spent by the non-resident enterprise, the time test applies to each "*connected project*" of the enterprise or *any connected activities* conducted by a "*related person*". Thus connected projects or activities shall be regarded as a single unit, irrespective of the fact that the projects or activities are conducted by the enterprise itself or a related person. To illustrate this point through an example;

> ***X-Tigi*** *Company, a resident of China, is hired by* ***Medroc*** *Company to perform technical services in a mining operation in Ethiopia for a period of 8 months. In order to avoid an increase in the overall cost of the operation as a result of taxation,* ***Medroc*** *Company and* ***X Tigi*** *Company divided the said operation into two different contracts each lasting 4 months. The first contract is concluded with* ***X-Tigi*** *Company and the second contract is concluded with* ***Xian Company*** *a wholly owned subsidiary of* ***X-Tigi*** *Company and a resident of China. At the request of* ***Medroc*** *Company, which wanted to ensure that* ***X-Tigi*** *Company would be contractually liable for the performance of the two contracts, the contract provides that* ***X-Tigi*** *Company is jointly and severally liable with* ***Xian*** *Company for the performance of* ***Medroc*** *company's contractual obligations under the Xian-Medroc contract.*

In the above example, since *Xian Company* constitutes "*related person*" (as per the definition of '*related person*' provided under Art 4 of Federal Tax Administration Proclamation No.

[209] Income Tax Regulation No.410/2017, Art. 4(1).
[210] Income Tax Regulation No.410/2017, Art. 4(1).

983/2016) and participated on the *same project* that started by its owner *X-Tigi Company,* in determining time spent by the *X-Tigi Company,* the time test applies to each connected activities conducted by a *Xian Company* (i.e. related person). Thus Ethiopia's tax authority can automatically aggregate the duration spent in each contract both by the *Xian and X-Tigi Company* as both are related companies and participated in the same and connected project.

But the problem with this requirement of "*the same or connected project*" is it contributes towards making the PE threshold high, especially in light of globalization and electronic commerce which has made the remote provision of services possible.[211] Until the 2017 update, the UN MC also contained the words "*for the same or a connected project*". UN commentary notes that this wording was removed as the "project" limitation was easy to manipulate and created difficult interpretive issues and factual determinations for tax authorities, which in particular for developing countries like Ethiopia is an undesired administrative burden.[212] *Arnold* argues that "if the intention is that a non-resident be subjected to tax in the source state if it is found to be participating significantly in the economic life of the source state, then the days-of-work threshold should not be viewed on a "project-by-project basis".[213] To illustrate this point through an example;

> *XCO is a company resident of China. It specializes in Construction and consultancy Engineering. It entered into a contract with Niyala Company resident of Ethiopia for the construction of building. During the period present in Ethiopia, XCO also entered into another contract with Awash Company for the service of consultancy Engineering and with Mr. Z an individual, for the design of a building. XCO completed the building of Niyala Company within five months. It also completed its service with Awash Company within 60 days and the design of Mr. Z's building within 30 days. In general, XCO stayed in Ethiopia for 9 months and derived a profit of 100 million Birr from the project.*

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that under the Ethiopian tax law PE definition, XCO will not be found to have created a PE. Because all the projects are completed below 183 days, thus do not meet the

[211] Arnold, B.J. (2018). *The taxation of income from services under tax treaties: cleaning up the mess*. Bulletin for International Taxation. 65(2), 1–29. Available: IBFD. p.12.
[212] Commentary on Article 5 para. 12 UNMC
[213] Arnold, B.J., (2018) p.12.

days-of-work threshold as they are not the *same or connected project*. This result shows that the "*same project or connected projects*" requirement imposes an unjustified limitation on Ethiopia's taxing rights, because as long as XCO worked in Ethiopia for more than 183 days, the degree of XCO involvement in the commercial life of Ethiopia is the same, regardless of the number of projects involved and clearly justifies Ethiopia's taxing the income from those activities, whether they are provided for one project or multiple projects. There is no reasonable justification of why non-resident MNEs that may be present in Ethiopia rendering services/working on the construction, on multiple projects and deriving significant profits from Ethiopia, should not be subjected to tax merely because those projects were, individually, undertaken for a period of less than 183 days in a twelve-month period.[214]

Thus, the inclusion of the "*same or connected projects*" requirement reduces the effectiveness of the services and construction PE and makes this threshold even more unattainable. Had this requirement was meant to be used only for the determination of days-of-work concerning activities performed by the *related person* it would be an effective remedy for fighting artificial avoidance of PE status through splitting contracts up into several parts between related enterprises, as it would not be reasonable to take into account unrelated or unconnected activities performed by a related person for the determination of days-of-work threshold.

Therefore, the researcher contends that, a non-resident enterprise's operation in Ethiopia should be viewed as a whole and not merely on an individual project level. In this regard, it is recommended that Ethiopia should adopt UN standards.[215] Which provides days-of-work shall be determined by aggregating the periods during which activities (whether connected or not) are carried on by the non-resident enterprise or any connected activities conducted by a related person.[216] In other words, while determining the days-of-work threshold the overall activity (not on an activity by activity basis) of the non-resident company or any connected activities conducted by a related person in Ethiopia should be taken into consideration.

The failure of ITP as well as ITR to define what constitutes the "*same or connected project*" exacerbates the problem of artificial avoidance of PE status. Technical Note on ITP 979/2016

[214] Arnold, B.J., (2018). p.12.
[215] UN MTC Commentary on Article 5, para. 15.
[216] UN MTC Commentary on Article 5, para. 12.

provides guidance for the determination of the '*same or connected project or activities*'. It notes that the determination of whether projects are connected should be considered from the perspective of both the service provider and their customer.[217] It provides the following guidance (which is directly copied from OECD)[218] for the determination of the same or connected project or activities.

1 whether the projects are covered by a single master contract
2 whether the projects would have been undertaken under a single contract in the absence of tax consideration
3 whether the contracts covering the different projects were concluded with the same customer or an associate of the customer
4 whether the conclusion of additional contracts with a customer is a logical consequence of a previous contract concluded with that customer or an associate of the customer
5 whether the nature of services provided under the different projects is the same or similar
6 whether the same individuals are performing the services under the different projects

However given the non-binding nature of the Technical Note and the underlying importance of the definition of the terminology, the lack of definition, could be an impediment for the proper implementation of this anti-avoidance measure, while at the same time opening the room for artificial avoidance of PE status. Even Technical Note on ITP 979/2016 notes that the ITR may provide guidance on the meaning of "*connected project*". In the absence of any definition, the success of these anti-avoidance measures is dependent on Ethiopia's tax authorities' capacity in terms of administrative resources and expertise necessary for detecting tax avoidance practices. The lack of definition also leads to the usage of subjective test criteria by the tax authorities for the determination of the same or connected project or activities. The subjective criterion on other hand undermines the degree of certainty in the taxation system of the country by enabling tax authority to deem PE situations for non-resident enterprises in an unpredictable way. This also opens the ground for the many controversial discussions between the tax authority and foreign non-resident enterprises. This in turn leads to increased administrative costs which are totally not feasible for Ethiopia's tax authorities.

[217] Technical Note- Income Tax Proclamation No. 979-2016, p. 25.
[218] OECD BEPS, (2015), Action 7, Final Report, P. 43-44.

The strong side of this sub-provision is that it does not contain exception provision to exclude temporary discontinuations of the project due to reasons beyond the control of non-residents while determining the total time period i.e. 183 days-of-work threshold. As the time period threshold requirement is easy to manipulate, non-inclusion of such exception is important to avoid any possibility of abusive exploitation of such exception through aggressive tax avoidance strategies. Accordingly in the Ethiopia context, the project term will not be considered to cease when work is temporarily discontinued, even due to factors or abnormal circumstances beyond the control of an enterprise, such as seasonal factors, (bad weather), natural disaster (floods, earthquakes), economic crisis (currency or monetary crisis), political crisis, (instability), industrial disputes (strikes, third party agencies problems), shortage of material or labor difficulties and others. Thus, temporary interruptions shall not be taken into consideration while determining the life of the project.

Some writers argue that this rule leads to unfair taxation standards in the source state due to circumstances that occur outside the control of an enterprise.[219] This writer contends that the exception should not be included for several reasons. **First**, the introduction of exceptional provision broadens the PE concept and would evoke further difficulties and complexities, such as how to draw the line between events that are tenable to the exception and those which are not. **Secondly**, the introduction of a new exceptional provision would result in the abusive exploitation of exceptions through aggressive tax avoidance strategies.[220]

**Thirdly**, the PE concept was introduced primarily for the purpose of sharing of taxation revenue between contracting states, based on the principle of international equity in that it provided a reasonable compromise between the interests of contracting states. Hence, the source state taxes the profits of non-resident enterprise only if the enterprise maintains a PE in it and vice versa; in either of case, an enterprise bears tax liability.

Accordingly, (one), if a non-resident enterprise recorded a loss due to whatsoever factors, it will be required to file a tax return in the source state, but this does not mean it will actually pay a tax, merely due to the fact that PE has existed. It is surely axiomatic that, in this case, a non-

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[219] Kelleher, C. (2012): *Problems with Permanent Establishments*, available at http://www.ttn-taxation.net/pdfs/prizes/CormacKelleherEssay.pdf (visited on 9/11/2021), PP. 3.
[220] Commentary on art. 5 para. 18. See also OECD *BEPS Action 7 - 2015 Final Report*, p. 9.

resident enterprise can claim tax loss credit, from the host state. But (two), if it has made profit irrespective of interruption of the work, its tax liability through PE to the source state is from the income it earned, after the deductions and allowances adjustments. Thus, the writer argues that here nothing leads to unfair taxation in the source state due to the existence of PE, since the source state levied a tax on the income of a non-resident enterprise. However, (three) if exceptional provision is introduced to cover the occurrence of abnormal circumstances; as long as the non-resident enterprise has made a gain, irrespective of interruption of the work, it will still be liable to the taxation, (in the absence of other facts and circumstances showing otherwise) for the home state through its residency status. The introduction of a new exceptional provision, therefore, simply facilitates a transfer of tax revenue from the source state to the residence state. Thus it will, or at least may, in practice lead to a reduction of source state taxing rights.

### 3.5. Problems Related With the Lack of Definition of Important Terminologies.

Besides, of failure of Ethiopian tax law to define what constitutes "*same or connected project*" it also failed to define "elements of the definition of fixed place PE concept" in particular, "*fixed place of business" and "effective place of management* and *place of management",* which are the important point in determining whether a non-resident's activities in Ethiopia are sufficient to create a PE. For e.g. pursuant to article 4(2) (a) of ITP 979/16, "*place of management''* is one element to determine whether the non-resident enterprise has a PE status or not. At the same time, article 5(5) (b) of ITP 979/2016 provides an "*effective place of management*" as a requirement in determining whether a certain body is resident or not. Here, the without clear legal definition it would be difficult to distinguish between the place of management and effective place of management. This concern has also been appraised by the Federal Ministry of Revenue; the circular no. 10/107/12 issued by the Federal Ministry of Revenue elaborates on the definition of the concept of the PE and its constituents. The circular defines the *place of effective management*, -based on relevant facts and circumstances each case- as the place where *key management and principal business decisions* that are necessary for the operation of enterprises are made by most *senior* management body of an enterprise.[221] The circular also provides that, places used by the enterprises for ordinary business management and commercial decisions shall

[221] Ministry of Revenue Circular, No. 10/107/12, PP. 3.

not constitute the *effective place of management*.[222] Thus, the circular uses subjective criterion of "*key management and principal business decisions making by the senior management body of the enterprise"* as a test to distinguish *effective place of management* from *place of management*.[223] However, since most of time the circulars have limited accessibility and also available only in Amharic language, it would be better to include this kind clarification within main legislations such as regulations or at least in directives.

Since the concept of PE is one of the most complex and challenging concepts that tax authorities and taxpayers face.[224] It still leads to different interpretations among countries and subsequently continues to cause confusion in treaty interpretation. Thus, lacks of definition of important terminologies, such as the *same or connected project/activities, place of management and effective place of management, and fixed place of business, others* within main legal documents would inevitably create a certain sort of confusion in determining whether a given activity by non-residents would give rise to the creation of PE or not. This is the reason why multi-national Model Conventions such as UN and OECD MCs provide a detailed clarification of the each of the 'elements of the definition of PE' through their commentary.

The absence of the same under Ethiopian law leads to the usage of subjective test criteria by the tax authority while at the time decreasing the degree of certainty in the taxation system of the country by enabling tax authority to deem PE situations for non-resident enterprises in an unpredictable way. This also opens the ground for the many controversial discussions between the tax authority and foreign non-resident enterprises. This in turn leads to increased administrative costs, which is totally not feasible for Ethiopia's tax authorities while at the time exacerbating artificial avoidance of PE. Therefore, having improved, clearer and more updated working definition, is vital to help taxpayers to determine if they will have a taxable presence, as well as to enable tax authorities to determine taxable presence of non-resident enterprise and fight artificial avoidance of PE status.

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[222] Ministry of Revenue Circular, No. 10/107/12, PP. 3.
[223] Ministry of Revenue Circular, No. 10/107/12, PP. 3-5.
[224] R. Glenn H. (2014) '*Transfer Pricing and Defining the Most Challenging BEPSs Action Items*. pp. 124.

### 3.6. Problems Related with Taxation of Insurance Business

As demonstrated in the chapter two UN MC in its Art 5(6) provided for the contextualised definition of an insurance PE.[225] However, Ethiopia's ITP contains no such provision and therefore reflects the OECD model's approach.[226] This means, a non-resident insurance company will have PE in Ethiopia, if it has a fixed place of business within the meaning of Article 4(1) or if it carries on business through an agent within the meaning of Article 4(4) of ITP. Nonetheless, pursuant to Art 51 of ITP a non-resident insurance company that does not have PE through the operation of Art 4 of ITP, will still be subject to taxation; Art 51 of ITP 979/2016 provides that a non-resident insurance enterprise carried on business (other than through PE) in Ethiopia and has derived an Ethiopian source insurance premium shall be liable for non-resident tax at the rate of 5% of the gross amount of the premium. In addition, Art 63 of ITP 979/2016 provides that a person who derives any income that is not taxable under other Art of ITP 979/2016 shall be liable for income tax at the rate of 15% on the gross amount of the income. From this, it's imperative to conclude that as long as the person has derived an Ethiopian source income he shall be liable for income tax under any circumstances.

But, when it comes to international taxation, DTAs provides for the taxation of enterprises only through PE, while exempting incomes derived by non-residents without having PE from taxation under source jurisdiction. For e.g. Ethiopia's DTAs with the UK, China, India, and Turkey, similarly provides under Art 7 of respective agreements that, "the profits of an enterprise of a Contracting State shall be taxable only in that State (residence state) unless the enterprise carries on business in the other Contracting State (source state) through a PE situated therein and only to the extent that the profits are attributable to the PE".[227] On point of this, Art 48 of ITP 979/2016 also provides that if there is any conflict between the terms of a tax treaty having a legal effect in Ethiopia and the ITP 979/2016 (except Art 48(3) & part Eight of ITP 979/2016) the tax treaty shall prevail over the provisions of ITP.[228] Therefore, there is less possibility to apply Art 51 of ITP 979/2016 for non-resident insurance enterprises that do not have PE, which would open the

[225] Article 5(6) of UN MTC
[226] However some Ethiopia's tax treaties included corresponding provisions; such as India (Art 5(6)), Singapore (Art 5(6)), UAE (Art 5(7)), and UK (Art 5(7)).
[227] See Article 7 of Ethiopia's DTAs with UK signed on 9 June 2011, China signed on 14th May 2009, India signed on the 25th May, 2011, and signed on 2nd March 2005.
[228] Income Tax Proclamation No.979/2016, Art. 48.

room for the artificial avoidance of PE. Thus, having contextualized specific provision for insurance like UN MC provides additional grounds for the taxation of insurance business in case the non-resident insurance company does not have PE through the fixed place of business or dependent agent threshold. And also it would be helpful to prevent some typical tax avoidance strategies of selling insurance in a source state without having a PE. Therefore, taking into account the above difficulties and unique nature of the insurance business it would be advisable to incorporate a unique provision to the definition of PE under Ethiopian tax law, to cater to the peculiarities of the insurance business.

### 3.7. Problems Related with the Taxation of Service Business

Although the service PE provision has been dealt with in Art 4(2(c) of ITP, the current PE threshold under ITP is not always compatible to properly establish the taxable presence of service business due to unique nature of this business model. Globalization and the advent of electronic commerce have made it possible for the provision of services in a source country even without the physical presence, i.e. without creating a direct tax liability in the source country.[229] Even in the case of physical presence, the provision of service could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise. To illustrate this point through an example, for instance,

> *X-Company resident of Turkey is engaged in a major project to provide consultancy services in Ethiopia and sends its employees to Ethiopia to provide consultancy services for a company resident in Ethiopia. X-Company's employees are only physically present in Ethiopia intermittently, for a period of 90 days spread over twelve months. During the period present in Ethiopia, X Company's employees worked at different locations and for different persons, and have derived a profit of 200 million Birrs from the project.*

Under the ITP service PE definition, which provides 183 days period (article 4(2(c)) X-Company will not be found to have created a PE in Ethiopia and will therefore escape tax in Ethiopia. This would be the case although the non-resident enterprise derived a huge profit from Ethiopia from rendering the consultancy services. This resulting increase in direct cross-border business

[229] Wichmann, M., (2018). p. 201-204.

activities without creating a direct tax liability raises the question over appropriateness of PE threshold for taxation service business models in the source country.[230]

To obviate this possibility, the researchers like Arnold (2018) proposes that consideration be given to reducing the days-of-work threshold under the services PE provisions to 90 or 120 days in the DTAAs.[231] Certain countries take cognizance of this fact and have lowered the threshold for a services PE in their DTAs to 90-days within twelve months.[232] However, the researcher contends that even this lowered threshold is still not always compatible to properly establish the taxable presence of service business taking into account the manner in which services are provided in this modern age. Globalization and electronic commerce have made the remote provision of services possible. It has therefore become relatively easy for a non-resident enterprise to render services without being present in Ethiopia for substantial periods and thereby avoid being subjected to income tax in Ethiopia on the service income derived.[233] Moreover, from a policy perspective, if a non-resident enterprise carried on business in Ethiopia and made substantial profits, its profit-making clearly establishes the substantial degree of its involvement in the commercial life of Ethiopia, irrespective of the period of time it spent to carry on business, and this clearly justifies Ethiopia's taxing the income from those activities.[234] That's why some countries totally avoided days-of-work threshold under the services PE provisions.[235]

Alternatively, this researcher proposes negotiating withholding tax for services projects in the DTAs. Withholding tax for the technical service fee has already been provided under article 51 of ITP 979/2016, which provides that, a non-resident carried on business (other than through PE) in Ethiopia and has derived an Ethiopian source technical fee shall be liable for non-resident tax at the rate of 15% of the gross amount of the fee.[236] Art 89 of ITP 979/2016 requires the person making payment of a technical fee to withhold tax from the gross amount paid. Article 2 (23) of

[230] Wichmann, M. (2018). The taxation of services: *is the permanent establishment the appropriate threshold*? *Bulletin for International Taxation*. 58(5), pp. 201-204. Available: IBFD.
[231] Arnold, B.J., (2018). p. 24.
[232] See for example South Africa's double tax treaties with Lesotho (Art 5(3(b)) June 2016), Swaziland (Art 5(2(h)) June 2005), Oman (Art 5(3(b)) January 2004); and India's Double tax treaty with Canada (Art 5(2(i)) August 1997), USA (Art 5(2(i)) January 1991), and UK (Art 5(2(k)) October 1993).
[233] Wichmann, M., (2018). p. 201-204.
[234] UN MTC Commentary on Article 5, para. 10.
[235] see for example Art. 5(4) of UK/Kenya Double Tax Treaty September 1977.
[236] Income Tax Proclamation No.979/2016, Art. 51.

ITP 979/2016 defines technical Fee, as a fee for technical, professional, or consultancy services, including a fee for the provision of services of technical or other personnel.[237]

However, except for the technical service, this provision does not apply to the other forms of service business. This researcher proposes this provision needs to be broadened to encompass all forms of service business. Be that as the case may, the application of this withholding tax was subject to the application of the relevant double tax treaties, which provides that, the profits of an enterprise of a contracting state shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein and only to the extent that the profits are attributable to the PE.[238] This means Ethiopia can only tax service fees to the extent that they are derived by a non-resident from a source in Ethiopia and attributable to the non-resident's PE situated in Ethiopia. To operate within the existing international tax regime, the withholding approach seeks to modify the application of the PE principle to allow source and residence countries to share the service income generated by the non-resident. Therefore the optimal effectiveness of this withholding tax regime will have to be backed up through DTAs reforms, through the re-negotiation of older treaties, or the signing of additional protocols. Regarding the rate to be applied, since withholding taxes is usually levied on a gross basis, it should be noted that efforts should be made to ensure a balanced approach that does not stifle foreign investment and at the same time preserves Ethiopia's tax base.

[237] Income Tax Proclamation No.979/2016, Art. 2(23).
[238] Article 7 of Ethiopia's double tax treaties with, UK signed 20th May 2011, China signed on 14th May 2009, India signed on the 25th May, 2011, and Turkey signed on 2nd March 2005.

# CHAPTER FOUR

# CONCLUSION AND RECOMENDATION

## 4.1. CONCLUSION

Although the characterization of PE is one of the most difficult and complex issues in international business taxation, there is a compelling need to clarify and ensure certainty in the PE concept and its requirements. Clarity and certainty are vital, on the one hand, to help taxpayers worldwide determine if they will have a taxable presence and on the other hand to protect the state's tax base and ensure adequate distribution of taxing rights between the residence country and the source country. The findings of this study have demonstrated that both ITP and ITR contains no definition of the important terminologies, which are necessary for determining whether a non-resident's activities in Ethiopia are sufficient to create a PE. In particular, Ethiopia's tax law does not define what constitutes "same or connected project", "related persons", as well as the "elements of the definition of PE concept". The lack of definition these terminologies, leads to the usage of subjective test criteria by the tax authorities to determine the status of the non-resident enterprises, while at the same time leading to artificial avoidance of PE. The subjective criterion also undermines the principle of certainty in the taxation system of the country by enabling tax authorities to deem PE situations for non-resident enterprises in an unpredictable way. It also opens the ground for the many controversial discussions between the tax authority and foreign non-resident enterprises. This, in turn, leads to increased administrative costs which are undesirable effects for the developing country like Ethiopia. Moreover "the same or connected project" requirement that has been adopted in the ITP and ITR, to address artificial avoidance of PE through splitting-up of contracts contributes towards making the Project and Service PE threshold high. On point of this, the current Ethiopia's service PE threshold is not always compatible to properly establish the taxable presence of service business due to the unique nature of this business model. This exacerbates the problem of artificial avoidance of PE status. Besides, Ethiopia's ITP, as well as ITR, contains no contextualised specific provision on the insurance PE which would also open the room for the artificial avoidance of PE.

## 4.2. RECOMMENDATION

### 4.3.1. Revamping the Definition of Important Terminologies

As demonstrated in chapter three Ethiopia's tax law does not define what constitutes "*same or connected project*", as well as the "elements of the definition of PE concept". The definitions of these terminologies are so important in determining whether a non-resident's activities in Ethiopia are sufficient to create a PE.

I. **For "the same or connected project":-** The new sub-article three (3) need to be added to Article 4 of ITR as provided below:

*The determination of whether projects are connected or the same depends on all the facts and circumstances, including consideration of the following:*

1) *Whether the projects are covered by a single master contract.*
2) *Whether the projects would have been undertaken under a single contract in the absence tax considerations.*
3) *Whether the contracts covering the different projects were concluded with the same customer or an associate of the customer.*
4) *Whether the conclusion of additional contracts with a customer is a logical consequence of a previous contract concluded with that customer or an associate of the customer.*
5) *Whether the nature of the services provided under the different projects is the same or similar.*
6) *Whether the same individuals are performing the services under the different projects.*

II. **For the Definition of *place of management and place of effective management***:- The new sub-article need to be added to Article 2 of ITP as provided below:

1. *"Place of effective management" shall mean based on relevant facts and circumstances each case, the place where the most senior person or group of persons makes the key management and commercial decisions necessary for the conduct of the company's business.*

2. *"Place of management" shall mean based on relevant facts and circumstances each case, the place where the day-to-day responsibility for the management of the company or entity and its direct and indirect subsidiaries is exercised.*

**III. For the "elements of the definition of fixed place PE concept":-** The new sub-article need to be added to Article 4 of ITR as provided below:

1. *The term "fixed place of business" shall mean based on relevant facts and circumstances of each case, any location, space, premises, facilities, or installations with a certain degree of permanency, used for carrying on the business of person whether or not they are owned, rented or used exclusively for that purpose.*

2. *The phrase "carried on through" shall mean, based on relevant facts and circumstances of each case, the existence of a specific kind of connection or precise link between the place of business and the business activity of non-resident person.*

In addition to above, given bulky nature of the definitions it would be better that Ethiopia has to provide the detail definitions of "elements of the definition PE" in the separate Commentary on the ITP or Technical Note on the ITP. Although such kinds of definitions are not binding in their nature they manifest the understanding of the Ethiopian government on the matter and have persuasive value in the eyes of the party. It also serves as baseline information for the tax authorities and minimizes controversial discussion between tax authority and the tax payer, which ultimately minimize administrative cost and increase certainty and predictability in the taxation system of the country.

### 4.3.2. Adopting Contextualized Standard for the Determination of 183 Days Threshold in Case of Project and Service PE

As discussed in chapter three "**the same or connected project**" requirement which has been recommended by the OECD Action Plan and also adopted in the Article 4(2(c) of ITP 979/2016 and Article 4 of ITR 410/2017 to curb artificial avoidance of PE through splitting-up of contracts contributes towards making the Project and Service PE threshold high. Therefore Art 4(2(c) of ITP 979/2016 and Art 4of ITR 410/2017 need to be amended as provided below;

Article 4(2(c) of ITP 979/2026;

> *The furnishing of services, including consultancy services, by a person, including through employees or other personnel engaged by the person for such purpose, but only when activities of that nature continue for a period or periods aggregating more than one hundred eighty-three days in any one year period.*

Article 4 of ITR 410/2017;

1. *In determining whether a person exceeds the 183 day period specified in Article 4(2)(c) of the Proclamation, account shall be taken of the overall activity of the person or any connected activities of a related person.*

2. *In determining whether a person exceeds the 183 day period specified in Article 4(3) of the Proclamation, account shall be taken of the overall activity of a person who operated the building site or conducted the project or activities referred to in Article 4(3) of the Proclamation or any connected activities conducted by a related person.*

As we can see here the "*same or connected activity*" requirement will be used only for the activities performed by the related person. This is specifically important to address the problem of the artificial avoidance of PE through splitting up of the contract between related enterprises. This means the connected projects or activities will be regarded as a single unit, irrespective of the fact that the projects or activities conducted by another enterprise provided that such other enterprise is a related enterprise.

### 4.3.3. Adopting UN Standard for the Taxation of Insurance Business

As discussed in chapter three, Ethiopia's PE threshold contains no contextualized specific provision for the taxation of insurance business. Accordingly, the new sub-article six (6) need to be added to Article 4 of ITP as provided below:

> *Notwithstanding the preceding provisions of this Article, an insurance enterprise shall, except concerning re-insurance, be deemed to have a permanent establishment in the Ethiopia if it collects premiums in the territory of Ethiopia or insures risks situated Ethiopia through a person.*

Here unlike UN MC the status of the person through whom the non-resident insurance enterprises carry on business is irrelevant. And also there is no requirement of negotiation or conclusion of contracts by such agent on behalf insurance enterprise.

#### 4.3.4. Reducing PE Threshold or Imposing Withholding tax for the Taxation of Service Business

The current Ethiopia's PE threshold is not always compatible to properly establish the taxable presence of service business due to unique nature of this business model. Thus, the researcher proposes reducing PE threshold or negotiating withholding tax for services business in the DTAs.

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# 6. ANNEXS

## 1. List of Interviewed Tax Experts

- **M/ro Mekia Mohammed,** Senior Officer of Federal Revenue Authority Office, an interview made on 20 September 2021, from 11:00 – 12:00 Am, held at Federal Revenue Authority Head Office, A/A.

- **W/ro Aselefech Kebede,** Senior Officer of Federal Revenue Authority Office, Research and Education Unit, an interview made on 20 September 2021, from 10:30 – 11:30 Am, held at Federal Revenue Authority Head Office, A/A.

- **Ato Zeleke Janbo Alemu,** Senior Legal Officer of Legal Service Directorate at Large Taxpayers Branch Office, an interview made on 23 September 2021, from 2:00 – 3:00 Pm, held at Large Tax Payers Office.

- **Ato Bochu Sentayehu**, Senior Legal Expert at MoFED and Drafting Committee Member of ITP 979/2016 and ITR 410/2017; an interview made on 23 September 2021, from 11:30 – 12:00 Am, held at MoFED Office.

- **W/ro Serkalem Eneyehu Amare,** Federal tax Appeal Commission Judge and Drafting Committee Member of ITP 979/2016 and ITR 410/2017; an interview made on 24 September 2021, from 9:30 – 10:30 Am, held at Federal tax Appeal Commission Office.

- **Ato Zinabu Tadesse,** Federal tax Appeal Commission Judge and Drafting Committee Member of ITP 979/2016 and ITR 410/2017; an interview made on 24 September 2021, from 10:30 – 11:30 Am, held at Federal tax Appeal Commission Office.

- **Ato Belay Boshe,** Federal tax Appeal Commission Judge and Drafting Committee Member of ITP 979/2016 and ITR 410/2017; an interview made on 23 September 2021, from 9:30 – 10:30 Am, held at Federal tax Appeal Commission Office.

- **W/ro Fasika Tamirat,** Federal tax Appeal Commission assistant Judge; an interview made on 24 September 2021, from 11:30 – 12:00 Am, held at Federal tax Appeal Commission Office.