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Taxation of Engineering, Procurement, and Construction Contracts

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Editorial
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Working in the field of uncertainty

Dear Reader:

In times of change, the following presentation of the tax treatment of engineering, procurement and construction projects can only be a snap-shot of the present legal situation in the respective countries and will provide a first guidance only for your daily work.

Though it covers a very important field of international taxation, the overall legal situation is characterized by a high degree of uncertainty. This is true on the one hand because ever since, there has been a considerable variation in the domestic laws of the countries and there has also been a lack of consensus amongst them as to the correct interpretation of art. 7 of the Double Taxation Conventions (DTC)[1]. On the other hand, the implementation of the Authorized OECD Approach (AOA) and the OECD initiative against business erosion and profit shifting (BEPS) ushers in a completely new era particularly when it deals with the taxation of the aforementioned activities.

The AOA clearly provides a significant difference in the interpretation of art.7 DTC in comparison to the OECD Model Commentary before the year 2010. The new approach shows an almost unrestricted independence for the permanent establishment (PE). The determination of profits now requires the attribution of assets and risks, based on significant people functions and the identification of respective "dealings" between the PE and its headquarter. Nevertheless, we have to bear in mind, that existing DTCs and domestic laws in force are still following the old model. In the event that jurisdictions adopt the AOA, there would be a need for changing the domestic law in order to ensure that domestic law is in line with the correct application of the DTCs. This will take some time. The following reports show that we are on the verge of the transition period from the pre-AOA era to the new system. Several countries have already implemented the AOA, others are about to do so, whereas not only a few will stay explicitly with the old system.

The complexity of this legal situation will be aggravated now by the BEPS initiative, especially its action 7, Preventing the Artificial Avoidance of Permanent Establishment Status. The definition of the term PE in Art. 5 OECD Model Treaty has been unchanged since 1977 and is still the standard definition of most DTCs in force. Now BEPS provides an extended definition. As a consequence, there will be more opportunities for the State of source to tax engineering, procurement and construction projects. More unintended PEs will be created and that generates more controversies about its qualification between the treaty partner states. The conflicting application and interpretation of the DTCs ends up with more double taxation. In order to avoid the double taxation, more competent authority procedures and arbitration have to be executed. Finally, the administrative burden for the taxpayer as well as for the tax administration increases significantly.

In the light of the ongoing changes in the taxation of engineering, procurement and construction projects, it is essential to observe carefully the further developments to come from OECD and the domestic legislation of the countries. Contracts and its execution have to be structured in accordance with the present legal framework but simultaneously in consideration of foreseeable future legislation. This is true especially with regard to the creation or non creation of PEs. In addition to a thoroughly elaborated tax concept, the preparation of a detailed documentation is crucial. It has to meet the requirements stated by BEPS and the AOA respectively.

We are confident that this brochure provides some guidance in these times of change and uncertainty. Therefore, we thank our authors for their valuable contributions. For any criticism, question or remark, please do not hesitate to contact us, any of the local-country authors or our competent global service line IPC, the specialists in International Project Consulting.


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Dr. Maximilian Görl


Ralf Pestl

1 cf. Cahiers de Droit Fiscal International, Vol. 91b General Report p. 34

Taxation of Engineering, Procurement, and Construction Contracts in China

Nationally-Sourced Income

For the purpose of tax, China's corporate income tax (CIT) Law has distinguished resident enterprises ("residents") from non-resident enterprises ("non-residents").

A non-resident, which has an office or premises ("establishment") in China must pay CIT on its income derived from sources inside China as well as on income that, although derived from sources outside China, is effectively connected with such an "establishment". Chinese tax law does not provide for a minimum requirement period of such establishment.

An "establishment" refers to a presence in China engaging in production or business operations, including premises where construction, installation, assembly, repair or survey projects, etc. are carried out.

The double taxation treaty (DTT) between China and Germany (effective from 5 April 2016) specifies that only a building site, construction, assembly or installation project, and supervisory activities in connection with a site or project lasting for a period of more than 12 months will be treated as a PE ("construction PE").

Registration

When a non-resident contracts construction operation in China, it must register for taxation with the tax authority in the place where the project is located within 30 days of a project agreement ("contract") being concluded. If the due date of registration is missed, the relevant tax office is entitled to impose a penalty.

Taxation

The creation of a PE in China influences the nature and scope of taxation.

The income of a construction PE is subject to corporate income tax. Technically, the non-resident must set up accounting records for the PE project to record the China-sourced revenue and related expenses, and then calculate the profit as taxable income. However, due to the difficulty a non-resident has in setting up accounting records in China, the approach of deemed profit is adopted in practice. Generally, the deemed profit rate of a construction PE ranges from 15% to 30%.

Apart from CIT, the non-resident of the PE is also subject to indirect tax in China. Before 1 May, 2016, construction operation was subject to business tax (BT) at a rate of 3% in China. However, due to the value added tax (VAT) reform as of 1 May, 2016, the construction operation is now subject to VAT.

If the PE is deemed to be a general taxpayer, the VAT rate on the construction operation is 11% and the VAT rate on supervision work is 6%; its related input VAT can be credited against output VAT. If the PE is deemed as a small-scale taxpayer, a rate of 3% is levied and no input VAT can be credited.

In addition, due to the nature of the contract, stamp duty (SD) of 0.03% of the contract value is imposed on the non-resident.

Employees of the non-resident who provide on-site services in China for a construction PE, no matter how many days they are staying in China, are subject to individual income tax (IIT) in China on their employment income. The tax rate ranges from 3% to 45% depending on the amount of the employment income.

Outlook

In recent years, the Chinese tax authority has issued a number of regulations to strengthen taxation administration on non-residents. Detailed compliance requirements are provided for non-residents in respect of tax registration and filings. Non-residents are encouraged to file Chinese taxes based on actual rather than deemed profits, provided that accurate accounts are available, and the actual profits of the PE in China should be commensurate with its functions and risks. These efforts are aimed at alignment with international practices.

Undoubtedly, the Chinese tax authorities are paying more attention to PE issues and are pooling resources in enforcing PE taxation, as evidenced by the steep rise in PE cases. However, despite improvements in legislation, implementation still varies in practice.

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CROATIA
POSLOVNO SAVJETOVANJE TUK D.O.O.

The construction market in Croatia is characterised by a slow post-recession recovery. The general focus is on infrastructure and the energy industry, where emerging markets, such as Croatia, are most likely to grow. The construction industry is highly sensitive to economic trends, particularly disruptions, and to government investment in the field of civil engineering. Increasing foreign direct investment has led to increased construction activity, with an extremely high share of GDP before the recent crisis. Despite the slow recovery of the construction industry in Croatia, it is still a significant sector for the Croatian economy. Because many large investment projects (i.e. building sites, construction, assembly and installation projects) involve foreign investors and, consequently, foreign construction companies, possible permanent establishment (PE) taxation issues are described in the following text.

Nationally-Sourced Income

The provisions of art. 5 of the OECD Model Convention, which defines the term PE, have been incorporated into the Croatian General Tax Act and Corporate Income Tax Act. Both acts define a PE as a permanent place of business operations through which the business of a company is wholly or partly performed. A PE of a non-resident company includes, inter alia:

- a building site, or a construction or an assembly project, only if they last longer than six months.

The idea behind the definition is that a PE must have certain degree of presence and direct contact in Croatia in order to be taxed on its Croatian-sourced income. The stipulations of bilateral agreements, such as agreements for the avoidance of double taxation, prevail over regulations under local law. As a consequence, differing deadlines for creating construction PEs could be applicable. The Croatian double taxation treaties (DTTs) are in line with the OECD Model Convention.

Registration

A non-resident construction PE must register with the relevant tax authorities in Croatia upon commencement of its business activities in Croatia.

According to the Croatian Company Act, foreign entities are not allowed to perform permanent business operations in Croatia unless they register at least a branch office in Croatia. Whether certain activities constitute permanent business activities is assessed on a case-by-case basis. Therefore, the characteristics of the activities of PE in any given case are relevant in determining the degree of permanency and the potential requirement for commercial registration.

Taxation

Taxation of the Croatian-sourced income of a PE is in accordance with the Corporate Income Tax Act, taking into account the provisions of the respective DTT (if one has been concluded). The income of a construction PE is subject to corporate income tax, with the taxable base being the difference between revenue and expenditure. Withholding tax does not apply in this regard.

The following tax rules apply to a foreign entity's PE in Croatia:

- Only profit earned in Croatia, i.e. profit that can be attributed to the PE, is taxable.
- The transactions of a PE with a non-resident parent company must be based on the arm's length principle.
- Costs that can be deducted to determine the profit of a PE are those which enable the PE to achieve a certain benefit for itself regardless of the country in which the costs are occurred.

Outlook

The rules for taxation of foreign PEs in Croatia have long been incorporated in the local tax rules. In practice, guidelines on taxation are highly necessary, not merely to inform the taxpayers, but also to enable the tax authorities to have a unified approach nationwide.

Although Croatia is not an OECD member, it accepts the rules set up by this body. Considering the recent discussions on international taxation within the BEPS initiative, which will lead to amendments to the OECD Model Convention, it is expected that the Croatian tax authorities will work towards implementing the rules of the BEPS package.

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Construction and assembly works are the most frequent cases where a PE arises in the Czech Republic. According to the Czech Income Tax Act, a PE is created if the duration of works exceeds six months, whereas this period of time is 12 months in most double taxation treaties.

Nationally-Sourced Income

According to the Czech Income Tax Act, income of non-residents from sources in the Czech Republic includes, inter alia, income from activities carried out through a PE.

According to the Act, a PE means a place of business in the Czech Republic, for example a construction site. Sites, places of construction and assembly works carried out by a taxpayer, its employees or persons working for the taxpayer are considered to be a PE if their duration exceeds six month within any period of 12 consecutive calendar months.

Performance of installation or assembly work outside of the actual construction project (such as in an already completed and used building) is considered to be a service and is assessed from the perspective of the "services-related permanent establishment".

A PE is also indicated by a certain level of permanency at a place. As regards construction and assembly work, this is assumed in the case of "line construction" (such as a highway or a natural gas pipeline).

The duration condition is assessed for each construction site, construction or project in terms of their continuity. The time spent in the territory of the Czech Republic by the same supplier in connection with fully unrelated activities or contracts is not included in the duration of the contract concerned. If, however, a comprehensive construction is divided into several subcontracts or partial projects (such as the supply of manufacturing premises consisting of several buildings), this division has no impact on how the duration is calculated.

Cases where a foreign general contractor uses subcontractors to supply a building are also assessed in their entirety and the time spent by all contractors at the construction site is totalled up.

Renewals or repairs of motorways, buildings, bridges, etc. are covered by the definition of a construction site, construction or a construction and assembly project only if they go beyond mere maintenance, redecoration, etc.

Registration

A non-resident must register the PE with the tax office that has territorial jurisdiction. However, there is no automatic obligation to register the PE as a branch of the foreign entity in the commercial register.

Taxation

The income arising from activities carried out by the PE is subject to income tax. The current income tax rates applying to legal entities and natural persons are 19% and 15%, respectively. The income of a PE is not subject to withholding tax.

Under the Czech Income Tax Act, the tax base of a PE may not be lower than the tax base arising from the same or a similar activity carried out under similar conditions by a Czech resident.

The ratio of profit or loss to costs or gross income may also be used to determine the tax base provided that the taxpayers, their activities, the amount of the margin (commission) and other similar data are comparable. The method of allocating total profit or loss of the PE founder to its several parts is also applicable.

The taxation may also be agreed with the tax office. However, this is a non-standard procedure that many tax offices are not willing to accept.

Outlook

The Czech Republic has engaged in the OECD's BEPS initiative. It can be expected that its conclusions, along with debates about the OECD Model Convention, will have an effect on the interpretation of PEs. However, we do not currently know the specific impacts on PEs created due to construction and assembly projects.

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Taxation of Engineering, Procurement, and Construction Contracts in Germany

GERMANY
WTS STEUERBERATUNGS-GESELLSCHAFT MBH

The mechanical engineering and industrial plant construction sectors are the two largest sectors in Germany, employing more people than other sectors. As producers of investment goods, they are strongly export-oriented and around two-thirds of German production in this sector is exported. As a consequence, this sector is often faced with tax challenges in foreign jurisdictions, e.g. the creation of permanent establishments in the case of building sites, or construction, assembly and installation projects and their associated supervisory activities ("construction PE"). Therefore resident companies have gained a lot of experience with regard to tax issues abroad. The tax treatment of the inbound case is described below.

Nationally-Sourced Income

Domestic income is defined as business income arising from the operation of a PE in Germany. Construction PEs shall generally be created in case of building sites, or construction, assembly and installation projects, if

- the single building site, or construction, assembly and installation project, or
- several building sites, or construction, assembly and installation projects that are ongoing in parallel, or
- several consecutive building sites, or construction, assembly and installation projects, without interruptions

last longer than 6 months.

The stipulations of bilateral agreements, such as double taxation treaties (DTTs), prevail over regulations under local law. As a consequence, differing deadlines for creating construction PEs could be applicable. Basically, the German DTTs are in line with the OECD Model Convention.

Registration

Any construction PE of a non-resident has to be registered for taxation with the relevant tax authority in Germany. There is generally no requirement for non-residents to register their German construction PE commercially.

Taxation

The creation of a PE in Germany influences the nature and scope of taxation. The income of a construction PE is subject to corporate income tax of 15% plus 5.5% surcharge (15.83%) plus trade tax (on average 14%). Withholding tax (WHT) does not apply in this regard. Generally, taxable income is the actual profit calculated as the difference between the German-sourced revenue and the related expenses.

From a German perspective, the allocation of PE-related costs from the head office to the construction PE is just a cost allocation and, as such, not subject to any withholding tax. There is generally no limit regarding the deduction of PE-related overhead expenses emanating from the head office.

Nevertheless, as the authorized OECD approach (AOA) was already implemented in German law three years ago only two methods of determining the taxable income are applicable:

- PE with routine service function
- Complex PE

In the case of a construction PE with routine service function, the applicable method for determining income is a cost-oriented transfer pricing method (cost plus), while in the case of a complex PE, a profit allocation method (profit split) is applicable. From the point of view of a German tax authority, a complex construction PE is assumed only in exceptional cases. Therefore the cost plus method is the prevalent income determination method for construction PEs of non-residents in Germany. Details are specified in the Ordinance on income for permanent establishments (PE) / respective decrees.

Outlook

Due to the latest international developments, several discussions have been taking place on the creation of PEs in general. Action point 7 of the BEPS initiative is the subject of particularly controversial discussions in Germany. The implementation of the AOA is also subject to ongoing supervision, as there are high expectations that the German tax authorities will issue further practical guidelines. The outcome of these discussions might have further impacts on the definition and tax treatment of construction PEs in Germany. Further guidelines are expected no later than the end of 2016.

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Taxation of Engineering, Procurement, and Construction Contracts in Hungary

As Hungary is a member of the European Union, companies registered within the EU are allowed to participate in construction projects without establishing a formal presence in certain cases (Hungarian registered company or branch) in the country. This article describes the main Hungarian tax rules that apply to a foreign company's permanent establishment in Hungary.

Nationally-Sourced Income

The Hungarian Corporate Income Tax Act states that foreign companies are subject to paying tax on their income which is attributable to a Hungarian PE. The following types of activities may create a construction PE:

- → construction or assembly projects
- → supervisory activity relating to construction or assembly projects

The period for creating a PE is set at 3 months under domestic law. In cases where the foreign company is resident in a country with which Hungary has concluded a double taxation treaty (DTT), the provisions of the treaty prevail over the domestic law. Thus, in most cases, the period provided for in the respective treaties applies (mostly 12 months, but generally varies between 6 and 24 months).

The concept is based on the OECD regulation that if a company has more than one project, the respective building sites should be assessed separately from a PE perspective. However, sites which form one single unit from an economic, business and geographic point of view should be considered as one site.

Registration

A foreign company with a construction PE has to be registered in Hungary for tax purposes. The tax registration is similar to VAT registration, meaning that certain documents are needed for administration purposes e.g. an excerpt of the foreign company's company registration, specimen signatures of the representatives of the foreign company (a fiscal representative is needed if a non-EU company is to be registered in Hungary). In some cases, the construction activity exceeds the originally planned time schedule, meaning that the foreign company has to be registered retroactively and tax returns for the previous periods have to be submitted in a single corporate income tax return.

Taxation

The income of a construction PE is subject to corporate income tax and, in certain cases, to local business tax. Local business tax is not often among the tax types listed in the DTTs, which can lead to double taxation in the countries involved. The general rate is applicable to PEs, i.e. 10% up to a profit of HUF 500 million (approximately EUR 1.7 million) and 19% on amounts above that. Generally, taxable income is the actual profit calculated as the difference between the Hungarian-sourced revenue and the related expenses.

A Hungarian PE should make a year-end closing in accordance with the Hungarian Act on Accounting and calculate its own profit before tax similarly to a domestic Hungarian company. However, there is one specific rule that applies to PEs, which is the assessment of tax deductible overhead expenses, defined as follows:

1. Firstly, the total overhead costs of the whole company (head office and all the PEs combined) have to be assessed.
2. Then the PE has to calculate the ratio of its revenue to the total revenue of the whole company (head office and PEs).
3. As a final step, the proportional overhead costs have to be calculated by multiplying the total overhead costs (step 1.) by the ratio calculated in step 2 above.

Outlook

At this stage, there are no special Hungarian PE rules tailored to the BEPS initiatives. However, the Hungarian Act on Corporate Income Tax clearly provides rules on the application of transfer pricing (TP) measures, i.e. transactions have to be set taking into account the arms' lengths rule and TP documentation has to be prepared for transactions between the non-Hungarian head office and the Hungarian PE if the market value of the transaction is more than HUF 50 million (EUR 170,000) in a tax year.

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The Direct Taxation Act, the basis of which was established in 1967, has undergone many changes and alterations. The most recent change was passed by the parliament in July 2015 which became effective as of 21st March 2016 .

The Act deals with taxes on properties, agricultural activities, salaries, professions, corporations, incidental and inheritance taxes. It consists of 284 articles covering the above subjects and exemptions, depreciation rates and basis, duties of taxpayers and the Taxation Organization and the hierarchy of the taxation system.

What is next most important to the Act itself are the interpretations of the articles made by the Taxation Affairs Organization. These are what make the taxation system in Iran rather complex one and somewhat less predictable some of these directives and circulars are in contradiction of the Law.

Nationally sourced income

In general, every person, whether natural or a legal entity, is liable to tax on income earned in Iran. The applicability of tax extends to Iranians earning income from abroad, Iranians resident abroad but earning income in Iran, and foreign persons earning income in Iran or from Iran in connection with the granting of concessions and rights and the provision of training and technical assistance.

Registration

The Business Registration Act requires that all operations conducted in Iran must be undertaken by an entity registered in the country. Therefore, foreign entities should have been registered in Iran prior to the execution of any activity therein. This will usually result in the existence of a branch in Iran.

Taxation

The taxable income of foreign natural persons and legal entities earned in and/or from Iran for building and installation design, topography, drawing, supervision and technical computations, training and technical assistance, transfer of technology and other services and transfer of rights and licences AND transfer of movies and images as screening rights or under other titles IN Iran or FROM Iran, other than those incomes for which another manner of determination of the taxable portion is provided by the Act, are determined by the nature of the activity and its profitability and through the application of predetermined coefficients between 10% and 30% of the amounts received in any fiscal year. Based on a 25% standard corporate income tax rate, the effective tax rates will range from 2.5% to 7.5% on services, royalties and licences.

There is no definition of a "permanent establishment" in the Iranian Tax Code and although there are more than fifty double taxation treaties concluded with various countries, there is little respect and understanding of the provisions and the aims of the treaties by the Iranian Taxation Authorities including issues related to PE and attributable income.

The supply portion of all contractual operations by foreign persons is exempt from Iranian taxation. This is a welcome development as it does not distinguish between governmental and non-governmental Iranian customers/clients of foreign contractors.

Where all or part of the contractual activities of a foreign contractor is subcontracted to an Iranian legal entity, the imported and local materials procurement portion of the main contract purchased by the Iranian subcontractor shall also be exempt from income tax.

Outlook

With the new approach – as mentioned in the introduction - adopted by the authorities, and reflected in the new Act, it is hoped that there will be less ambiguity and complexity in the interpretations of the articles made by the Taxation Affairs Organization.

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Taxation of Engineering, Procurement, and Construction Contracts in Korea

Nationally-Sourced Income

A non-resident or foreign corporation with a place of business in Korea ("non-resident") is liable to file and pay income tax or corporation tax ("income tax") on the income attributed to the permanent establishment in Korea ("PE") similar to a resident or domestic corporation ("resident") (Article 124 of the Income Tax Act, Article 97(1) of the Corporate Tax Act). "Places used for building; sites for construction, assembly or installation works; or places used for performing supervisory activities related thereto for more than six months" are deemed to be a PE for the purposes of domestic tax (Article 120(2)(4) of the Income Tax Act, Article 94(2)(4) of the Corporate Tax Act). However, if a tax treaty regulates the formation requirement of the construction PE differently, whether or not it is deemed to be a construction PE is determined by the tax treaty.

In detail, a non-resident's existence period for construction work is calculated as follows (Article 67 of the Enforcement Decree of the Corporate Tax Act).

1. The existence period of the construction work is the period from the start date of construction to the completion date of construction or permanent renunciation date. In this case, the start date is the date of starting preparatory work, such as the establishment of a design office.
2. If the construction is temporarily suspended due to seasonal conditions or lack of materials or labour, the existence period includes such periods of temporary suspension.
3. When a non-resident contracted for construction work subcontracts all or part of the work to another business operator, the contracted non-resident's existence period includes not only the non-resident's work period but also the subcontractor's work period.

Registration

A non-resident with a construction PE in Korea must report the business's registration to the tax office with jurisdiction over the construction PE.

Taxation

As mentioned above, a non-resident with a construction PE must file and pay income tax on the income attributed to the construction PE. In principle, the income received by the construction PE is subject to withholding tax. However, this does not apply if the non-resident has registered the business (Article 156(7) of the Income Tax Act, Article 98(8) of the Corporate Tax Act).

As for the resident, the non-resident's taxable income is determined by deducting expenses for the domestic place of business from the domestic source income of the construction PE.

The domestic source income arising from the transaction between a construction PE and its head office in a foreign country or other branch offices is the amount calculated based on the arm's length principle (Article 181(2)(1) of the Enforcement Regulation of the Income Tax Act, Article 130(1) of the Enforcement Regulation of the Corporate Tax Act). The common expenses incurred by the head office and other branch offices which are reasonably related to the accrual of the domestic source income of the relevant construction PE must be included in the necessary expenses of the construction PE by allocating those common expenses to the construction PE (Article 181(2)(3) of the Enforcement Regulation of the Income Tax Act, Article 130(2) of the Enforcement Regulation of the Corporate Tax Act).

Outlook

Like the other OECD member countries, Korea is currently undertaking studies on the implementation of the BEPS project. As a result, the Korean government is likely to amend the relevant tax laws to reinforce the formation requirement of the construction PE including regulation on the splitting-up of contracts.

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POLAND
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After its accession to the European Union, Poland has increasingly been a go-to destination for foreign investors to do business. This often means that a construction or assembly/installation project must be set up to develop the infrastructure needed for the business (such as when building a factory).

Many construction or assembly/installation projects in Poland, whether owned by domestic or foreign companies, are carried out by foreign undertakings. The construction/assembly/installation works they conduct can have tax consequences and the income associated with Polish-based projects of this nature can be subject to Polish tax.

Nationally-Sourced income

According to Polish tax regulations, taxpayers who do not reside or have their registered office or place of management in Polish territory are taxed only on income generated in Polish territory. This also includes income (profits) from their Polish-based permanent establishments (PE).

Polish tax law contains a definition of a PE. Under this definition, a PE includes, without limitation, a construction site, or a construction, assembly or installation project carried out in Poland by an entity having its registered office or place of management in the territory of another state, unless the double taxation treaty (DTT) provides otherwise.

Most DTTs to which Poland is a party are based on the OECD Model Convention to taxes on income and on capital. In accordance with the Model Convention, a construction site, or a construction, assembly or installation project constitutes a permanent establishment only if it lasts for more than 12 months. Specific DTTs entered into by Poland may vary that term (e.g., 18 months under the treaty between Poland and Italy).

Registration

If construction works establish a PE in Poland, there is a need to register for income tax. This is done by filing a registration form with the relevant tax authority. When a PE is created in Poland due to construction works carried out by a non-resident, the non-resident generally does not have to register with any Polish business or companies register.

Taxation

The income (profit) of a foreign enterprise which is attributable to its PE in Poland is subject to Polish income tax. Income means any positive difference between total revenue and total tax-deductible costs over a tax year. If such costs exceed total revenue, the difference is a loss.

For Polish tax purposes, taxable income is derived from accounting records which the foreign enterprise must keep for its PE in Poland. The accounting records should include all revenues and costs directly attributable to the PE's operations in Poland as well as an allocation of indirect costs, such as general and administrative expenses, which should be made in accordance with a reasonable and commercially sound allocation method.

There are no fixed rules for how to allocate indirect revenue and costs, therefore each case should be dealt with on its own merits. As a rule, there is an obligation to prepare TP documentation covering the transactions between foreign enterprise and its Polish PE (allocation of profit to PE). Such documentation shall be submitted at the request of tax authorities within 7 days from the receipt of the request.

In case tax authorities determine a higher income than declared by a taxpayer and a TP documentation is not submitted – the difference between an income declared by a taxpayer and determined by tax authorities is subject to taxation at 50% tax rate.

Outlook

Given the growth of foreign investment in Poland, the issue of taxation of construction or assembly/installation PEs in Poland is expected to gain in importance.

There may also be changes in future to the Polish PE taxation framework in the wake of the general discussion on the definition of a permanent establishment for OECD purposes (BEPS Action 7).

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Taxation of Engineering, Procurement, and Construction Contracts in Sweden

Every year, foreign companies undertake numerous building, construction or installation projects on Swedish territory. Some of these projects last for a period of less than 6 months and thus do not create a taxable presence – also called a "permanent establishment" – in Sweden. Other projects last for 6 to 12 months or more, which could result in a Swedish permanent establishment ("construction PE").

The tax treatment of these inbound cases are described in the following, primarily with respect to the main rules and also taking the changes expected in the future into account.

Nationally-Sourced Income

The general definition of the term permanent establishment under Swedish tax law (chapter 2(29) of the Swedish Income Tax Act (ITA)) is a fixed place of business in Sweden through which a business is carried out, either wholly or partly. Three conditions must be met for the creation of a permanent establishment:

1. There is a distinct "place of business",
2. which must be "fixed", meaning that it has a certain degree of permanence (at least 6 months), and
3. the enterprise must conduct its business through that fixed place of business.

The general Swedish definition (very similar to the OECD Model Tax Convention's Article 5) contains a list of examples that constitute a permanent establishment, one of which has particular relevance here: "a building site or construction or installation project" – hence a construction PE.

Stipulations of bilateral agreements, such as agreements for the avoidance of double taxation (DTT), prevail over the regulations according under law. As a consequence, differing deadlines for creating construction PEs are normally applicable. In some tax treaties, particularly with developing countries, the time limit is 6 months. Other treaties stipulate 12 months before a construction PE is established.

Basically all Swedish DTTs are in line with the OECD Model Tax Convention.

Registration

Any Swedish construction PE of a non-resident is required to be fiscally registered with the Swedish Tax Agency.

There is also a requirement in Swedish civil law for non-residents to register their Swedish construction PE commercially at the Swedish Companies Registration Office (Sw. Bolagsverket).

Taxation

The net taxable income of a construction PE is subject to a corporate income tax (CIT) rate of 22% in Sweden. As regards the (taxable) profit/loss allocation to a Swedish construction PE, the overall requirement is that the allocation is made with respect to the arm's length principle – ultimately in line with the OECD transfer pricing guidelines. Accordingly, the so called Authorized OECD Approach (AOA) is recognized for Swedish CIT purposes. Moreover, any transfer pricing method may be applied as long as it is deemed to be arm's length. Nevertheless, the most commonly used and recognized method for a Swedish construction PE for profit allocation is the cost-plus method. If the relevant Swedish construction PE is more complex, a profit split method may be appropriate and considered arm's length.

Outlook

As a result of recent international developments, there are widespread discussions in Sweden on the creation of PEs in general. Action 7 of the OECD's Base Erosion and Profit Sharing (BEPS) initiative, in particular, is the subject of discussion in Sweden. Although the ultimate outcome of the of the OECD guidelines is expected to widen the definition of a PE (and the Swedish regulation will change correspondingly), it is important to note that Sweden's existing DTTs with other countries remain in force without change until specifically amended (which is expected to take considerable time). Accordingly, it will be mostly new DTTs that will include the new/wider PE definition. In any case, any related changes/adjustments in Sweden are not expected until end of December 2016, at the earliest.

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Plant construction projects are usually carried out under engineering, procurement, and construction (EPC) contracts. Foreign contractors have to keep in mind that the profitability of such projects depends largely on the correct tax structure:

Nationally-Sourced Income

Foreign companies undertaking EPC projects in Thailand are usually providers of engineering services (normally carried out abroad), suppliers of goods from abroad, and suppliers of goods and services within Thailand including supervisory activities in connection with construction, assembly or installation projects over a period of time. If their period of time exceeds 6 months, they are deemed to have a permanent establishment ('construction PE') in Thailand (details depending on the applicable DTA). In this case, foreign contractors are generally subject to the following taxes in Thailand:

1. Withholding Tax: 5% of the whole gross income earned under the contract (this tax is a prepayment of the 20% Corporate Income Tax on the net profit and will be credited against the final tax payment)
2. Value Added Tax: 7% of the whole gross income earned under the contract
3. Stamp Duty Tax: 0.1% of the whole gross income earned under the contract
4. Corporate Income Tax: 20% of the net profit derived from the whole contract
5. Profit Remittance Tax: 10% of the amount of after-tax profit transferred out of Thailand

A popular solution to minimize the tax burden is to split the EPC contract into two separate contracts - an 'Onshore Contract' for the supply of services and local goods and an 'Offshore Contract' for the supply of goods from abroad. Thereby, only the income derived from the supply of services and local goods in Thailand is subject to tax in Thailand. Further, contracts for the sale of foreign goods are not subject to stamp duty tax and withholding tax.

Registration

There are two possible structures for supplying services in Thailand, knowing that the projects will exceed a period of 6 months: a branch or a special purpose vehicle (SPV).

A branch is a 100% foreign unit owned by an overseas head office and allowed to conduct business activity in Thailand, such as that for a contract project.

An SPV, being a registered limited company, is a foreign or Thai owned company limited.

Both the branch and the SPV need to apply for a Foreign Business License if the activity falls into one of the categories under the Foreign Business Act (FBA). Both must also apply for a Taxpayer Identification Card and Value Added Tax Registration with the Revenue Department.

Taxation

When operating as a branch, a withholding tax of 5% applies. This is a prepayment of the 20% corporate income tax on the net profit and will be credited against the final tax payment of corporate income tax. The main benefit of operating as a branch in Thailand is the corresponding allowance of expense allocation from the foreign head office to the Thailand branch. However, it is essential to make sure that the onshore and offshore parts are clearly separated in terms of scope, pricing and payment conditions.

It is therefore advisable to establish an SPV as it assures that the onshore and offshore parts are treated separately. To implement such structure, it is important to discuss it early with the Thai customer and to start setting it up at least 6 months before implementation of the onshore part commences. When using an SPV, the withholding tax rate is reduced to 3% on the gross services income in Thailand and is then credited against the final corporate income tax as a prepayment.

If the contract is awarded by a state agency, the withholding tax rate is reduced to 1% for both the branch and SPV structures.

Outlook

It is not foreseeable that any changes will be made to this tax structure.

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Taxation of Engineering, Procurement, and Construction Contracts in Turkey

Turkey has a string of large and ambitious construction projects, especially in the public sector. In parallel, there has also been a tremendous investment boost in the private energy sector in the last decade. The ongoing construction and installation projects perform a key role in fuelling economic strength, whereby new incentives are introduced to attract more foreign investment in Turkey.

Nationally-Sourced Income

Building sites, or construction, assembly and installation projects or supervisory activities are likely to create a permanent establishment (PE) for tax purposes if they last more than a certain period of time. As a consequence, foreign entities may risk unanticipated tax costs for this kind of construction project if they do not manage this proactively and efficiently.

Section 3 of the Turkish Corporate Income Tax Legislation (CITL) regulates that any income generated by non-resident entities through a PE is subject to taxation in Turkey. Turkey determines PE status (including construction PEs) based on the following main criteria:

- A fixed place of physical presence;
- Income generated by commencing business activities through a fixed workplace;
- Having a degree of permanence.

Construction-related projects undertaken in Turkey constitute a PE regardless of the duration of the work. However, subject to terms in different double taxation treaties (DTTs), Turkey usually determines the PE status of a foreign entity engaged in a construction-related site or project based on whether the project lasts for more than 6 months.

Registration

Any foreign entity that exceeds the threshold regulated in the respective DTT must register its Turkish PE for tax purposes and is subject to taxation on income generated through the PE.

Those non-residents who prefer not to establish a subsidiary or a branch for their temporary business projects could appoint a representative in Turkey for tax purposes. The appointed representative should register the PE at the Turkish tax office on behalf of the non-resident party they represent without being subject to commercial registration. Following the registration of the PE, the non-resident entity concerned becomes eligible to conduct business, employ personnel, apply for work permits for foreign employees and file monthly VAT declarations by being subject to statutory accounting and tax filing obligations in Turkey.

Taxation

Business profits derived through a PE in Turkey are assessed in the same way as for resident companies. The PE is obliged to meet the respective accounting and tax liabilities with regard to its Turkish-sourced income on behalf of the head office situated abroad. Corporate income tax is levied on a "net-earning" basis through quarterly provisional and annual corporate tax declarations. The profit attributable to the PE is subject to a competitive corporate income tax rate of 20%.

Retroactive PE registration is not possible in Turkey. For PE registration is the only way to be subject to tax in Turkey on a net-earning basis as well as to eliminate negative Turkish VAT costs, non-resident entities should carefully monitor their tax liabilities in terms of DTT regulations and register their Turkish PEs before starting their site activities in Turkey.

Outlook

As a result of new tax challenges of the digital economy, the Turkish government has recently introduced the draft of article 129 and 130 in the Tax Procedural Law No. 213, by launching the concept of an 'electronic taxpayer' and 'electronic place of business'. This new draft legislation is a reflection of the BEPS action plan 7, which attempts to prevent artificial avoidance of permanent establishment status by increasing the occasions on which a PE could be created.

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Construction of industrial plants, assembly and installation of machinery, and the operation of building sites is a major area of activity for foreign companies in Vietnam and also for companies registered in Vietnam with foreign investors.

Nationally-Sourced Income

All income resulting from activities in Vietnam or related to Vietnam is basically taxable in Vietnam. It does not matter where the payment is executed.

Registration

A registration is definitively required if a foreign company wants to establish a foreign-owned entity in Vietnam. An Operating License for Construction and a Project Management Office is required if the foreign company is deemed to be taking part in construction business under the relevant contract. Registration is also required if the foreign contractor wishes to apply certain methods of taxation (see below).

Taxation

Activities of a company with foreign investors registered in Vietnam are subject to the normal taxation with a Corporate Income Tax **(CIT)** rate of 20%. There is no difference for Vietnamese-invested companies.

Activities of a foreign contractor in Vietnam are subject to the Foreign Contractor Withholding Tax (**FCWT**). This is not a special tax, but a special way of calculating and applying the CIT and the Value Added Tax (**VAT**). No FCWT is applied for contracts that do not include any services in Vietnam besides warranty. Transportation to Vietnam is considered as such a service. If any service in Vietnam is provided, the full contract value is taxable. All contracts under consideration in Vietnam related to construction, assembly and installation are subject to the FCWT. Under certain DTA's the foreign contractor may apply for exemption from the FCWT-CIT. The main condition is that the project is not considered a permanent establishment (PE). No exemptions are made concerning the FCWT-VAT. However, this is input VAT for the Vietnamese contractual partner. No tax exemption under a DTA is applied directly but only after successful application for such exemption, which is not granted easily.

The tax rates are different depending on the type of business. The maximum is 5% VAT and 5% CIT. If the service and the sale of goods are separate within the contract, the rates are as follows: sale of goods: no VAT and 1% CIT, services 5% VAT and 5% CIT. Without separation it is 3% VAT and 2% CIT.

Under the withholding method, the Vietnamese contractual partner handles all issues related to the FCWT; the foreign contractor does not have to do anything.

If the projects constitutes a PE, the foreign contractor may apply the full Vietnamese Accounting Standard and pay tax exactly like a Vietnamese entity or use a mixed method under which only the VAT will be recorded in an accounting system and the CIT is paid at deemed rates. Most foreign companies prefer the withholding method under which they do not have any obligations.

The issue of creating a PE is only relevant for the option of applying for exemption under a DTA (if no PE is created) and for having the choice of taxation methods under the FCWT regime (if a PE is created). It might be useful to design the project so it does create a PE (6 months rule) in which case the favorable FCWT CIT-rate is applied and no exemption in Vietnam is possible. This may have tax benefits in the home country.

Some contracts include a sophisticated tax clause under which the Vietnamese contractual partner will not only have to handle the FCWT but must also pay all taxes. The contract states that the contract price is understood as net after deduction of all taxes, otherwise the FCWT will be deducted from the contract price.

Outlook

The FCWT regime is very favorable for foreign contractors since it provides a simple system of taxation and applies favorable rates, especially if the contract matches the conditions for applying the lowest rates.

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