

## Kuwait Tax Authorities adopt "Virtual Service PE" concept

### Executive summary

Kuwait's Department of Inspections and Tax Claims (DIT) has changed its approach to the interpretation of the Permanent Establishment (PE) concept with respect to services rendered by nonresidents in Kuwait. The DIT has introduced the concept of a "Virtual Service PE," which may result in the denial of income tax relief claimed by nonresidents under the applicable double tax treaties of Kuwait.

### Detailed discussion

The DIT's new approach is not in line with the PE concept outlined in the double tax treaties concluded by Kuwait, in accordance with the Organisation for Economic Co-operation and Development's (OECD) Model Convention. The DIT's interpretation of a "Virtual Service PE" is likely to affect many multinational enterprises which have concluded or plan to conclude service arrangements with customers in Kuwait. Taxpayers should carefully consider the matter in advance, taking into account the wordings of tax indemnity clauses and other provisions of their service agreements.

### Interpretation

Although the new approach adopted by the DIT has not been officially announced, in several recent cases, the DIT has denied use of the OECD interpretation of PE clauses in double tax treaties, and subjected nonresident companies to domestic taxation on the basis of the "Virtual Service PE" concept.

The Virtual Service PE concept takes into account only the duration of the contract itself, rather than the actual activities of the service provider in Kuwait. The DIT takes the position that a nonresident is deemed to have a PE in Kuwait, particularly, if the following conditions are met:

- ▶ A nonresident furnishes services to an entity in connection with the latter's activity in Kuwait.
- ▶ The period during which such services are rendered according to the contract, exceeds the threshold period under the applicable tax treaty.

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The DIT's approach does not consider the physical presence of employees or contractors of a nonresident service provider for establishing the nexus to the source country, although such a threshold condition is clearly provided by both the OECD and UN Model Conventions, and applied in many countries. Consequently, any work or services performed under cross-border agreements, concluded by a customer in Kuwait with a nonresident for a period longer than the tax treaty threshold (e.g., 183 days) will, prima facie, create a Service PE in Kuwait. This will be created even if employees of the former are not present in Kuwait and perform their activities entirely offshore.

## Implications

The immediate implication of the DIT's current approach to a "Virtual Service PE" is that the applicability of tax treaty-based income tax exemptions with respect to cross-border services has become highly uncertain.

It is questionable whether the new approach represents a type of "treaty override" through a unilateral interpretation of tax treaty terms. The majority of the double tax treaties of Kuwait contain a Service PE provision: a PE is deemed to exist if a service provider furnishes services in a source state for a period or periods aggregating more than the threshold period under the applicable tax treaty.

Under the literal interpretation of the provision, the physical presence of the service provider in Kuwait is required. However, under the new interpretation adopted by the DIT, actual physical presence is ignored, effectively removing the required PE threshold for the projects under consideration.

In practice, the customary contractual legal remedies that could protect the financial interests of foreign suppliers of services may need to be considered. These include tax indemnity (gross-up) clauses and other provisions. Such provisions have become increasingly important in the context of the recent changes in tax practices in Kuwait.

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