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**Western India Regional Council of  
The Institute of Chartered Accountants of  
India**

**International Tax Refresher Course**

**Concept of Permanent Establishment ('PE')**

**Ravi Mahajan/Mihir Desai**

**EY LLP**

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# Agenda

**1** Concept of PE

**2** Types of PE

**3** Article 5 of the Treaty – Typical structure of a PE article

**5** Illustrative Indian rulings on PE

**6** Issues in the context of digital economy

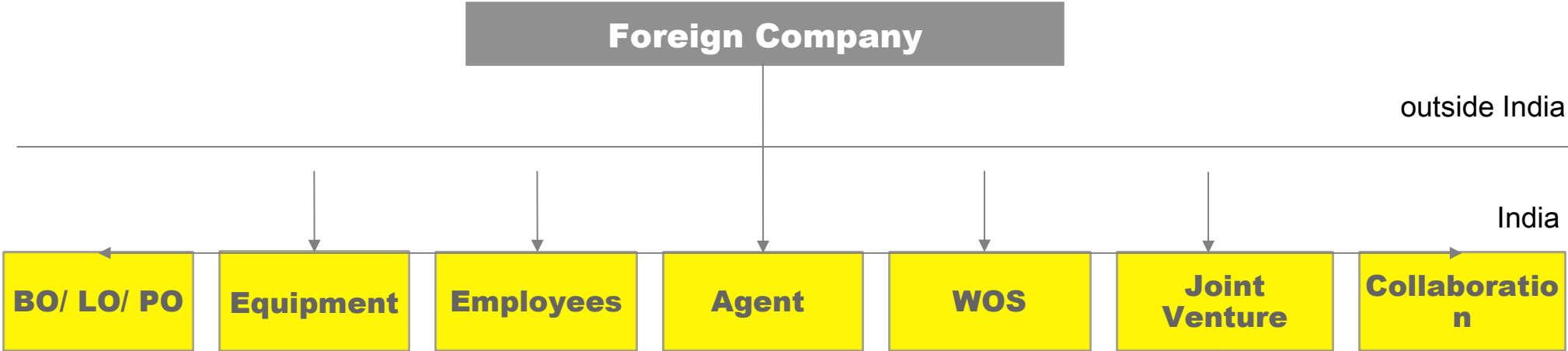


# Concept of PE

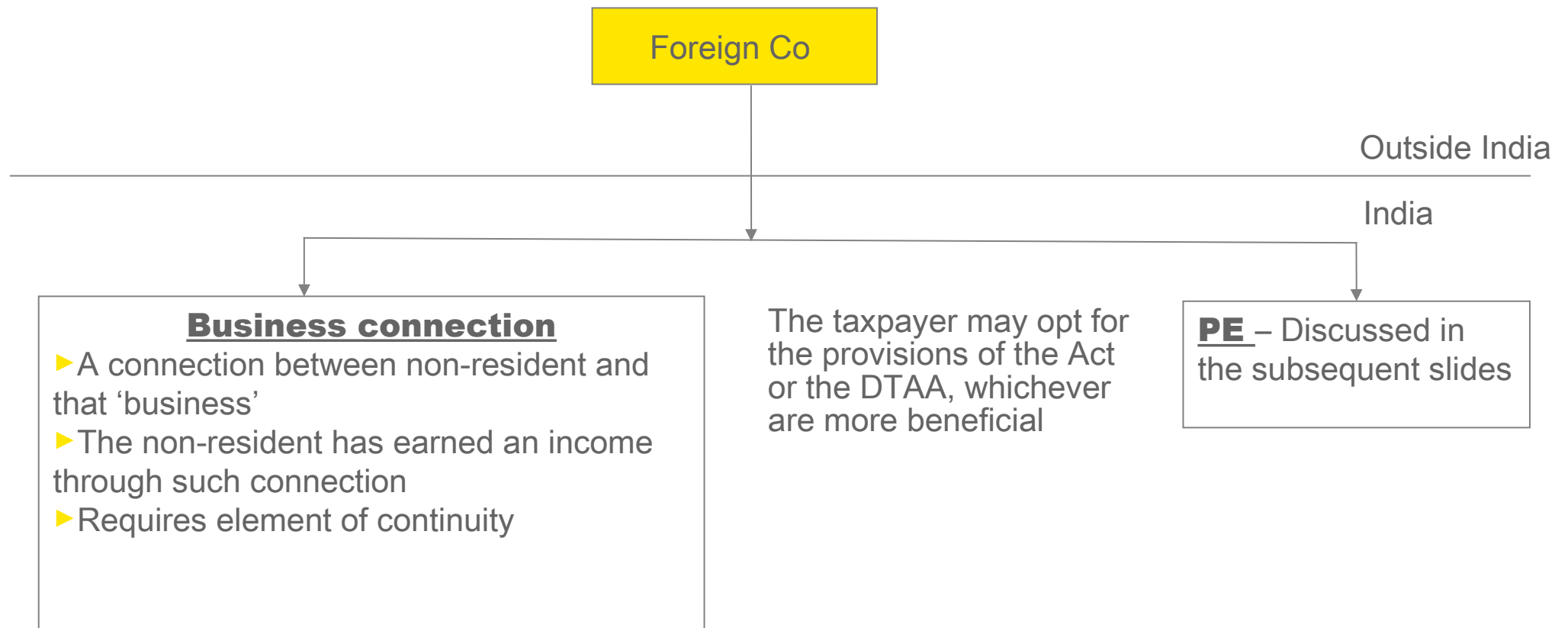


# Foreign Company – commercial presence in India

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# Foreign Company – Tax presence in India



Business connection has a wider meaning than a PE

# Concept of Permanent Establishment ('PE')

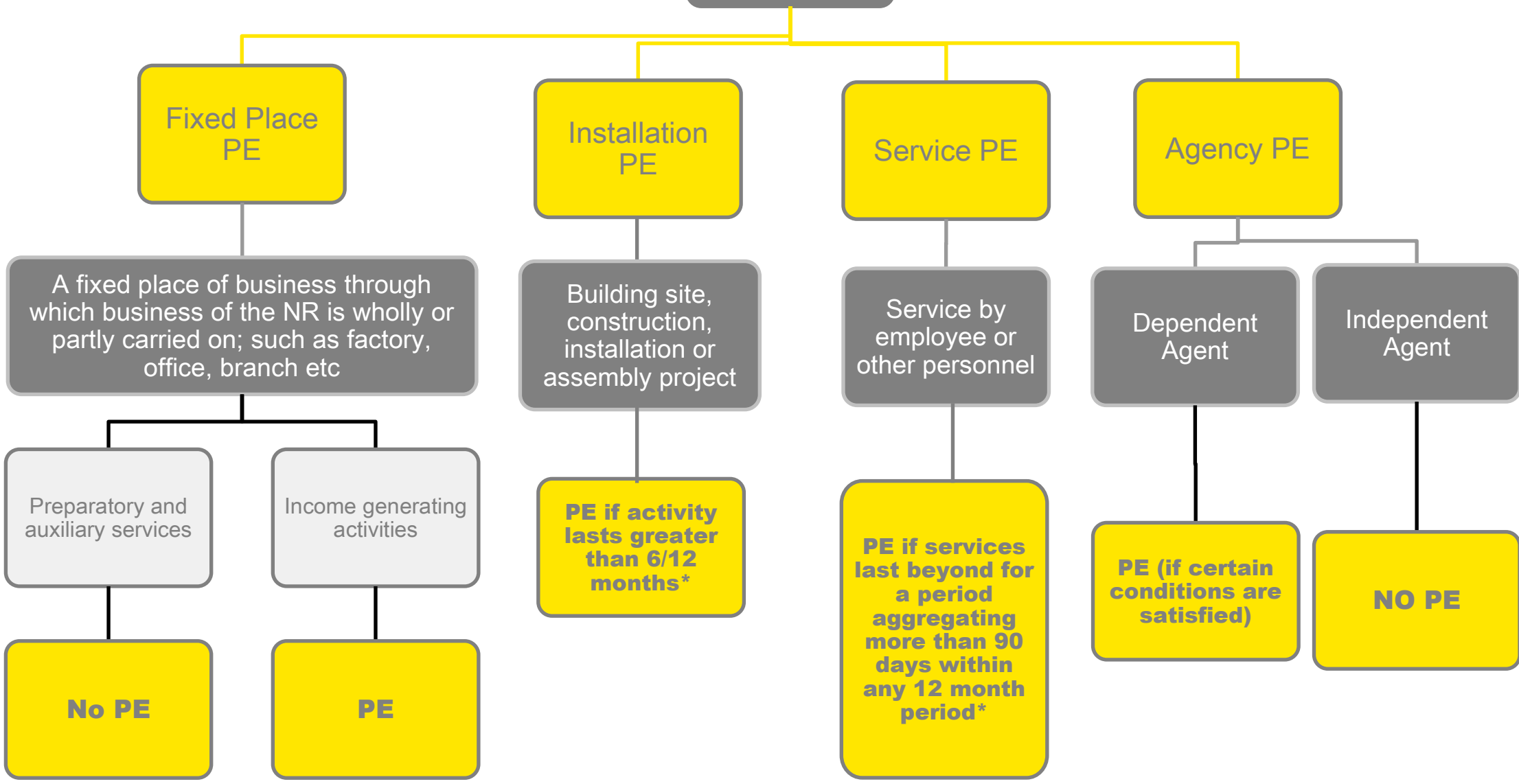
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- ▶ Business profits in case of non residents are taxable only if there is a **PE**
  - ▶ Other streams of income such as capital gains, royalties, fees for technical services, interest etc. will also be taxed in the same manner as business profits, if they are effectively connected with the PE
- ▶ **Concept of a PE** is to determine the right of a Source State to tax the Business profits of the foreign enterprise
- ▶ Under Article 7 of the tax treaty a Contracting State cannot tax the profits of an enterprise of the other Contracting State **unless it carries on its business through a PE situated therein**
- ▶ Genesis of PE taxation is a significant economic bond between the enterprise and the Source State

# Types of PE



# TYPES OF PE



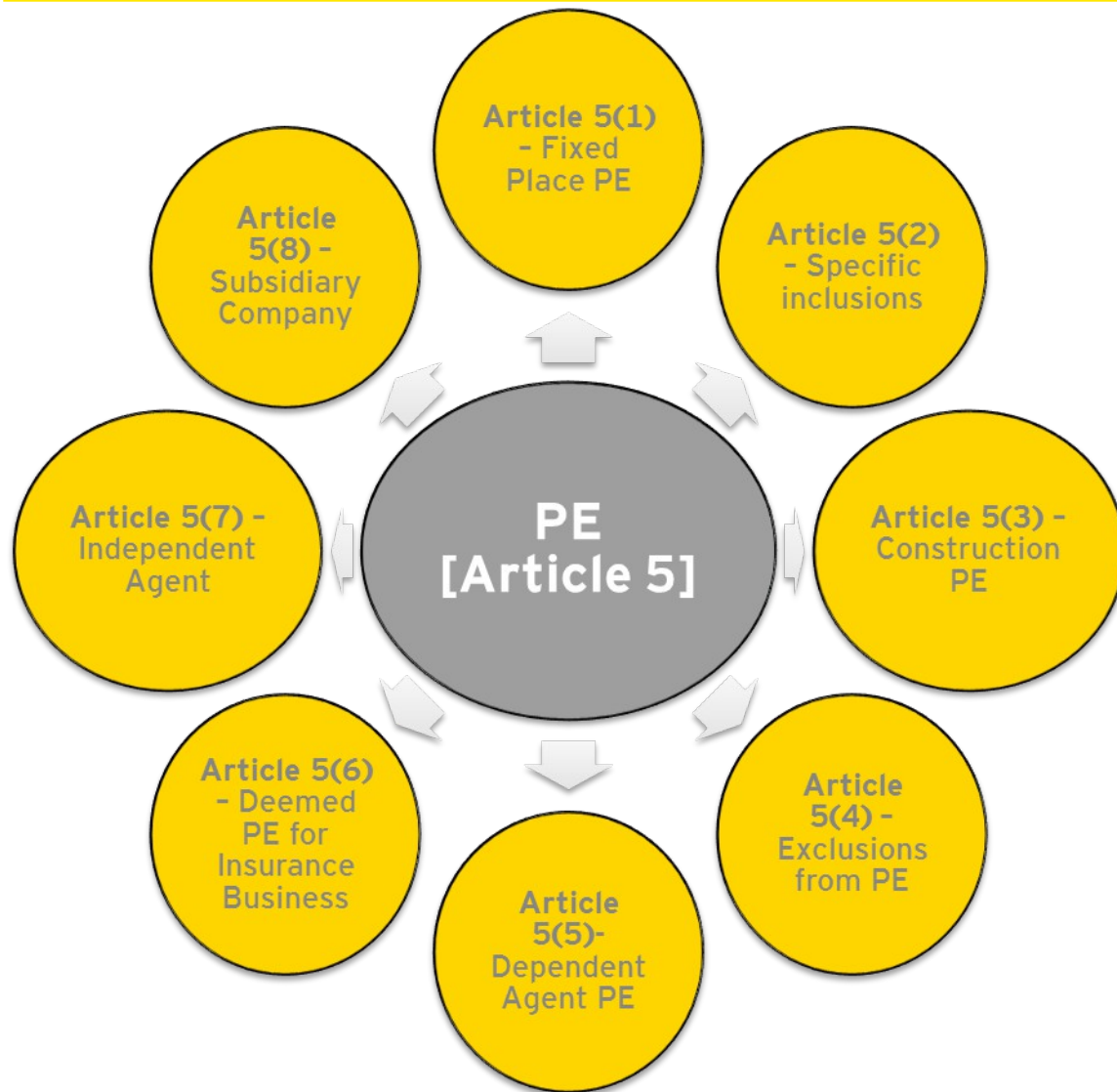
\* General – Relevant tax treaties to be checked



# Article 5 of the Treaty – Typical structure



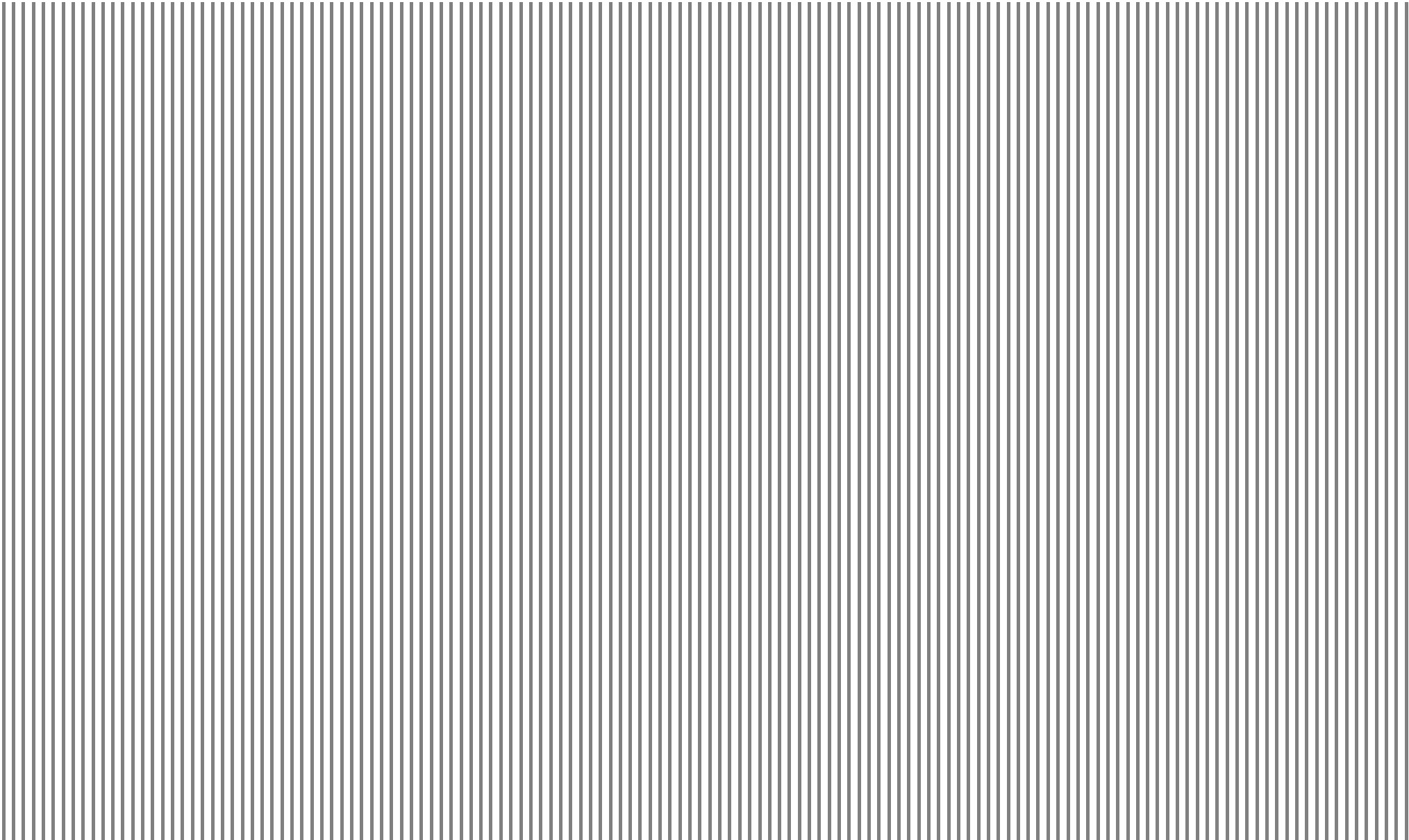
# Structure of Article 5 - UN Model



- ✓ **Article 5(1)** Fixed Place PE
- ✓ **Article 5(2)** Specific inclusions
- ✓ **Article 5(3)** Construction PE & Service PE
- ✓ **Article 5(4)** Exclusions from PE
- ✓ **Article 5(5)** Dependent Agent PE
- ✓ **Article 5(6)** Deemed PE for Insurance Business
- ✓ **Article 5(7)** Independent Agent
- ✓ **Article 5(8)** Subsidiary Company

Service PE Article and Article 5(6) is not present in the OECD Model

# Article 5(1) - Fixed Place PE



# Article 5(1) - Fixed Place PE



Under Article 5(1), the following conditions are required to be satisfied exists for a Fixed place PE:

- ▶ There is a **place of business** (“place of business test”)
- ▶ Such place of business is at the **disposal** of enterprise (“disposal test”)
- ▶ Such place of business is **fixed** (“location test” and “permanence test”)
- ▶ The **business** of the enterprise is **carried on** (“business activity test”) wholly or partly through such fixed place of business

A PE can be constituted under “Basic Rule” only if **ALL** of above tests are cumulatively satisfied

# Basic Rule for PE – Place of business test

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- ▶ 'Place of business' is not defined
- ▶ It usually means a premises, facilities, machinery, equipment, installations of the enterprise used for carrying on the business, whether or not it is exclusively used for business

- ▶ Which of these are a place of business?
  - ▶ Residential premises/ Hotel accommodation
  - ▶ Office of 3 metres by 6 metres
  - ▶ An automatic vending machine installed at a premises
  - ▶ A computer server located in India
  - ▶ Possession of mailing address without an office, telephone listing or bank account

# Fixed place PE – Disposal Test

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- ▶ Place should be at the disposal of NR
  - ▶ Mere occasional factual use of the place not sufficient
- ▶ The place may be owned, rented or leased
- ▶ Legal right to use need not be the sole determinant; factual use or exercise of such right will have a greater bearing

## **Is disposable test satisfied?**

- ▶ Foreign training agency imparting training at the customer's premises
- ▶ Salesman visiting customers office regularly to collect orders

# Fixed place PE – Location test

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- ▶ Presence to be 'visible' in the other contracting state
  - ▶ Link between place of business and geographical location
- ▶ Movable places of business with a temporary fixed location meet the location test

## **Is location test satisfied?**

- ▶ A diving offshore vessel functioning within a defined area
- ▶ A dealer selling merchandise from a mobile van or moving caravan
- ▶ A pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand

# Fixed place PE – Permanence Test

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- ▶ No minimum threshold
  - ▶ PE normally considered to exist where business carried on for more than six months – OECD Model Commentary
- ▶ The place of business must have a certain degree of permanence, i.e. should not be of purely temporary nature
- ▶ An isolated activity cannot lead to establishment of a fixed base PE as the ingredients of regularity, continuity and repetitiveness are essentially missing
  - ▶ Conducting of golf tournament in India for 6 - 7 days considered as a solitary or isolated activity - NO PE in India - *Golf in Dubai, LLC [2008] 306 ITR 374 (AAR)*



# Fixed place PE – Permanence Test (contd..)

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► **An example**

Activities	Dates	Remarks
Arrival of NR in India	1 April 2015	
Started business set up activities	5 April to 31 May 2015	Not considered
Commencement of business	1 June 2015	Commencement of PE
No business due to heavy rains/ riots	15 July to 31 August 2015	Temporary interruptions (excluded for time threshold)
Business closed and place of business disposed off	31 December 2015	Cessation of PE

# Fixed place PE – Business Activity Test

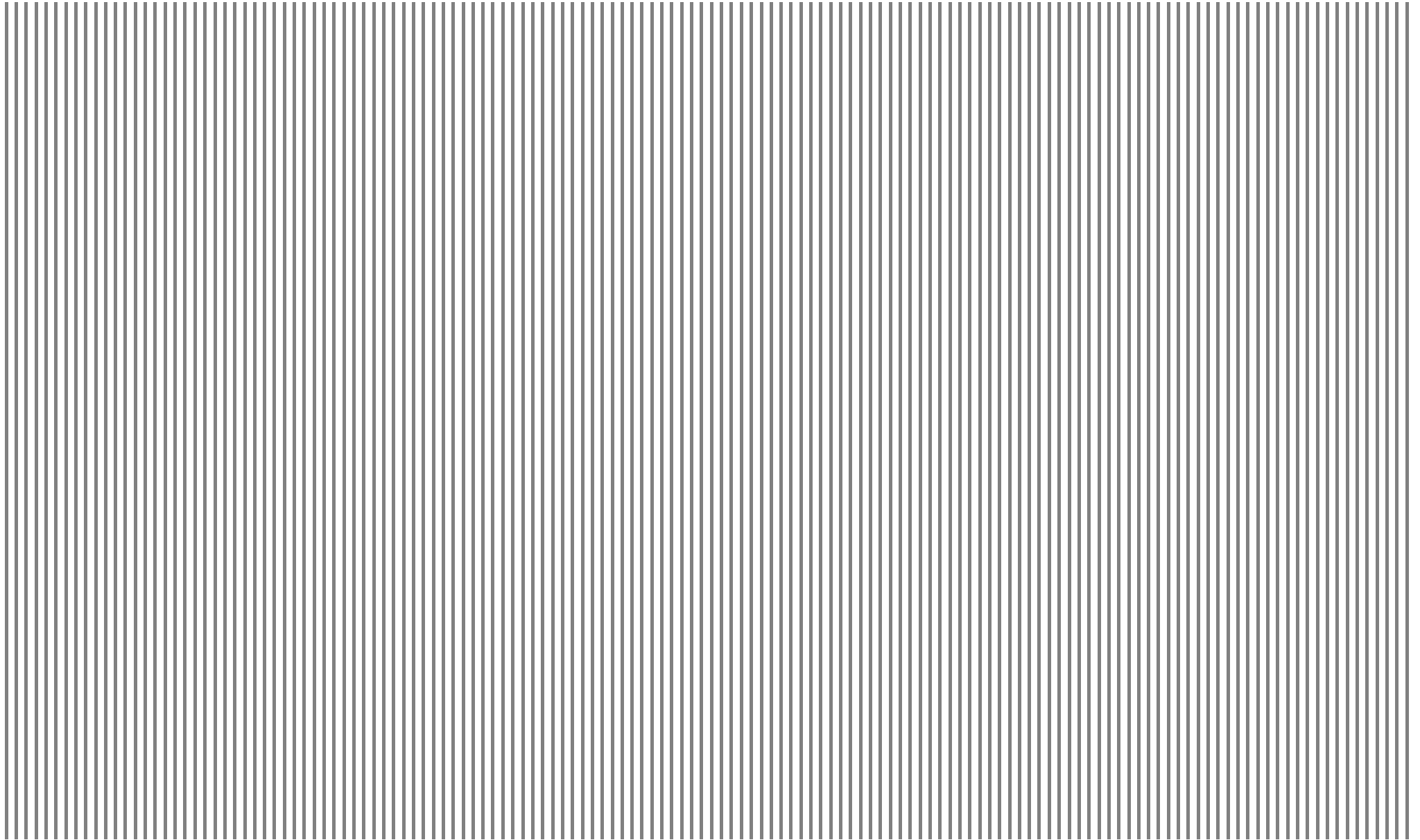
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- ▶ The business of the foreign enterprise, wholly or partly, ought to be carried out in India through the fixed place
- ▶ Place of business must 'serve' the business activity.
  - ▶ The use of premises by an agent for purpose of business of the principal may lead to the interpretation that such premises are at the disposal of the principal and hence constitute a PE

## **OECD Commentary**

Activity need not be permanent in the sense that there is no interruption of operation, but operation **must be carried out on a regular basis**

# Article 5(2) – Specific inclusions



# Article 5(2) – Specific inclusions

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## ▶ PE includes

- ▶ A place of management
- ▶ A branch
- ▶ An office
- ▶ A factory
- ▶ A workshop
- ▶ A mine, an oil & gas well, a quarry or any other place of extraction of natural resources

### **Example:**

- ▶ An NR has a branch in India. Only activities of the branch are payment to seconded employees working in India
  - ▶ *Branch not to constitute PE as activity of making payment does not satisfy conditions in Article 5(1) of carrying business in India<sup>1</sup>*

<sup>1</sup> Whirlpool India (140 TTJ 555) (Del ITAT)

# Article 5(2) – Specific inclusions

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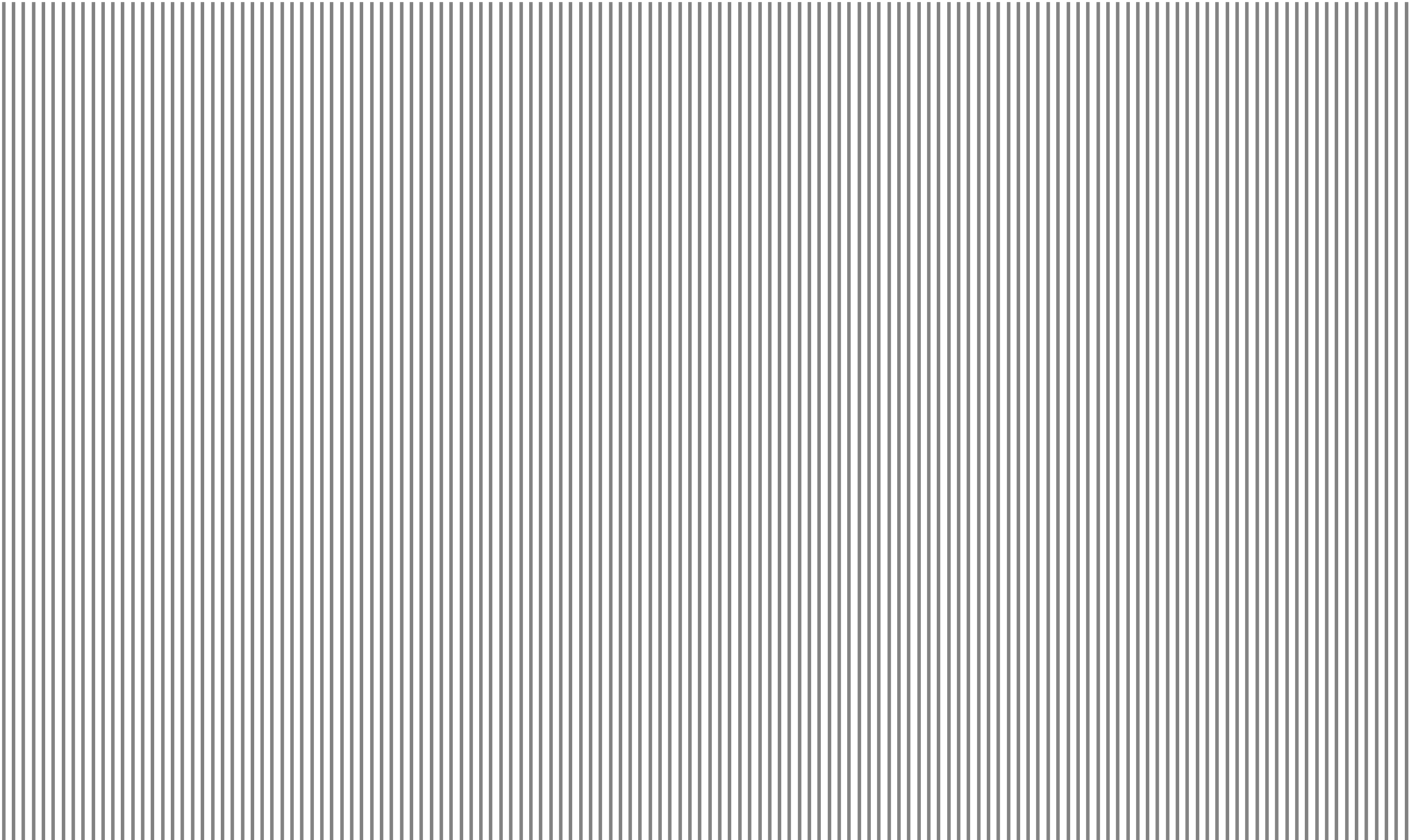
## Whether inclusions in 5(2) independent of 5(1) ?

- ▶ Divergent views on interplay between Article 5(1) and Article 5(2)
- ▶ **One view<sup>1</sup>**
  - ▶ Place of business constitutes PE only if it satisfies the tests of basic rule for PE as specified in Article 5(1)
- ▶ **Other view<sup>2</sup>**
  - ▶ Article 5(2) is independent of Article 5(1)

<sup>1</sup> UN Commentary (2011) para 4, OECD commentary (2010) para 12, ABC (P No. P No. 24 of 1996) [1999] 237 ITR 798 (AAR)

<sup>2</sup> Fugro Engineers B.V. Vs. ACIT [2008] 122 TTJ 655 (Del ITAT), Boudier Christian Vs. ITO [1993] 46 ITD 114 (Del ITAT)

# Article 5(3) – Construction and Service PE



# Article 5(3) – Construction PE

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- ▶ **Building site or construction or installation project constitutes a PE only if it lasts more than**
  - ▶ 12 months (OECD MC)
  - ▶ 6 months (UN MC)

## **Consideration in calculation duration of Construction PE**

- ▶ Includes period for any preparatory work;
- ▶ A site exists until the work is completed or permanently abandoned;
- ▶ Temporary interruptions not to be excluded
- ▶ Twelve month test applies to each individual site or project
- ▶ A building site should be regarded as a single unit, even if it is based on several contracts

# Article 5(3) - Service PE

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▶ **PE exist if the following conditions are satisfied:**

- ▶ Services are furnished by NR within the Source State;
- ▶ Such services are not in the nature of FTS/FIS – Relevant tax treaties to be checked
- ▶ Services are furnished through employees or other personnel
- ▶ The period of furnishing services exceed the specified threshold period
  - ▶ Under the India – USA treaty – Article 5(2)(l)(i) *‘Activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve month period’*
  - ▶ Under the India- Finland treaty – Article 5(3)(b) – *‘the furnishing of services..... of that nature continue (for the same project or connected project) within the country for a period or periods aggregating more than 183 days within any 12 month period’*
- ▶ Services rendered to self excluded (i.e. requires two parties)

▶ Service period falling in two financial years – Protocol to India-US tax treaty

OECD MC – No such provisions exist



# Article 5(3) - Service PE contd..

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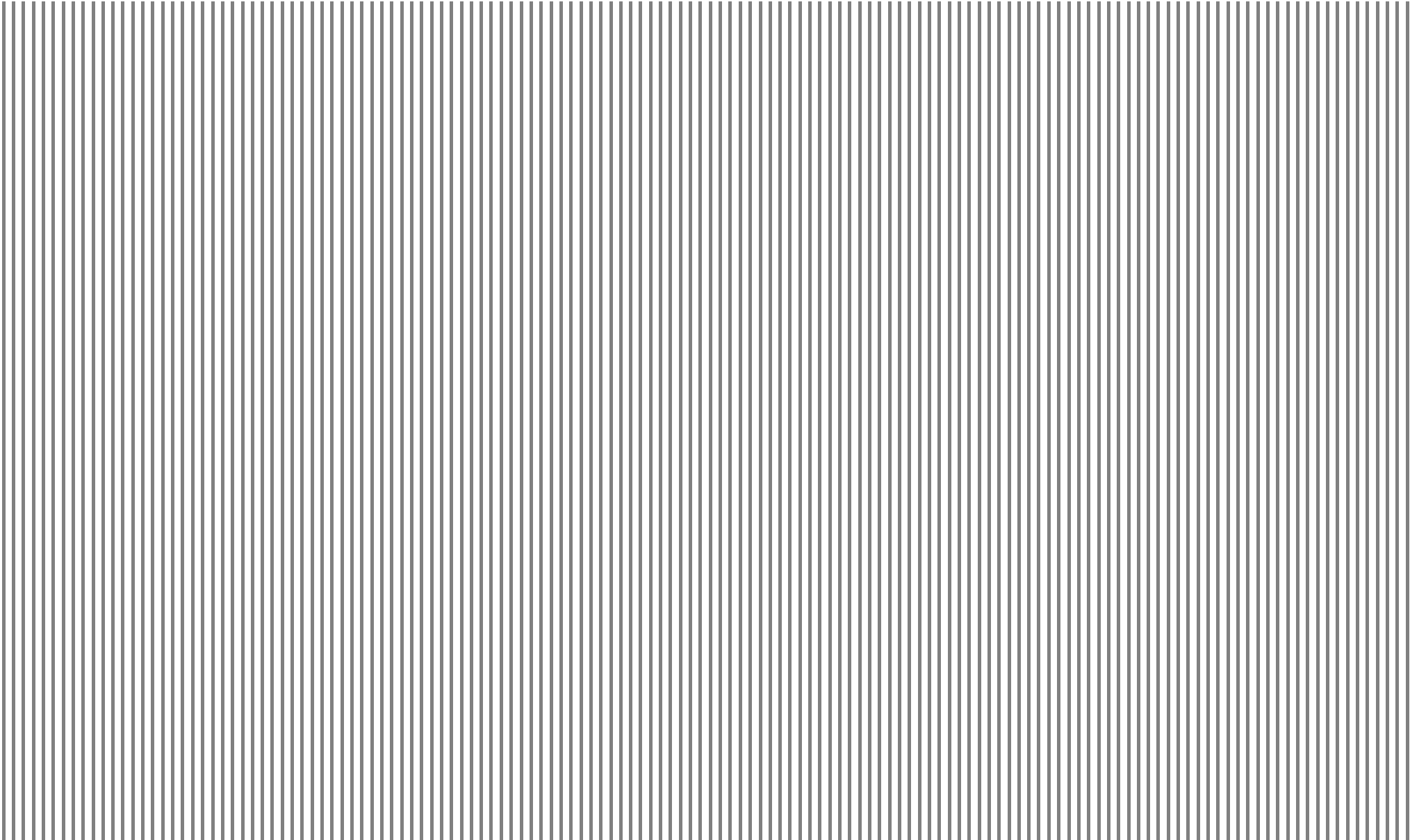
## ▶ **Solar v Man days for computing limit**

- ▶ A foreign company sent 10 employees for furnishing services in India. The employees work in India for 40 days in a fiscal year
  - ▶ Scenario 1 – Total stay of 10 employees in India as per solar/calendar days is 40 days
  - ▶ Scenario 2 – Total stay of 10 employees in India as per man days is 400
- ▶ Whether Solar days are to be considered for computation of Service PE or man days?
  
- ▶ Better view seems to be solar days and not man days<sup>1</sup>

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<sup>1</sup> Clifford Chance (82 ITD 106) (Mum ITAT); MSEB (90 ITD 793) (Mum ITAT)

# Article 5(4) – Exclusions from PE



# Article 5(4) – Exclusions from PE

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## ▶ **Why Article 5(4) ???**

- ▶ Activities of NR in the nature of preparatory or auxiliary character;
- ▶ Activities so remote from actual realisation of profits that it is difficult to allocate any profits to such activities
- ▶ **UN MC - PE will not include :**
- ▶ Use of facilities solely for storage or display of goods or merchandise;
- ▶ Maintenance of stock of goods or merchandise solely for storage, display;
- ▶ Maintenance of stock of goods or merchandise solely for purpose of processing by another enterprise;
- ▶ Maintenance of fixed place of business solely for purpose of purchasing goods, or collecting information;
- ▶ Maintenance of fixed place of business solely for purpose of carrying on any activity of a **preparatory or auxiliary character**;
- ▶ ...solely or combination of any of the above

### **OECD MC – In addition to above, following are also excluded :**

- ▶ Use of facilities solely for delivery of goods or merchandise
- ▶ Maintenance of stock of goods or merchandise solely for delivery

# Meaning of Preparatory / auxiliary activities

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- ▶ ‘Preparatory activity’ as the one that is,
  - ▶ carried on **in contemplation of** the carrying on essential and significant part of the activity of the enterprise as a whole
  - ▶ Usually **but not always**, carried on during a relatively short period
  - ▶ Example - Training provided by a construction enterprise to its employees at one place before sending them to the remote construction site is preparatory activity for the construction enterprise
- ▶ ‘Auxiliary activity’ is the one that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole
  - ▶ An activity requiring a significant proportion of the assets or employees of the enterprise is unlikely to qualify as auxiliary in nature
  - ▶ E.g. large warehouse maintained in State S by an online selling enterprise is not P/A

# Illustrations : Preparatory / auxiliary activities

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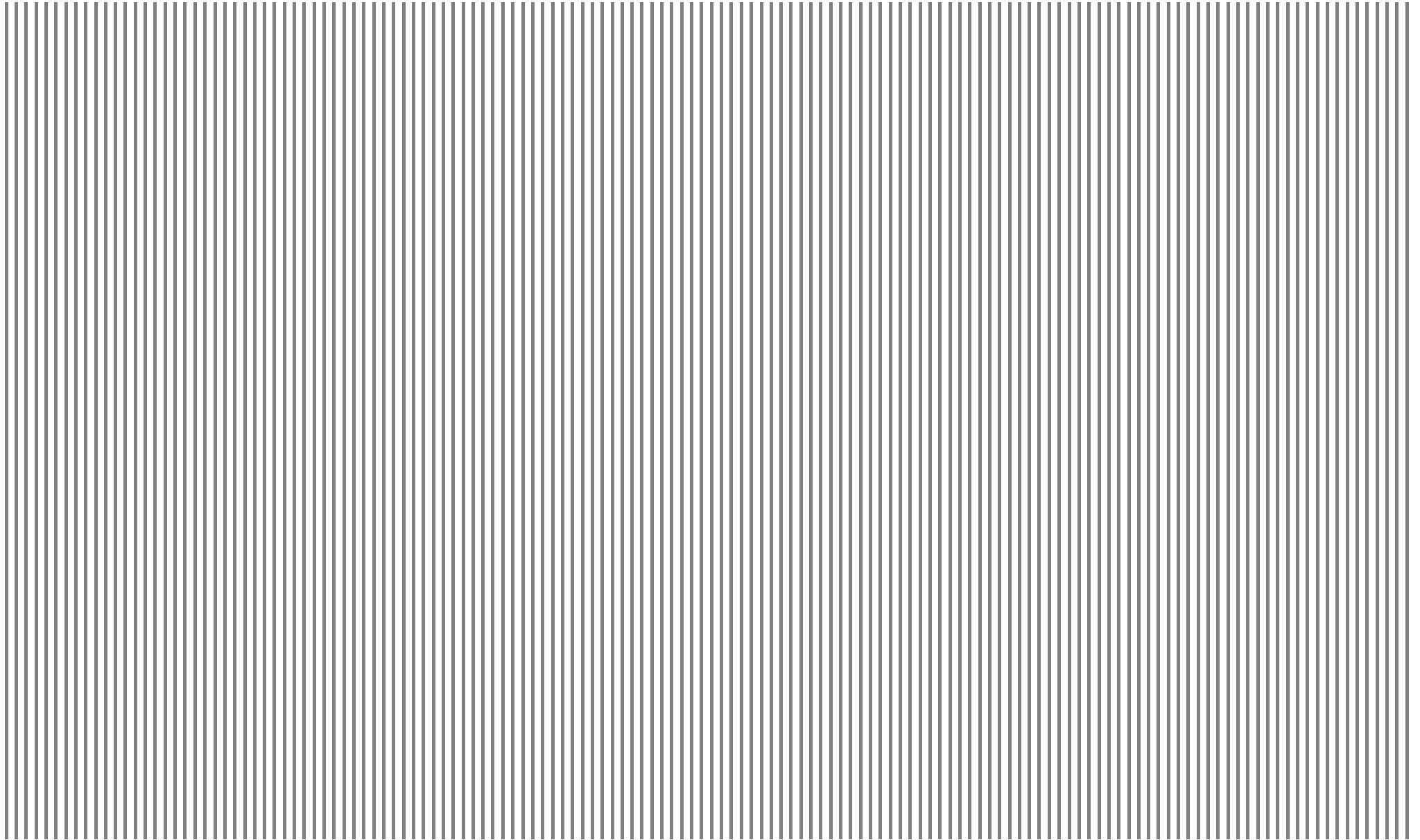
## ▶ **Preparatory / auxiliary activities**

- ▶ Market survey / Industry analyses / economy evaluation
- ▶ Furnishing of information including product information to prospective customers/vendors
- ▶ Ensuring technical presentation to potential users
- ▶ Development of market opportunities
- ▶ Preliminary operations before commencement of business activities in India
- ▶ Holding of seminars, conferences to create awareness
- ▶ Accounting / finance services
- ▶ Advertising

## ▶ **Non preparatory / Non auxiliary activities**

- ▶ Managing an enterprise or its parts
- ▶ A management office for supervisory and coordinating functions
- ▶ After sales services to customer

# Article 5(5) & 5(7) - Agency PE



# Agency PE - The Concept

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## Why agency PE clause?

- ▶ **An enterprise considering performing business in a host country may:**
  - ▶ Perform the activity by itself;
  - ▶ Perform the activity through a separate legal entity; or
  - ▶ Consider outsourcing that same activity to an agent (resident or not in the host country)

The mere **absence** of an Agency PE clause in a Tax treaty would represent the **possibility of avoiding source taxation** just by interposing an agent between the NR and the local customer

# Article 5(5) – Dependent Agent PE

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## Conditions to be satisfied - (Cumulative conditions)

- ▶ Should be a 'Person'
- ▶ Agent other than an agent of independent status as per Article 5(7)
- ▶ Acting on behalf of NR
- ▶ Has an **authority to conclude contracts** in a contracting state
- ▶ **Habitually exercises** such authority in contracting state in name of NR
- ▶ No auxiliary activities
- ▶ UN MC also includes habitually maintaining stock of goods or merchandise and regular delivery of goods for and on behalf of NR

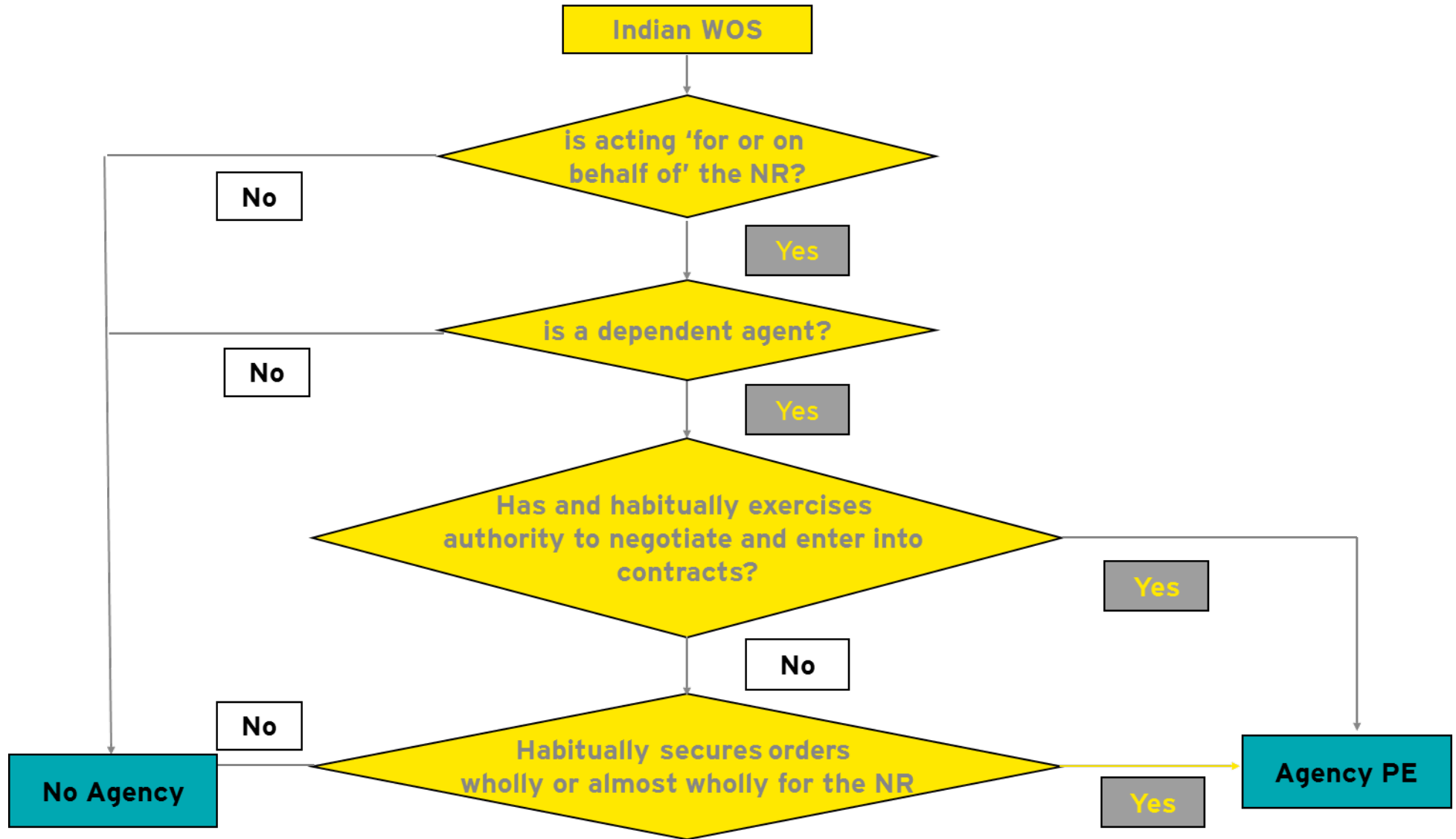


# Authority to conclude contracts

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- ▶ **Person said to have authority to conclude contracts if, he/she:**
  - ▶ Has sufficient authority to bind NR and decide final terms
  - ▶ Can act independently, without control from the principal NR
  - ▶ Is authorized to negotiate all elements and details of a contract
  - ▶ Where approval of contract by the NR is a mere formality
- ▶ **OECD Position**
  - ▶ Agent is required to conclude contracts relating to operations which constitute business proper of the NR
  - ▶ Participation / attendance in mere negotiations of contracts not sufficient to trigger DAPE
- ▶ **Signature**
  - ▶ No signature but negotiation of all elements and details of the contract in a way binding on the enterprise

# Dependent Agent



# Article 5(7) - Independent Agent

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## A PE will NOT include:

- ▶ Carrying on of business in the other contracting state through:
  - ▶ A broker,
  - ▶ General commission agent, or
  - ▶ Any other agent

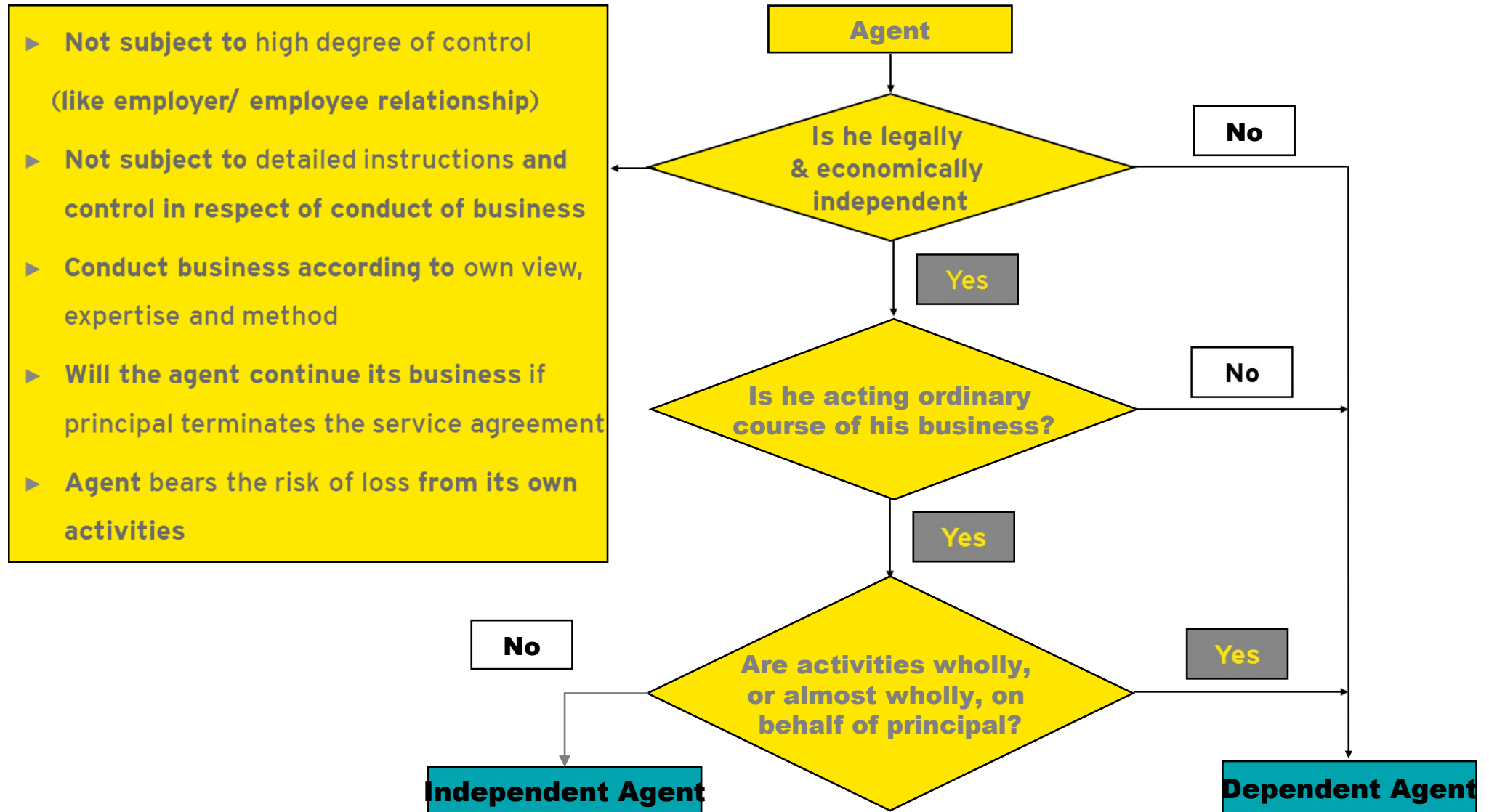
of an **INDEPENDENT** status acting in the ordinary course of their business - legal and economic independence

- ▶ **UN MC - An agent will not be considered as 'independent' if :**
- ▶ His activities are devoted exclusively or almost exclusively on behalf of his principal; and
- ▶ Transaction between them are not made at arms length price

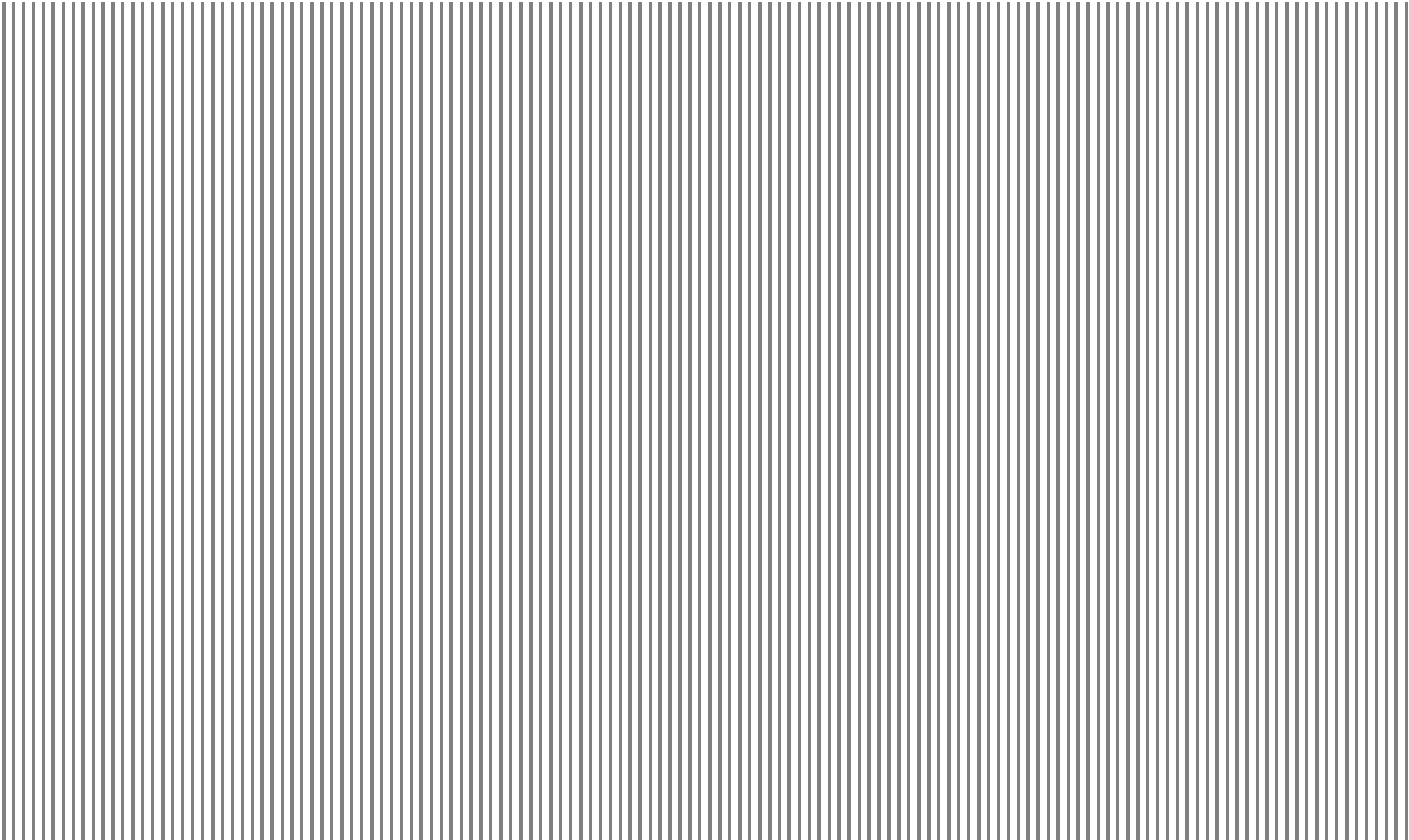
### **Example of Independent Agent**

A newspaper publishing company, whose principal business is publication of newspapers in India also carries on business of collection of advertisements for NR publishers would be considered as agent of independent status as it acts in the 'ordinary course' of business

# Independent Agent – Tests



# Article 5(8) – Subsidiary PE



# Article 5(8) - Subsidiary PE

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- ▶ Existence of a subsidiary by itself does not constitute PE
- ▶ Enterprise under the same control need not be a PE
- ▶ Subsidiary company will constitute PE only if it satisfies any of the basic conditions for creating a PE

# Impact if PE constituted

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- ▶ PE liable to tax on net income basis
  - ▶ For Royalties/ FTS effectively connected to the PE – the income needs to be computed as per Section 44DA
- ▶ Income attributable to the PE taxable
  - ▶ Attribution to be done based on FAR analysis
- ▶ Applicable tax rate [i.e. 40% plus applicable surcharge and cess]
- ▶ Maintenance and Audit of accounts of PE's operation<sup>1</sup>
- ▶ Attracts tax withholding obligations and related compliances
- ▶ Obligation to file return of income
- ▶ Obligation to comply with the transfer pricing provisions

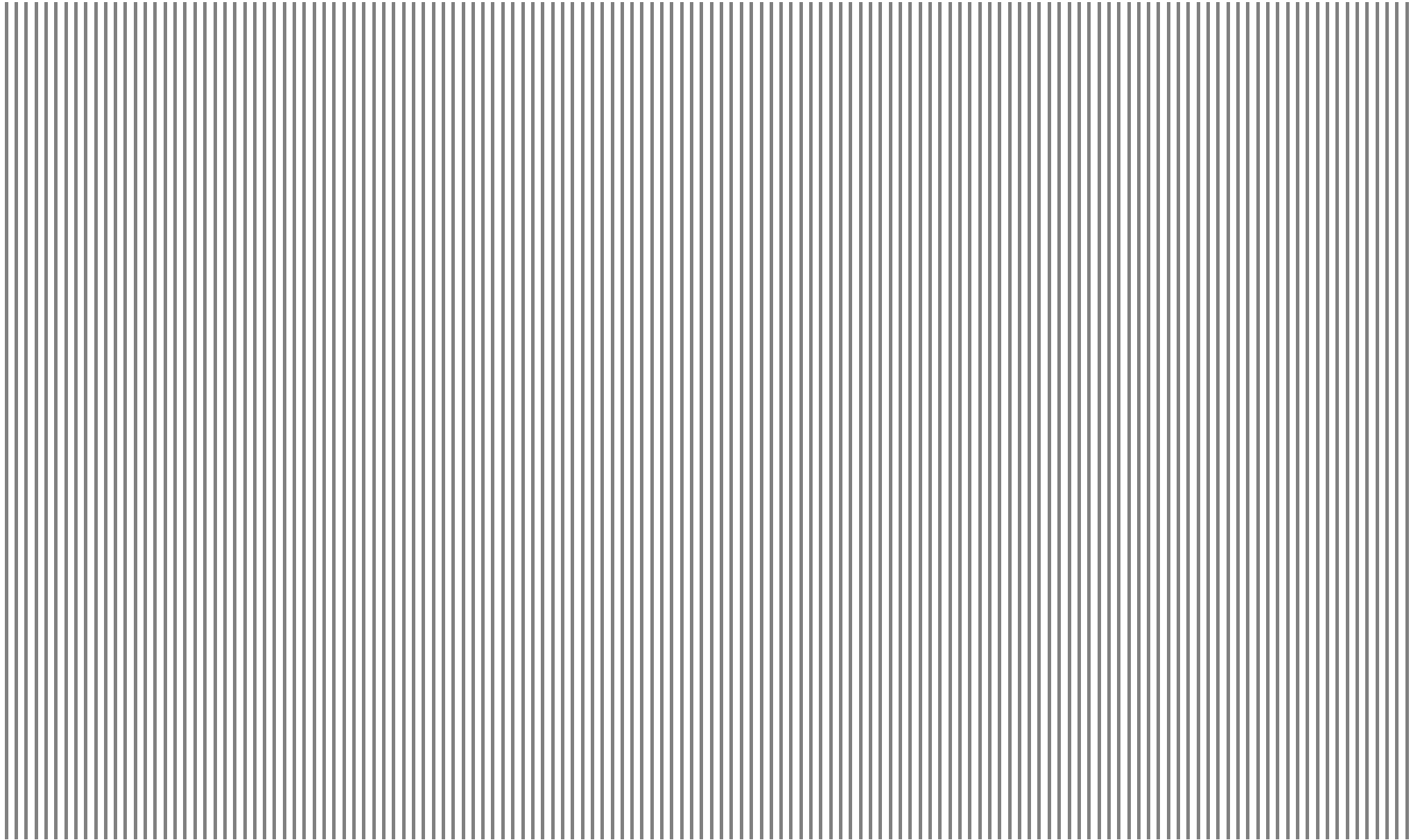
<sup>1</sup> Companies Act/ FEMA/ Section 44DA

# Illustrative Indian rulings on PE

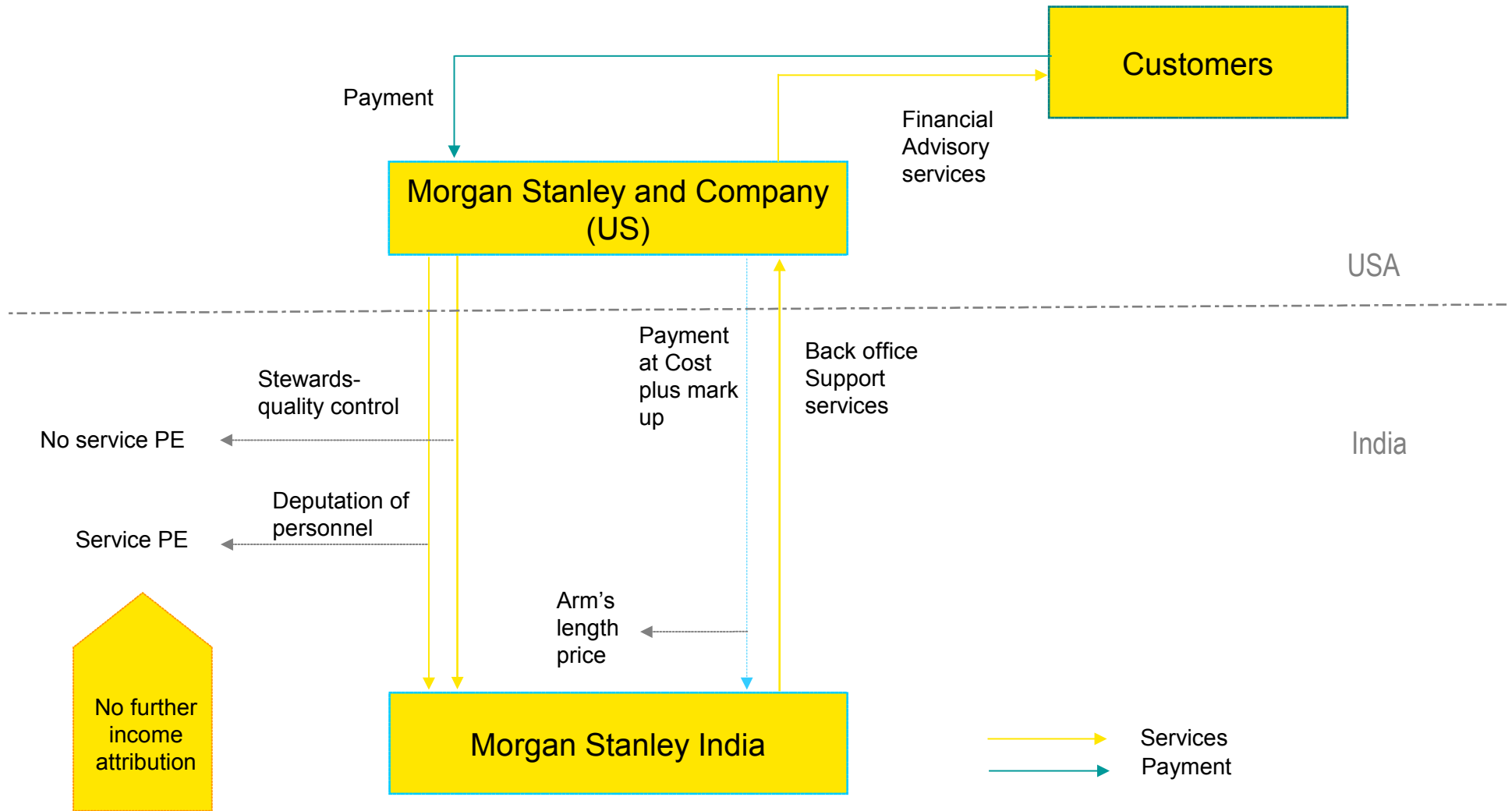




# Morgan Stanley vs DIT (SC) (292 ITR 416)



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## Facts

- ▶ Morgan Stanley & Co (MS & Co) has a wholly owned subsidiary in India viz., Morgan Stanley Advantage Services Private Ltd (MSAS)
- ▶ MSAS provides support to group's front office and infrastructure unit functions in their global operations - remunerated at an agreed mark up
- ▶ Pursuant to an agreement with MSAS, MS & Co proposed to send its employees/ personnel to India:
  - ▶ for stewardship and other similar activities
  - ▶ to work under control of MSAS and substantively perform functions within capacity of MSAS's staff (deputees had lien on the employments with MS & Co)
- ▶ Salary costs of deputed personnel paid by MS&Co and later recharged to MSAS. Costs of stewardship activities borne by MS & Co
- ▶ MSAS had no authority to conclude contracts on behalf of MS & Co

# Morgan Stanley vs DIT (SC) (292 ITR 416)

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## Issues

- ▶ In light of the arrangement with MSAS, would MS & Co be taxable in India under provisions of India-USA DTAA
  - ▶ PE Exposure?
  - ▶ Appropriate transfer pricing methodology?

## Ruling of the AAR

- ▶ No fixed place Permanent Establishment (PE) under Article 5(1)
- ▶ Service PE on account of “furnishing of services” to MSAS by provision of stewardship services and deputation of personnel under Article 5(2)(I)
- ▶ No Agency PE
- ▶ As long as MSAS is remunerated for services rendered on an arm’s length basis and all its actual income brought to tax, no further profits attributable to PE in India
- ▶ AAR declined to admit question on determination of most appropriate transfer pricing method for transactions

# Morgan Stanley vs DIT (SC) (292 ITR 416)

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## **SLP before the Supreme Court**

### Grounds raised by Department

- ▶ MS & Co has a PE in India under Article 5(1) of the DTAA as MS & Co proposed to carry on its business through MSAS
- ▶ MSAS was legally and financially dependent on MS & Co and constituted an 'Agency PE' of MS & Co under Article 5(4) of the DTAA
- ▶ The AAR has wrongly held that in case MSAS is remunerated at arm's length by MS & Co, then no further income can be attributed in the hands of the PE of MS & Co

### Grounds raised by MS & Co

- ▶ The AAR erred in finding that the personnel sent by MS & Co to India on "deputation" and for "stewardship activities" constituted a PE under Article 5(2)(I) of the DTAA

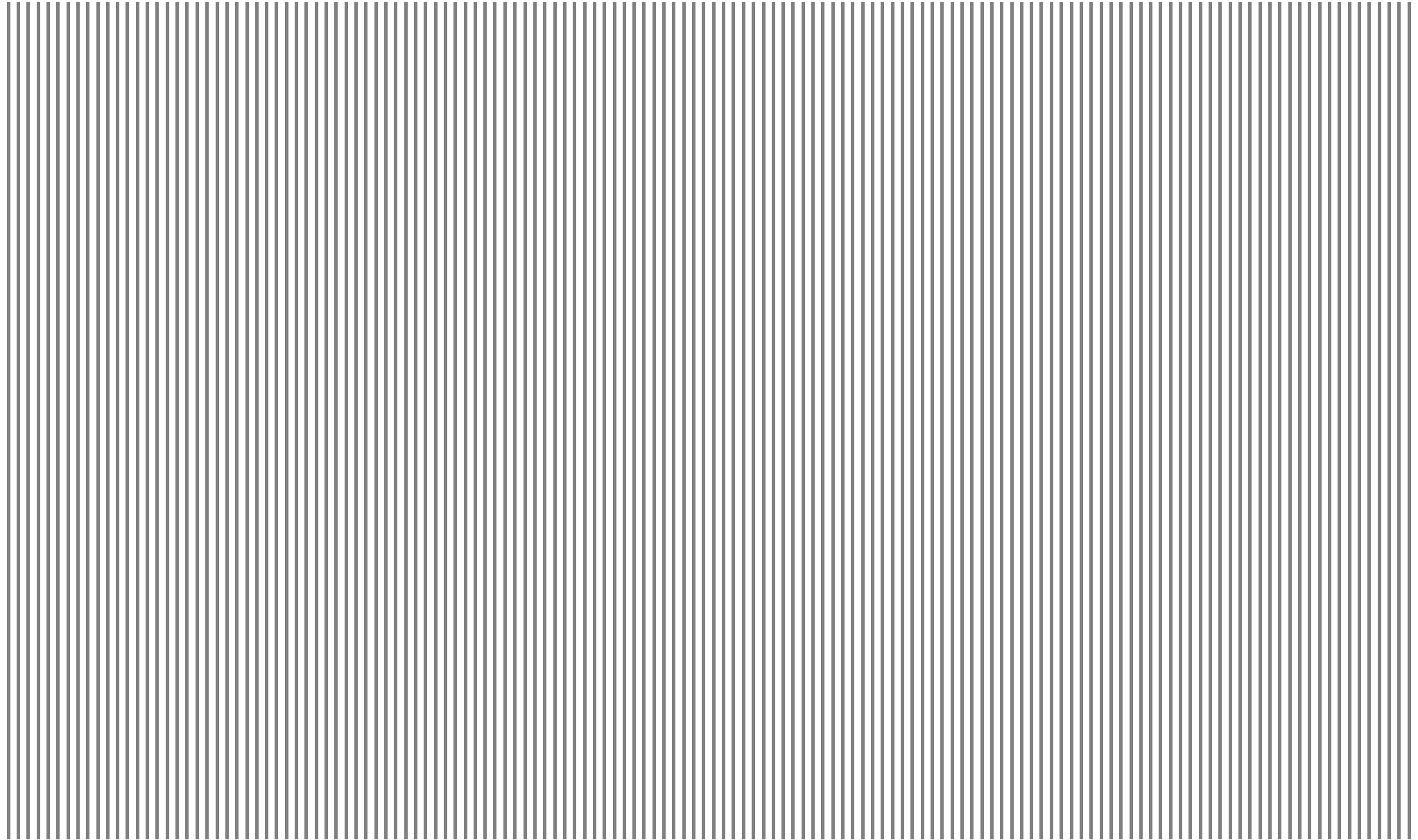
# Morgan Stanley vs DIT (SC) (292 ITR 416)

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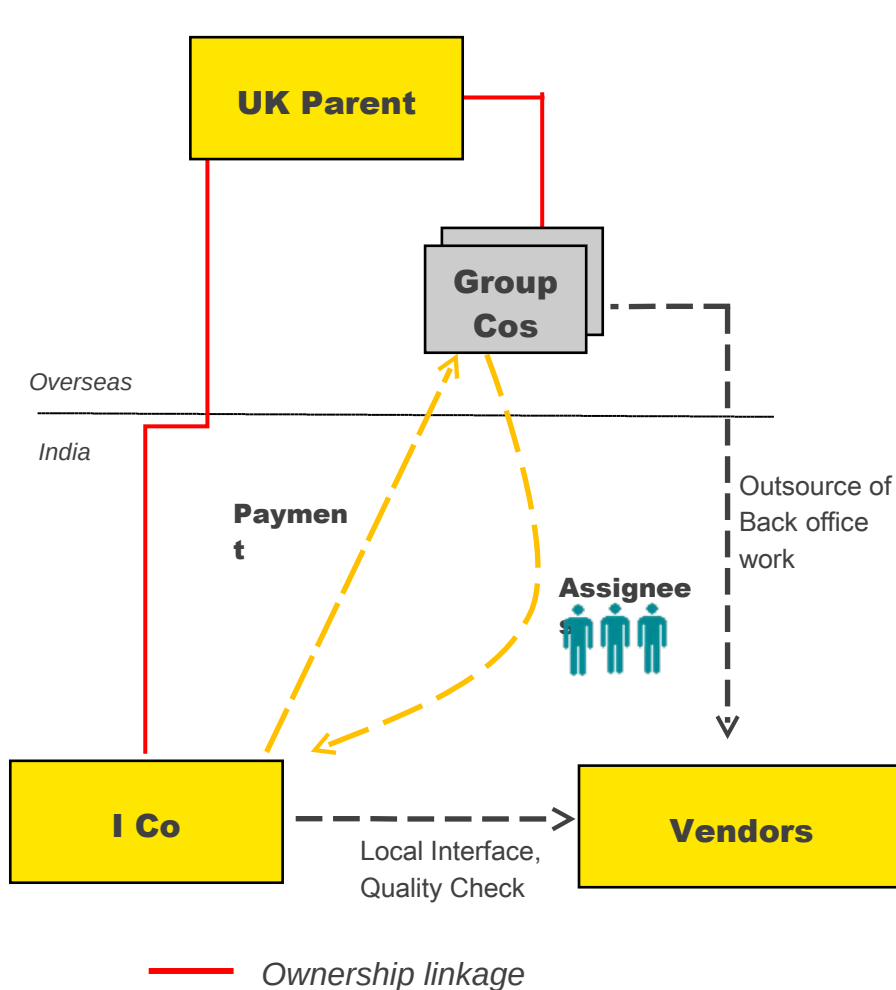
## **Ruling of the SC**

- ▶ No Fixed Place PE - MSAS only performs 'back-office' operations; in any case 'preparatory and auxiliary' in nature: Article (5)(3)(e)
- ▶ No Agency PE - MSAS has no authority to conclude contracts in India
- ▶ No Service PE (stewardship) - Employees of MS-Co perform stewardship function merely to protect MS-Co's interests; no services flow to MSAS
- ▶ Service PE (deputation) - Deputies retain lien on their jobs with MS-Co; services rendered to MSAS through employees
- ▶ Profit Attribution - MSAS, a (deputation) service PE, remunerated on arm's length basis – No further attribution possible if transfer price takes into account all functions & risks of MNE

# Centrica India Offshore Case - [TS-237-HC 2014(DEL)]



# Centrica India Offshore Case - [TS-237-HC 2014(DEL)]



- ▶ Centrica India, an Indian company (I Co) and Group Cos were subsidiaries of a UK parent
- ▶ Group Cos outsourced back office support functions to third party vendors in India. I Co was required to act as the local interface for vendors in India
- ▶ Since I Co was newly incorporated, it needed the knowledge of processes and practices of the Group Cos. For this purpose, Group Cos seconded some assignees with knowledge and experience to work with I Co in India.
- ▶ Salary was disbursed overseas by Group Cos and it was recovered monthly from I Co
- ▶ Issue – tax treatment of the payments made by I Co to Group Cos and whether Group Cos had a PE in India?

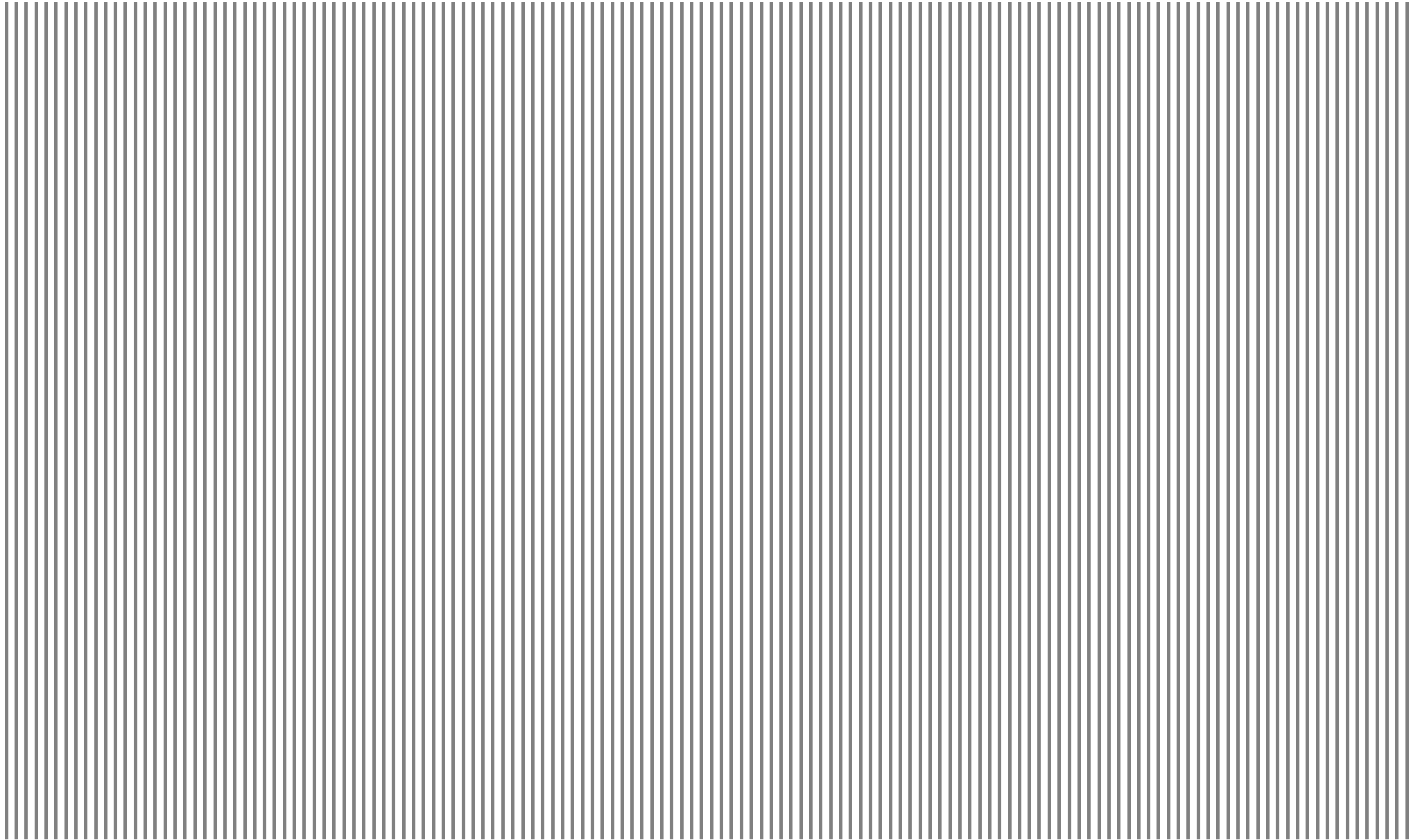


# Centrica India Offshore Case - [TS-237-HC 2014(DEL)]

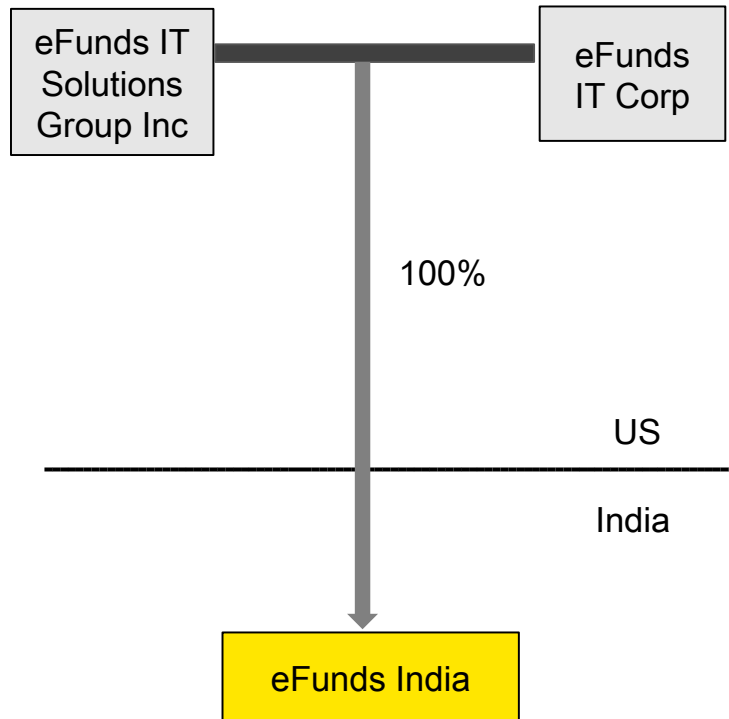
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- ▶ Ruling of Delhi HC
  - ▶ Assignees remained employees of Group Cos
    - ▶ There is subsisting and independent employment relationship with Group Cos,
    - ▶ Assignees retained “lien” on employment with Group Cos; they continued to participate in retirement and social security plans and other benefits
    - ▶ Group Cos were not conduits and employment with them is not fraudulent
    - ▶ I Co merely had operational control over the assignees and had to bear the risks/ rewards of their work, which is not sufficient
    - ▶ I Co had no right to terminate their employment with Group Cos
    - ▶ Right to remunerate assignees as well as to legal recourse lied with Group Cos and right to terminate employment is not with I Co
  - ▶ Payments by I Co amounted to Fees for Included Services (FIS) under the relevant tax treaty
  - ▶ Furthermore, the presence/ activities of assignees created service PE for Group Cos in India based on the SC decision of Morgan Stanley

# **E Funds Corporation – Delhi HC [TS-63-HC-2014 (DEL)]**



# E Funds Corporation – Delhi HC [TS-63-HC-2014 (DEL)]



**Rendition of following services by eFunds India to the Parent in lieu of remuneration – back office operations**

- ▶ Call centre services
- ▶ Financial shared services and data entry
- ▶ Software development services

## **Facts of the case**

- ▶ E Funds Corporation and E Funds IT Solutions Inc. (Taxpayers) are companies incorporated and residents of the US and E Fund India is indirect WOS of E Fund Corp
- ▶ The taxpayers were engaged in the business of electronic payments, ATM management services, decision support services etc
- ▶ The Tax Authority contended that the taxpayers had a taxable presence in India by way of business connection as well as a PE (Article 5 of the India-USA DTAA)
- ▶ On appeal, the Tribunal upheld the Tax Authority’s contention that a PE exists. However. Tribunal deviates from the method of attribution of profits
- ▶ The Taxpayers and tax authority appealed to the HC against the Tribunal’s ruling

## **Question before HC**

- ▶ Whether outsourcing of services to an Indian affiliate results in a PE in India for the F Co. under DTAA and if yes, the appropriate method of attribution of profits to such PE

# E Funds Corporation – Delhi HC [TS-63-HC-2014 (DEL)] Permanent Establishment

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## **Ruling of HC**

### *On Subsidiary PE*

- ▶ Held that a subsidiary constitutes an independent legal entity for taxation purpose. Hence holding-subsidiary relationship or control exercised by a parent on its subsidiary, by itself, does not result in a PE in India in terms of Article 5(6) of the DTAA
- ▶ The facts that Indian Co didn't bear sufficient risk, intangibles software provided by taxpayers to Indian Co, earning of income of I Co is dependent upon taxpayers, taxpayer had (sub) contracted work to Indian Co to save cost and increase profits, are irrelevant for determination of PE

### *On Fixed Place PE*

- ▶ A fixed place PE exists when foreign co has a fixed place of business in India at its disposal with certain degree of permanence and business (except certain functions as mentioned in negative list of DTAA) is carried on through such place
- ▶ The term through refers that foreign co should have power or liberty to control the place and right to determine conditions for itself
- ▶ The taxpayers didn't have any asset of office as their presence in India. The office of Indian Co cannot be constituted a fixed place PE of taxpayers in India

# E Funds Corporation – Delhi HC [TS-63-HC-2014 (DEL)] Permanent Establishment

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## **Ruling of HC**

### *On Service PE*

- ▶ The nature and functions performed by deputed employees need to be examined as also who exercises control and supervision over them. The employees of F Co were transferred to I Co for its overall control
- ▶ I Co was a service provider to F Cos. Thus, merely sending the employees by F Co to I Co to ensure quality and confidentiality for stewardship activities do not make a PE in India

# E Funds Corporation – Delhi HC [TS-63-HC-2014 (DEL)] Permanent Establishment

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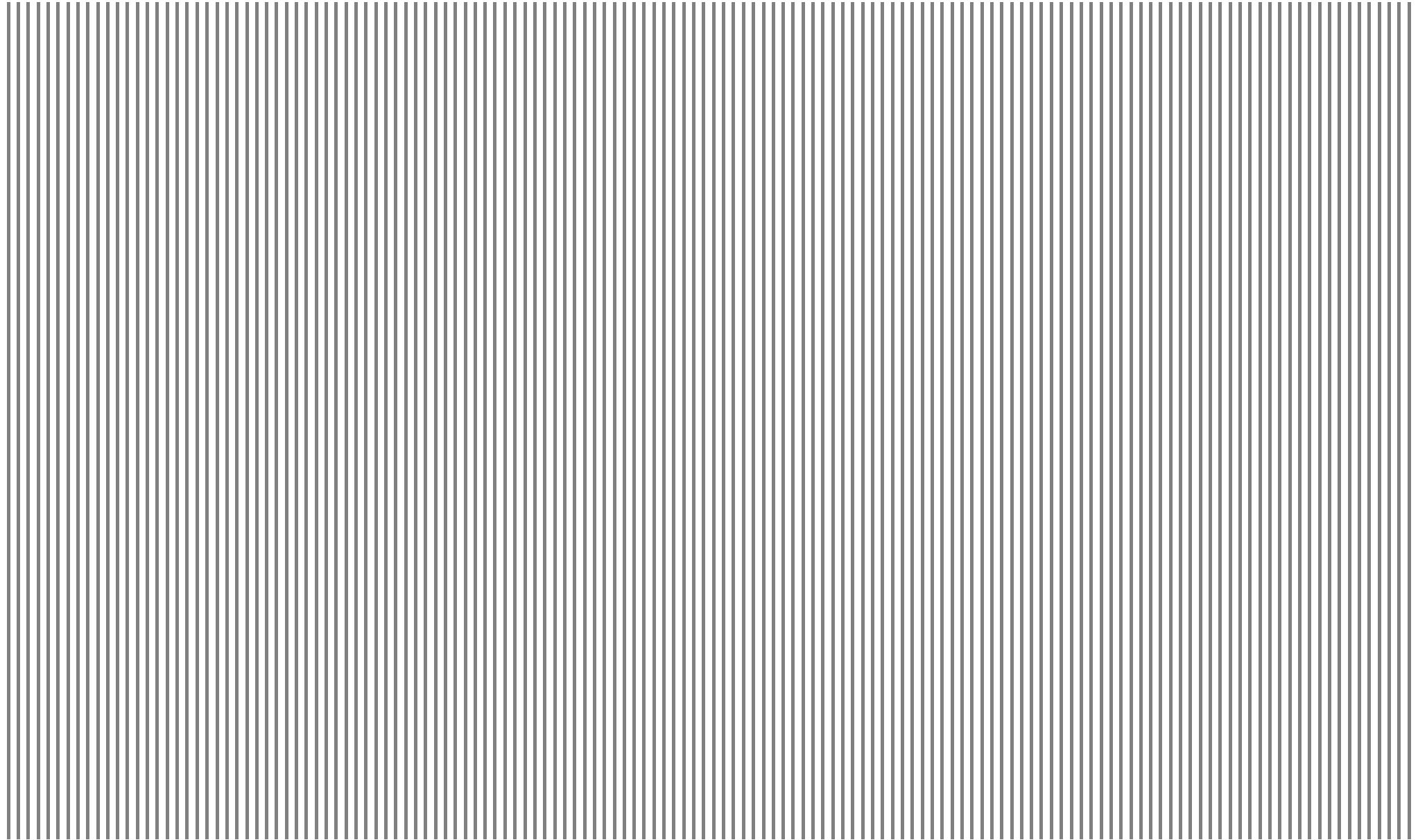
## On Agency PE

- ▶ Agency PE replaces fixed place PE with personal connection. A dependent agent who follows instruction and is personally dependent upon principal, represents dependency agency
- ▶ As per DTAA, an agency PE is created when a dependent agent exercises an authority to conclude contracts or maintains stock or secure orders on behalf of principal
- ▶ Further as per DTAA, where such agent is being remunerated at arm's length then by the fact that he wholly works on behalf of foreign co will not hamper its dependency otherwise
- ▶ The Indian co is engaged in providing inputs and information to taxpayers to enable them to enter into contracts but not entering into negotiation to conclude or secure contracts with third parties, neither maintaining any stock for Taxpayers in India. Thus, Taxpayers does not constitute PE in India

# Issues in the context of digital economy



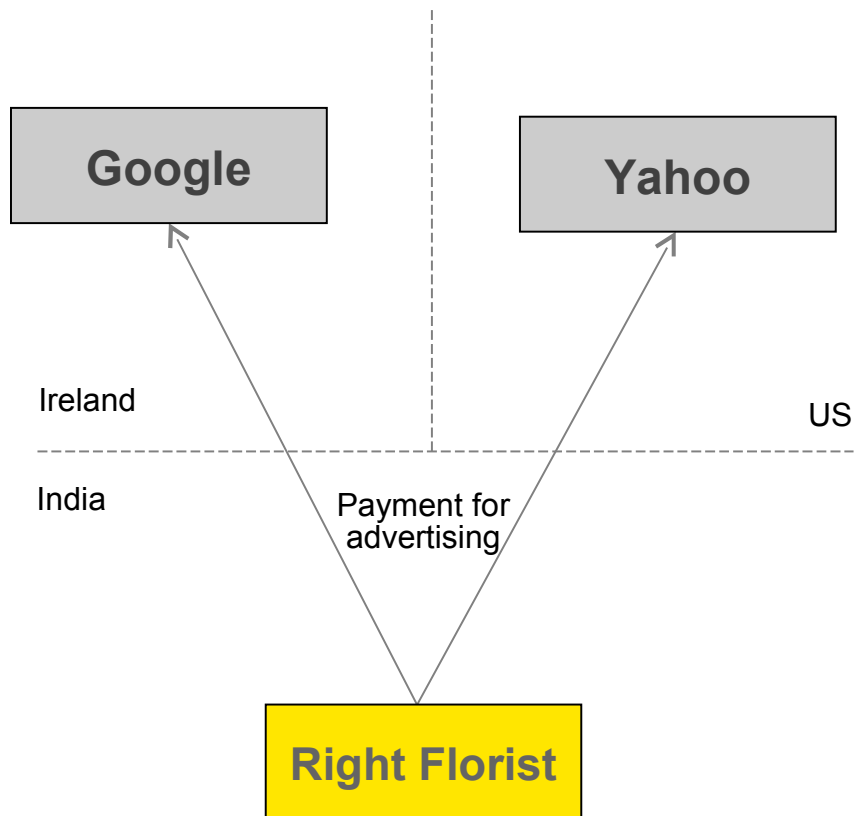
# Right Florists Case (143 ITD 445)(Kol) (2013)





# Right Florists Case (143 ITD 445)(KOl) (2013)

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## ▶ Facts

- ▶ Right Florist, an Indian company (Taxpayer), used search engines of Google/Yahoo for advertising its business.
- ▶ Payments were made to Google Ireland (Google) and Yahoo US (Yahoo) for displaying the Taxpayer's advertisement when certain key terms were used on such search engines.

## ▶ Relevant issue

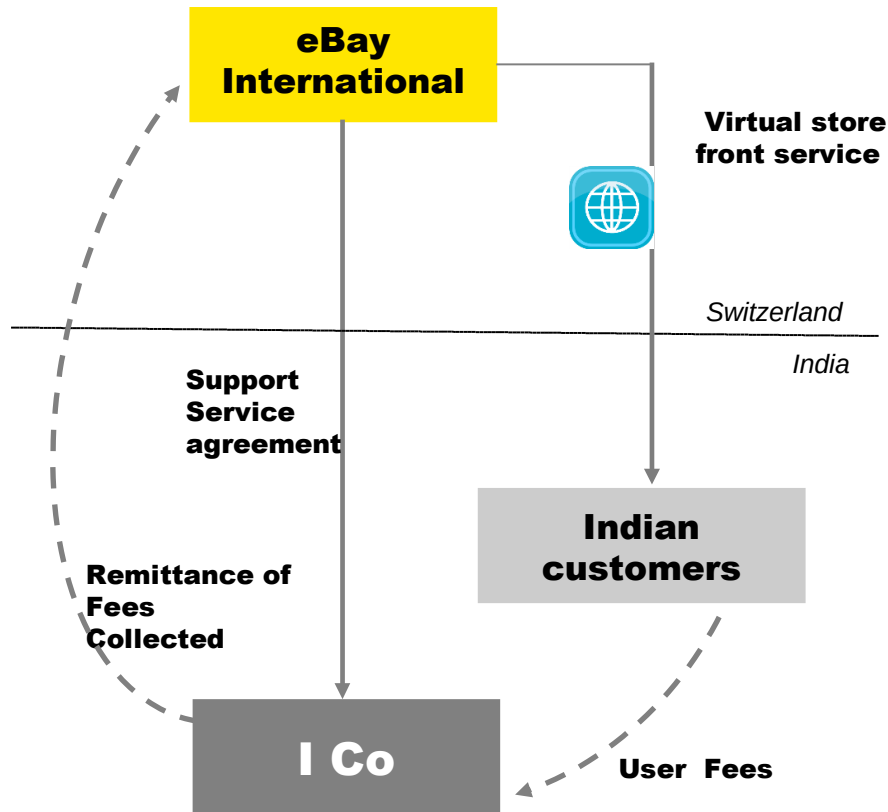
- ▶ Do Google/Yahoo have a taxable presence in India?

# Right Florists Case (143 ITD 445)(Kol) (2013)

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- ▶ Ruling of Tribunal
  - ▶ Reliance placed on OECD MC to conclude that a search engine, which has presence through its website, cannot have a PE in India, unless the web servers are located in India
  - ▶ India's reservations on the OECD MC have no role to play in the judicial analysis of treaties entered into by India after expressing its reservations (i.e., after 2008)
    - ▶ Reservations state that the website may constitute a PE in "certain circumstances", but it does not specify the circumstances in which a website could constitute a PE
    - ▶ Reservations can be treated as *contemporanea expositio* in respect of tax treaties. Beyond this, they do not play a role in judicial analysis
  - ▶ Traditional PE tests fail when it comes to e-commerce models, and it is time to find an alternative to the PE concept

# eBay International Case (140 ITD 20)(Mum) (2012)



## ▶ Facts

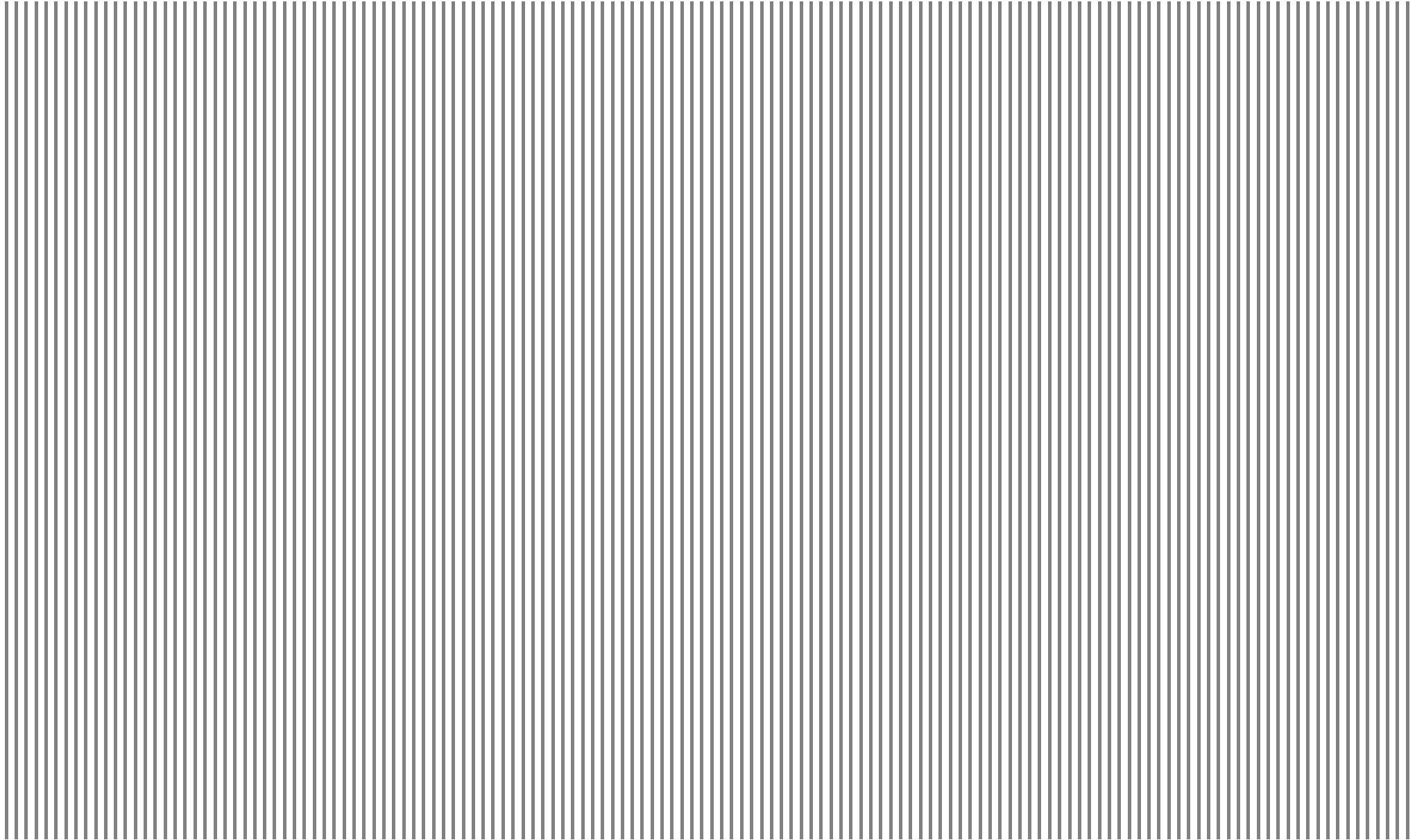
- ▶ eBay International AG (eBay), a Swiss tax resident, operated India-specific websites for facilitating the trade of goods and services to Indian customers.
- ▶ eBay earned a “user fee” from Indian customers on every successful sale of its products on the website.
- ▶ eBay engaged its Indian affiliate (I Co) for certain support services such as collection of payments from Indian users and of marketing data, promotional activities and market awareness for attracting customers.
- ▶ I Co was compensated on an arm’s-length basis
- ▶ Issue
  - ▶ Whether eBay had a PE in India

# eBay International Case (140 ITD 20)(Mum) (2012)

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- ▶ Ruling of Mumbai Tribunal
  - ▶ eBay's websites are analogous to a "market place" where buyers and sellers assemble to transact
  - ▶ Agreements between eBay and customers were entered into online through eBay's websites and were situated and controlled from abroad. There was no interference/ involvement of I Co
  - ▶ Websites of eBay are not directly or indirectly controlled by I Co
  - ▶ Although I Co makes advertisements in India to create awareness among sellers, it has no role in directly introducing users to eBay
  - ▶ I Co does not constitute a DAPE for eBay
    - ▶ I Co is a dependent agent of eBay, since it provides exclusive services to eBay and its only source of income is from eBay. However, I Co does not did not perform DAPE trigger activities
  - ▶ I Co does not constitute a "place of management" (POM) for eBay
    - ▶ POM refers to a place where overall managerial decisions of the enterprise are taken
    - ▶ All business decisions and deals are settled through eBay's websites, and I Cos has no role to play either in the maintenance or in the operation of the websites

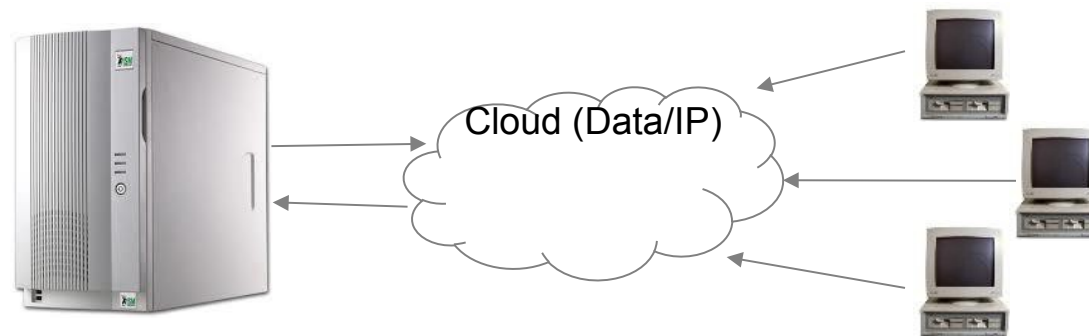
# Cloud Computing



# Cloud computing – Concept

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- ▶ ‘Cloud’ is considered synonym with integrated framework of computers
  - ▶ Internet is an example of cloud



- ▶ Cloud computing often provides customers with a cost effective alternative to purchasing and maintaining their own IT infrastructure
  - ▶ the cost of the consumer resources is generally shared among a wide user base
  - ▶ The typical arrangement would have reference to grant of licence,etc
    - ▶ This is a feature of DE which uses the term licence more to indicate scope of rights and limitation of the user
- ▶ Cloud computing are largely driven by economies of scale in setting up the infrastructure and maximising server usage by sharing space among clients whose needs for space and processing power may vary on a flexible basis

# Cloud Business models

<b>Particulars</b>	<b>Infrastructure as a service (IaaS)</b>	<b>Software as a service (SaaS)</b>	<b>Platform as a Service (PaaS)</b>
Brief nature of Transaction	Involves offering of computers servers, network infrastructure and other resources	Involves delivering applications over the Internet as a service. SaaS provider manages access to the application including security, availability, and Performance	Involves cloud providers deliver a computing platform, typically including operating system, programming language execution environment, database, and web Server
Contractual terms	Customer receives access to server or network infrastructure of vendor	Customer receives the access to the software or database of the vendor, whether owned or obtained on lease from third party	Customer receives the access to the platform of the vendor, whether owned or obtained on lease from third party.

Also emerging models are (a) Network as a Service (NaaS), (b) Communication as a Service (CaaS); (c) Anything as a Service (XaaS); (d) Business Process as a Service; (e) Database as a Service etc.

# Typical Direct tax Issues

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## ▶ **Taxability of payments for cloud services?**

- ▶ Identify the nature of services as Royalty, FTS or Business profits
  - ▶ Business profits are taxable in a source state (i.e. India) only where there exists a PE in India

## ▶ **Taxability of payments for cloud services as Business Profits?**

- ▶ Typically, the servers/ equipment are located outside India
- ▶ In the absence of any fixed place in India and absence of any activity in India, there may not be a Fixed place PE implication
- ▶ Conclusion of contracts in India by a dependent agent (if any) needs to be evaluated on the facts of each case
- ▶ Whether a PE exists considering the existence of a fixed place PE, agency PE and a Service PE under the respective tax treaty?
- ▶ Impact of India's observation to the OECD's Model convention?
- ▶ **While cloud arrangements are popularly referred to as services and do generally have element of service, the nomenclature is neither conclusive nor likely to obliterate an arrangement where the substance involves grant of use of equipment or software on a dedicated basis to the payer**



# BEPS developments (Action 7)



# Action 7: Background

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- ▶ Action 7 aims at developing changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS
- ▶ BEPS proposals are not legally binding but they represent a **consensus** of OECD and G20 member countries participating in the project \*
  - ▶ All OECD and G20 members (**including India**) committed to implement the proposals
- ▶ Action 7 proposals require amendment of existing tax treaties\*
  - ▶ About 90 countries have already started negotiation of a MI to implement the treaty-related BEPS measures and modify bilateral tax treaties in a synchronised and efficient manner
  - ▶ MI implementing treaty changes is expected to be open for signature in 2016

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\* Source : OECD's Frequently Asked Questions on 2015 Final Reports ([www.oecd.org](http://www.oecd.org))

# Action 7: Background

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- ▶ Changes to apply prospectively; not to effect the interpretation of former provisions of OECD MC and current treaties based on it\*
- ▶ Additional guidance on profit attribution to PEs resulting from the changes proposed in Action 7 Final Report is expected in 2016
- ▶ Incorporation of changes resulting from Action 7 Final Report into OECD MC through an update of the MC in 2016
- ▶ May include additional clarification on the new treaty wording as introduced by the Final Report on Action 7

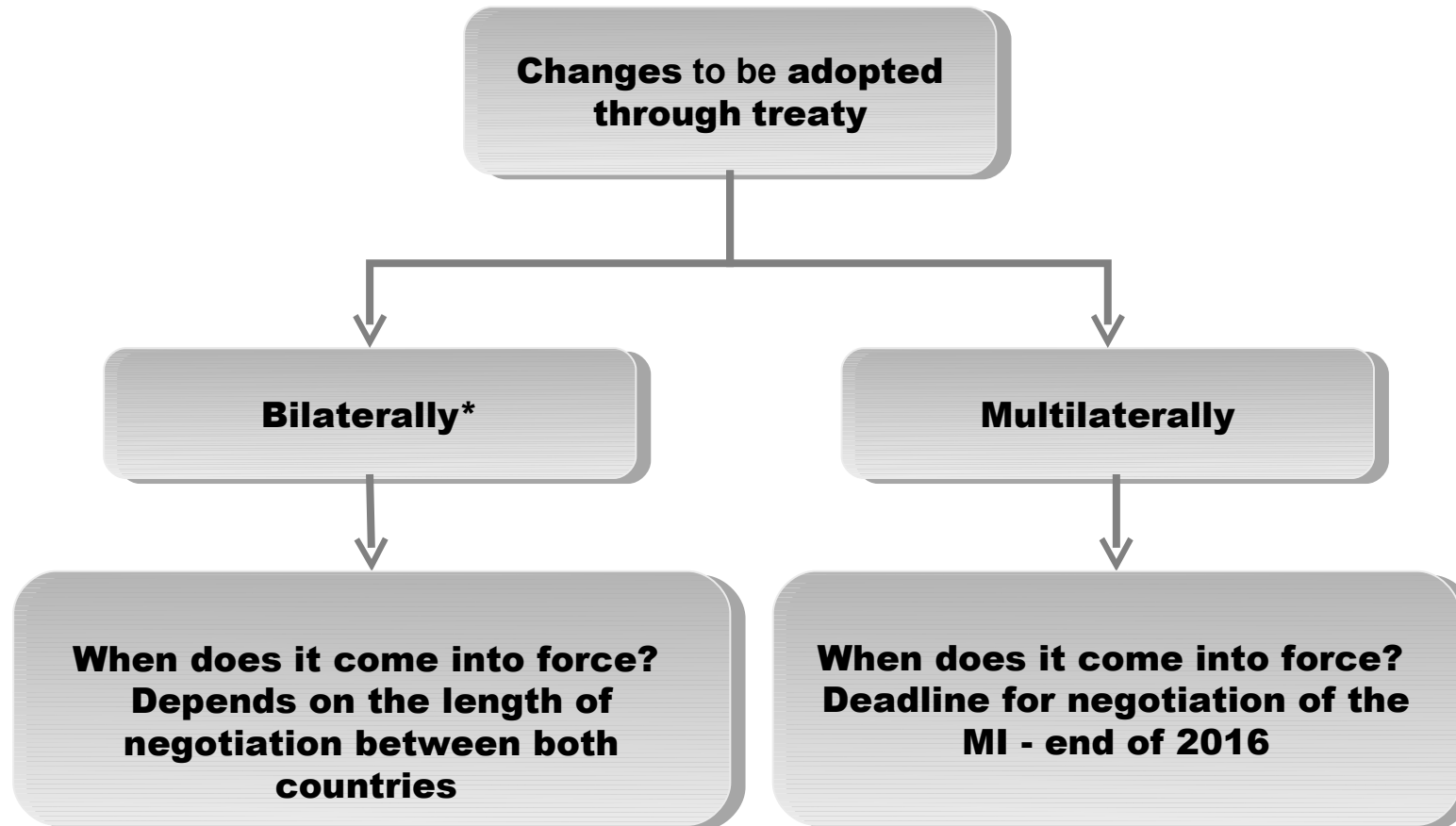
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\* Source : Action 7 Final Report, Background (Para 4)

# Action 7: Implementation

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- ▶ Implementation of final proposals is key at this stage!



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\* May be relevant where a treaty partner does not sign the MI or for implementation in future treaties

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# PE concept : OECD BEPS context

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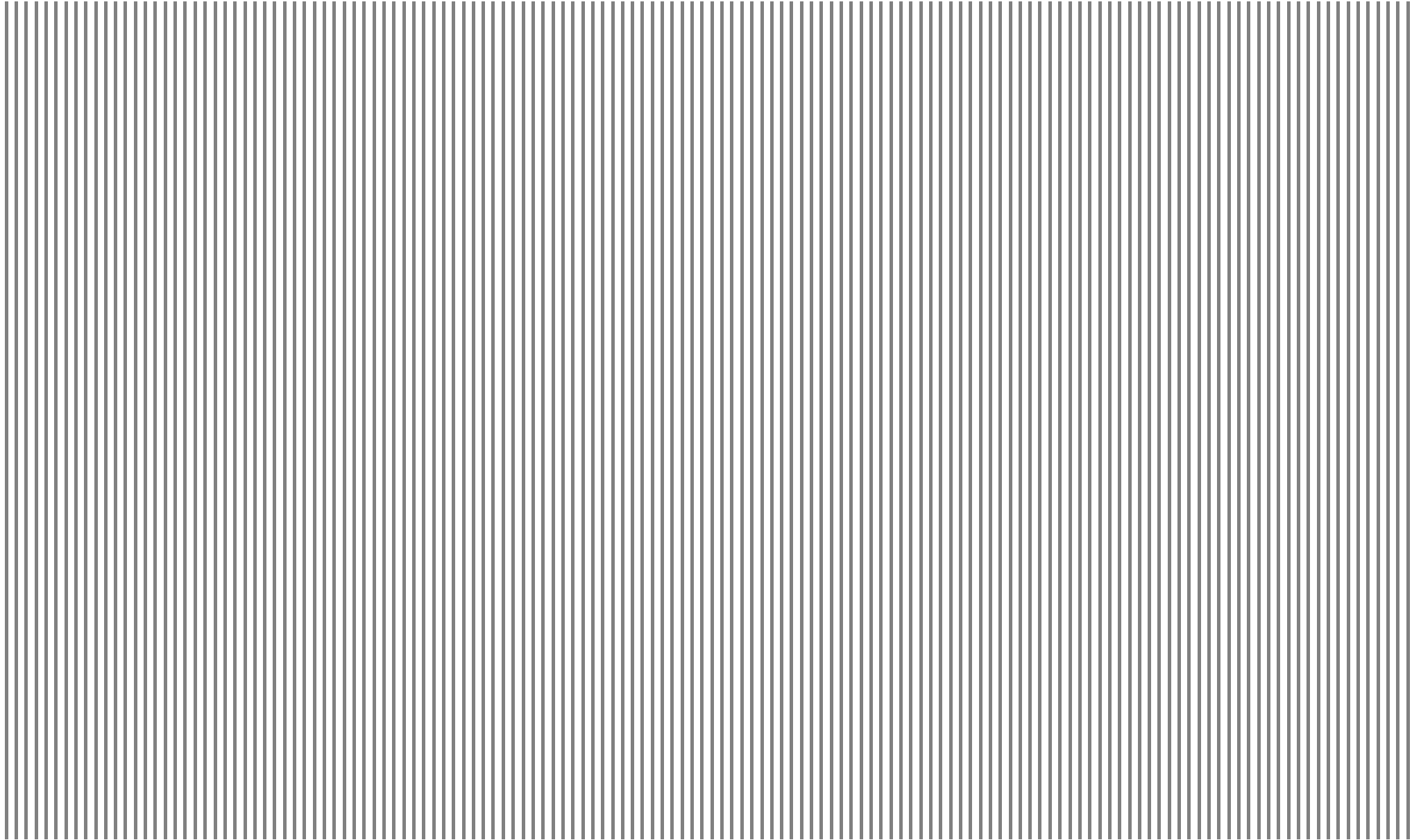
- ▶ PE: Continues to be sole criteria of taxing business profits of FE
  - ▶ Business profits of a FE are taxable in a State only to the extent that FE has a PE in that State, to which the profits are attributable
- ▶ Present concept of PE revolves around ‘substantial & physical’ presence
  - ▶ Fixed place of business - Art 5(1) Fixed PE
  - ▶ Construction PE – Art 5(3)
  - ▶ Presence through Agents - Art 5(5)
  - ▶ Above forms of PE are subject to 5(4) Exclusions
- ▶ Aim of BEPS Action 7: Preventing artificial avoidance of PE Status
  - ▶ Develop changes to the definition of PE to prevent artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues

# Action 7 Final Report : At a glance

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	<b>Areas of focus</b>	<b>Final proposals</b>
1	Commissionaire (and similar arrangements)	Expansion of Art. 5(5) and 5(6) by lowering PE threshold and tightening independence criteria
2	Specific activities exemptions	Narrowing scope of PE exemptions in Art. 5 (4) by inserting general condition of activity being P&A in nature
3	Splitting up of contracts (Projects where services are carried out by several entities)	Application of general anti-abuse rules based on principal purpose test
4	Attribution of profits	Follow up work on attribution of profits under Art 7, to come out with additional guidance by 2016

# Changes to Article 5(5), 5(6)



# Action 7 Final Report

## Article 5(5) – Existing and Proposed

<b>Existing Article (in OECD MC 2014)</b>	<b>Proposed article (as per Action 7 Final report)</b>
<p>Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and</p>	<p>Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where person is acting in a Contracting State on behalf of an enterprise and, in doing so,</p>
<p>and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise.</p>	<p>habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are</p> <ul style="list-style-type: none"> <li>a) in the name of the enterprise, or</li> <li>b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or</li> <li>c) for the provision of services by that enterprise</li> </ul>
<p>, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph</p>	<p>that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</p>



# Article 5(5) – Existing v/s Proposed Comparison

Condition for dependent agent to create PE	Coverage	
	Existing Article	Proposed as per Action 7
Acting on behalf of FE	*	*
Habitually exercising authority to conclude contracts , or	*	*
Habitually concludes contracts in the name of FE	*	*
Habitually plays principal role leading to conclusion of contract (whether or not in the name of FE) that are routinely concluded without material modification by the enterprise	<b>X**</b>	*
Contracts that are -		
a)in the name of the enterprise, or	*	*
b)for the transfer of the ownership of, or for the granting of the right to use, property owned FE or	<b>X</b>	*
c)for the provision of services by FE	<del>X</del>	*
Exclusion to independent agents under Art 5(6)	<del>X</del>	<del>X**</del>
Exclusion to Art 5(4) activities carried though fixed POB	*	**

\* Though not explicitly included in proposed Art 5(5), gets covered in substance

\*\*Action 7 Final Report alters scope of these provisions

# Proposed Article 5(5) – Changes from existing provision

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- ▶ Enlarged Scope of Article 5(5) [Referred to as Extended Agency PE Rule (EAPE)]
  - ▶ Deemed PE if person acts “on behalf of” the FE
  - ▶ Continues to cover an agent who ‘habitually concludes contracts’ in the name of FE
  - ▶ **Also extends to the agent who:**
    - ▶ **habitually plays the principal role;**
    - ▶ **which leads to conclusion of contracts;**
    - ▶ **which contracts are routinely concluded without material modifications by the FE**
- ▶ Proposed article to apply in relation to contracts that are :
  - ▶ in the name of the foreign enterprise, or
  - ▶ for the transfer of ownership of property owned by the FE; or
  - ▶ for granting of right to use property (including tangible/intangible) in respect of which FE has right to use property; or
  - ▶ for the provision of services by FE

# Proposed Commentary to Art 5(5)

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- ▶ Reiterates that nature of agent's activity (and not the scope of authority of agent) is relevant to determine agency PE
  - ▶ Agency-principal relationship is relevant; P2P arrangements excluded
- ▶ Elaboration on meaning of "acting on behalf of"
  - ▶ "Acting on behalf of" FE is a necessary pre condition
  - ▶ Test of "acting on behalf of" the FE not fulfilled if the FE is not directly or indirectly affected by the action performed by agent
  - ▶ **Distributor (in source state) who buys products (including from an AE) in his own name, owns the property and resells it does not trigger an Agency PE as he does not act on behalf of the FE**
  - ▶ Likewise, Agency PE not triggered when a LRD concludes contracts on its own behalf
    - ▶ Transfer of title of property from FE to LRD and then from LRD to customer
    - ▶ LRD derives profits from sale as against commission from FE
    - ▶ Duration for which title of the property held by LRD is irrelevant

# Proposed Commentary : EAPE Rule

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- ▶ PE trigger example: Activities of securing and soliciting orders (without formal finalization) which are directly sent to warehouse from which goods belonging to the FE are delivered and such transactions are routinely approved by FE
- ▶ PE not created - Mere promotion and marketing function that does not directly result in conclusion of contracts
  - ▶ Representative of pharmaceutical enterprise promoting drug manufactured by FE by contacting doctors do not create a PE. Such marketing activity does not directly result in conclusion of contract between FE and doctor

# EAPE rule: Commissionaire Arrangement

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- ▶ Action 7 proposals explicitly deal with ‘commissionaire arrangements’
- ▶ Commissionaire arrangements exposed to PE risk
  - ▶ Covers commissionaire agents who, in their own name, concludes contract / plays principal role in conclusion of contract for transfer of title of goods / property owned by the FE or for provision of services
- ▶ Commissionaire models not common in India
  - ▶ Commissionaire is a civil law concept generally also recognized under European Civil law concept of agency
  - ▶ Typically, Commissionaire acts in “its own name” but for the account of a principal for the sale of principal's goods to customers, does not create a PE under current wordings of Article 5(5) requires agent to “conclude contracts in the name of the enterprise”
  - ▶ Under common law an undisclosed principal is legally bound to a third party by a contract made by an agent acting within its authority
  - ▶ India follows common law system and actual conduct is considered more relevant in determination of Agency PE

# Impact Analysis

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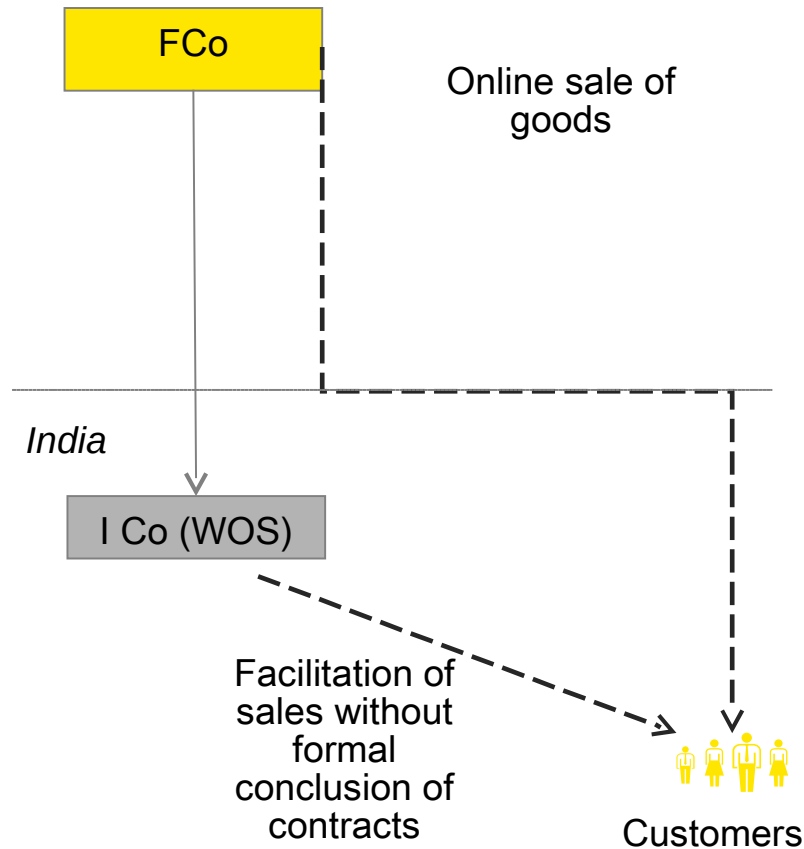
## **What is specifically included in EAPE?**

- ▶ Covers even the agency relationship of a service provider in addition to all forms of transfer/use of tangible/intangible properties including present and future properties
- ▶ Agency PE may now get extended also to services by agents like advertising, television, gaming, online services, cloud services etc.

## **What is excluded?**

- ▶ Excludes P2P activities and LRD in particular
- ▶ Support activities provided by BPO or KPO (such as call center for dismantling information, contract research) may not get covered by EAPE
- ▶ Mere Promotion and marketing of goods in a way which does not directly result in conclusion of contract remains outside the purview of Agency PE

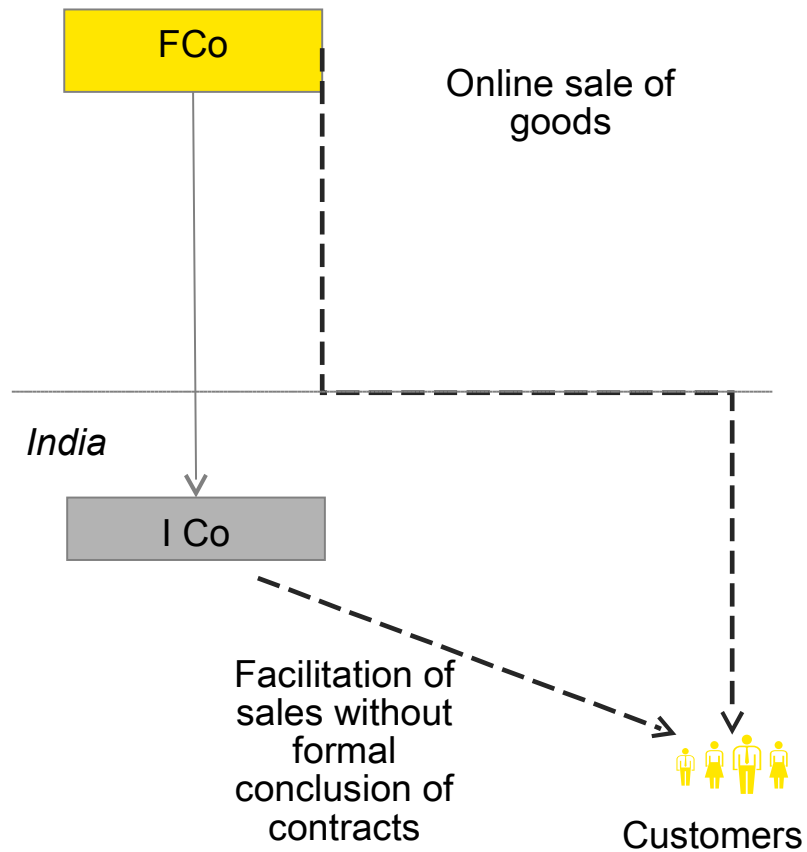
# Illustrating applicability of EAPE Rule- Example on Online distribution creating PE (Proposed Para 32.6 in Final Report)



## Facts

- ▶ FCo is a global distributor of goods and services through its website.
- ▶ Employees of I Co facilitate sales of F Co in India;
  - ▶ Identify potential customers
  - ▶ Use relationship building skills to understand need of customers
  - ▶ Convince them to buy the products/ services offered by F Co through emails, visits to large organisations
  - ▶ Responsible for large accounts
  - ▶ Explain standard terms (viz. fixed price, quantity, mode of concluding contracts online etc.)
- ▶ ICo employees cannot modify price structure
- ▶ Contracts are concluded online between FCo and the customers basis price structure presented and for discussed
- ▶ *See impact analysis on next slide – Illustrates playing of principal role + routine conclusion on standard terms*

# Illustrating applicability of EAPE Rule - ... contd



## Implications under current provisions

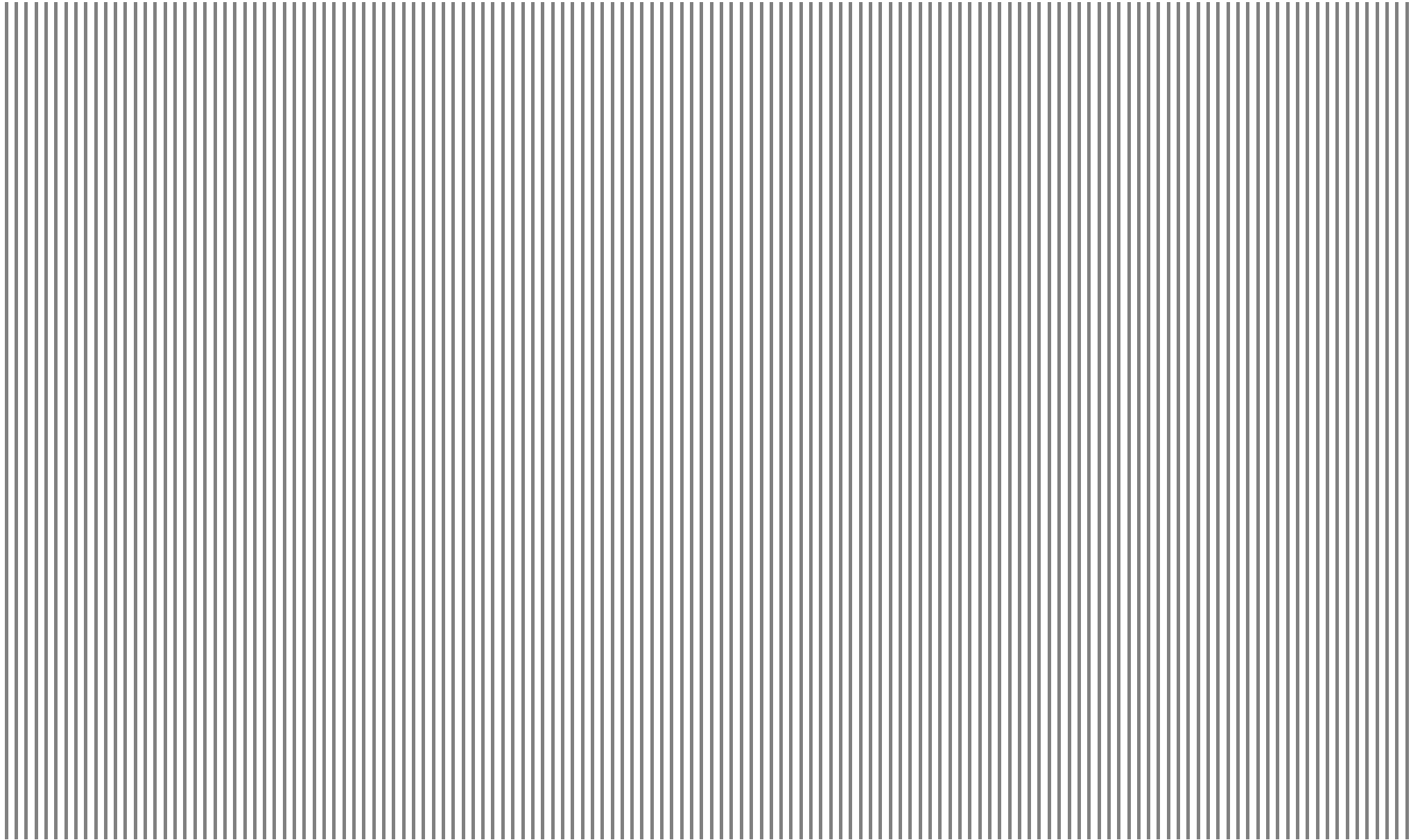
- ▶ Possibly no PE under 'conclusion of contract' test

## Implication under proposed provision

- ▶ Employees play principal role resulting in conclusion of contracts
- ▶ Also, presence of non-alterable standard terms do not impact that contracts were as a result of performance by ICo employees to convince the customers to accept the terms
- ▶ Role of ICo's employees a crucial element to conclusion of contract
- ▶ Triggers dependent agent PE of FCo in India



# Changes to Art 5(6)



# Proposed Article 5(6)

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- ▶ Independent Agent – An exclusion to Agency PE – proposed to be made stricter
- ▶ A person qualifies as an independent agent for exclusion under Art 5(6) if
  - (a) He acts as an independent agent, **and**
  - (b) He act in the ordinary course of business, **and**
  - (c) He does not act exclusively or almost exclusively on behalf of one or more Commonly Controlled Entities ('CRE')
- ▶ The above conditions need to be cumulatively satisfied to qualify for exclusion from Agency PE under Art 5(5)
- ▶ Proposed Commentary elaborates on scope of “ordinary course of business”

# Proposed Commentary to Art 5(6)

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- ▶ Explains meaning of “ordinary course of business”
  - ▶ Agent not acting in ordinary course if performs activities unrelated to agency business
  - ▶ If a person acts as a distributor for multiple unrelated parties but acts as an agent for CRE, the distribution activity will not be relevant for ascertaining ordinary course of his business as an agent
    - ▶ The test of ordinary course and consequently IA status fails even if the agent is independent of CRE
- ▶ Explains meaning of “exclusively or almost exclusively”
  - ▶ A person working for more than one enterprise does not automatically become independent. Article 5(6) criteria (i.e. legal/economic independence, ordinary course of business) needs to be fulfilled
  - ▶ Independent status less likely if acting exclusively for one principal or related entities **‘over a long time duration’**
  - ▶ Acting “almost exclusively” where person has no significant business activities apart from activities conducted for CREs
  - ▶ Illustrates a threshold of 90% to deny the independence status

# Exclusively, almost exclusively : India perspective

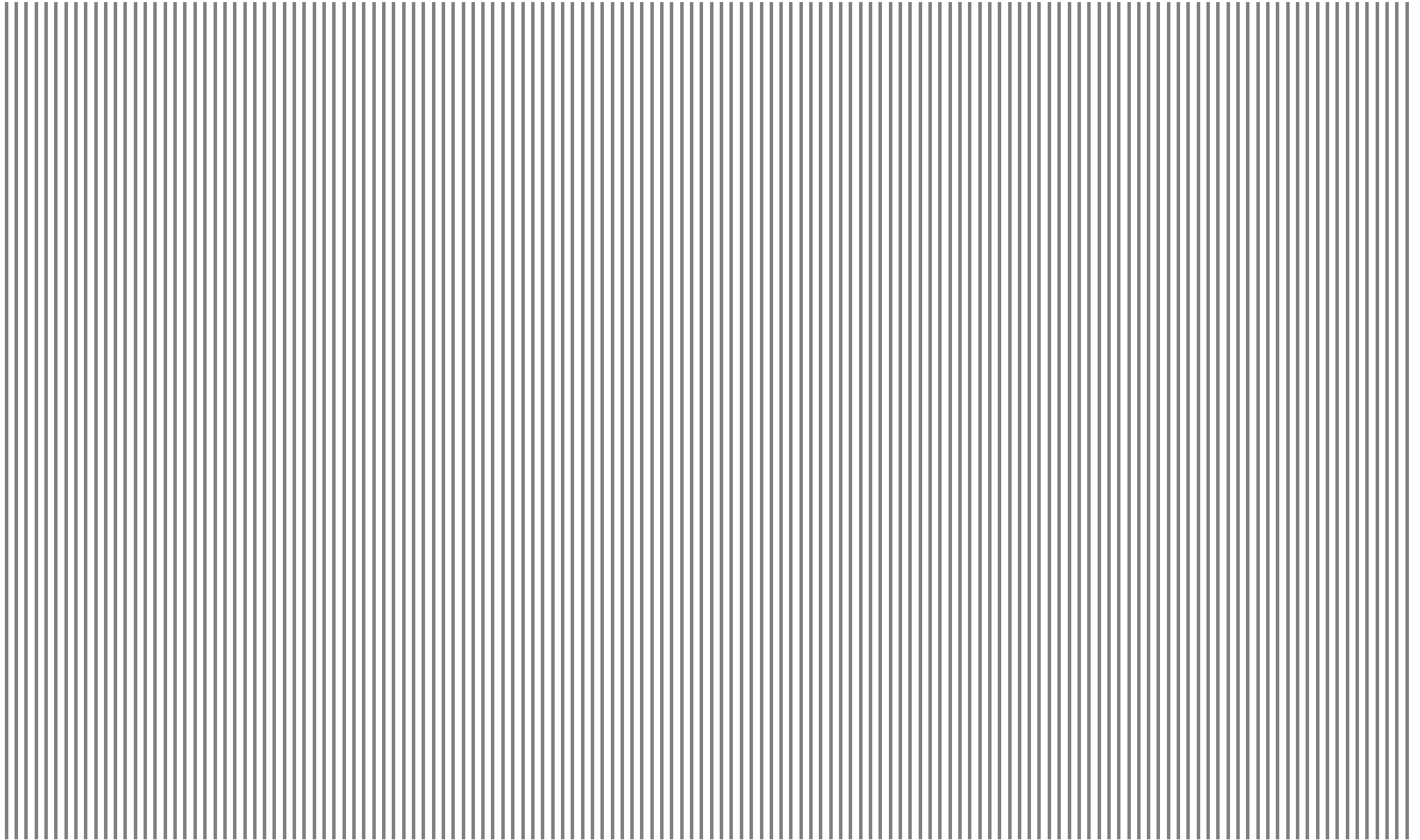
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- ▶ “Exclusively, almost exclusively” [“wholly or almost wholly”]
  - ▶ Condition also present in UN MC 2011, many Indian treaties and S. 9 of the Act
  - ▶ “Exclusively or almost exclusively” may be considered similar to “wholly or almost wholly”
  - ▶ Indian Courts have interpreted “wholly or almost wholly” ; sets 90%+ threshold to categorise as dependent agent\*

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\* Specialty Magazines (274 ITR 310)  
Western Union Financial Services (101 TTJ 56) (Delhi ITAT)

# Specific activity exemption : Article 5(4)



# Specific activity exemption : Present Position

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- ▶ Art 5(4) of OECD MC: Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
  - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
  - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
  - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
  - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, **any other activity of a preparatory or auxiliary character;**
  - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), **provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character,**

There is ambiguity on whether exceptions under sub-paras (a) to (d) Article 5(4) are subject to condition of being P&A in nature

# Action 7 Final Report - Proposed Article 5(4)

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- ▶ Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
  - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
  - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
  - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
  - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
  - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),

**provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.**

# BEPS Action 7 - Specific activity exemptions

## OECD's concern?

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- ▶ P&A activities were generally considered **non-value adding activities** and therefore little profit would be allocated thereto
  - ▶ Thought such P&A activities contribute to the productivity, these services are so 'remote' from actual realization of profit that it is difficult to attribute profits to it

What is the OECD's concern?

- ▶ Specific activity exemptions open to BEPS abuse
- ▶ Activities performed in source state may in fact be value-added for the taxpayer's business if
  - ▶ Delivery of goods, purchasing of goods or collecting information is core function, or
  - ▶ Cohesive business activities are artificially fragmented
- ▶ Profits that should be taxed in source state are instead taxed in resident state where the taxpayer is resident



# Proposed Commentary on Article 5(4)

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- ▶ Art 5(4) exemption applies only if the listed activities have a P&A character
- ▶ Reiterates that P&A activities are carried on for the FE itself and not on behalf of other enterprises
  - ▶ Example : An office maintained by FE for advertising its own products / services would constitute a PE if it were to engage in advertising on behalf of other enterprises at the same office\*
- ▶ Onus on taxpayer to demonstrate that activities are for self and are of P&A character
- ▶ Reiterates that P&A character to be determined in the context of activities of the business of FE as a whole

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\* *Proposed para 21.3 of OECD Commentary*

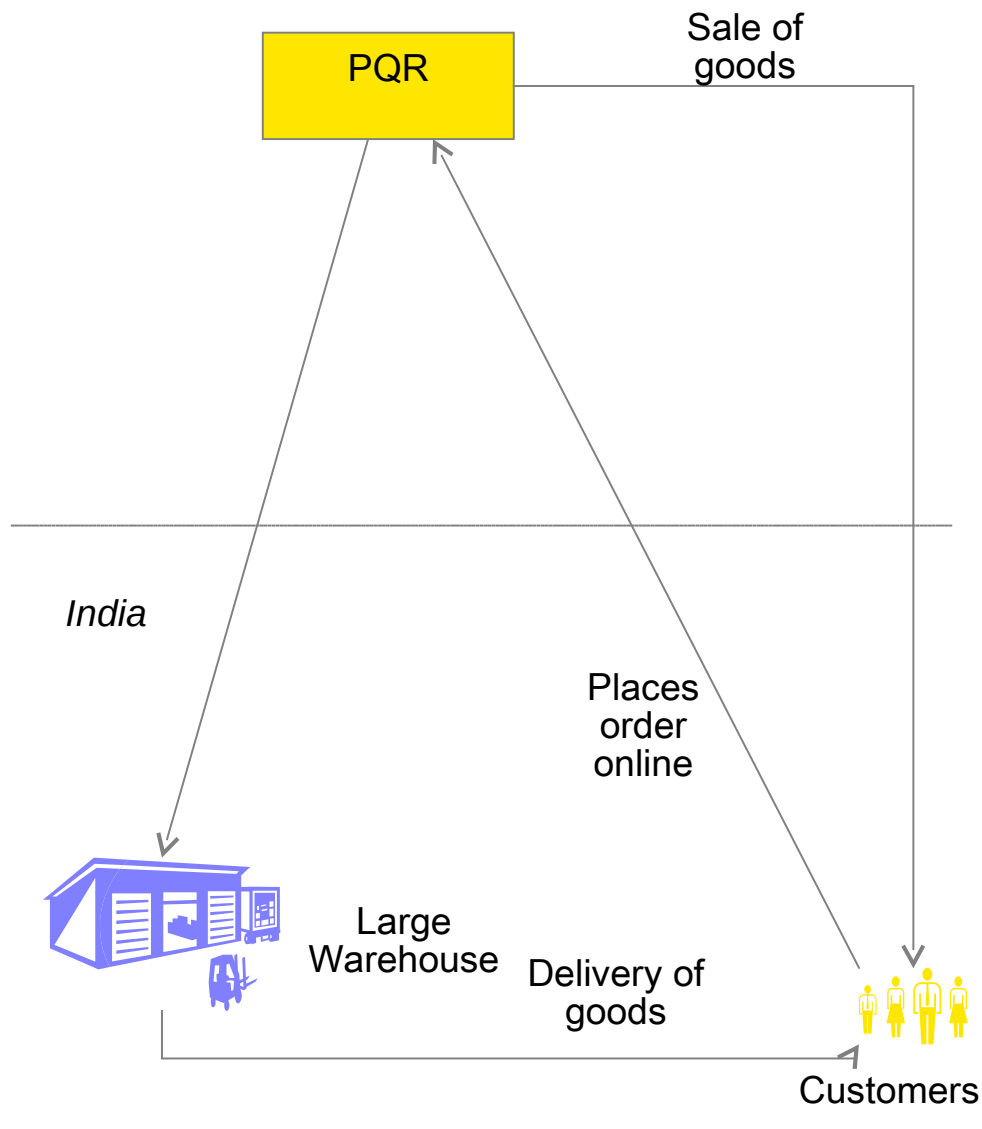
# Article 5(4)(a): Storage, display or delivery of goods

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**“(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise”**

- ▶ **PE:** Enterprise maintains in another State a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in that other State
- ▶ **PE:** Delivery of spare parts to customers for machinery supplied and, in addition, for the maintenance or repairs of such machinery
- ▶ **No PE:** Examples of activities qualifying as P&A\*
  - ▶ Bonded warehouse, used by exporter of fruits from another state, solely for storing fruits in controlled environment during custom clearance process
  - ▶ Delivery : Fixed place of business maintained solely for delivery of spare parts to customers for machinery supplied to them – without an obligation of servicing

# Proposed Commentary to 5(4)(a): Examples of activities not P&A in nature\*



## Facts

- ▶ PQR is an online selling company.
- ▶ It maintains a large warehouse in India involving a significant number of employees who work for the main purpose of storing and delivering the goods.

## Whether P&A in nature under proposed provision of article 5(4)

- ▶ Activities carried out at the warehouse will not qualify as P/A activity, since:
  - ▶ Warehouse represents an important asset and requires a number of employees
  - ▶ Constitutes an essential part of the sales and distribution function of PQR

▶ Unlikely to apply in most Indian cases as treaties do not regard 'delivery' to be P&A

\* Proposed para 22 of OECD Commentary

# Art 5(4)(d): Purchase exclusion\*

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**“(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise”**

- ▶ **PE:** Purchasing office where the employees who work at that office are experienced and well paid buyers who visit producers in that State, determine the type / quality of the products according to international standards and enter into different types of contracts (spot or forward) for the acquisition of the products by enterprises
- ▶ **No PE:** Enterprise operates a number of large discount stores, maintains an office in another State during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow the enterprise to establish stores in that State. During that period, employees of the enterprise occasionally purchase supplies for their office

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*\*Proposed para 22.5 of OECD Commentary*

# Art 5(4)(d) Purchase Exclusion: Impact analysis

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## ▶ **Impact of proposed commentary**

- ▶ Scope of purchase exclusion diluted significantly:

- ▶ Proposed illustrates indicates that exclusion limited to

- (a) “Occasional purchases”

- (b) when such occasional purchases are part of auxiliary function of FE

- ▶ Regular purchase of raw material for manufacturing enterprise may not qualify for exclusion

- ▶ Section 9(1)(i)(b) of the ITL specifically exempts income arising in India from purchase activity for the purpose of exports

- ▶ Exemption proposed for encouraging exports

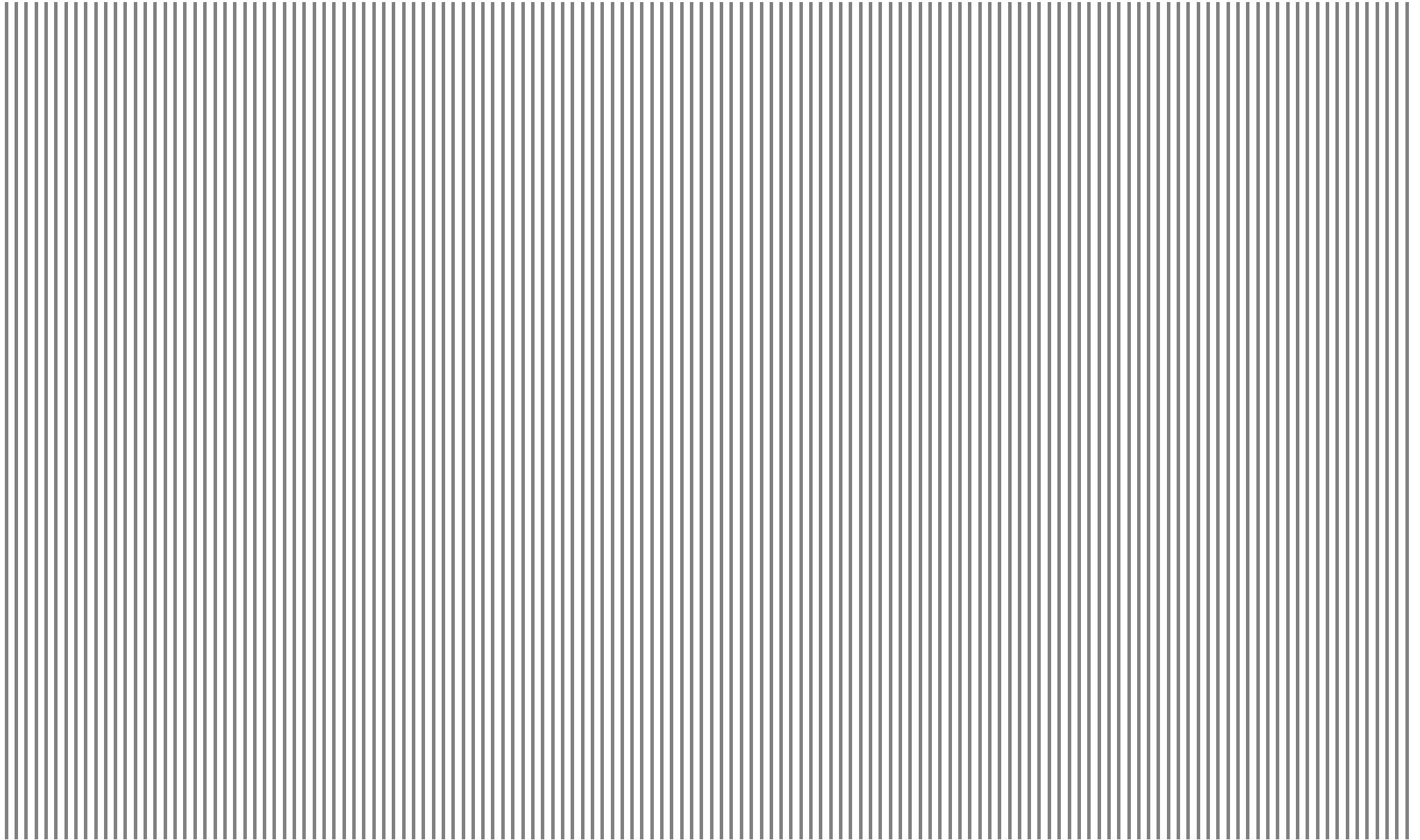
- ▶ Changes by the proposed commentary may not be relevant for India in view of wide exemption in ITL itself

# Art 5(4)(d): Collection of information

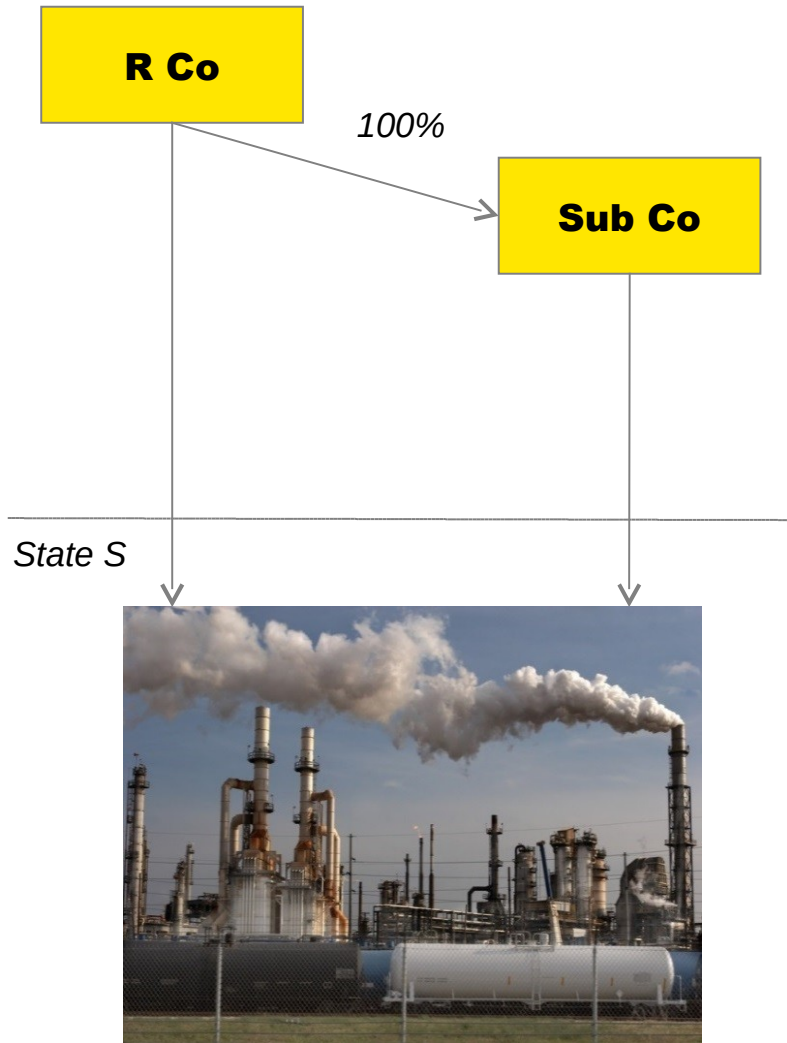
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- ▶ Art 5(4)(d) : Collection of information
  - ▶ Examples of activities qualifying as P&A
    - ▶ An insurance enterprise collecting information such as statistics on risks etc.
    - ▶ A newspaper bureau collecting information on possible news stories without advertising
    - ▶ An investment fund collecting information on possible investment opportunities in source state- preparatory in nature
  - ▶ Example of not P&A activity
    - ▶ Supply of information along with furnishing of plans etc. specially developed for customer
    - ▶ Section 9(1)(i) exempts collection of news and views for news companies: narrower than Art. 5(4) scope of 'collection of information'

# Splitting up of contracts



# Splitting up of contracts



- ▶ Splitting up of contract, being split up to fall below the prescribed threshold of PE
  - ▶ Separate contracts with different group entities
- ▶ Illustration
  - ▶ Construction / Installation PE threshold of 12 months as per relevant DTAA
  - ▶ Construction of power plant to be carried out for over 22 months
  - ▶ During negotiation, separate contracts entered into with group entities R Co and Sub Co (100% subsidiary of R Co) covering time period of 11 months each
  - ▶ R Co newly incorporated for the purpose of the project
  - ▶ Both entities jointly and severally responsible for the contract
  - ▶ No PE for both R Co and Sub Co



# Splitting up of contracts

## What is OECD's concern?

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- ▶ Art. 5(3) of the OECD Model Tax Convention provides that a building site or construction or installation project is a PE only if it lasts more than 12 months
- ▶ 2010 OECD Commentary recognizes splitting of contracts as an abusive practice for application of anti avoidance rules
- ▶ What is the OECD's concern?
  - ▶ 12 month rule is open to BEPS abuse
  - ▶ Because, contracts for construction-type activities can be split up such that they are:
    - ▶ carried out under separate contracts allocated to different associated enterprises; and
    - ▶ each contract covers a period of less than 12 months, such that no PE is created
  - ▶ As such profits relating to these construction activities that should be taxed in the source state are instead taxed where the various associated enterprises are tax resident

# Action 7 Final Report : Proposed **Changes to Commentary on article 5**

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- ▶ 'Principal Purpose Test' (PPT) rule to be added to the OECD Model as per the report on BEPS action 6 dealing with prevention of treaty abuse
  - ▶ PPT rule - A PE may be deemed to exist if contracts are concluded with a principal purpose of claiming an exemption under Article 5(3)

# Splitting up of Contracts Impact Analysis

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## ***BEFORE***

Construction-type activities carried out under separate contracts by different companies do not create PEs as long as each contract does not exceed 12-month threshold

## ***AFTER***

Under a general anti-abuse rule, a PE may be deemed to exist if contracts are negotiated and concluded with a principal purpose of claiming an exemption under Article 5(3)

Under the alternative proposal, it would be necessary to evaluate the activities carried on by one or more closely related enterprises at the same building site, construction or installation project to determine whether they are connected activities that should be aggregated

- ▶ Amendment in splitting of contracts to impact even genuine arrangements
  - ▶ Difficulties for group companies conducting different activities in different entities due to genuine legal and commercial reasons

# Action 7

## *India relevance*

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- ▶ How do BEPS proposals impact India's existing tax treaties?
- ▶ Purchase exclusion under Indian Tax Law (ITL) applies to operations confined to purchase of goods in India for the purpose of export
- ▶ Proposals may have impact beyond tax avoidant arrangements; possible emergence of new PEs in genuine arrangements
- ▶ PE emergence has consequential impact on employee taxation, capital gains tax for PE assets
- ▶ Attracts consequential withholding obligation, default for payers, etc.

# PE – Certain global trends

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## United Kingdom

- ▶ Diverted Profit tax of 25%<sup>1</sup> introduced from April 2015
- ▶ Introduction aimed to target ‘contrived’ arrangements by MNCs that divert profits from UK by avoiding a UK taxable PE and/ or by adopting other contrived arrangements between connected entities

## Kingdom of Saudi Arabia (‘SA’) and Kuwait

- ▶ Introduced a concept of virtual Service PE whereby a Service PE would arise based on the duration of contract (exceeding specified threshold) even where the services are rendered from outside
- ▶ Thus, any work performed under cross border agreements, which are concluded by a customer in SA/ Kuwait with a non resident for a period greater than the tax treaty prescribed threshold, will prima facie – create a Service PE in SA/ Kuwait even if the employees of the service provider are not present there and perform the services entirely offshore

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<sup>1</sup> – Diverted Profit Tax – 25% of diverted profits relating to UK activity

# Some illustrative key rulings on PE

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- ▶ Set Satellite Singapore PTE Limited [ 221 CTR 617] [Bom HC]
- ▶ Rolls Royce PLC [339 ITR 147] [Del HC]
- ▶ Nike Inc [265 CTR 508] [Kar HC]
- ▶ Brown & Sharpe Inc (ITA No. 219 of 2014) [Del HC]
- ▶ National Petroleum Corporation Limited [66 taxmann.com 16] [Del HC]
- ▶ Nortel Networks India International Inc. [49 taxmann.com] [Del HC]
- ▶ B4U International Holdings [ITA no. 1621 of 2013] [BOM HC]
- ▶ Delmas France [ ITA No. 1648 of 2012] [BOM HC]
- ▶ Aramex International Logistics (P) Ltd [348 ITR 159] [AAR]
- ▶ Speciality Magazines P. Ltd [274 ITR 310] [AAR]
- ▶ Daimler Chrysler A.G. [39 SOT 418] [Mum ITAT]
- ▶ NGC Network Asia LLC [64 taxmann.com 289] [Mum ITAT]
- ▶ Motorola Inc [95 ITD 269] [Del ITAT] [SB]
- ▶ Varian India [142 ITD 692] [Mum ITAT]

A decorative graphic on the left side of the page consists of a series of vertical lines of varying heights, creating a tapered, cone-like shape that points towards the center. On the right side, a large, solid yellow triangle points towards the center, meeting the tapered lines. The background is white.

# Thank You

**EY**

Building a better  
working world

# Annexures



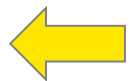


# Article 5 – UN Model

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## Article - 5(1) – Fixed Place PE

*For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*



# Article 5 – UN Model

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## Article - 5(2) – Specific Inclusions

*The term “permanent establishment” includes especially:*

*(a) A place of management;*

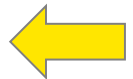
*(b) A branch;*

*(c) An office;*

*(d) A factory;*

*(e) A workshop;*

*(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*



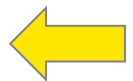
# Article 5 – UN Model contd..

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## Article - 5(3) – Construction PE & Service PE

*The term “permanent establishment” also encompasses:*

- (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;*
- (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.*



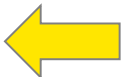
# Article 5 – UN Model contd..

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## Article - 5(4) – Exclusions from PE

*Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:*

- (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;*
- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;*
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
- (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
- (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.*
- (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*



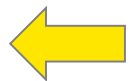
# Article 5 – UN Model contd..

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## Article - 5(5) – Dependent Agent PE

*Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 7 applies—is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:*

- (a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or*
- (b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*

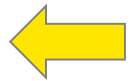


# Article 5 – UN Model contd..

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## Article - 5(6) – Deemed PE for Insurance Business

*Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.*

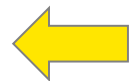


# Article 5 – UN Model contd..

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## Article - 5(7) – Independent Agent

*An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.*



# Article 5 – UN Model contd..

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## Article - 5(8) – Subsidiary PE

*The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.*

