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UNTANGLING TAX RESIDENCY

EVALUATING THE NEED FOR PERMANENT
ESTABLISHMENT REGISTRATION
FOR FOREIGN ENTITIES



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UNTANGLING TAX RESIDENCY

To better understand the complexities of tax implications for foreign entities in Nepal, the key points related to Permanent Establishment (“PE”) are dealt with in the following paragraphs:

1. WHAT IS PERMANENT ESTABLISHMENT (PE):

- 1.1. According to **Section 2 (aab)** of the **Income Tax Act, 2058 (2002)** (the “**IT Act**”), a foreign entity's place of business becomes a PE in Nepal if its business operations are conducted, fully or partially, through specific modes or locations within Nepal for more than 90 days (at a stretch or with an interval) in a period of 12 months.
- 1.2. The concept of PE involves four key components:
 - 1.2.1. **Non-Resident Entity:** The foreign entity acts as the owner of the business in question.
 - 1.2.2. **Business Activity:** The business conducted by the non-resident entity.
 - 1.2.3. **Location:** The presence of the business, either in whole or in part, in Nepal.
 - 1.2.4. **Business Activities in Nepal:** The specific activities carried out within Nepal that constitute the business.

2. SIGNIFICANCE OF PE REGISTRATION:

- 2.1. PE is a critical concept in determining the tax residency of foreign entities in Nepal.
- 2.2. Cross-border transactions are a pivotal aspect of international business, and they take place in Nepal through two primary channels:
 - 2.2.1. **No Local Presence:** A foreign entity, residing in its home country, provides goods or services to Nepal without having a physical presence in the country.
 - 2.2.2. **With Local Presence:** A foreign entity, residing in its home country, supplies goods or services to Nepal with a direct physical presence in Nepal, often through agents or employees.
- 2.3. In the first scenario, where there is no tangible presence of the foreign entity in Nepal, these transactions generally do not incur taxation in Nepal. However, in the second scenario, questions arise regarding the potential for double taxation, the applicable tax rates, and the possibility of claiming tax credits based on taxes paid in the foreign country. This is where the concept of PE becomes relevant.

3. LEGAL FRAMEWORK REFERENCE:

- 3.1. To elaborate further, reference is made to various regulatory documents:

- 3.1.1. **Income Tax Act 2058 (2002 AD)**,
- 3.1.2. **Permanent Establishment Directive 2077 (2019 AD)** (hereinafter the "**PE Directive**"),
- 3.1.3. **Company Act 2063 (2006 AD)** (hereinafter the "**Company Act**"),
- 3.1.4. **Company Directive 2072 (2015 AD)** (hereinafter the "**Company Directive**")

4. CRITERIA FOR PE TRANSACTIONS:

- 4.1. The law prescribes the following transactions by foreign non-resident entities conducted for more than 90 days in a period of 12 months that are considered as activities constituting PE in Nepal:
 - 4.1.1. If the company conducts business through a dependent agent.
 - 4.1.2. If the company's main equipment and machinery are situated/used/installed in Nepal.
 - 4.1.3. If the company, through its employees or others, provides technical, professional, or consultancy services for a period exceeding the period mentioned above.
 - 4.1.4. If the company is involved in construction, supervision, or other projects for the period mentioned above.

4.2. In Nepal, the following business activities are considered when determining whether a Permanent Establishment exists:

4.2.1. **Independent Agency:** Activities conducted by independent agents are not regarded as Permanent Establishments.

4.2.2. **Fixed Place of Business:** This applies regardless of the number of days spent conducting business activities in Nepal.

4.2.3. **Construction-Related Activities:** If a foreign entity is engaged in construction activities within Nepal for over 90 days, it qualifies as a Permanent Establishment.

4.2.4. **Service Providers:** If a foreign entity engaged in service provision spends more than 90 days out of a moving 365-day period in Nepal, it qualifies as a Permanent Establishment.

5. EXCEPTIONS TO PE CRITERIA:

5.1. If the foreign party conducts business through an independent agent working in the ordinary course of business.

5.2. If the foreign party carries out business in Nepal for a period not exceeding a total of 90 days within 12 months.

- 5.3. Further, the following must be duly considered:
- 5.3.1. **Import Activity:** Merely importing goods into Nepal is insufficient to determine or establish a PE.
 - 5.3.2. **Individuals/Natural Persons:** Individuals or natural persons cannot qualify as a Permanent Establishment; only entities are entitled to PE status.
 - 5.3.3. **Presence of Non-Resident Entity:** The non-resident entity's presence in Nepal is a prerequisite for PE determination.
 - 5.3.4. **Unregistered Foreign Entity:** Unregistered foreign entities cannot have a PE in Nepal.
 - 5.3.5. **Business Conducted in Nepal:** The business activity must be conducted by a non-resident entity within Nepal.

6. BUSINESS ACTIVITY OF PURCHASE, CONVERSION, AND SALES:

- 6.1. **Purchase Activity:** Simply purchasing goods in Nepal without subsequent conversion and sales does not constitute a business activity for PE purposes.
- 6.2. **Conversion Activity:** Engaging in conversion activities in Nepal, regardless of whether purchases or sales occur in Nepal, qualifies as a business activity for PE determination.

- 6.3. **Sales Activity:** Sales activities, whether items are sold within or outside Nepal, count as a business activity for PE purposes. However, sales to Nepali importers do not constitute a business activity in Nepal for PE determination.
- 6.4. **Establishing a Godown or Presence:** Establishing a godown (warehouse) for sales activities is considered a business activity in Nepal.

7. PE WITH RESPECT TO INVESTMENTS AND SPECIAL BUSINESS:

- 7.1. **Business Activity Requirement:** A business activity is essential to qualify as a Permanent Establishment. For instance, a non-resident person with investments in Nepal may not automatically be considered a PE established in Nepal. Since a PE must be an entity, it cannot be created for individuals with employment or investment income.
- 7.2. **Specific Provisions:** Some provisions of the IT Act or Special Treaties may stipulate those certain activities are not recognized as PE. For example, PE is not created for international flight operations and communication services (including roaming charges), or royalty income as per **Sections 67 & 70** of the IT Act.

8. REGISTRATION OF PERMANENT ESTABLISHMENT:

- 8.1. A Permanent Establishment needs to be registered with the tax authorities, particularly if it

is registered as a branch under the Companies Act.

9. TAXATION OF PERMANENT ESTABLISHMENTS:

- 9.1. Permanent establishments are treated as Foreign Permanent Establishments (**FPEs**) and are subject to taxation in Nepal similar to resident entities. Agreements between FPEs and their main entities determine the allocation of overhead expenses, income, and liabilities.
- 9.2. FPEs are responsible for filing taxation returns for their activities conducted in Nepal. Any amount remitted abroad by an FPE is treated as dividends sent to the main entity and taxed accordingly.
- 9.3. The disposal of an FPE is subject to taxation as a gain on disposal if it has its source in Nepal. Comprehensive record-keeping is required by FPEs, following the prescribed format, to maintain proper documentation of their activities. PE registration is relevant primarily within the context of taxation.

10. PE & DOUBLE TAXATION AVOIDANCE AGREEMENTS (DTAAs)

- 10.1. When a Permanent Establishment (PE) is established in Nepal by a foreign resident entity Double Taxation Avoidance Agreements (**DTAAs**) can provide relief to prevent double taxation of the FPE's income in its home country and Nepal. These DTAAs are bilateral

- agreements between Nepal and other countries designed to promote international trade and investment by addressing the issue of double taxation
- 10.2. The majority of DTAAAs signed by Nepal were established prior to the introduction of the IT Act. Therefore, it is argued that the provisions outlined in **Section 73(5)** of the IT Act should not be applicable to these DTAAAs.
 - 10.3. Moreover, in cases where DTAAAs were signed after the commencement of the IT Act and do not explicitly include a limitation of benefit provision, it becomes essential to evaluate the operation of the limitation of benefit provision, as stipulated in **Section 73(5)**. This evaluation should be conducted in light of the **Nepal Treaty Act, 2047 (1990)**, which states that domestic law provisions inconsistent with treaty provisions shall be considered void to the extent of their inconsistency.
 - 10.4. Nepal has established DTAAAs with ten countries, which include:
 - 10.4.1. People's Republic of China
 - 10.4.2. India
 - 10.4.3. Mauritius
 - 10.4.4. Sri Lanka
 - 10.4.5. Pakistan

- 10.4.6. Republic of Korea
 - 10.4.7. Thailand
 - 10.4.8. Austria
 - 10.4.9. Norway
 - 10.4.10. Qatar
- 10.5. The application of the limitation of benefit provision in the context of these DTAAs should be carefully considered, considering both the specific agreements and the relevant domestic legislation. This ensures that tax-related matters are addressed in accordance with the established treaties and applicable laws.
- 10.6. In summary, comprehending the intricacies of Permanent Establishment is essential for foreign entities navigating Nepal's taxation landscape. The decision on tax residency and the need for PE registration should be based on a thorough analysis of the nature of transactions and adherence to applicable tax regulations.

KEY CONTACTS

If you have any questions or would like to know how this might affect your business, get in touch with these key contacts



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