Taxation of Permanent Establishment (Article 5)

Mrugen Trivedi

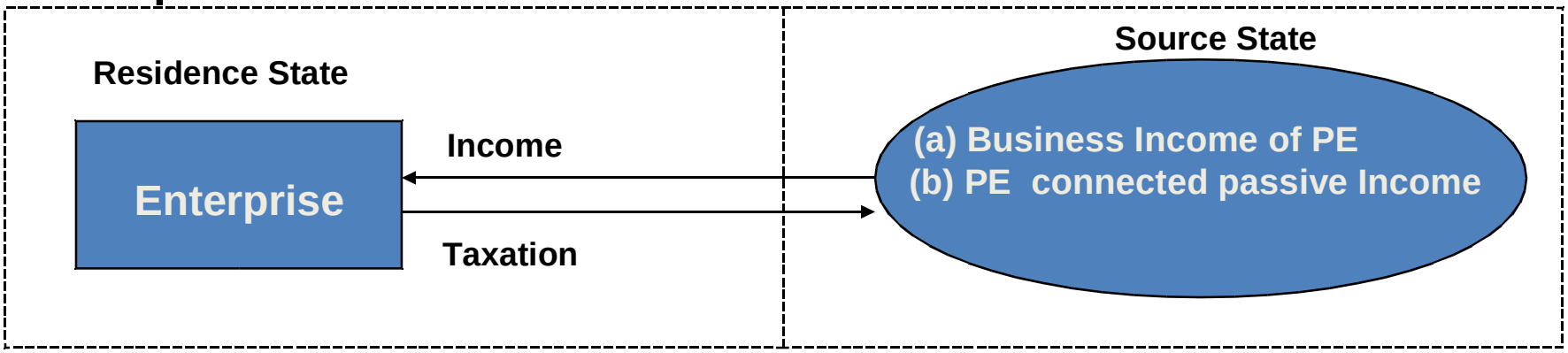
5 March 2016

Contents

Permanent Establishment

Permanent Establishment

Concept of PE



- **Source Country's right to tax Residents of Other Contracting State under Tax Treaties**
- **Visakhapatnam Port Trust [1983] 144 ITR 146 (AP)**

"The words 'permanent establishment' postulate the existence of a **substantial element** of an **enduring or permanent nature** of a foreign enterprise in another country which can be attributed to a **fixed placed of business** in that country. It should be such as that it would amount to a **virtual projection** of the foreign enterprise of one country into the soil of another country."

Permanent Establishment under Income-tax Act

- The **concept of PE was introduced** in the Act as part of the statutory provisions of transfer pricing by the Finance Act, 2001
- Circular No. 14 of 2001 ([2001] 252 ITR (St.) 65, 107) clarified that the term PE has not been defined in the Act but its meaning may be understood with reference to the tax treaty entered into by India.
- However, vide Finance Act, 2002, **the definition of PE was inserted** in the Act under section 92F(iiia) which states that the PE includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.
- Morgan Stanley [2007] 292 ITR 416 (SC) – Supreme Court observed that the PE
  - is an inclusive definition
  - covers service PE, agency PE, construction PE, etc.
- Budget 2016 – MAT and Equalization Levy refers to 'not having PE in India'

Various types of PE

Overview of article of OECD Model Commentary is as under:

Article no.	Particulars	Type of PE
Article 5(1)	Basic rule	Fixed base PE
Article 5(2)	Illustrative list of PE	Inclusions to fixed base PE
Article 5(3)	PE in relation to projects	Construction PE & Service PE
Article 5(4)	List of exclusions	Exclusion from fixed base PE
Article 5(5) & (6)	Dependent / Independent agent	Agency PE
Article 5(7)	Associated enterprise	Subsidiary PE

Article 5(6) in UN Model contains a special rule for agents of insurance company & is absent in OECD and US model

Fixed base PE

- Article 5(1) of the OECD Model Commentary governs basic rule for Fixed base PE

  "For the purpose 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"

- Definition is identical under UN and US Model

- Elements of Fixed base PE
  - Existence of 'place of business'
  - Place of business is at disposal
  - Place of business must be 'fixed'
  - Business is carried on wholly or partly through fixed place of business

Above conditions need to be cumulatively satisfied

What is the place of business?

Reasonable degree of permanence and continuity

- Place of business maintained for less than six months – para 6 of OECD MC unless –
  - The nature of business is such or
  - Business is exclusively carried on in the source state only
- Activity of recurrent nature - aggregate period is to be considered and not each period on a stand alone basis
- Temporary interruptions (seasonal business, holidays) to be ignored while determining permanency

What is the place of business?

Geographical and Commercial Coherence

- Movement of activities between neighboring locations

➢A very large mine or an oil field

➢Office regularly rented by a consulting firm in a hotel building

➢Trader setting up regular stand in a pedestrian street or in an outdoor market/fair

- Whether PE exist in the following cases - Geographical coherence exist

➢Painter working for different clients in a building

➢Painter working on a single contract undertaken through out the building for single client

What is the place of business?

- **Whether PE exist in following cases – cases of commercial coherence**
  - A consultant working at different branches in separate locations pursuant to a single project for training the employees of a bank – each branch should be considered separately
  - A consultant moves from one office to another within the same branch location pursuant to a single project for training the employees of a Bank

Existence of both Geographical as well as Commercial Coherence is must

Reference to para 5.2, 5.3 & 5.4 of OECD MC

Place of business at disposal

- Certain space should be available at the disposal
- Ownership test – immaterial
- Some rights / domain / control to use is required
- Test of place of business at disposal (reference to para 4.2 – 4.6 of OECD MC)

Not at disposal	At disposal
Regular visits by Salesman to meet purchase director to take orders	Employee of parent, is allowed to use office of subsidiary company under a contract with parent for sufficiently long period of time
Road transporter using a delivery dock for a number of years for delivering of goods purchased by client	Painter, for two years, spending 3 days a week in large office building of client for painting purpose
Foot print area of a satellite	
Roaming arrangement where home country operator transfers call to a foreign network	

Fixed base PE

- Article 5(2) of the OECD Model Commentary provides inclusive definition of PE
- Basic rule reads as under –

➢ The term ‘permanent establishment’ includes especially:

- A place of management;
- A branch;
- An office;
- A factory;

-A workshop, and

-A mine, an oil or gas well, a quary or any other place of extraction of natural resources

- This list is inclusive and not exhaustive
- Definition is identical under UN and US Model

Power of Disposition - judicial precedents

- There should be some evidence to indicate that whenever any employee of the foreign enterprise came to source state, he could straightaway walk into the business premises and occupy a space or a table
  - Motorola Inc [2005] 95 ITD 269 (Del) (SB)
  - Western Union Financial Services Inc [2006] 101 TTJ 56 (Del)
- US Co engaged in providing Computer Reservation Services had a PE in India under Article 5(1) as it exercised complete control over the computers installed at the premises of the subscribers and the computers could not be shifted from one place to another within the premises of the subscriber
  - Galileo International Inc [2008] 19 SOT 257 (Del)
- The premises of a wholly owned subsidiary in India were available to all the employees of the UK company in respect of its business operations in India - The UK Co. had a place of business at its disposal and a PE in India
  - Rolls Royce Plc [2009] 122 TTJ 359 (Del)

Construction / Installation PE

Article 5(3) - Comparison

OECD Model Convention	UN Model Convention	US Model Convention
"A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months"	"The term 'permanent establishment' likewise encompasses: a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;	"A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than twelve months"

Analyses of Construction / Installation PE

- **Analyses of Construction / Installation PE in following situations**:
  - Single Contract v. Multiple Contracts
  - Project office – if more than six months
  - Construction / Installation activities along with supervisory activities
- Once it is found that the duration in respect of each contract is less than 9 months, it will not constitute PE in terms of Article 5 of the India Mauritius tax treaty.
  - J. Ray McDerrmott Eastern Hemisphere Limited [2012] 54 SOT 363 (Mum)
- While computing the time limit of nine months for construction and assembly projects, preparatory activities for starting the projects have to be considered but purely preliminary activities such as visits for negotiations and taking soil samples need not be considered.
  - Cal Dive Marine Construction (Mauritius) Ltd. [2009] 315 ITR 334 (AAR)

Construction/Installation PE – Judicial Precedents

- **Supervisory services provided by a foreign company through its technicians do not constitute a PE in India under Germany tax treaty**

  - *GFA Anlagenbau Gmbh [2014] 47 taxmann.com 313 (Hyd)*

  - **Activities relating to installation of pipe lines by a marine vessel are treated as 'construction and assembly' and results into PE if carried on for more than nine months under the Mauritius tax treaty**

- *GIL Mauritius Holdings Ltd [2011] 48 SOT 17 (Del)*

- **The time period of independent installation and assembly projects cannot be aggregated in order to determine the constitution of a PE under Article 5(3) of Singapore tax treaty**

- *Tiong Woon Project & Contracting Pte Ltd [2011] 338 ITR 386 (AAR)*

- **Rectifying or supplementing installations of Pipelines can be construed as installation or assembly project**

- *ABC [1999] 237 ITR 798 (AAR)*

Service PE

- **Service PE - Features**

➢ Furnishing of ‘services’ within India which is not FTS / FIS

➢ Through employees or other personnel

➢ Activities continue for a period exceeding 90 days (30 days or one day where services are rendered by associated enterprises)

➢ OECD / US Model Convention does not have an Article governing this

➢ No service PE clause in some Treaties – Netherlands, France, Mauritius, etc.

Relevant judicial pronouncements:

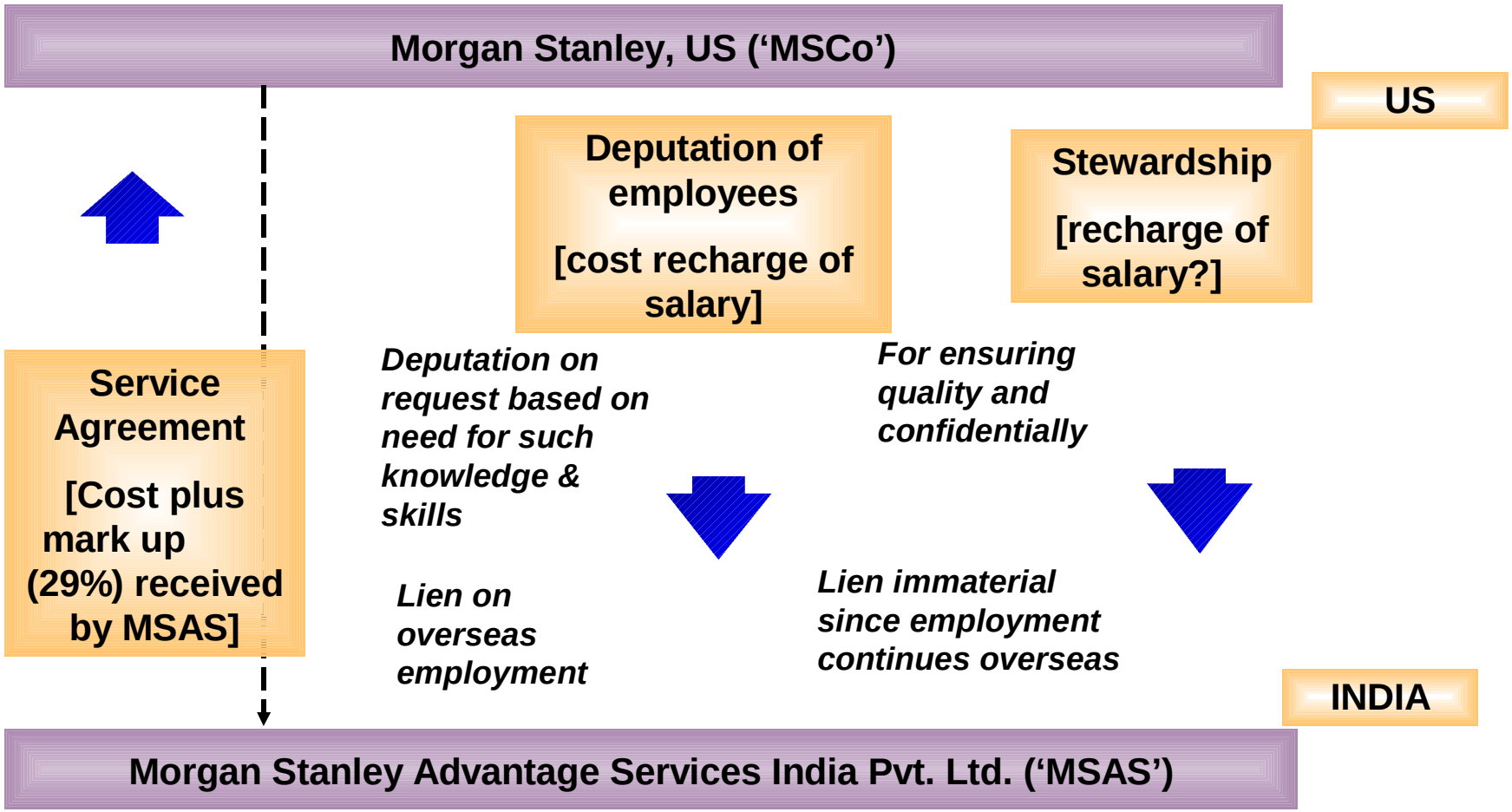
- **Deputation of personnel by the US Company to the Indian Company, without providing any further service cannot create a PE in India**

➢ *Tekmark Global Solutions LLC [2010] 38 SOT 7 (Mum)*

- **Foreign company is having a service PE in India by virtue of employees of its sister concern being made available to the Indian subsidiary to carry out the project**

➢ *Lucent Technologies International Inc. [2009] 28 SOT 98 (Del)*

Morgan Stanley & Co. Inc [2007] 292 ITR 416 (SC) - Facts



Morgan Stanley & Co. Inc [2007] 292 ITR 416 (SC)

- Employees of MSCo sent on stewardship (for short duration) to protect the interest of MSCo. Employees not engaged in day-to- day management of MSAS nor in any specific services to be undertaken by MSAS. Hence, no Service PE
- Service PE created on deputation of employees to MSAS, even if they work under control and supervision of MSAS. Key factors considered:
  - ✓ Lien on employment with MSCo; hence control over employee's terms of employment
  - ✓ Employees continues to be on the payroll of MSCo
  - ✓ On completion of tenure, employee is 'repatriated' to parent
  - ✓ Responsibility for risks and rewards of service with MSCo
  - ✓ Request for deputation from MSAS based on need for those skills in India

Exceptions in Article 5(4) -Exclusions of activities that do not result in PE

- **Exclusions of activities**
  - Use of facilities for storage or display of goods
  - Maintenance of stock of goods for storage or display
  - Maintenance of stock for processing of goods
  - Purchasing goods or merchandise or for collecting information for the enterprise
  - Carrying on, for the enterprise, any other activity of a preparatory or auxiliary character

Preparatory /Auxilliary	Non-Preparatory/Auxilliary
Market survey / Industry analyses / economy evaluation	Managing an enterprise or its parts
Furnishing of information including product information to prospective customers	A management office for supervisory and co-ordinating functions
Ensuring technical presentation to potential users	Supervisory or control of performance of contract
Development of market opportunities	After sales services to customers
Basic operation before commencement of business activities in India	A fixed place of business for the delivery of spare parts to customers

Agency PE

- **Article 5(5) of the OECD Model Commentary**

"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".

- **Article 5(5) of the OECD Model Commentary is identical to Article 5(5)(a) of UN Model Commentary & Article 5(5) of US Model Commentary**

Agency PE

- Person said to have authority to conclude contracts if, he/she:

➢ Has sufficient authority to bind foreign enterprise and decide final terms

➢ Can act independently, without control from the principal

➢ Is authorized to negotiate all elements and details of a contract

➢ Where approval of contract by foreign enterprise is a mere formality

- **Klaus Vogel** - "A general authority cannot be taken to exist if the authority to negotiate and conclude contract is so restricted that it allows the agent to settle for only such prices and terms and conditions as were fixed in advance by his principal, the agent having no scope for decisions of his own in this respect…"
- **Arvid Skaar** "No agency PE ……when the authority is limited to fixed prices and other fixed conditions determined by the principal, even if the contract is concluded by the agent ……."

Agency PE

Comparison – Article 5(6) of the conventions

OECD and US Model Conventions

"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 as independent agents".

UN Model Convention

Notwithstanding the preceding provisions of this article, …… an enterprise of a Contracting State shall not be deemed ……. **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 & 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".**

Dependent Agent - activities

- Whether mere negotiating is sufficient to constitute PE if actual signing does not take place in the other State ~ depends on the authority of the agent
- Authority must be habitually exercised
  - Mere one-off contract or a single contract does not lead to an agency PE (Extent & frequency of the transactions)
  - Mere existence of authority to conclude contracts does not lead to PE unless the agent is actually engaged and concludes in a manner (Klaus Vogel at page 334)
  - If the principal has put the agent in a position where a bonafide third party is justified in believing that the agents action are based on an authorization and thus create an obligation for the principal

Agency PE – Relevant Judicial Precedents

- **Since an agent represents multiple principals and provide similar services to various principals and the agent does not act exclusively for the sole principal, such agent does not have an agency PE in India**

➢ *AL NISR Publishing [1999] 239 ITR 879 (AAR)*

- **Even though the agent acts independently in the ordinary course of his business, if they devote their activities, wholly or almost wholly on behalf of the foreign enterprise, they would be considered as dependent agents**

➢ *Reuters Limited Construction House [2011] 48 SOT 246 (Mum)*

- **Pre-sale activities and incidental post sale support activities for products supplied by the foreign company cannot be treated as DAPE**

➢ *Varian India Pvt Ltd [2013] 33 taxmann.com 249 (Mum)*

- **Agency PE does not exist as long as it is shown that the transactions between the agent and the taxpayer are made under arm's length conditions**

➢ *Delmas, France [2012] 17 taxmann.com 91 (Mum)*

- **The Applicant did not constitute a dependent agent of the UK Company as the income from the UK company was only 75% to 80% of the total revenues of the Indian Company**

➢ *Specialty Magazines P. Ltd. [2005] 274 ITR 310 (AAR)*

Subsidiary PE

- **Article 5(7) of the OECD Model Commentary**

  "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"

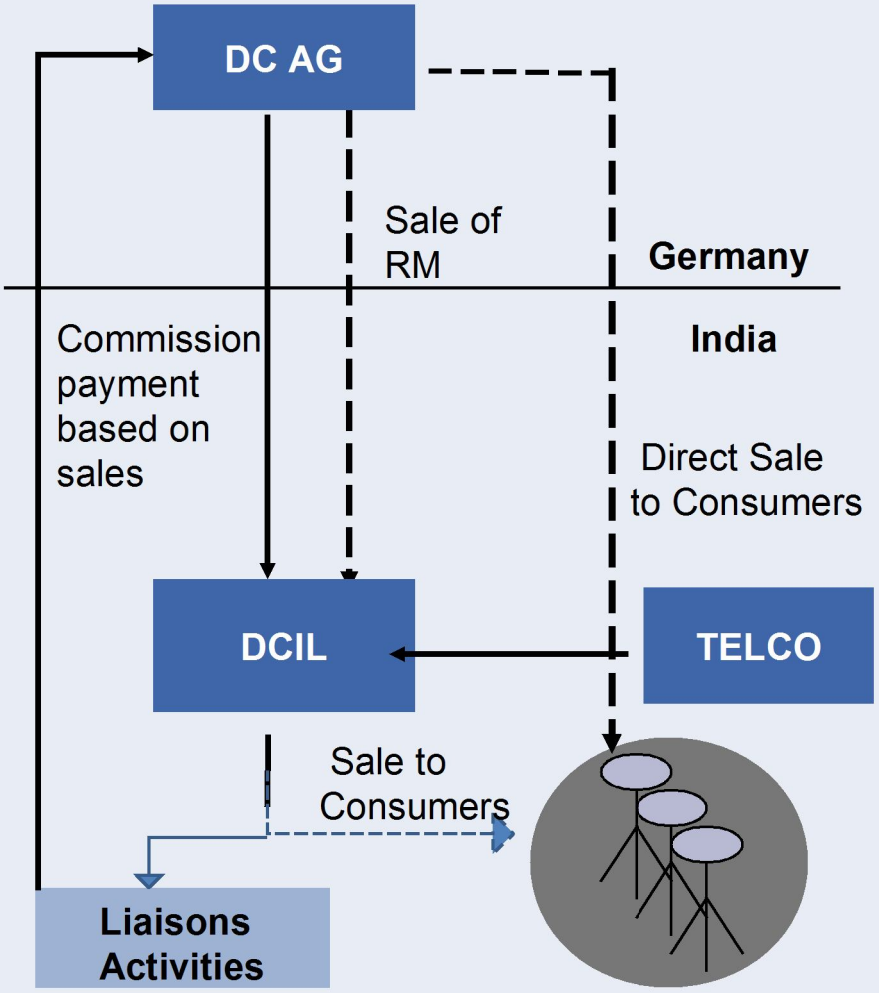
  - **Definition is identical under UN and US Model Commentaries**
  - **Existence of a subsidiary by itself does not constitute PE**
    - Legal independence of the subsidiary respected
  - **Test of fixed base PE / service PE / agency PE need to be satisfied**

Judicial Precedents

- Subsidiary of the taxpayer was treated as a PE in India by virtue of employees of affiliates being made available to the Indian subsidiary to carry out the project
  - Lucent Technologies International Inc. [2009] 28 SOT 98 (Del)
- Indian subsidiary created for securing orders in India wholly for the group and having a right to conclude contracts for the group is an Agency PE for the group
- The exception with respect to control over Subsidiary not constituting a PE as per Article 5(10) of the tax treaty is not applicable as the whole business in India of the multinational group is carried on within the geographical contours of India
  - Aramex International Logistics Private Limited [2012] 348 ITR 159 (AAR)

Daimler Chrysler A.G. [2010] 39 SOT 418 (Mum)

Subsidiary Company – whether PE?



Facts

- DC AG, set up a JV with TELCO viz. DCIL in India for the manufacture / assembly and sale of cars
- DC AG sold RM, CKDs and other parts to DCIL
- DCIL Role:
  - Manufacture and sale of cars for sale to Indian consumers
  - Liaison activities in connection with Direct Sales by DCAG for a commission based on sales
- MD & ED of DCIL was deputed by DCAG

Daimler Chrysler A.G. [2010] 39 SOT 418 (Mum)

Subsidiary Company – whether PE?

Formation of PE – whether fixed place / Place of Management PE was formed due to deputation of MD and ED?

- **No Fixed place PE :** Mere existence of a subsidiary does not constitute a PE
  - Foreign Co was not given right to use Indian Co's premises
  - Sale of CKDs to Indian Co was on P2P basis; Indian Co does not constitute sales outlet / warehouse of Foreign Co
- **No Place of Management :** Foreign Co had separate board of directors in India from Indian Co
  - MD and ED were deputed as employees of Indian Co

Agency PE – Indian Co is a DAPE of Foreign Co in respect of cars sold directly to Indian consumers?

- **No Agency PE**: Indian Co was only acting as 'Post office' between Foreign Co & Indian consumers
- Indian Co does not bear any risk or carry out negotiation of price, finalizing deal etc.
- The activity was not main business of Foreign Co but just preparatory or auxiliary activities

E-commerce

- Key elements in e-commerce transaction – website, server, computer of user, telecom infrastructure, etc.
- No physical presence or contact
- Lack of identification of parties to a transaction
- No physical trails or records
- New methods of payment
- Lack of active human involvement at point of service

Treaty characterisation of E-commerce transactions

E-commerce transaction	TAG (OECD view)	India position
Online shopping portals	Business profits	Business profits
Online auctions	Business profits	Business profits
Subscription to a web-site allowing the download of digitized products	Business profits	Royalty
Electronic access to professional advice	Business profits	FTS
Electronic ordering and downloading of digital products	Business profits	Royalty
Electronic ordering and downloading of digital products for purposes of copyright exploitation	Royalty	Royalty

eBay International AG [2013] 40 taxmann.com 20 (Mum)

SWITZERLAND

INDIA

eBAY International

Support services for India Specific website
i)Suggest eBay legal requirements
ii)Provide market data relating to industry
iii)Marketing and promotional services
iv)Payment processing and collection activities
v)Local customer support activities
vi)Furnishing of reports and information
vii)Other administrative and support activities

OPERATING INDIA-SPECIFIC WEBSITE

Indian Group entities

eBay International AG [2013] 40 taxmann.com 20 (Mum)

- **Tribunal's findings on existence of DAPE**
  - ***Website not controlled directly or indirectly by Indian group companies***
  - ***Indian group companies have no role in introducing any specific customer to Assessee***
  - ***Transaction on website is finalised through website operated from outside India***
  - ***No DAPE under Article 5(5) of DTAA as:***
    - Indian group companies are dependent agents but do not constitute DAPE
    - Indian group companies have not negotiated or entered into contract for and on behalf of Assessee
    - There is no case of habitually maintaining stock of goods for or on behalf of Assessee since goods are delivered by seller to buyer directly
    - No manufacturing or processing of goods in India for Assessee
- **Tribunal's findings on existence of Place of Management PE:**
  - ***Indian group companies are not taking any managerial decisions, and are simply rendering certain marketing services to the taxpayer.***
  - ***They have no role in the operation of the websites***
  - ***Hence, no place of management PE can be said to exist***

Right Florist (P.) Ltd. [2013] 143 ITD 445 (Kol)

Facts

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

Issue

- Whether Google/Yahoo have a taxable presence in India

Ruling

- Reliance placed on OECD MC to conclude that a search engine, which has a presence through its website, cannot have a PE in India unless the web servers are located in India

Whether Liaison Office constitutes a PE?

Liaison Office (LO) does not constitute a PE

- **As long as the Indian LO was conducting its operations within the restricted activities permitted by the RBI, it does not constitute a PE in India**
  - Mitsui & Co. Ltd 39 ITD 59 (Del)
  - Sumitomo Corpn 110 TTJ 302 (ITAT)
  - Motorola Inc 95 ITD 269 (Del) (SB)
  - Western Union Financial Services Inv 101 TTJ 56 (Del)
  - Metal One Corpn. [2012] 52 SOT 304 (Del)

- **Where LO of the taxpayer merely co-ordinated its purchases in India, it could not be regarded as taxpayer's PE in India under the India-USA tax treaty**
  - M. Fabricant & Sons Inc. [2011] 48 SOT 576 (Mum)

Whether Liaison Office constitutes a PE?

LO constitutes a PE

- **LO is engaged in the actual marketing of the products of the foreign company, and therefore constituted PE and the income attributable to the it taxable in India**

➢ Brown and Sharpe Inc. [2014] (ITA No.- 219 of 2014) (Del)

- **Indian LO of a foreign enterprise engaged in remittance services performs essential activity of downloading information, prints cheques / draft and dispatches them through courier – it falls outside Article 5(4)(e) exception**

➢UAE Exchange Centre LLC [2004] 268 ITR 9 (AAR)

- **Indian LO of a foreign enterprise engaged in commercial activities constitutes a PE of the Head office under India-Korea tax treaty**

➢Jebon Corporation India [2011-TII-15-HC-KAR-INTL]

- **Activities of LO were not confined to the purchase of goods in India and therefore there is Business Connection and PE in India**

➢ Columbia Sportswear Company [2011] 337 ITR 407 (AAR)

Whether Project/Branch Office constitutes a PE?

Project/Branch office does not constitute a PE

- **A project office does not carry on business at all and is merely a support office existing solely for the purpose of facilitating the performance of the contract**
  - BKI/HAM VOF [2001] 70 TTJ 480 (Del)
- **Branch office set up in India which merely remunerated employees seconded by US group company does not constitute a PE under Article 5 of the India-USA Tax Treaty**
  - Whirlpool India Holdings Ltd. [2011] (ITA no. 622 (del)/ 2006) (Del)

Project offices constitutes a PE

- **Project office constitutes a PE since certain expenditure were incurred out of rupee receipts by a project office**
  - Micoperi S.p.A Milano [2002] 82 ITD 369 (Mum)
- **Activities of a project office for engineering, procurement and installation set up in India constituted a PE under Article 5 of the India Korea tax treaty**
  - Samsung Heavy Industries Ltd v. ADIT [2011] 133 ITD 413 (Del)

National Petroleum Corporation Limited v. DIT [2016] 66 taxmann.com 16 (Del - HC)

Facts

- The taxpayer is a company incorporated in the **UAE, engaged in fabrication of petroleum platforms, pipelines and other equipment**
- The taxpayer entered into **contracts with ONGC for installation of petroleum platforms and submarine pipelines**
- The activities relating to **survey, installation and commissioning were done in India**. The **platforms were designed, engineered and fabricated overseas**
- The AO held that taxpayer had **fixed place of PE in the form of Project office**, **Construction/ Installation PE** and **DAPE**.

Held

- Article 5(1) and 5(2) of the tax treaty complement each other. All clauses of PE's as specified in **Article 5(2) would be construed as a PE subject to condition of 5(1)**
- Exclusions provided in **Article 5(3) would override the provisions of Article 5(1) and 5(2)** of the tax treaty

National Petroleum Corporation Limited v. DIT [2016] 66 taxmann.com 16 (Del - HC)

Held

- **Activities of Project office** of the taxpayers **fall within the exclusionary clause of 5(3)(e)** of the tax treaty and therefore **cannot be construed as PE** in India

- **Installation activities** in India was much **less than the minimum period of 9 months**, therefore there was **no installation PE** in India

- Consultants appointed in India has acted on behalf of the taxpayer in its normal course of business. The **consultancy agreement does not authorize consultant to conclude contract on behalf of taxpayer. Therefore, no DAPE in India**.

OECD BEPS Action 7 –

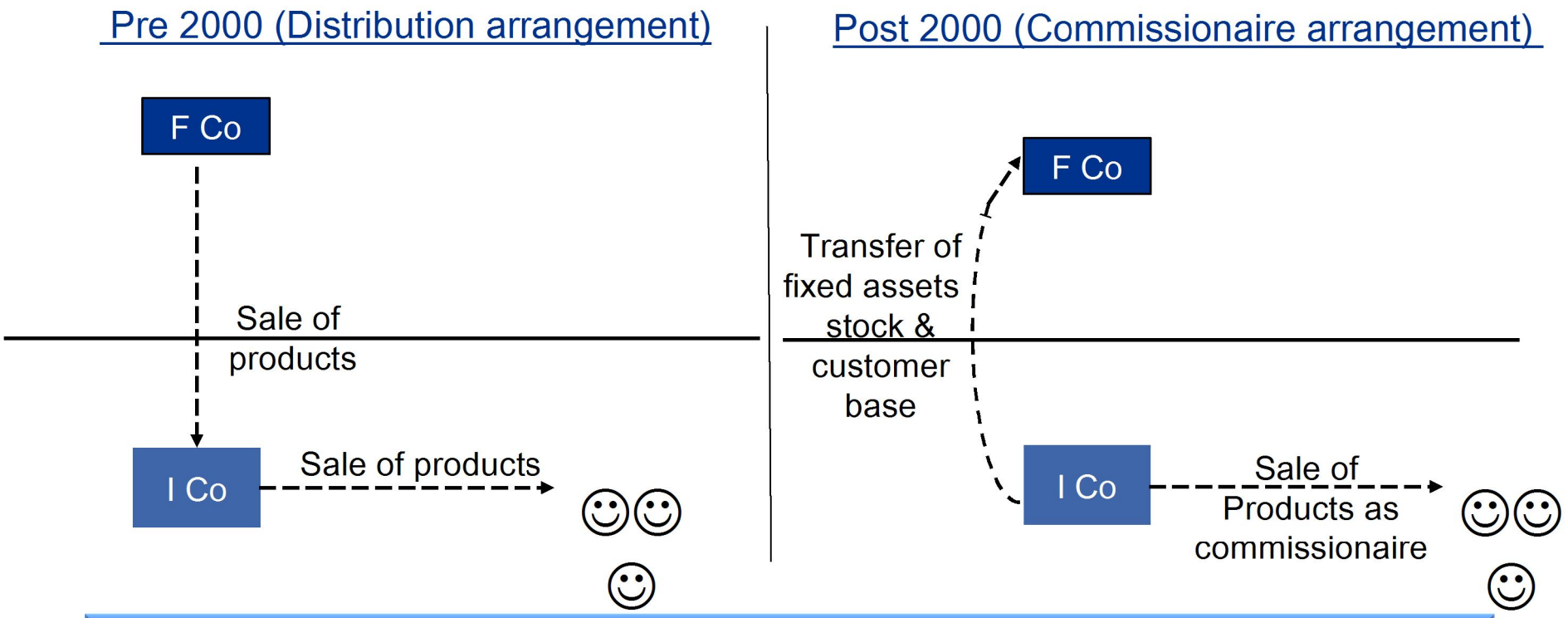
Preventing the artificial avoidance of PE status

BEPS Action 7 – Important Changes

Points for consideration	Proposed changes
gency PE	• Article 5(5) and Article 5(6) amended to broaden the scope of PE
reparatory or Auxiliary rule & Fragmentation of activities	• Exemption from PE status in Article 5(4) restricted to activities of preparatory or auxiliary character • New anti-fragmentation rule introduced to deny exemption where place of business maintained by an enterprise or a closely related enterprise in specific circumstances
plitting up of Contracts	• Application of a principal purpose test rule or, alternatively, aggregation of time spent on connected activities

Agency PE - Commissionaire arrangement

- Commissionaire – arrangement through which a person sells products in his own name but on behalf of a foreign enterprise that owns the products



Commissionaire arrangement does not result in PE

Revised Article 5(5) – Agency PE

Revised Para 5

- PE of an enterprise deemed to be in a source State
  - where a person is acting on behalf of an enterprise (i.e. agent) and
    - he habitually concludes contracts, or
    - *habitually plays the principal role leading to conclusion of contracts without material modification by the enterprise, and*
  - *these contracts are:*
    - *in the name of the enterprise, or*
    - *for transfer of ownership or granting right to use property of the enterprise, or*
    - *for provision of services by the enterprise*

Impact of Proposed Changes to Article 5(5)

Existing	Proposed
abitual conclusion of contracts in the name of the foreign principal required to create a PE	Foreign principal deemed to have a PE when a person acting on its behalf habitually concludes contracts or habitually plays the **principal role leading** to the conclusion of contracts and no material modification by the principal
f no conclusion of contracts in the name of the enterprise: generally no PE	Merely **convincing buyers to accept standard terms** of contract without any material modification of contract terms could create PE risk
ontracts concluded with third party on behalf of the principal but in the name of the agent (such as in commissionaire arrangements):generally no PE	• Commissionaires that are dependent agents give rise to a PE for the principal • Contracts concluded by a person even though **not legally binding** enterprise to third party but **indirect obligation is cast** on such enterprise are covered • A contract may be considered to be concluded in a State even if it is **signed outside that State**

Revised Article 5(6) – Independent Agent

Para 6

•Para 5 shall not apply where the agent is an independent agent acting in the ordinary course of that business

•However, if the agent acts exclusively / almost exclusively for closely related enterprise(s), he shall not be considered to be an independent agent

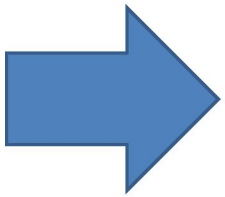
−close relation to be determined based on control test or beneficial interest test

•Exclusively / almost exclusively for closely related enterprise(s)

−sales by agent for unrelated enterprise is less than 10% of over all sales concluded by such agent

Existing

Depending on the facts and circumstances, an agent acting on behalf of a related enterprise could be considered to be an independent agent



Proposed

A person acting **exclusively or almost exclusively** on behalf of one or more enterprises to which it is **closely related** shall **not** be considered to be **an independent agent**

Independent agent

OECD Commentary - Important guidelines for determining independence

- Agent would not be independent where
  - his activities are subject to detailed instructions or comprehensive control by the enterprise
- An agent acting for several principals would be independent where
  - his activities constitute an autonomous business & he bears risk through use of his entrepreneurial skills & knowledge
- Impact on Agency PE where the agent has substantial non-agency business

BEPS Report : Non-agency business not relevant in determining independence of the agent

Agency PE – possible impact areas

- Mere approval by F Co of order and signature outside India is no more relevant
  - need to demonstrate active participation in conclusion of contracts / material modification by F Co. (re-design commercial arrangement/ document trail)

- Higher exposure for digital commerce (such as search engines, digital advertisement, e-commerce, online streaming videos / content, etc)
  - Indian agents securing orders where standard contracts are signed by the Indian customer with the foreign companies could create PE exposure

- An agent acting exclusively or almost exclusively for closely related enterprise could create PE exposure – not an Independent agent

- Low-risk Distribution model (reseller) can be considered to mitigate PE exposure
  - Title to property should pass on
  - Negative judicial precedent in the context of “service” business

Proposed changes to Article 5(4)

Existing

.5(4) – PE shall not be deemed to include:

(a) use of facility for storage, etc

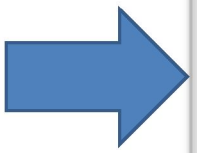
(b) maintenance of stock of goods

(c) processing of goods

(d) purchasing goods or collecting info

(e) any other activity of a prep or aux character

(f) combination of above mentioned



Proposed

A.5(4) – PE shall not be deemed to include:

- (a) use of facility for storage, etc
- (b) maintenance of stock of goods
- (c) processing of goods
- (d) purchasing goods or collecting info
- (e) any other activities
- (f) combination of above activities

provided that such activity or in the case of (f) the overall activity is of prep or aux character

Article 5(4) – meaning of certain terms

Preparatory

- Activity in contemplation of the essential and significant part of the activity of the enterprise

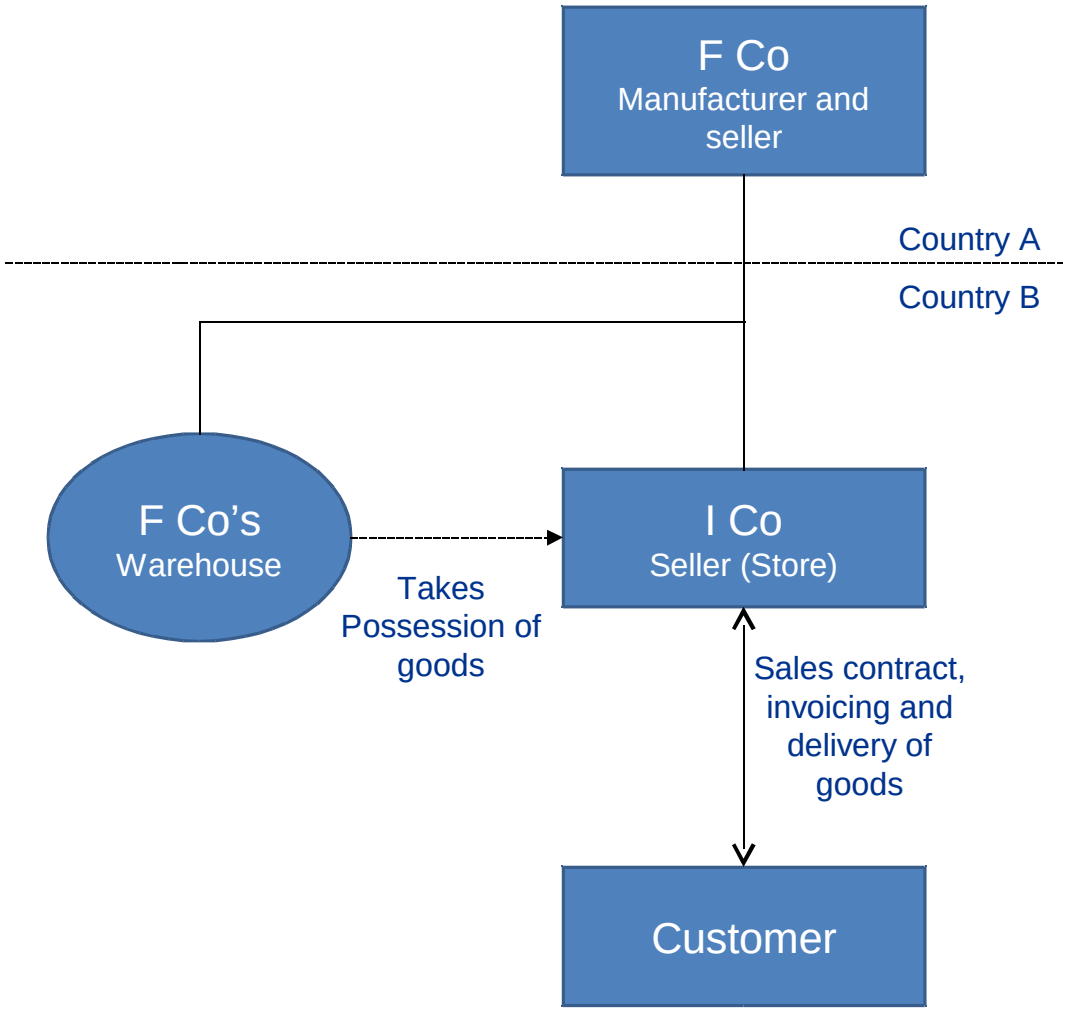
Auxiliary

- Activity to support the essential and significant part of the activity of the enterprise

Fragmentation

- Carrying out activities listed at 5(4)(a) to (e) through different places constituting complimentary functions

Illustration of anti-fragmentation rule in action



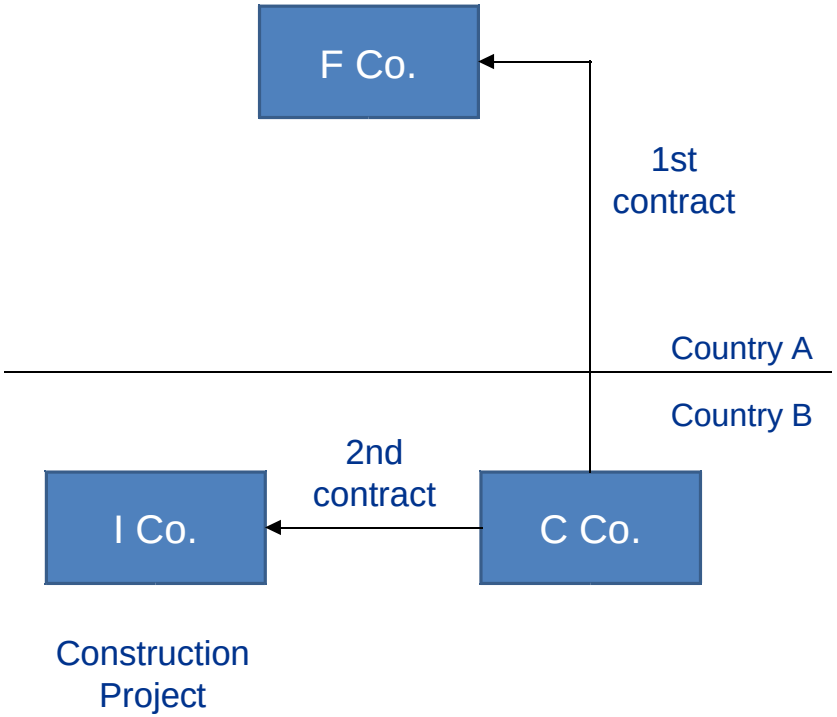
- F Co and I Co are closely related enterprises
- The business activities carried on by F Co at its warehouse and by I Co at its store constitute complementary functions that are part of a cohesive business operation (i.e., the storing of goods in one place and the selling of these goods through another place)
- Hence, F Co's warehouse cannot be exempt from PE on the ground that storage, display & delivery of goods of a preparatory or auxiliary character

Splitting-up of contracts – Proposed Changes

"principal purpose test" proposed under Action 6
and
Also include an example to the general anti-abuse rule to clarify the intent (discussed in next slide)

Aggregate time spent by connected activities at the same project to calculate the 12-month period when each enterprise performs such activities for more than 30 days

Splitting-up of contract – Illustration



- F Co. wins bid for construction project from customer (C Co.)
- Estimated time period for entire project is 22 months
- F Co. enters into contract with C Co. for 1st project
  - Estimated time period 11 months
- I Co. enters into contract with C Co. for 2nd project
  - Estimated time period 11 months
- Overall responsibility of both these projects remains with F Co.

Aggregate period exceeds 12 months period – construction PE of F Co. exists

Recent decisions

Centrica India Offshore Pvt. Ltd. [2014] 364 ITR 336 (Del)

Facts:

- Foreign companies are in the business of supplying gas and electricity to consumers across the UK and Canada.
- The overseas entities outsourced their back office support functions to Indian company
- Indian company is charging full costs plus a mark-up of 15 percent to overseas entities
- To seek support during initial year of its operation, the taxpayer sought some employees on 'secondment' from the overseas entities and therefore, it entered into a 'secondment agreement' with the overseas entities
- The taxpayer reimbursed salary cost to overseas employers on cost to cost basis. The taxpayer offers salaries paid to every seconded employee for taxation purpose and withheld their taxes in India.
- AAR held that overseas entities constitute Service PE on account of employees deputed by overseas entities under the terms of secondment agreement.

High Court Ruling

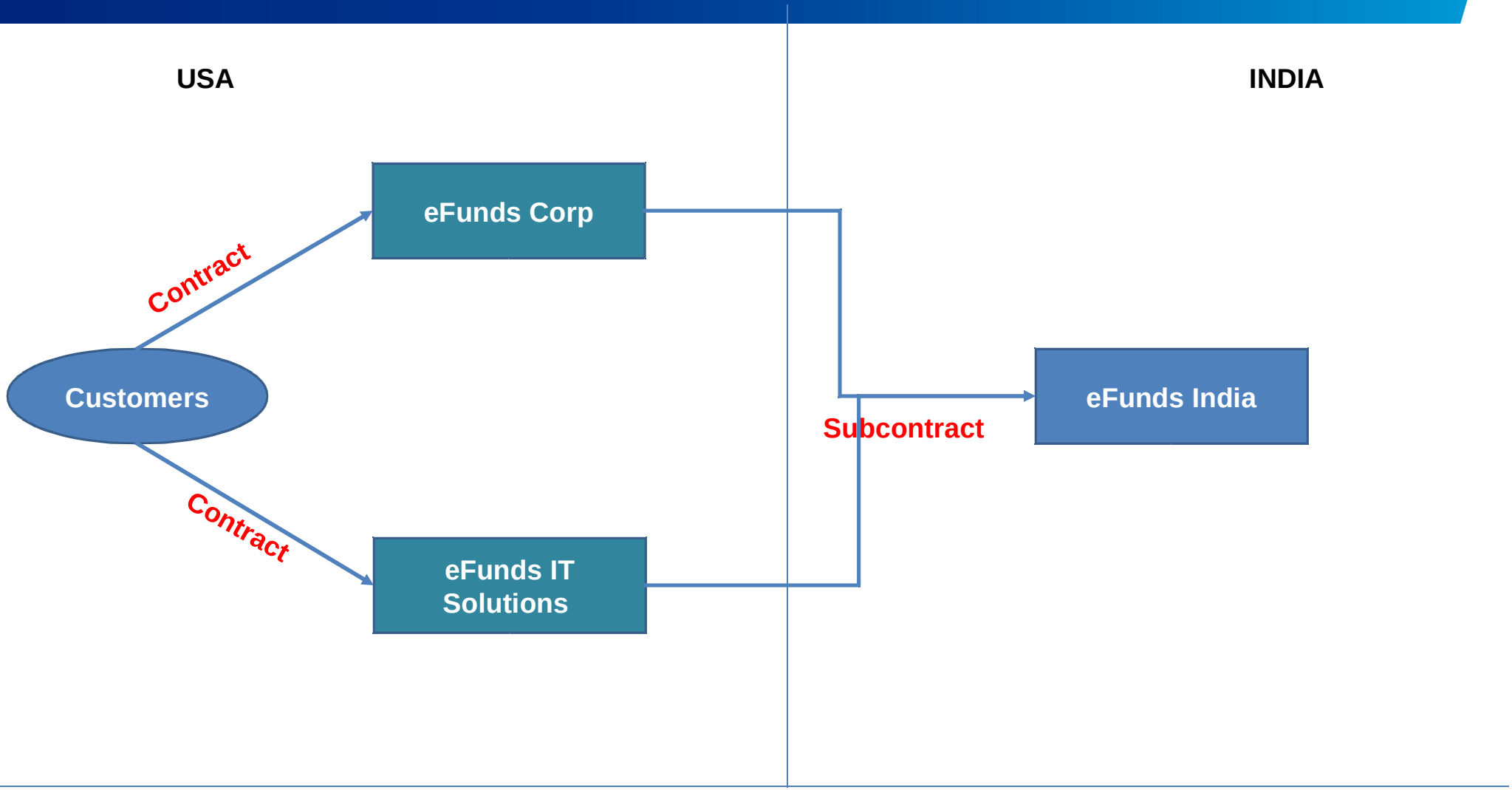
- There was no purported employment relationship between the taxpayer and the secondees. None of the documents, including the attachment to the secondment agreements, reveals that the secondment arrangement can be terminated.

Centrica India Offshore Pvt. Ltd. [2014] 364 ITR 336 (Del)

- All direct costs of such seconded employees and other costs were ultimately paid by the overseas entity
- Employees have only been seconded or transferred for a limited period of time to Indian Co, in order to utilise their technical expertise in the latter
- The employment relationship between the secondees and the overseas organisation was at no point terminated, nor was the taxpayer given any authority to even modify that relationship. The salary was paid through the overseas entity, which was not a mere conduit
- OECD Commentary - Foreign company may not constitute a service PE if the seconded employees work exclusively for the Indian enterprise and they were released by the foreign enterprise which was not the case in this decision.
- The HC discussed the concept of economic employer v. legal employer
- Accordingly, **overseas entities constituted Service PE in India**

SLP filed by Centrica India has been dismissed by the Supreme Court

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)



E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- **Case deals with key issue of PE Implications to foreign companies sub-contracting services to Indian subsidiaries**
- **Significant impact to IT/ITeS sectors and other sectors where delivery centers are located in India**
- **Tribunal held that eFunds Corp and eFunds IT Solutions (both US companies) were having PE in India on account of them sub-contracting work under their customer contracts to the group's Indian subsidiary**
- **High Court reversed Tribunal's decision and held as under:**
  - ***Existence of business connection in India:*** Since the Indian entity was providing information/details to the US entities for the purpose of entering into contracts with third parties and subsequently the said contracts were performed fully or partly by e-Funds India as an assignee or sub-contractee, a business connection was established
  - ***Subsidiary as* PE:** Subsidiary constitutes an independent legal entity for the purpose of taxation. Holding or a subsidiary company by themselves would not become PE unless other requirements of the PE definition are satisfied.

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- ***Fixed Place PE*: <u>Nothing to show that the US Cos had a fixed place of business</u> in India <u>or had any right to use premises of eFunds India</u>.**
- ***Place of Management PE*:** International division headed by President managed operations of eFunds entities in UK and Australia and provided marketing support to various overseas entities. **<u>Prima facie Place of Management PE could be constituted - but this provision was not invoked. Issue requires factual investigations and cannot be made matters to be decided for the first time in an appeal before the HC under section 260A of the Act</u>**
- ***Articles 5(3) v. 5(1) and 5(2)*: <u>Not falling within the exclusions in Art. 5(3) does not automatically result in the formation of a PE. The requirements of Art. 5(1) or 5(2) must be satisfied</u>**
- ***Service PE:*** Employees of the eFunds India were its employees and not of the US entities. Hence, a Service PE could not be constituted.
  - <u>Two employees of efunds US deputed to efunds India were working under control and supervision of efunds India, therefore does not constitute service PE in India</u>

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- ***Agency PE:***
  - Subsidiary company by itself would not become dependent agent of Hold Co.
  - Requirement of Article 5(4) and 5(5) were not satisfied in present case
  - Under India-USA treaty, no agency PE if transactions between agents and principal are at arm's length, even if agent is devoted wholly or almost wholly for the principal
- **MAP agreement** relevant but cannot be primary basis to decide whether Foreign companies have PE in India
- **Attribution of Profits to the PE –** in view of the income declared and taxed in the hands of eFunds India, nothing remains to be attributed or taxed in the hands of eFunds USA

Nortel Networks India International Inc. [2014] 49 taxmann.com 147 (Del)

Facts

- Taxpayer was a leading supplier of hardware and software products for GSM cellular radio telephones system
- Indian subsidiary of the taxpayer, entered into a contract with Reliance Infocom for supply of hardware equipment
- AO held that the taxpayer does not have any manufacturing or trading infrastructure
- It does not have any financial or technological capability of its own. The taxpayer was only a paper company incorporated for the sole purpose of evading taxes in India
- Indian Subsidiary was a fixed place of business and DAPE of the taxpayer as well as it had a business connection in India

Permanent Establishment

- Indian Co had undertaken the responsibility for negotiating and securing the contracts. The contract for installation and commissioning was also undertaken by Indian Co.
- The taxpayer was merely a shadow company of Nortel group
- Since the hardware supplied by the taxpayer was installed by Nortel India and the contracts were pre-negotiated by the same, it was constituted a fixed place of business and DAPE of the taxpayer in India

Nortel Networks India International Inc. [2014] 49 taxmann.com 147 (Del)

- Liaison office of Nortel Canada was rendering all kinds of services to all the group companies including the taxpayer – Fixed place PE
- The subsidiary acted as a service provider and at the same time acted as a sale outlet co-operating with after sale service
- The activities carried out by the PE are the core activities of the taxpayer resulting in generation of income and they cannot be considered to be preparatory and auxiliary

Attribution of income

- The accounts of the taxpayer furnished in the assessment proceedings have no sanctity and the same were not audited.
- AO's reference to the global accounts of the Nortel and gross profit margin percentage as 42.6 per cent was accepted.
- The tax authorities were justified in resorting to Rule 10. However, when profits are computed under Rule 10 after applying the profit rate, the expenses pertaining to the PE have to be allowed as deduction
- Based on the facts attribution of 50 per cent of the profits to the activities of PE in India would be a reasonable attribution

Convergys Customer Management Group Inc. [2013] 58 SOT 69 (Del)

Facts

- US Co provides IT enabled customer management services by utilising its advanced information system capabilities, human resource management skills and industry experience
- US Co had a subsidiary in India by the name of CIS
- CIS provides IT enabled call centre/back office support services to the taxpayer

Ruling

Permanent Establishment

- The employees of US Co frequently visited the premises of CIS to provide supervision, direction and control over the operations of CIS and such employees had a fixed place of business at their disposal - there exist a fixed place PE
- CIS was the projection of taxpayer's business in India and carried out its business under the control and guidance of the taxpayer and without assuming any significant risk in relation to such functions
- No DAPE as relevant conditions under tax treaty not satisfied

Convergys Customer Management Group Inc. [2013] 58 SOT 69 (Del)

Attribution of profit

- Overall attribution of profits to the PE was a TP issue and no further profits can be attributed to a PE once an arm's length price has been determined for the Indian associated enterprise, which subsumes the FAR of the alleged US Co (PE) had a subsidiary in India by the name of CIS
- The risk was outside India with the taxpayer as the CIS was remunerated at Cost+14 percent irrespective of failure of service delivery
- Even otherwise, no attributions can be made on account of risks in terms of Article 7(5) of the tax treaty
- AO/CIT(A) was not correct in invoking the provisions of Section 44C of the Act in attributing the income of the taxpayer without allowing the cost incurred to earn the revenue outside India thereby attributing the entire receipts
- The revenue of the taxpayer cannot be considered as the revenue of the PE by any stretch of imagination
- The taxpayer had submitted that it does not prepare India specific accounts, therefore the attribution of profits on the basis as disclosed in the TP study for assets and software cannot be accepted

Convergys Customer Management Group Inc. [2013] 58 SOT 69 (Del)

Tribunal provided approach to arrive at the profit attributable to PE

- Compute global operating income percentage of the customer care business as per annual report
- This percentage should be applied to the end-customer revenue with regard to contracts/projects where services were procured from CIS. The amount arrived at is the operating income from Indian operations
- The operating income from India operations is to be reduced by the profit before tax of CIS. This residual is now attributable between USA and India
- The profit attributable to the PE should be estimated on aforesaid residual.

Attribution of Indian PE income should be made at 15 percent of profit retained by taxpayer in the USA

NGC Network Asia LLC v. JDIT [2015] 64 taxmann.com 289 (Mum)

Facts

- The taxpayer is a US based company and is a subsidiary of 'Fox Entertainment Ltd'

- Taxpayer appointed **NGC India** as its **distributor to distribute its television channels and also to procure advertisement for telecasting** in the channels

- The AO held that taxpayer is having DAPE in India

Held

- **NGC India habitually exercises in India an authority to conclude contracts on behalf of the taxpayer** and the same is binding on the taxpayer

- Therefore, **NGC India constituted DAPE** in India

Reuters Limited v. DCIT [2015] 63 taxmann.com 115 (Mum)

Facts

- The taxpayer is a resident of **the UK**. It is engaged in the **business of providing world-wide news and financial information product**
- **In India** the taxpayer provides Reuters products to its Indian subsidiary named as RIPL. **RIPL distributes such products to the Indian subscribers independently in its own name**
- The taxpayer had **deputed its persons** as the news Bureau chief of **Mumbai** for gathering, writing and distributing the news and overall coverage of news
- The AO held that RIPL constituted DAPE in India

Held

DAPE

- **No records show that RIPL was habitually exercising its authority to negotiate and to conclude contracts** on behalf of the taxpayer in India which is binding on the taxpayer

Reuters Limited v. DCIT [2015] 63 taxmann.com 115 (Mum)

- RIPL has **independent contract with the subscribers**
- It is **not habitually securing the orders wholly and almost wholly for Reuters**
- RIPL was **earning substantial income from its own dealing with third party** customers
- RIPL was completely an **independent entity** and the relationship between the taxpayer and RIPL was on **principal to principal basis**
- Therefore, taxpayer was **not having DAPE in India**

Service PE

- There was **no furnishing of services by Bureau chief into the RIPL** which had lead to earning of a distribution fees to taxpayer
- The **Bureau chief has nothing to do for providing of Reuters services to distributor**
- Therefore, **no service PE in India**

Key Takeaways

Key takeaways

- **PE – a dynamic concept - especially with emergence of economic and technological advancements**
- **Computation / Attribution of profits to PE – very contentious in practice**
- **PE assertions among the top cross-border tax issues faced by multinational groups in India**
- **Issues also impact Indian group entities / customers on account of withholding tax obligations**
- **Mitigation / caution points:**
  - Structuring of sub-contracting agreements to mitigate PE risks (Fixed place, virtual projection, agency etc.)
  - Need to balance oversight requirements with potential PE risks
  - Presence of executives with management / oversight roles over group entities abroad
  - Reciprocal arrangements could be considered as mirror image leading to PE exposure
  - Documenting functional analysis – key defense
  - Attribution vis-à-vis arm's length payments

Mrugen Trivedi