

Click icon to add picture

Basics of Permanent Establishment

By Harsha Rawal

7th January, 2017

Index of Content

- Glossary of terms
- Business Connection
- Structure of Article 5
- Fixed Place PE
- Specific PE (inclusions)
- Installation/Construction PE
- Exclusions from PE
- Agency PE
- BEPS- Action plan 7
- Case Studies

Glossary of terms

Description for terms used	Terms used
Authority for Advance Ruling	AAR
Dependent Agent Permanent Establishment	DAPE
Double Taxation Avoidance Agreement	Tax treaty
Fees for Technical Services	FTS
Foreign Company	F Co
High Court	HC
Income Tax Act, 1961	Act
Income Tax Appellate Tribunal	ITAT
Indian Company	I Co
Liaison Office	LO
Model Convention	MC
Non Resident	NR
Organisation for Economic Co-operation and Development	OECD
Permanent Establishment	PE
Wholly Owned Subsidiary	WOS
Supreme Court	SC
United Nations	UN

Section 9(1)(i) – Business connection

Business Connection (BC)

- Section 9(1)(i) of ITA, 1961 - BC is the Indian equivalent of PE
- Finance Act, 2003 inserted inclusive definition mainly including business carried on through Dependent Agent as BC
- Two major factors relevant in determination of the BC
 - Real and Intimate connection
 - Continuity
- In order to have a BC, there must be a real and intimate connection between the activity carried on by the non-resident outside India and the activity carried out in India and such activity must be one, which contributes to the earnings of profits by the non-resident in his business – CIT v R D Aggarwal & Co 56 ITR 20 (SC)

BC vs. PE

BC

Domestic law concept

No exhaustive definition

No classification

Wider concept

PE

International tax concept

Defined exhaustively as well as illustratively

Classified as fixed place, agency, construction & service PE on the basis of activities performed

Narrower concept

Structure of Article 5

Structure of Article 5 – OECD

Fixed Place PE

Fixed Place PE

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

Location / Duration Test

- Location test requires that place of business to be located at a single place.
- OECD –Both geographical and commercial coherence are necessary, the fact that activities may be carried on within a limited geographical area should not result in that area being considered as a single place of business.
- An isolated activity cannot lead to establishment of fixed place of PE as the ingredients of regularity, continuity and repetitiveness are essentially missing.

Case studies

In which case would a PE arise for Mr. X ?

Specific PE (Inclusions)

Specific PE (Inclusions)

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
- Article 5(2) is inclusive in nature

Additional inclusions - Indian Tax treaties

- Warehouse in relation to person providing storage facilities for others - Tax treaties with Singapore, USA, Mauritius, Netherlands etc.
- A store or premises used as a sales outlet – Tax treaties with UK, Netherlands, etc.
- Installation or structure used for exploitation of natural resources – Tax treaties with US, Australia, Netherlands etc.
- Farm, plantation or any other place where agriculture, forestry, plantation or related

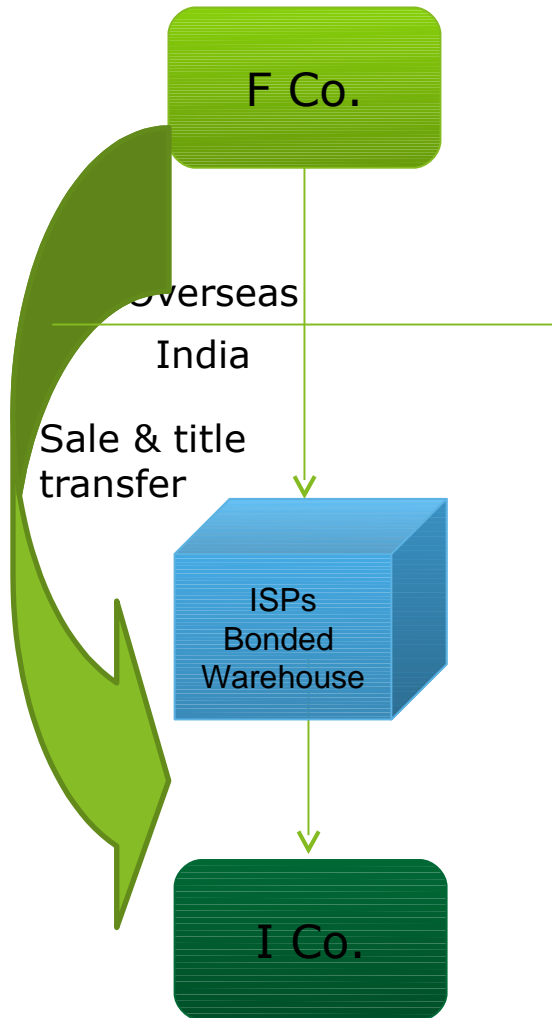
Specific PE (Inclusions)

- Whether inclusions in 5(2) independent of 5(1) ?
- Divergent views on interplay between Article 5(1) and Article 5(2)
 - One view- Place of business constitutes PE only if it satisfies the tests of basic rule for PE as specified in Article 5(1)
 - Other view- Article 5(2) is independent of Article 5(1)

² UN Commentary (2011) para 4, OECD commentary (2010) para 12, ABC (P No. P No. 24 of 1996) [1999] 237 ITR 798 (AAR)

³ Fugro Engineers B.V. Vs. ACIT [2008] 122 TTJ 655 (Del), Boudier Christian Vs. ITO [1993] 46 ITD 114 (Del)

Case Study I



- F Co engaged in the business of manufacture and sale of electronic goods
- F Co has a sales contract to supply goods to I Co as and when required
- F Co has appointed W Co, an unrelated party, to maintain stock of goods and deliver to I Co
 - 'Just-in-time' inventory management system
 - Title to goods remains with F Co until delivery to I Co
 - W Co has to store goods in accordance with F Co specifications
 - F Co may enter the premises for inspection of goods/display/repacking
- Does the facility where goods are stored constitute a "fixed place" PE for F Co?

Installation/Construction PE

Installation/Construction PE

- A building site or construction or installation project includes:
 - construction of roads, bridges or canals
 - renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals
 - Laying of pipelines
 - excavating and dredging
 - installation of new equipment in an existing building or outdoors
 - onsite planning and supervision of the construction of a building
- Where a office / workshop is used for a number of construction projects, then even if none of the projects continues for more than 6 months, it will be considered as PE under Art 5(2) if it satisfies the condition of Art 5

Installation/Construction PE- Comparison

Constituents of construction/installation PE	OECD	UN	US
Building site	√	√	√
Construction	√	√	√
Assembly Project	X	√	X
Installation Project	√	√	√
Supervision activities in connection with above	X	√	X
Drilling rig used for exploration of natural resources	X	X	√
Ship used for exploration of natural resources	X	X	√
Duration – Lasts for more than	12 months	6 months	12 months

Installation/Construction PE- Supervisory Activities

- The pre-requisite for supervisory activity constituting a PE is that such activity should be carried out only in connection with a building site, a construction, assembly or installation project and not otherwise
- A PE is constituted if the supervisory activities exceed the time limit
 - It is immaterial whether the individual building site, a construction, assembly or installation project (in respect of which the supervisory services are rendered) meets the time test
 - Minimum threshold in case of supervisory activities covered under a separate and independent contract must be considered from the date when such activities start and not from the date of commencement of the entire project – [Krupp UDHE GmbH (28 SOT 254) (Mum)]
- There is no condition that the person performing supervisory activities should also be providing installation service.

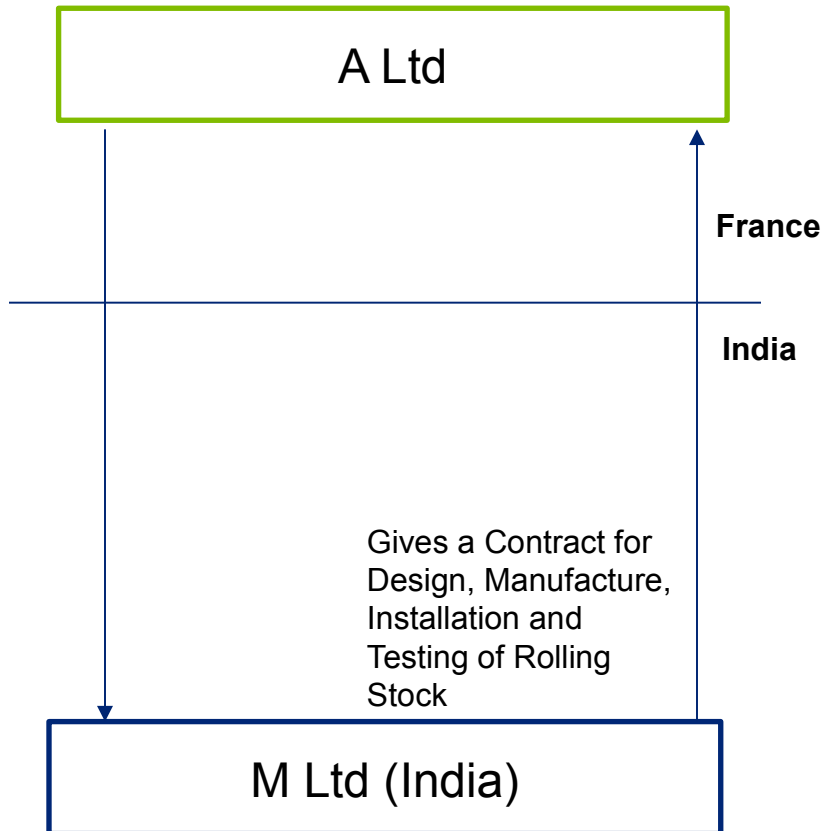
Installation/Construction PE- Measurement of Time Period

- A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established (eg. a planning office is installed)
- It continues until the work is complete or permanently abandoned.
- A site should not be regarded as ceasing to exist when work is temporarily discontinued – for example, due to bad weather, shortage of material, labour difficulties
- Temporary discontinuance of the work cannot be regarded as cessation of the site. Seasonal and temporary interruptions should be included in determining the life of a site
- In some projects, due to its nature, contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. For example – this would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid.
- OECD MC and UN MC provide that a site exists from the date on which a contractor begins his work including any preparatory work in the country where the construction is to be established
- If a foreign enterprise sub contracts part of its work in Source State in relation to such site or project or activities to a sub-contractor, the time spent by the sub contractor must be considered as time spent by the main contractor in source state.

Installation/Construction PE- Measurement of Time Period (Multiple Sites/Projects)

- OECD Commentary provides that the threshold time limit has to be determined separately for each individual site or project
- Time spent previously on other sites or project (which are unconnected) should not be counted
- The threshold limit applies to each site or project except where such sites or projects form a coherent whole commercially or geographically [Sumitomo Corp - 110 TTJ 302 (Del)]
- No aggregation of duration projects were if separate [Tiong Woon Project and Contracting Pte. Ltd. 338 ITR 386 (AAR)]
- The 'duration test' is to be applied on each independent contract separately unless the activities undertaken are so inextricably interconnected or interdependent that these are essentially required to be viewed as a coherent whole [M/s Valentine Maritime (Mauritius) Limited 130 TTJ 417 (Mum)]
- Aggregation of the activities of unconnected projects is unwarranted, in the absence of aggregation provision under the India Germany treaty – [Krupp UDHE GmbH (28 SOT 254) (Mum)]

Case Study II



- A Ltd, a tax resident company of France, wins a contract for Design, Manufacture, Installation and Testing of Rolling Stock.
- The Design services would be rendered from France
- Manufacture of Rolling Stock would partly take in France and partly by a subsidiary of A Ltd in India
- Installation and Testing would take 2 years of time in India and will be undertaken by employees of A Ltd and employees of the subsidiary of A Ltd in India

Will A Ltd have a PE exposure in India?

Case Study II

Exclusions from PE

Exclusions from PE

- **Why Article 5(4) ???**

- Activities of NR in the nature of preparatory or auxiliary character;
- Activities remote from actual realisation of profits that it is difficult to allocate any profits to PE

- **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 :**

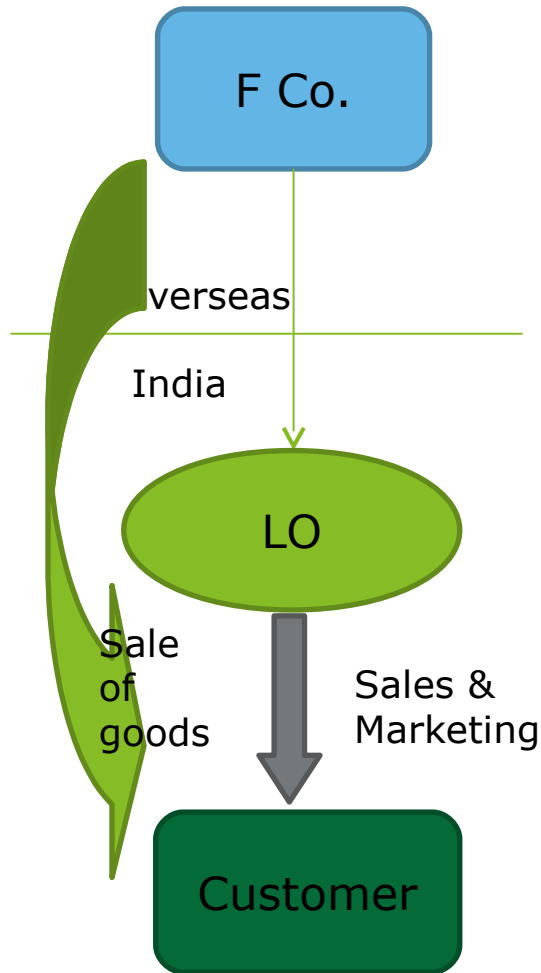
- Use of facilities solely for delivery of goods or merchandise;
- Maintenance of stock of goods or merchandise solely for delivery

Exclusions from PE

Meaning of preparatory or auxiliary activities

- Dictionary meaning
 - Preparatory – something that prepares or serves to prepare for something following; preliminary or introductory
 - Auxiliary – an activity that involves helping, assisting or supporting main activity
 - Analysis to be done on a case by case basis
- The decisive criterion is whether the activity of the fixed place of business in itself is an essential part of the activity of the enterprise as a whole
- If the purpose of the fixed place of business is identical to the purpose of the general enterprise then it is not preparatory or ancillary

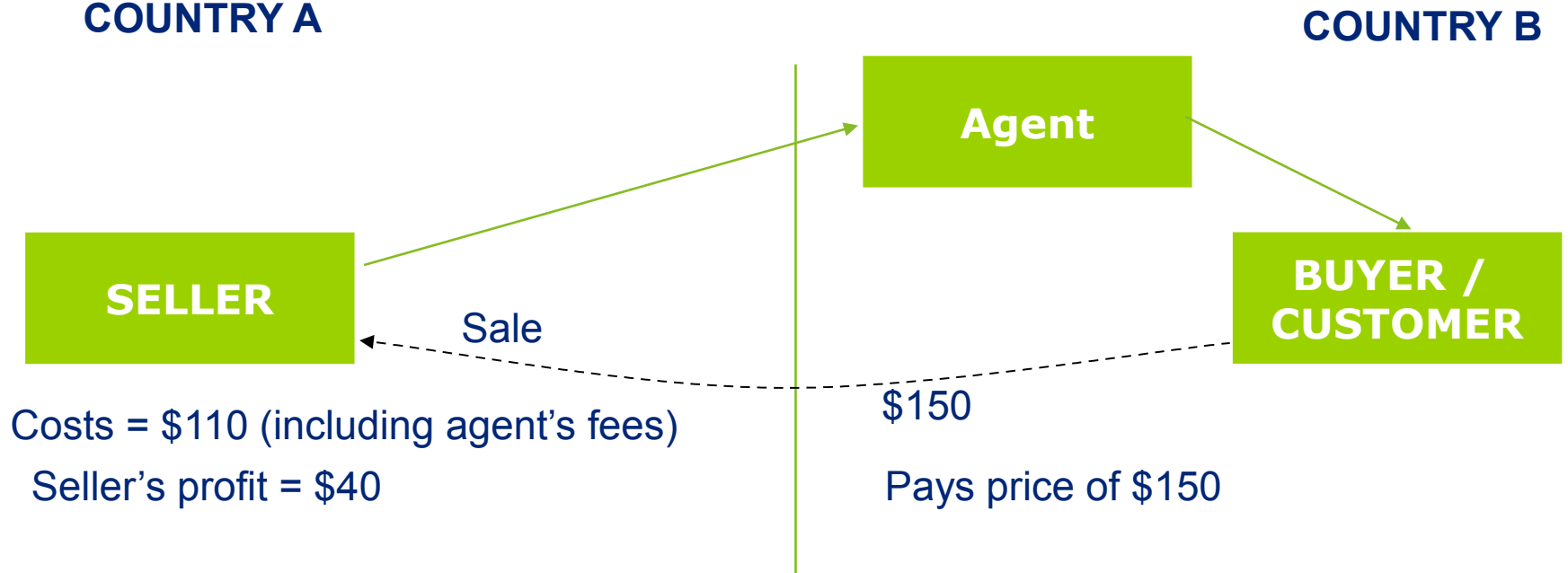
Case Study III



- F Co is engaged in the business of manufacture and sale of electronic goods
- F Co has Liaison Office (LO for sales & marketing activities)
 - Identifies customers, seeks technical specifications, sends quotations to head office
 - Negotiates, finalizes prices with buyers in India.
 - Carries out after sales and follow up on payments
- Customer places purchase orders directly on F Co
- F Co arranges for delivery of goods to customer
- **Does LO constitute fixed place PE for F Co?**

Agency PE

Agency PE – Basic concept



Question: Can country B tax part of seller's profit

→ Has seller an agency PE in country B

An enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business

Why an 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

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 - Habitually maintains stock of goods or merchandise and regularly delivers goods for and on behalf of NR

**Satisfaction of ALL the above conditions is
necessary**

Authority to conclude contracts

- **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

Example on Agency PE

A domestic custodian of NR, who is obliged to act in accordance with instructions of NR in relation to its securities in India and also liable for operating & maintaining its bank account on behalf.

Article 5(7) - Independent Agent

- **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

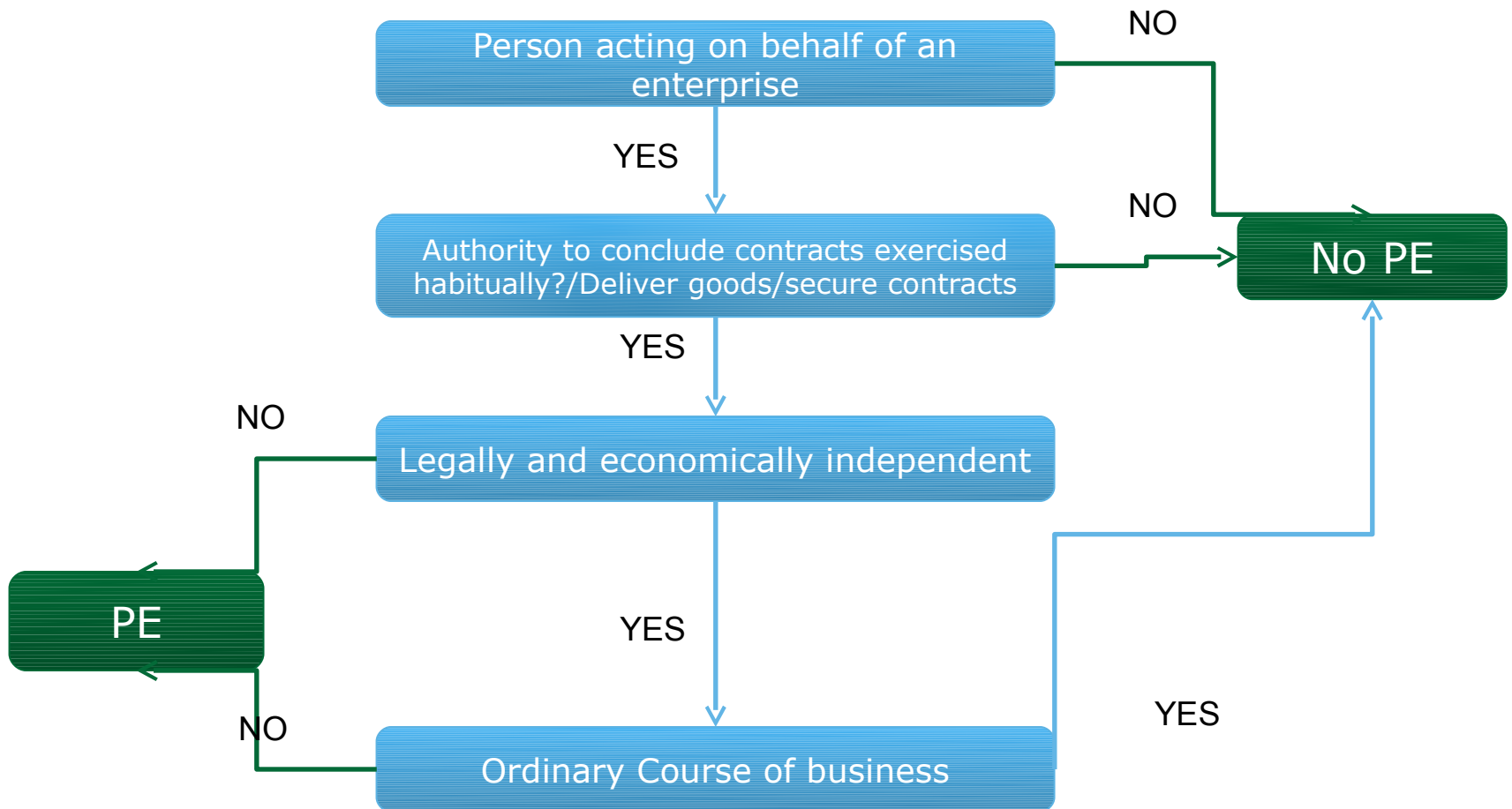
UN MC - An agent will not be considered as 'independent' if :

- His activities are devoted exclusively or almost exclusively on behalf of his principal;
- Transaction between them are not made at arms length price

An 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

Agency PE- Summary



Service PE

Service PE

- Service PE could be constituted in India where any enterprise:
 - renders services in India (other than fees for technical/ included services)
 - to third party/ associated enterprise
 - through employees or other personnel
 - for a specified period

Requisite period or Revenue Test to constitute service PE	UN Model	OECD Model
Services rendered to Unrelated Enterprise	183 days	183 days
Services rendered to Associated Enterprise (AE)	183 days	183 days
Revenue test	No	More than 50% of gross revenue attributable to active business activities of the enterprise during the period

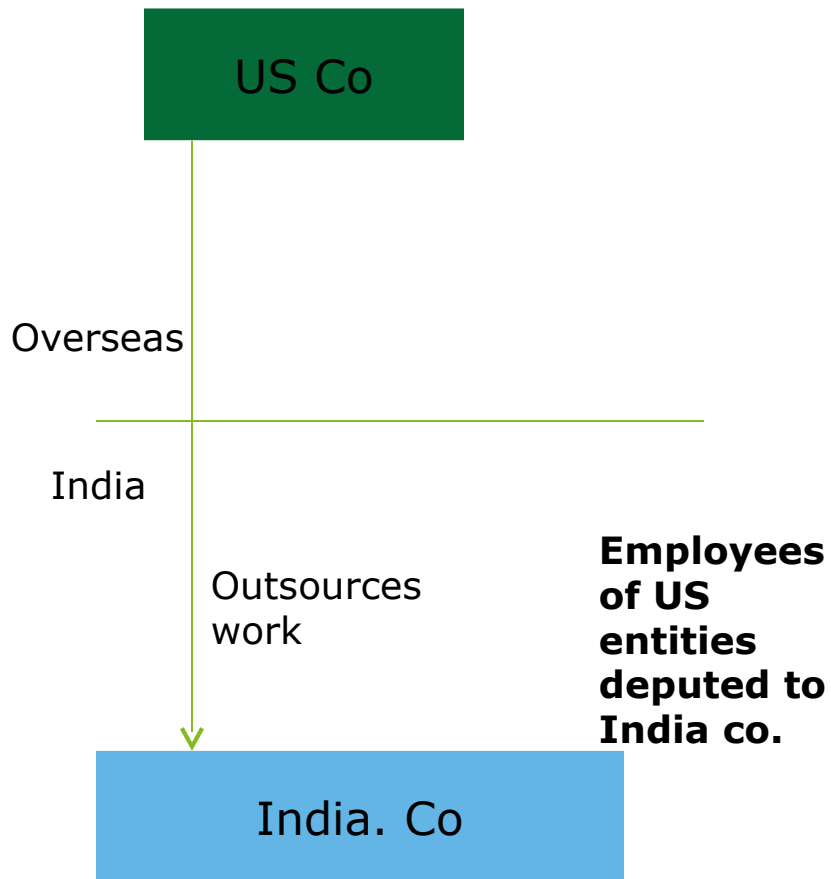
Practically, many treaties have lower threshold for services rendered to AE

Service PE-Checklist for determining existence of Service PE

Criteria	Check
Furnishing services other than Royalty / FTS	✓
Services through employees or other personnel within state	✓
No. of days the employees or other personnel furnishing services in India	✓
Test of employment whether of the foreign company or Indian company	✓
Service PE vis-à-vis Activities falling within Negative List of PE [i.e. preparatory and Auxiliary activities – Article 5(4) or combination thereof]	✓

Majority of DTAA's signed by India which have a service PE clause specifically exclude income covered under Article 12/13 (Royalties and Fees for Technical Services)

Case Study IV



- Does the arrangement give rise to a PE under the Basic rule?
- Is there a place "at the disposal" of US Co?
- Does US Co carry on its business through that place?
- Is there a Service PE?

Base Erosion Profit Shifting (`BEPS`)- Action Plan 7

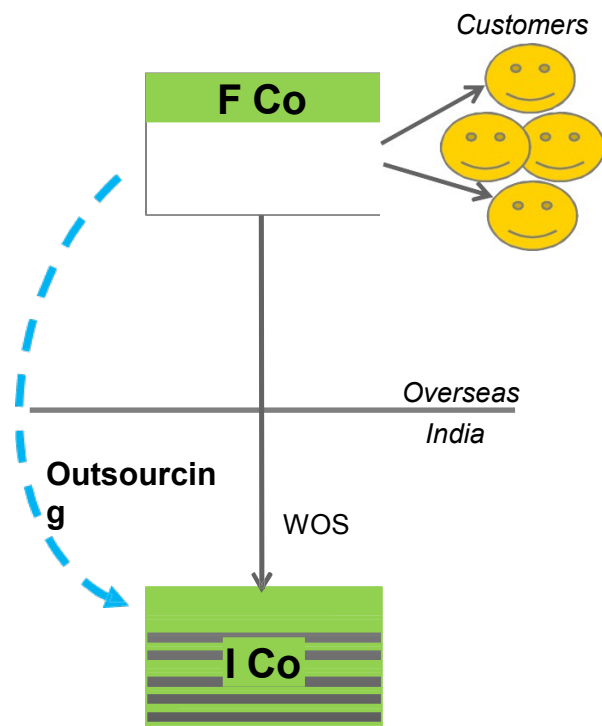
BEPS: Action Plan 7-Artificial Avoidance of Permanent Establishment

- Action 7 seeks to address certain rising concerns in the present format of Article 5 'Permanent Establishments' ('PE') in the OECD.
- Tax treaties generally provide that the attributed business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has a permanent establishment ('PE') in that State.
- The rising concerns in respect of taxation of income attributable to permanent establishments were mainly threefold:
 - i. certain business models that were previously considered 'preparatory and auxiliary' for conventional businesses may have turned into being core activities in the digital economy
 - ii. Use of commissionaire arrangements and similar strategies to overcome creation of a dependent agent PE.
 - iii. Artificial splitting up of contracts (particularly construction contracts) between closely related enterprises so as to manage the presence in the other state at a level below the threshold limit specified for establishing PE

BEPS : Action Plan 7

Case studies

Case Study V



Facts

- F Co engaged in providing IT/ BPO services to unrelated customers
- F Co subcontracts large portion of its contract to Indian affiliate (I Co)
- F Co is responsible for work performed by I Co
- F Co exercises direction & supervision over the work performed by I Co through its employees stationed in India
- Services are carried out from the premises of I Co on continuous basis

Issues

- Does the arrangement give rise to a PE under the Basic rule?
- Is there a place “at the disposal” of F Co?
- Is the place fixed?
- Does F Co carry on its business through that place?
- Are activities carried out by F Co preparatory or auxiliary in nature?

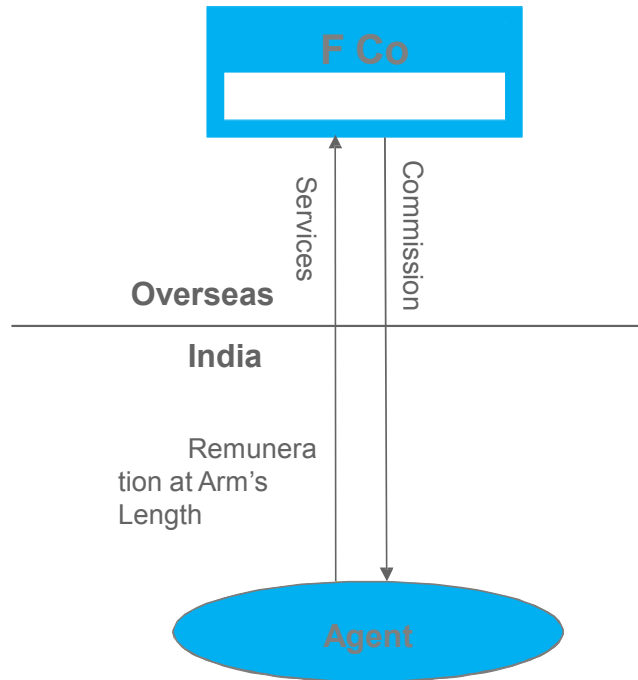
Case Study V

On Fixed Place PE

- Activities of I Co effectively resulted in F Co carrying on its business in India
- Business activities of F Co carried out through premises of I Co on a continuous basis, premises at the disposal of F Co
- Both F Co and I Co legally obligated to provide services, though no significant risks borne by I Co
- Activities cannot be regarded as preparatory or auxiliary if they are core income generating activities

Efunds Corporation Vs. ADIT [2010] 42 SOT 165 (Del)

Case Study VI



Facts

- F Co, a French company, engaged in the business of operation of ships in international traffic
- Indian agent remunerated at arm's length
- F Co contended that as it did not have a PE in India as defined in the India - France Tax treaty, its business profits could not be taxed in India
- Specific Article 5(6) of the India-France Tax treaty
- India- France Tax treaty, specifically provides that where a person's activities are devoted wholly or almost wholly for the enterprise, the person will not be regarded as an agent of independent status, if it is shown that the transactions between the agent and the enterprise were not made under **arm's length** conditions

Issues

- Whether Indian agent could constitute PE of F Co in India?

Case Study VI

- **On basic rule for PE**

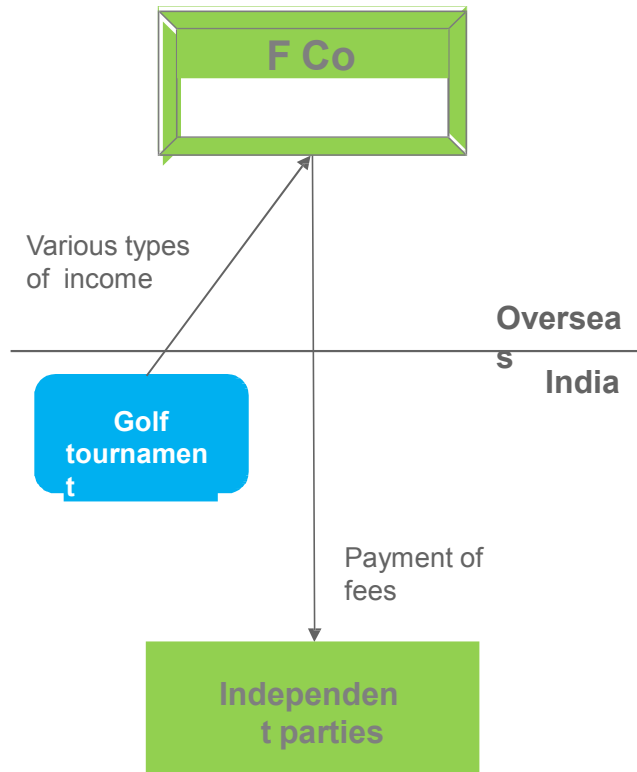
- Agency PE overrides Basic rule PE. Business model of the tax payer to be considered.
- In agency model, business of a F Co is carried out by an agent and principal does not have powers or right to use the agent's place nor does it have a right of disposal of that place
- Use of physical location is only by the agent even though it was for the furtherance of business interest of the principal

- **On DAPE**

- Agent of an independent status cannot create a PE. India- France Tax treaty specifically provides that even when an agent is wholly or almost wholly dependent on F Co, it would still be treated independent agent, unless, transactions are not at arm's length
- Unless this negative finding is recorded, cannot be inferred that it is not independent agent. Onus is on tax authorities

Delmas France Vs. ADIT [2012] 144 TTJ 273 (Mum) Varian

Case Study VII



Facts

- F Co, a UAE based company engaged in the business of promoting sport of golf by organising golf tournaments in different countries
- F Co organized golf tournament in India by hiring independent third parties, i.e. contractors and suppliers
- F Co paid fees to independent parties in India for using the golf course
- F Co earns sponsorship fees, management fees, income from sale of merchandise at the venue
- Golf tournament last for not more than 6-7 days once at a time

Issues

- Does F Co has a PE in India ?
- Whether income received by F Co is taxable in India ?

Case Study VII

- In order to constitute a PE under Article 5(1) of the Tax treaty, there had to be a “fixed place” through which “the business is **carried on**”
- During the days when the golf tournament is conducted, the golf course can be regarded as a “place of business”
- Golf course was at the disposal of the F Co for the stipulated time frame
- The words ‘**carried on**’ conveys the ingredient of regularity, continuity and repetitiveness
- Since, golf tournament is a solitary or isolated activity during the year, it was difficult to infer the existence of a PE

Golf in Dubai [2008] 306 ITR 374 (AAR)
- Is it correct view ?

Click icon to add picture

Thank you