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**Permanent Establishment
– Concepts and Latest Developments**

Refresher Course on International Taxation, 2017

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Introduction to PE

Introduction to PE

- Similar to business connection, *albeit* more objective
- PE is the basis of taxing a non-resident on its business income in a source country
- PE results in attribution of profits
- Initially was confined only to taxing physical locations
- It has evolved to include construction PE, agency PE, service PE etc
- Though concerns and debates continue if concept of PE has kept pace with changing business



Fixed place PE

A fixed place of business through which the business of the enterprise is wholly or partly carried on

Pre-condition for a fixed place PE?

LOCATION TEST

- Physical premises or location – equipment covered
- Owned or leased
- Some degree of permanence
- Tangible – intangible not covered.

RIGHT TO USE TEST

- Place of business to be at constant disposal either entirely or a part thereof
- Formal legal right to use not mandatory
- Mere presence does not necessarily satisfy disposal test

BUSINESS ACTIVITY TEST

- Must carry on business
- Must not be of only preparatory or auxiliary character
- For eg: wet lease vs dry lease; dry lease should not constitute a PE

- **Website not a PE [Rights Florist – Kolkata Tribunal (pending at HC)]**
 - Website is not a PE; in line with international commentaries
 - India's reservation not considered
- **Warehouse considered PE (Seagate – AAR)**
 - Earmarked space and right to entry, provision of inventory system support and other operational control
- **Constitution of PE outside the theoretical concept (Formula One - Delhi HC)**
 - Disposal test and functionality test satisfied, non-resident taxpayer had full and exclusive access to the circuit and had provided pre-defined terms of the contract

- **Expats constitute PE (GE – Delhi Tribunal)**
 - Expats permanently using office of the Indian LO and Indian subsidiary, expats under control and supervision of non-resident
- **Subsidiary in India should do not constitute PE (Adobe Systems – Delhi HC)**
 - No business operations in India, Indian subsidiary did not cover ‘end-to-end’ software development, no right to use Indian subsidiary premises’; Indian subsidiary compensated on arm’s length



Specific PE

Specific PE – Principles (1/2)

- PE specifically includes following:
 - Place of management
 - Branch
 - Office
 - Factory
 - Workshop
 - A mine, an oil or gas well, a quarry or any other place of extraction of natural resource
- Relationship between article 5(1) vs 5(2) - whether an item of example appearing above should constitute PE only where it satisfies the conditions of a fixed place PE?

- **Sub-contract period not to be added to the main contract (Pintsch Bamag - AAR)**
 - Indian sub-contractor not under control and supervision of main contractor
 - Indian sub-contractor operated at a place far away from installation site and independently
 - Occasional or brief visits should not give rise to PE
 - OECD position



Dependent Agent PE

Dependent Agent PE – Principles (1/4)

- Notwithstanding provision of paragraph 1 and 2 (fixed place PE and specific PE)
- Where a **person** other than an agent of an **independent status**
- Acting on behalf of an enterprise
 - Has and habitually exercises in India an **authority to conclude contracts** in the name of foreign taxpayer (OECD / UN Model / Most tax treaties / Indian domestic law)
 - Has no such authority but habitually maintains in India a **stock of goods** or merchandise from which he regularly delivers goods or merchandise on behalf of the foreign taxpayer (UN Model / Most tax treaties / Indian domestic law)
 - Habitually **secures orders** in India, wholly or almost wholly for the foreign taxpayer (Most tax treaties / Indian domestic law)
- Unless the activities are limited to those covered under paragraph 4 (excluded activities)

Independent agent – Principles (2/4)

| USA | Germany | UK |
|--|---|--|
| <p>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</p> | | |
| <p>However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph</p> | <p>and in their commercial and financial relations to the enterprise no conditions are agreed or imposed which differ from those usually agreed between independent persons.</p> | <p>However, if the activities of such an agent are carried out wholly or almost wholly for the enterprise (or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it or are subject to same common control) he shall not be considered to be an agent of an independent status for the purposes of this paragraph</p> |

Relevance of negotiation?

- Agency PE if authorized to negotiate **all elements** and details
- **India's position on OECD:** agency PE if authorized to negotiate the **essential elements** and not necessarily all
- Participation in negotiation – **relevant factor** in determining his function
- **India's position on OECD:** Participation in negotiation **in certain circumstances** can itself constitute an agency PE

- **Routine functions with no negotiations, no PE (B4U International – Mumbai ITAT)**
 - Indian entity not involved in negotiations/discussions, activities incidental or auxiliary/preparatory nature, remuneration on arm's length basis
- **Incentive plans indicative of “sales” activities of a LO PE in India (Brown and Sharpe – Delhi HC)**
 - Sales incentive plan, performance targets to employees of representative office - constitutes PE
- **Distributor concluding contracts constitutes PE (NGC Network Asia LLC – Mumbai ITAT)**
 - Relationship of principal- agent, distribution agreement disregarded as could not be consumed elsewhere other than the non-resident's channel – act of dependent agent; independency of the distributor in India disregarded



Service PE

- Service PE constituted where non-resident taxpayer rendered services (other than ‘included service’) in India through employees / other personnel for a specified threshold
- Other personnel – interpreted to cover persons over whom enterprise exercises control or in a position to influence
- Service - bilateral concept, thus where activities undertaken for a benefit of oneself should not constitute PE
- **Stewardship should not constitute PE (Morgan Stanley - SC)**
 - Stewardship activities should not constitute PE
 - For the benefit of customer / shareholder / group
 - Stewards not involved in day-to-day management or assisting / rendition of any specific services



Secondment PE

- **Morgan Stanley (SC)**
 - Overseas entity real economic employer of the seconded employees
 - Deputed employees continued on the pay rolls of the overseas entity or they continue to have their lien with jobs with overseas entities
 - Rendition of service in India
 - Service PE constituted
- **Centrica India (Delhi HC – SLP in SC rejected by ruling in favour of revenue)**
 - Employees entitled to overseas retirement and social security plans and other benefits
 - Deputed employees have no right to sue the India entity
 - India entity has no power to terminate the employment agreement
 - Service PE constituted
 - Payment qualified as fees for technical service also – no argument that FTS is excluded from service PE



BEPS concept of PE

Agency PE

- Commissionaire arrangements targeted
- Adopts a substance based approach - “habitually plays a principal role leading to the conclusion of contracts that are routinely concluded without material modification”
- Standard contracts – convincing customers is the threshold
- Redefines “in the name of” with subjective standards
- Independent agent exception not to apply where activities undertaken for a single group
- Low risk distributor arrangements

Specific activity exemption

- Changes in the way in which the business is conducted
- Activities previously considered to be preparatory and auxiliary in nature may correspond to core business
- Each exception to qualify as ‘preparatory or auxiliary’ – eg, purchase or storage are not preparatory or auxiliary activities for retailers
- Anti-fragmentation rule – covers situations where the combined activities of connected persons at the same place or different places in the same country exceed what is considered to be preparatory or auxiliary

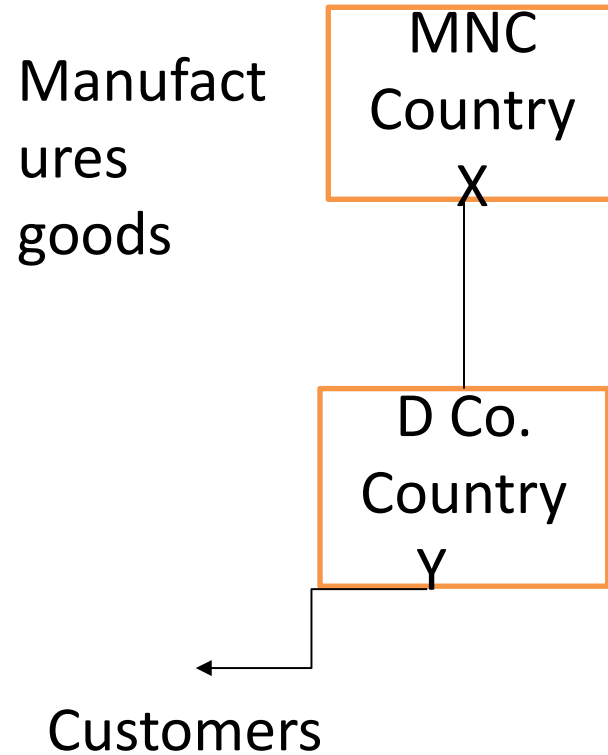
Splitting up of contracts

- All exemption activities subject to condition of being preparatory or auxiliary
- Deletion of exemption related to “delivery of goods” and “purchasing of goods and collecting information”
- Anti-fragmentation rule - to consider all complementary business activities by associated enterprises (whether or not they constitute a PE individually) as a cohesive business and hence, a PE
- Principal Purpose Test (recommended under AP 6) to counter against abusive splitting up of contracts
- Alternative proposal for activities by related enterprises above 30 day threshold



Case studies

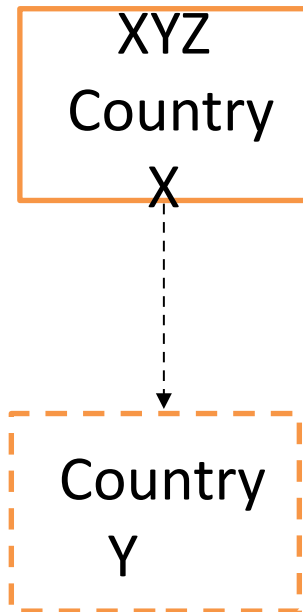
Case Study 1



- D Co. has office in India, full time sale force
- D Co. sells medical supply equipment manufactured by MNC and other subsidiaries
- D Co. is contracting party on sales contract
- Contract preapproved by MNC; D Co. may not modify
- Sales price is on price list provided by MNC every three months
- D Co. pays for inventory when customer contract signed
- D Co. held harmless by MNC if customer fails to pay

- **Does MNC have PE in Country Y?**
- **What if the sales contract went back to MNC for approval?**
- **How would you advise MNC and D Co. arrange their affairs to preclude PE?**

Case Study 2



- XYZ is an investment fund
- XYZ personnel sent to Country Y, at XYZ office
- Risk manager to evaluate- political and economic risks
- Research analysis- research industries to consider, target investments
- Business development person- actively reaching out to potential investors to fund the investments in Country Y

- Does XYZ have PE in Country Y?

THANK YOU