

Permanent Establishment – The Evolving Horizon

Seminar on International Taxation

Western India Regional Council of the ICAI

Mumbai

18 May 2019

CA Ganesh Rajgopalan

Fixed Place PE

- Place of business test
- Location test
- Disposal test
 - Formal legal right to use place not necessary
 - Mere presence at a particular place not PE
 - Salesman who visits customer and meets his Purchase Manager to take orders, not PE
 - Factual use v. legal right to use
- Permanence test
 - Not perpetual, but for an indefinite duration
 - Short duration PE-
 - Recurrent activities though lasting for short periods
 - Activities exclusive in Source State
- Business activity test
 - Should be business activity under domestic law
 - Should be business activity under treaty
 - Activity should not be of P or A nature
 - Activity to be connected with the place of business (“through”)

*Formula One World Championships**

- Race Promotion Contract between FOWC and Jaypee
 - right to host, stage and promote the event given to Jaypee for 5 years
- Circuit rights, media & title sponsorship assigned by Jaypee to FOWC affiliates
- FOWC/affiliates controlled participation of teams, the circuit and the paddock
- Physical control of the circuit with FOWC/affiliates from inception ,
 - Jaypee obliged to authorize access to restricted parts of the circuit only through passes issued by FOWC
- Ruling
 - Jaypee's capacity to act as promoter extremely restricted
 - Virtual projection of F-1 on Indian soil
 - RPC tenure for 5 years – annual event-FOWC presence not ephemeral or fleeting, or sporadic
 - Golf in Dubai – recurrent /exclusive activities (OECD MC Comm exceptions)
 - Entire event (F1 FIA Championship) in the circuit organized and controlled in every sense of the term by FOWC
 - FOWC played the central and dominant role
 - FOWC carried on business in India for the duration of the race (and for two weeks before the race and a week thereafter)

* [2017] 80 taxmann.com 347 (SC)

Nokia Networks OY*

- Facts

- Four separate contracts-

- Supply contracts of NF with customers
 - Installation contracts between NIPL and customers
 - Marketing support agreement between NF and NIPL
 - Technical support agreements between NIPL and customers

- Majority view

- No fixed place PE as premises of NIPL in India not at the disposal of NF
 - The test of “Virtual Projection” cannot be de hors other tests of Fixed Place PE
 - No DAPE due to absence of authority to NIPL to conclude contracts on behalf of Nokia Finland.

- Minority view

- NIPL not independent of NF

- NIPL charged merely 5% mark-up on costs relating to marketing/admin services – that too received at year-end without imputing interest cost Consideration recd not at arm’s length
 - Both NIPL and NF operated in tandem
 - NF provided performance guarantee to customers of NIPL
 - NF committed to dilute stake below 51% in NIPL
 - NIPL a ‘direct PE’
 - Acted as ‘proxy’ for NF
 - The ‘business test’ and ‘disposal test’ must be tested vis-à-vis such separate legal entity acting as a proxy, and not NF as there cannot be a question of NF using the place of business of subsidiary.
 - NIPL a virtual projection of NF, an alter ego of NF in India

BEPS Project - Action 7 (2013)

Action 7 – Prevent the Artificial Avoidance of PE Status

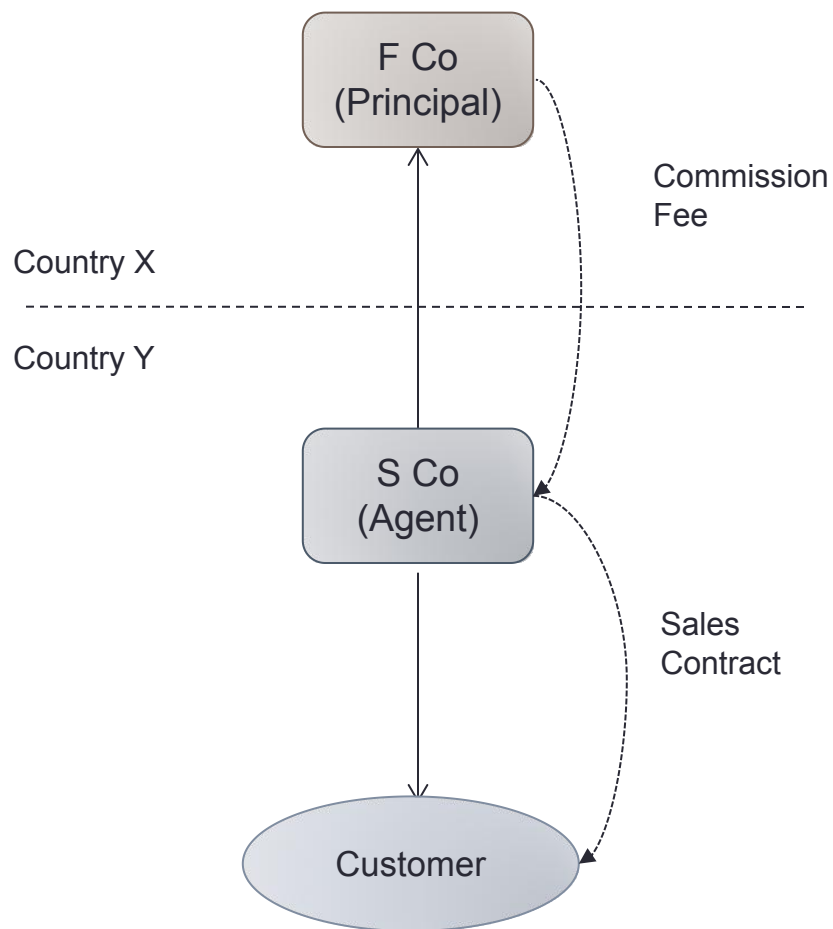
Develop **changes to the definition of PE** to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of **commissionnaire arrangements** and the **specific activity exemptions**. Work on these issues will also address related profit attribution issues.

Agency PE – Provisions (post-MLI)

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6,

- where a person is acting in a Contracting State **on behalf of** an enterprise and
- in doing so, 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
 - 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 by that enterprise** or that the enterprise has the right to use, or
 - c) **for the provision of services by that enterprise**
- that enterprise shall be deemed to have a permanent establishment in that Contracting State in respect of any activities which that person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment.

Commissionaire arrangements & similar strategies



Facts:

- F Co and S Co, enter into a commissionaire arrangement to sell medical products manufactured/sourced by F Co in Country Y.
- S Co sells the products of F Co in its own name but at the risk of F Co.
- S Co earns a commission

Issues:

- Will Y Co Constitute a PE of SX Co in Country Y as per Art. 5(5)?

Commissionaire arrangements &

- Article 5(5) pre-BEPS
 - *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 has, and habitually exercises, in a Contracting State an authority to conclude contracts **in the name of the enterprise**, 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.*
- Civil Law concept, prevalent in mainland Europe)
 - Customers can enforce contract only against the Commissionaire and not against the Principal
- Under common law, undisclosed principal is usually bound by a contract made by his agent within its authority
 - Sec. 231 of Contract Act, 1872
 - *If an agent makes a contract with a person who neither knows, nor has reason to suspect, that he is an agent, his principal may require the performance of the contract; but **the other contracting party has, as against the principal, the same rights as he would have had as against the agent if the agent had been the principal.***

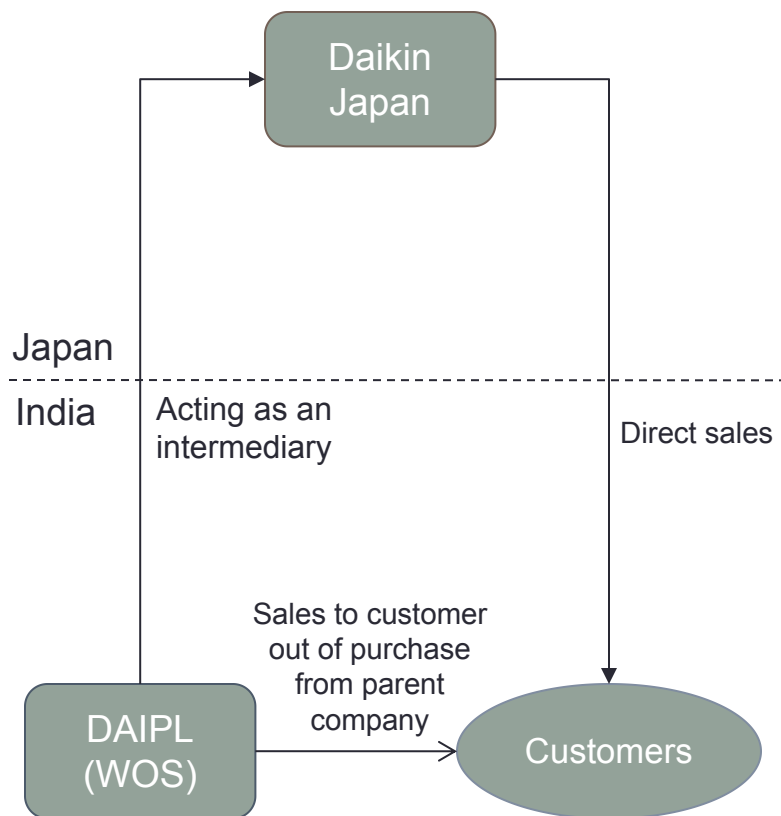
Agency PE – role of agent

- “acting on behalf of”
 - Acting on own account – P to P (e.g. LRDs) not covered
- Playing the principal role
 - OECD Comm (pre BEPS)
 - *The mere fact that a person has attended or even participated in negotiations in India between a foreign enterprise and a client will not be sufficient, by itself to conclude that a person has exercised an authority to conclude contracts. Such fact may be relevant in determining the exact functions performed by that person on behalf of the foreign enterprise*
 - India’s position
 - *...this fact by itself will be sufficient to conclude that the person has exercised the authority to conclude contract. Further, a person who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements of contracts can be said to exercise authority to conclude contracts*
 - Agent acting in host country
 - Takes final agreed document for signatures
 - Attends document signing ceremony
 - Acts as spokesperson seeking specific direction
 - Persuades the other party
 - Acts to reach agreement within pre-defined limits
 - Coordinates with the principal and its functionaries overseas to prepare response to bid
 - Decides on variation in scope
 - Decides on material terms

Securing orders

- India US DTAA, US Technical Explanation
 - For **an agent to be treated as habitually securing orders wholly or almost wholly for the enterprise** all of the following tests must be met:
 - Agent frequently accepts orders for goods or merchandise on behalf of the enterprise.
 - Substantially all of agent's sales-related activities in the Source State consist of activities for the enterprise.
 - Agent habitually represents to persons offering to buy goods that acceptance of an order by the agent constitutes the agreement of the enterprise to supply goods under the terms or conditions specified in the order.
 - The enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.
 - Principal role and securing orders - overlap

Daikin Industries Ltd*



- DA IPL was a distributor of Daikin air conditioners in India. It incurred substantial selling and distribution expenses.
- Daikin Japan made direct sales to customers in India
- Daikin Japan unable to provide evidence of its direct involvement from Japan in making sales to customers in India and to prove that role of DA IPL was simply confined to a communication channel.

Held

- DA IPL was a DAPE of Daikin Japan as it was habitually exercising authority to conclude contracts in India.

* (2018) (94 Taxman.com 299 (Delhi-Trib))

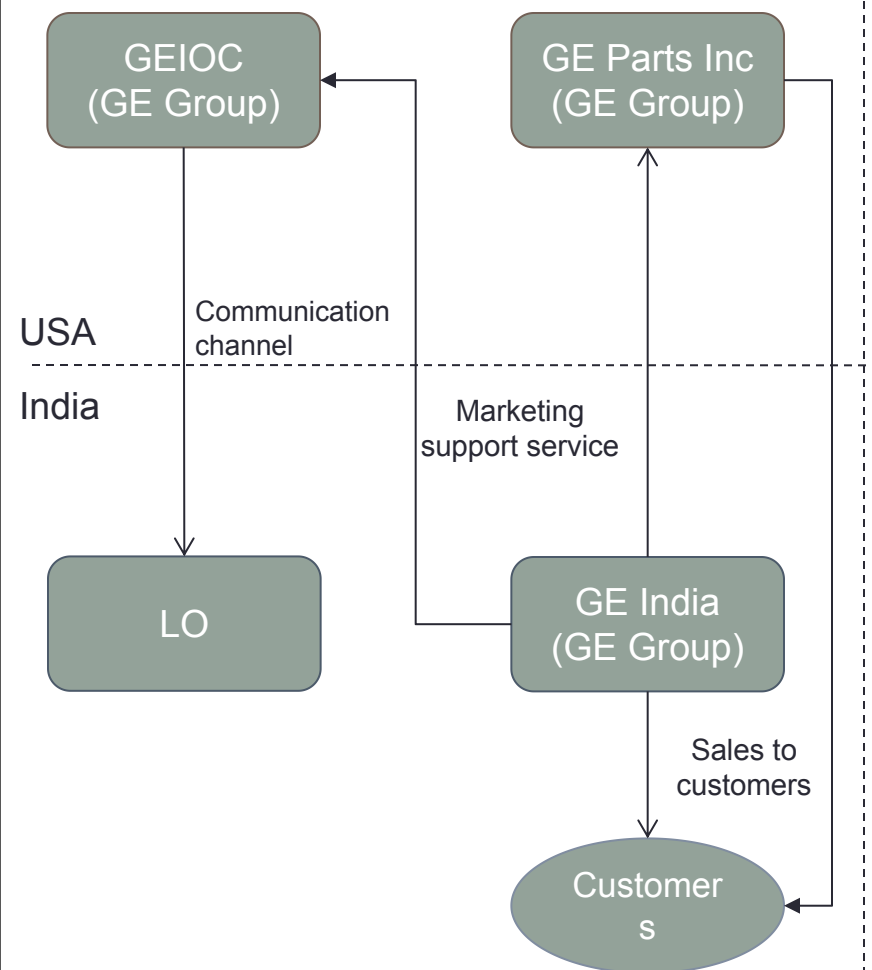
General Energy Parts, Inc*

Facts

- General Energy Parts Inc. (“GEP”), manufactures industrial equipment and sells its products on a principal to principal basis, to customers in India. The title to goods sold to Indian customers is transferred outside India.
- Another GE Co set up a LO in India to act only as a communication channel.
- GE India part of the group provided marketing support services to GE overseas companies under a Global Service Agreement for a cost-plus remuneration.
- Does GE India constitute a DAPE of GE Overseas?

Held

- An entity can be considered “devoted wholly or almost wholly” even if related to several related enterprise of the same group.
- Even in absence of formal authority to conclude contracts, participation in sales meeting/ negotiations in some case would lead to conclusion of contracts.



* (2019) (101 Taxman.com 142 (Delhi))

Independent Agents- Provision

- MLI Provision

Paragraph 5 shall not apply

- *where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State*
 - *as an independent agent and*
 - *acts for the enterprise in the ordinary course of **that business**.*
- *Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise*

- Article 5(6) – Existing

*An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that 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**.*

- Independence to be seen from agency activities alone; other businesses not relevant.

Closely related - defined

- *For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances,*
 - *one has control of the other or*
 - *both are under the control of the same persons or enterprises.*
 - *In any case, a person shall be considered to be closely related to an enterprise if*
 - *one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or*
 - *if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.*

Agency PE – Art. 12 MLI

- Post-MLI
 - 27 countries have reserved the application of Article 12 (MLI)
 - 22 countries have not made any reservation, the Article will apply
 - India positions to the OECD Model & Comm (2017)
 - “... principal role leading to the conclusion of contracts that are **routinely** concluded without material modification”
 - “Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises **to which it is closely related**, ...”

Specific activity exemption

- Preparatory character
 - Short duration
 - Prior to starting main activities
- Auxiliary character
 - Supports but not essential & significant part of activity of enterprise as a whole
 - Unlikely that such activities require significant proportion of assets or employees
- GE Energy Parts Inc
 - “..... test for determining a P & A activity is not to see if the core activity can or cannot be performed without it. Rather, **the test is that such activity merely supports the core activity and does not per se lead to earning of income.** If the activity carried on from a fixed place in India is simply in aid or support of the core income generating activity and is remote from the actual realization of profits, the same assumes the character of a P & A nature.*
- Examples of what is not of P & A nature
 - Warehouse for storing spare parts where the enterprise undertakes maintenance of machinery for customers
 - Purchase of goods by a large buyer for distributing worldwide
 - Purchasing function an essential and significant part of overall activity
- Combination of specified activities

Article 5(4) post MLI Art. 13 (Option A)

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

a) Use of facilities solely for storage, display or deliver of goods belonging to the enterprise;

b) The maintenance of a stock of goods belonging to the enterprise solely for storage, display or delivery

c) The maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise;

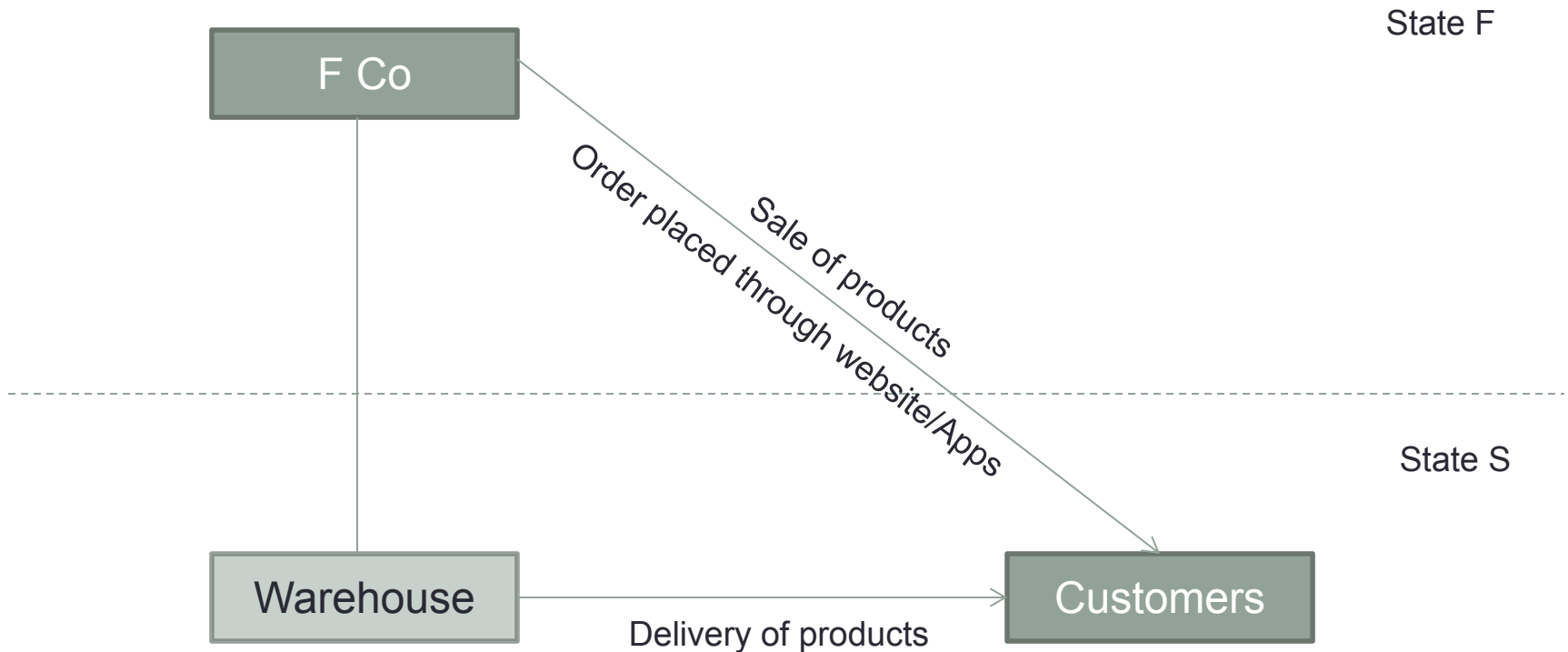
d) The maintenance of a stock of goods belonging to the enterprise solely for the purpose of purchasing goods or of collecting information, for the enterprise

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.~~

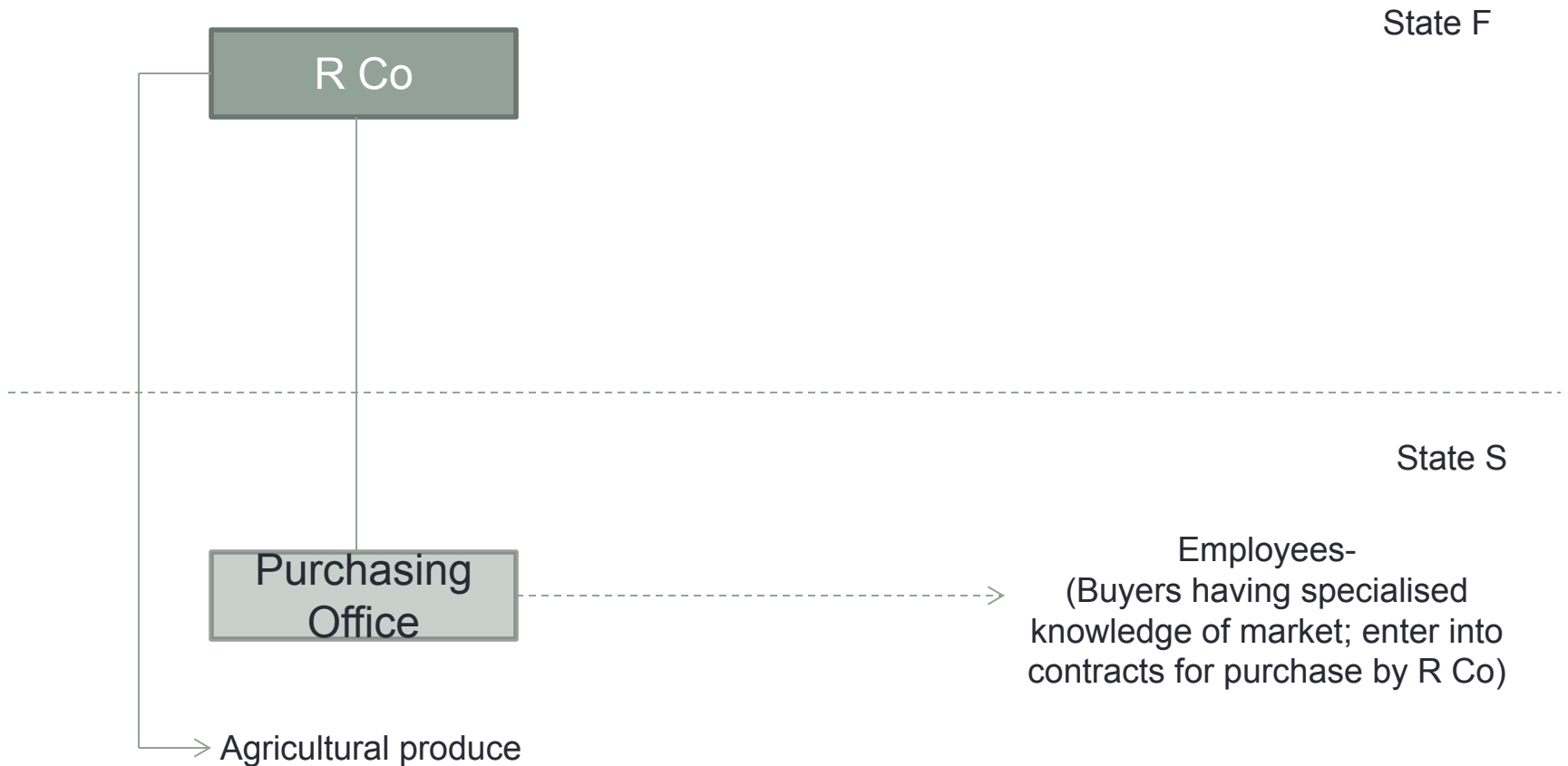
provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

Specific activity exemptions – Illustration 1



- F Co's Warehouse not P & A-
 - Storage and delivery from Warehouse essential part of F Co's sale/distribution business.

Specific activity exemptions – Illustration 2



Specific activity exemptions

- Option B for countries which believe
 - Specific activities intrinsically of P & A nature
 - Not to impose additional condition to be of P & A
 - To provide greater certainty for tax administration and taxpayers
- Position under MLI (Article 14)
 - India notified Option A
 - 25 countries also selected Option A to apply in place of Art. 5(4) of CTA
 - Neither Option applies in case of
 - 8 countries selected Option B
 - 2 countries selected neither Option
 - 16 countries that have reserved entire Article 13 of MLI

India – Australia DTAA, Art. 5(4)

An enterprise shall not be deemed to have a permanent establishment merely by reason of :

- (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 storage or display ;
- (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; or
- (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities **which have a preparatory or auxiliary character, for the enterprise.**

(f) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;

(g) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e),

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

However, the preceding provisions of this paragraph shall not apply where an enterprise of one of the Contracting States maintains in the other Contracting State a fixed place of business for any purpose other than those specified in this paragraph.

Anti-fragmentation rule - Provision

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise **if the same enterprise or a closely related enterprise** carries on business activities **at the same place or at another place in the same Contracting State** and

a) **that place or other place constitutes a permanent establishment** for the enterprise or the closely related enterprise under the provisions of this Article, or

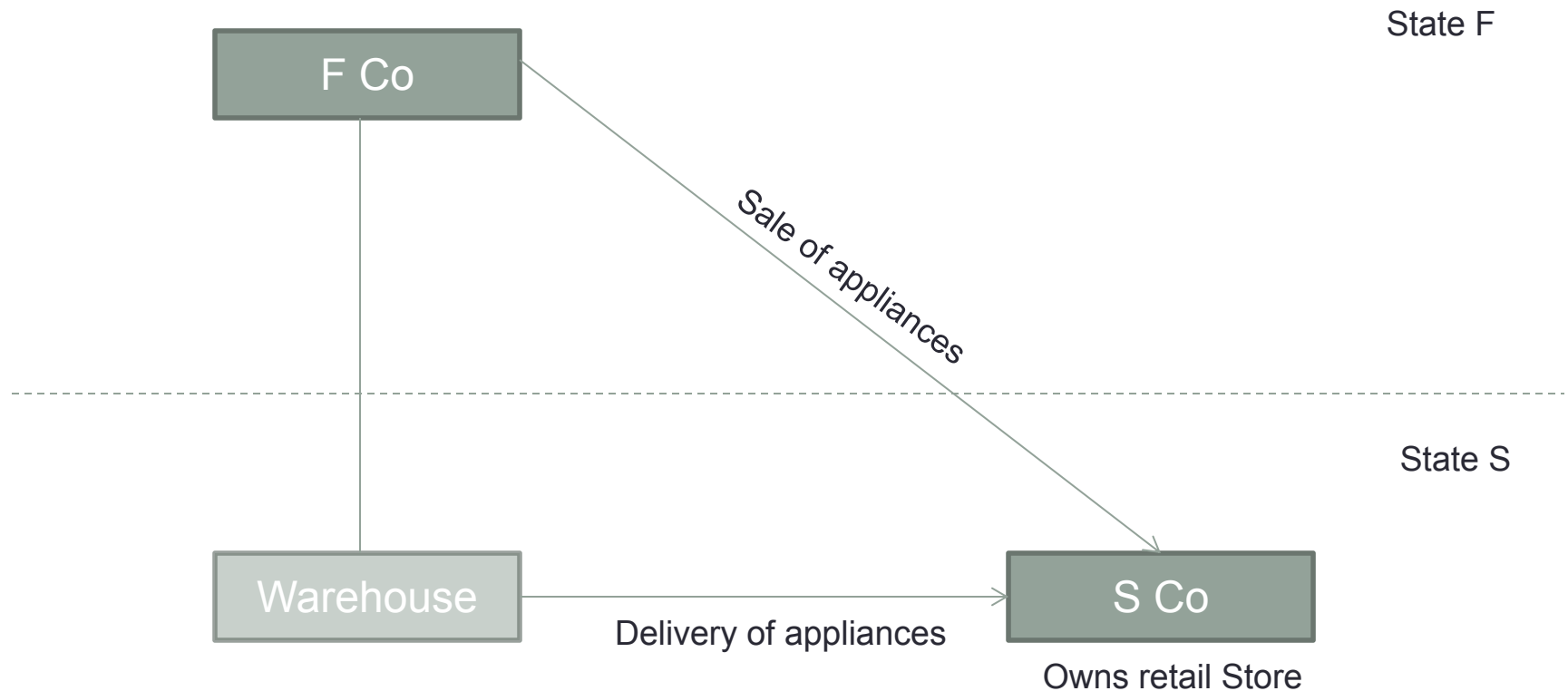
b) **the overall activity** resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is **not of a preparatory or auxiliary character**,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, **constitute complementary functions that are part of a cohesive business operation**.

Anti-fragmentation rule

- Objective
 - To prevent fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in P & A activity*
- Activities
 - Of closely related enterprises
 - At the same place or another place in the Source State
 - that constitute complementary functions that are part of cohesive business operations
 - At least one of these places to constitute a PE or Overall activity must go beyond P & A
- Applies to only fixed places of business, does not cover agency PE
- Position under MLI (Article 14)
 - India not reserved application of this provision
 - Rule does not apply-
 - Austria, Luxembourg and Singapore reserved application of this provision
 - Article applies in case of CTAs with 29 countries

Anti-fragmentation rule - Illustration



- If -
 - F Co and S Co related
 - S Co has a PE in State S (not necessary that it must be a PE of a NR)
 - Storage and delivery cohesive business operation
- Rule applies, warehouse not exempt as P & A.

Construction PE

- For activities that do not meet the Basic Rule PE conditions
- Applicability
- Building site, a shipyard, or another place where construction or installation activities performed
- Construction sites which relocate
 - Road or rail laying project
- Identifying a PE
 - ‘Geographically and commercially, a coherent whole’, ‘a unity of execution’
 - Same location supports geographical unity; absence does not rule out PE
 - Commercial unity if – same contract, same client, at the same time, a single thing constructed (e.g. a ship, bridge); absence does not rule out PE
 - Various parts made at different places to be later assembled – PE
 - Sub-contractor in site to be included
 - Splitting up of contracts -Examples
 - P1 (11m) and P2 (4m) – No PE if these are not connected projects
 - P1 (13m) and P2 (4m) – P1 a PE, but P2 not a PE if not connected

Splitting up of contracts - Provision

For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded,

- a) where an enterprise of a Contracting State carries on activities in the other Contracting State **at a place that constitutes a building site or construction or installation project** and these activities are carried on during one or more periods of time that, in the aggregate, **exceed 30 days** without exceeding twelve months, and*
- b) **connected activities** are carried on **at the same** building site or construction or installation project during different periods of time, **each exceeding 30 days**, by one or more enterprises closely related to the first-mentioned enterprise,*

*these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities **at that building site or construction or installation project.***

Splitting up of contracts

- Activities connected if
 - contracts wrt different activities concluded with **same or related persons**;
 - conclusion of additional contract with a person is a **logical consequence of a previous contract** concluded with that person or related persons;
 - activities **would have been covered by a single contract absent tax planning** considerations;
 - **nature of the work** involved under the different contracts is the **same or similar**;
 - the **same employees** are performing the activities under the different contracts
- Position under MLI (Article 14)
 - India not reserved application of this provision
 - 30 countries reserved application of this Article- Article does not apply
 - Article applies in case of CTAs with 19 countries

Splitting up of contracts - illustration

Entity	Relationship	Contract Description	Duration	Description of activities	From	To	Duration for PE
Fco		Contract with customer	1 mth	Site preparation	Jan-18	Jan-18	1 mth
SCo ₁	AE of Fco	Sub-contract with Fco	15 days	Machinery mobilisation	Feb-18	Feb-18	1 mth
SCo ₂	AE of Fco	Independent contract with customer	4 mths	Piling work and foundation	Mar-18	Jun-18	4 mths
TCo ₁	Non-AE (belongs to T Group)	Sub-contract with Fco	3 mths	Pillars and Spans construction	Jul-18	Sep-18	3 mths
FCo		Contract with customer	5 mths	Supervisory activities	Sep-18	Jan-19	4 mth
TCo ₂	Non-AE (belongs to T Group)	Independent contract with customer	3 mths	Fittings and Painting	Dec-18	Feb-19	
		Total	14 mths				13 mths
	S - F Treaty	12 mths threshold					
	S - T Treaty	6 mths threshold					

Splitting up of contracts – India-Armenia DTAA

5(3). A building site or construction, installation or assembly project or supervisory activities in connection therewith constitutes a permanent establishment only if such site, project or activities last more than 270 days.

For the sole purpose of determining whether the period (or periods) referred to in a provision of a Covered Tax Agreement that stipulates a period (or periods) of time after which specific projects or activities shall constitute a permanent establishment has been exceeded:

- a) where an enterprise of a Contracting Jurisdiction carries on activities in the other Contracting Jurisdiction at a place that constitutes a building site, construction project, installation project or other specific project identified in the relevant provision of the Covered Tax Agreement, or carries on supervisory ~~or consultancy~~ activities in connection with such a place, in the case of a provision of a Covered Tax Agreement that refers to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant provision of the Covered Tax Agreement; and*
- b) where connected activities are carried on in that other Contracting Jurisdiction at (or, where the relevant provision of the Covered Tax Agreement applies to supervisory ~~or consultancy~~ activities, in connection with) the same building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,*

these different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement.

Thank you!