



## **Discussion on amendments to Agency PE rules in Budget 2018**

Jimit Devani  
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# Agenda

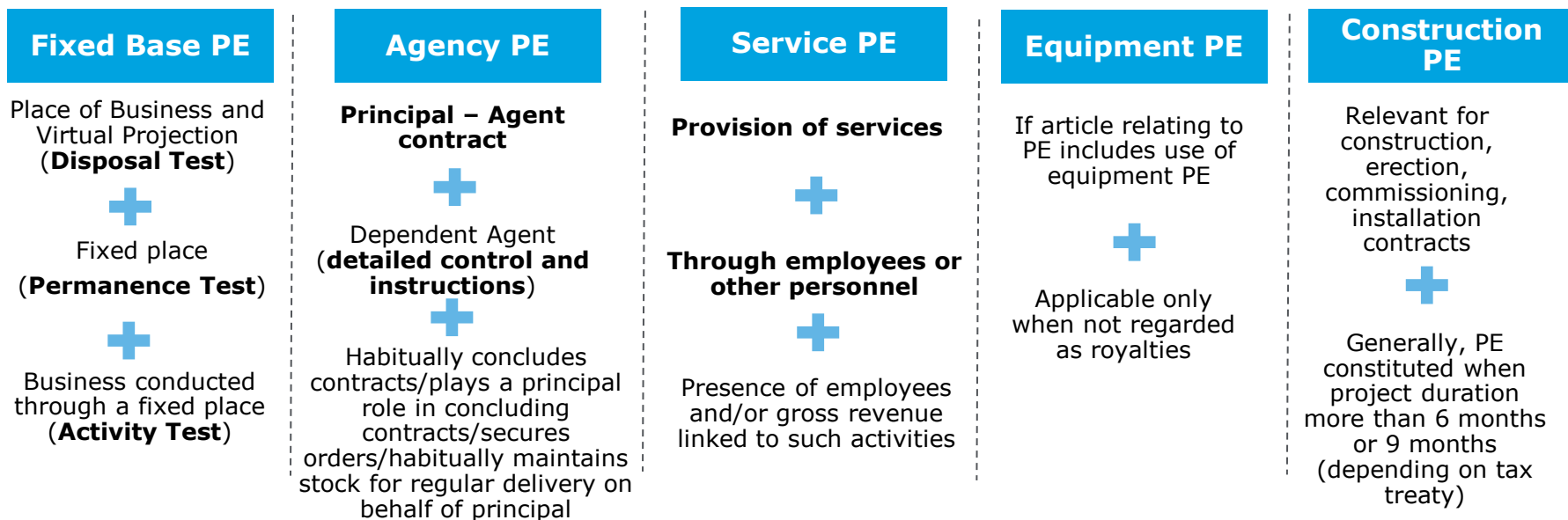
- Concept of Permanent Establishment (PE)
- BEPS Action Plan 7
- India budget update
- Consequence of PE
- Way forward
- Recent Judicial precedents
  - Diakin International
  - Formula One
  - E-funds IT Solutions Inc.
  - Other key Indian rulings
- Questions

# Concept of PE

# Concept of Permanent Establishment (PE)

## What is PE?

- The concept of PE determines right of a source state (India) to tax profits of a non-resident from business in a source state (India). Three important factors in PE are:
  - Determination of PE
  - Profit attribution to PE
  - Taxation mechanism for a PE to any avoid double taxation
- What are the types of PE?



**PE should not be constituted where only preparatory and auxiliary activities are performed**

# Concept of Permanent Establishment (PE)

## Agency PE – In detail

- The OECD model commentary defines agency PE under article 5(5). The extract is as under:

*5. 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.*

*6. 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.*

- **Base erosion strategies adopted**

- ✓ Commissionaire arrangements
- ✓ Contracts are substantially negotiated in India but finalized/ signed/ authorized outside
- ✓ Despite being closely related parties, personal habitually concluding contracts constituted an independent agent

# **BEPS Action Plan 7 - Measures**

# Agency PE

## Overview

### I. Pre-BEPS

#### *Article 5(5)*

- Agency PE created if a person (other than an agent of independent status) acting on behalf of a foreign enterprise has 'authority to conclude contract in the name of the enterprise'
- Commissionaire arrangements (more common in Europe) were employed to overcome article 5(5) PE as goods were sold by an agent in its own name in the other State on behalf of the foreign enterprise, though owned by a foreign enterprise
- PE under Article 5(5) was also avoided in situations where contracts though substantially negotiated in one State were finalized/ signed/ authorized abroad
- The person habitually exercising authority to conclude contracts constitutes an independent agent in spite of being closely related enterprise
  - *Article 5(6)*
- Article 5(5) did not apply if the business of the foreign enterprise was carried on in the other state by a broker, general commission agent or any other agent of independent status.

# Agency PE

## II. Post-BEPS

- *Article 5(5)*

Agency PE is created under Article 5(5) if a person acting in a Contracting state on behalf of an enterprise either:

- 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 (*emphasis supplied*)
- Contract for provision of services; for the transfer of the ownership of, or for the granting of the right to use, property owned by an enterprise or that the enterprise has the right to use; are now included under Article 5(5) in addition to contracts entered into by the agent in the name of the enterprise. (*emphasis supplied*)

**Agent with contract concluding authority has been expanded to cover an agent who concludes contracts or habitually plays the principal role in concluding contracts.**



# Agency PE

## II. Post-BEPS

### *Article 5(6)*

- Article 5(5) shall not apply if the business of the foreign enterprise is carried on in the other state by independent agent acting in the ordinary course of business.
- If 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
- A person will be Closely related to an enterprise if :
  - One enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest/ 50 per cent of the aggregate vote and value of the company's shares in the other; 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

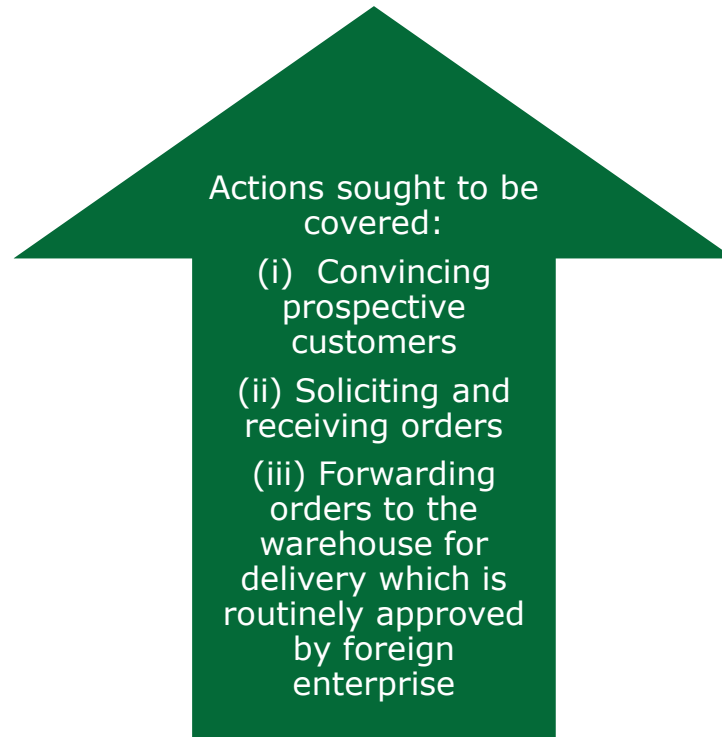
## *Key amendments in the Commentary:*

- Meaning of the phrase “ habitually concludes contracts”
  - Concludes contracts as per relevant law governing contracts of the country
  - It has not been expressly mentioned whether contract law of country of residence or source or any other country has to be applied.
  - Contract may be concluded in the state in which a person acting on behalf of a foreign enterprise accepts an offer made by a third party to enter into a contract/ negotiates all elements and details of the contract, even if contract is signed outside that state (i.e. oral contract within the state to be followed by written contract outside the state)
  - Contract may be concluded without any active negotiation of the terms of that contract (i.e.)( in case of a standard contract) by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise.
  - Interpretation of the term ‘habitually’~ no precise frequency test laid down \*
- Will depend on the nature of contracts and business of principal

\*In a different context of interpreting the term ‘habitually’, Supreme Court in the case of Vijay Narain Singh v State of Bihar AIR 1984 SC 1334 held that where acts are not of the same class or even if they are of the same kind but committed with a long interval of time between them, the acts cannot be said to be habitual ones.

# Agency PE

- Meaning of the phrase 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'



Phrase to be interpreted in the light of the object and purpose of paragraph 5 (i.e. to cover cases where a person acts as the sales force of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State)

# Agency PE

- Article 5(6) – an agent who acts exclusively or almost exclusively for a closely related enterprise
  - Illustration states that sales that an agent concludes for enterprises to which it is not closely related represent less than 10 percent\* of all the sales that it concludes (*Para 38.8*), that agent would be considered as acting exclusively on behalf of closely related enterprises
  - It is not free from doubt whether the above threshold would apply to entire sales concluded by the agent or only to sale of that specific product line

\* Similar threshold used for determining whether an agent is dependent on the principal or not in the Indian AAR ruling in the case of Speciality magazines (P) Ltd. [2005] 144 Taxman 153 and by the US Tax Court in the case of Inver World [1996] TCM 1996-301

# India Budget 2018

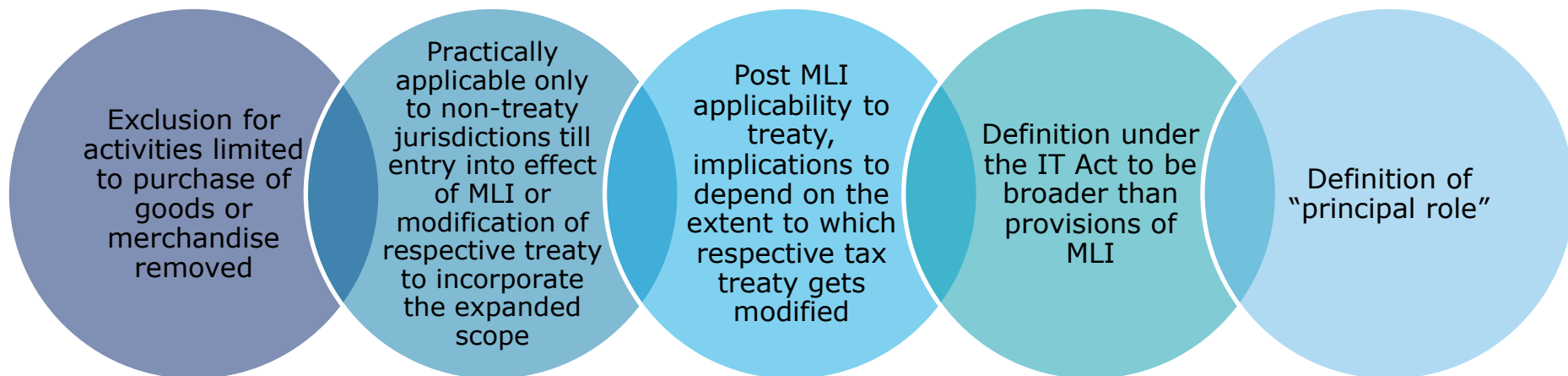
# India Budget 2018

## Business connection widened to include agency contracts

### Definition of the term business connection widened to include agency contracts

“Business connection” to now include any business activity carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident and the contracts are

- In the name of the non-resident; or
- For the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
- For the provision of services by the non-resident.



# India Budget 2018

## Rationale for amendment

- 'Business connection' includes business activities carried on by non-resident through dependent agents;
- Recommended, inter alia, modifications to provide that an agent would also include a person who habitually plays a principal role leading to the conclusion of contracts
- BEPS recommendations now included in MLI (to which India is a signatory). MLI provisions will, as a result, automatically modify India's DTAs covered by MLI (provided the treaty partner has also opted for the same)
- Dependent Agent PE provisions under India's DTAA, as modified by MLI, would have become wider than section 9(1)(i) of the Act
- However, the modified DTA provisions could have been ineffective in view of section 90(2) of the Act since the Act or the DTA whichever is more beneficial to apply
- Hence, it is proposed to amend the provisions of section 9(1)(i) of the Act to bring in line with MLI provisions

# India Budget 2018

## Business connection – Key principles for agency

01

Agent

- S. 163 lays down that an 'agent' in relation to a NR includes any person in India, who has BC with the NR

02

Independence

- Independent agent will typically be responsible to his principal for the results of his work but not be subject to significant control ~ OECD Commentary
- Legal as well as economic independence

03

Ordinary course of business

Persons cannot be said to act in the ordinary course of business if they perform activities for an entity which, economically, belong to the sphere of that entity rather than to that of their own business operations ~ OECD Commentary

04

Mainly or wholly

- Not technical terms - must receive their ordinary meaning

05

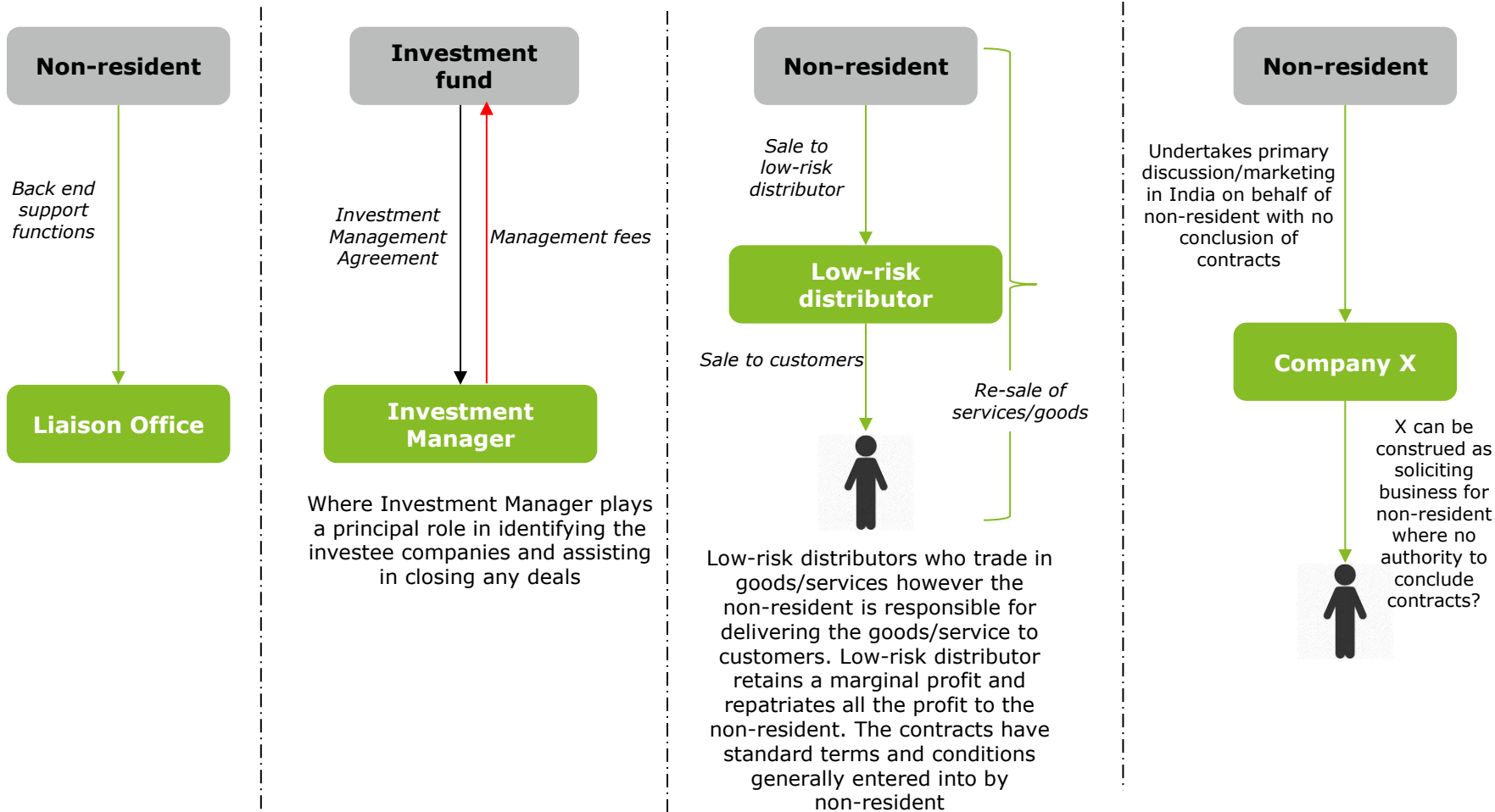
Commission agent

- If a NR has a commission agent in India, who enters into transactions on its behalf, the NR would be regarded as having a BC in India



# India Budget 2018

## What will be the impact?

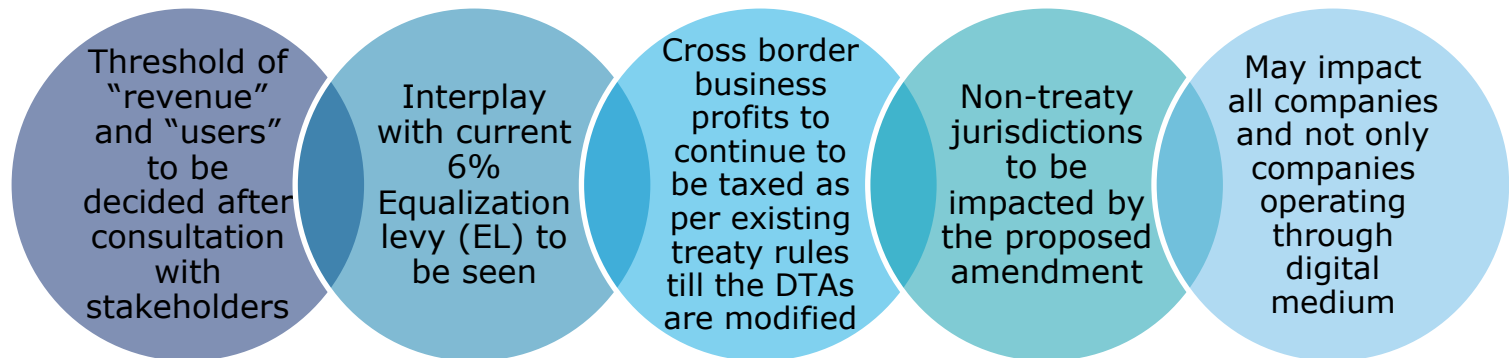


# India Budget 2018

## Business connection widened to include significant economic presence

### Definition of business connection widened to include nexus based taxation through significant economic presence

- Definition of “business connection” widened to include “significant economic presence” in India. “Significant economic presence” to mean
  - Transaction in respect of goods, services, or property carried out by a non-resident in India, including provision of download of data or software in India, if the aggregate of payments arising from such transactions during the previous year exceeds the prescribed threshold; or
  - systematic and continuous soliciting of business activities or engaging in interaction with the prescribed number of users in India through digital means
- Transactions/activities to constitute significant economic presence in India, whether or not the non-resident has a residence or place of business in India, or renders services in India, or the agreement for such transactions or activities is entered in India



# India Budget 2018

## Rationale for amendment

- As per existing DTAAAs, business profit of an enterprise is taxable in the country in which the taxpayer is a resident unless the enterprise carries on its business in another country through a PE
- PE defined as a 'fixed place of business' through which the business of an enterprise is wholly or partly carried out subject to certain exceptions
- Nexus rule based on physical presence used as against regular economic connection to determine existence of a PE
- New business models of operating remotely through digital medium have emerged with the advancement in information and communication technology in the last few decades
- Non-resident enterprises interact with customers in another country without having any physical presence in that country, results in avoidance of taxation in the source country
- Right of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded
- OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy
- The scope of existing provisions of section 9(1)(i) restrictive - essentially provides for physical presence based nexus rule
- In view of above, it is proposed to amend the provisions of section 9(1)(i) of the Act to introduce the concept of "significant economic presence"

# Consequences of PE

# Consequences of PE

## Why is it important to analyze PE?

- Higher tax rate of 40% (plus applicable surcharge and cess) to apply on profits attributable to PE in India
- Computation of profits attributable to the PE subject to the Indian domestic tax law provisions
  - Restrictions relating to disallowance of expenditure for withholding tax default would be applicable, allowance of certain expenses on payment basis, deduction of head office expenditure, etc. to apply
- Various compliances such as PAN, TAN may be required to be obtained
- Filing of corporate tax returns in India (even if there is no PE, tax return filing obligation exist)
- Compliance with the withholding tax provisions (withholding tax from payments, filing tax withholding returns, etc.) may be attracted
- Customers would withhold tax at a higher rate – obtain lower withholding tax order
- Impact on short stay exemption for employees – personal taxation of employees may be impacted
- Maintenance of books of account and having the same audited in accordance with the Indian domestic tax law
- Compliances under indirect tax laws and corporate law to be considered

# Way forward

# Way forward

- Existing models

- Revisit the PE positions taken in the past in light of these recent decisions
- Revisit the contracts to verify whether it triggers a PE in India
- Consider alternative options, if any, available for undertaking business in India and mitigate PE exposure, if any

- New business model into India

- Understand the commercial rationale including analysis with respect to where the control of the business exists
- Contracts need to be appropriately drafted after considering the actual conduct/business operations in India
- Analyze and factor the PE risk while setting up business in India or conducting business with Indian entities
- Mitigate PE risk, wherever possible and if PE exist, then undertake the necessary compliances

# Questions

