Article 5 - Exclusions to Permanent Establishment

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Concept of PE

- The concept of a PE plays an important role in determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State.
  - Existence of a PE is the decisive condition for taxing business income under all the three Model Conventions.
  - In other words, under Article 7, a Source Contracting state cannot tax the profits of an enterprise of the Resident Contracting state unless it carries on its business through a PE in the Source Contracting state.
  - This rule is designed to ensure that business activities will not be taxed by a Source Contracting state unless and until a significant presence (in the form of Fixed, Service, Agency, Installation or Construction PE) is created in the Source Contracting state.
  - The profits that are attributable to such PE would be taxed in the source state. Force of attraction applicable in case of specific treaties.
- Definition of PE is narrower compared to the term 'business connection'

Structure of Article 5

Article 5 - OECD MC

Article 5(1)
Fixed PE

Article 5(2)
Specific PE

Article 5(3)
Construction PE

Article 5(4)
Exclusions from PE

Article 5(5)
Dependent Agent PE

Article 5(6)
Deemed PE – Insurance Companies

Article 5(7)
Independent Agent

Article 5(8)
Subsidiary Company

Article 5(4) of OECD MC 2017

- Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be **deemed not to include**:

a) the use of facilities solely for the purpose of storage, display or delivery 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, display or delivery; [Refer Seagate Ruling]

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

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; [Refer Columbia Sportswear Ruling]

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~~ **(removed in OECD MC, 2017)**; [Refer UAE Ruling]

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, or in the case of subparagraph (f) is of a preparatory or auxiliary character. **(modified by OCED MC, 2017)**

Clause C - A typical case of a Toll Manufacturing. F Co1 enters into an agreement for sale of finished goods to F Co2. F Co1 sends raw materials to I Co1 for processing and export thereon.

Article 5(4) - OCED vs UN MC

- UN treaty has predominantly adopted the OECD 2017 version except for the following

  - The UN Model excluded the word ‘delivery’ from clause (a) and (b) of Art 5(4). This reflects the majority view of the Committee that a ‘Warehouse’ or ‘Facility’ used for the purpose of ‘delivery’ could be regarded as PE, if the requirement of para 1 is met.

  - Treatise entered by India follow a mixed approach of OECD MC and UN MC

    - Only occasional Delivery considered as PoA - Singapore, US, Canada, Turkey, Malta, Vietnam etc.
    - Delivery Included under PoA - Germany, Austria, South Africa, Korea, Sweden etc.
    - Delivery Excluded from PoA - UK
    - Unloading included under PoA - Ukraine
    - Scientific Research included under PoA - Refer treaties with Australia, Belgium, Canada, France

India’s reserves their position on Para 4 as they consider that the term ‘delivery’ should be deleted from subparagraph a) and b)

Article 5(4) - Characteristics

- These are activities which prepares for core function or is <u>supportive</u> in nature
- These activities <u>precedes another activity;</u> therefore, it will be often carried on during a relatively <u>short period</u>.
- Auxiliary activities that aid or support the core activities and <u>does not in any way contribute to the commercial profits significantly.</u>
- PoA activities may not require a significant proportion of employees/assets of the enterprise
- Reason for exclusion of activities:
  - Remote from core business activities
  - Remote from actual realization of profits

All facts and circumstances need to be evaluated to determine whether an activity is PoA or not.

Article 5(4) - ‘Other’ aspects

Para 75 of OECD commentary (2017).PNG

- Article 5(4) commence with a non obstante clause and it overrides Art 5(1) to 5(3).

- In view of specific exclusion in Art 5(5)(a), Art 5(5)(a) is also subject to Art 5(4) - For e.g. Manager of place of business where PoA activities are carried on concludes a contracts necessary for establishing and maintaining the place of business **- Para 75 of OECD MC, 2017**

- Other enterprises: The Article uses the expression ‘belonging to the enterprise’ or ‘for the enterprise’. Hence activities referred in sub para (a) to (e) refers to activities carried on for the enterprise itself.

- Other activities: Only exempted activities should be carried on from that fixed place. If the place is used for exempted and other activities, then Art 5(4) shall not apply - **Para 61 of OECD MC, 2017**

- Other place of business: Benefit of PoA may not be available, if enterprise maintains any other fixed place of business in that State - **DTAA with Singapore, Ukraine, Norway, Australia, Italy, Poland**

Article 5(4) - Interpretation of clause (a) to (d)

Pre MLI

- Article 5(4) commence with a non obstante clause and contains deemed exclusionary clauses **(Speciality Magazine Pvt Ltd (AAR) 274 ITR 310; Motorola Inc. (2005) 95 ITD 269)**

- The above view is also supported by **Para 20 of UN MC of 2011** - The exceptions are absolute notwithstanding that a particular activity otherwise satisfies the tests of a PE. Also refer **Para 78 of OECD MC, 2017** where states allowed to adopt a its own view

- As per the provisions of article 5(4)(d), collecting information for an enterprise by a LO located abroad is considered as an auxiliary activity, unless the collecting of information is the primary purpose of the enterprise **[K.T. Corporation (AAR) 224 CTR 234]**

- If the activities are performed to more than one person, then that activity cannot be treated as PoA - **GE Energy Parts Inc (Del) (2017)**

Para 78 of OECD commentary (2017).PNG

Whether exemption is Automatic ?

View 1 - Not be tested for Preparatory or Auxiliary (PoA)

Activities listed from (a) to (d) are always exempt from PE and are not to be tested for PoA –

- Philip Baker in his commentary has suggest that PoA test is only relevant for subparagraph (e) and (f) "*it is only paragraphs (e) and (f), which refer to preparatory or auxiliary activities. Art. 5(4)(a) to (d) mention specific activities; 5(4)(e) includes any other activities of a preparatory or auxiliary character and 5(4)(f) includes a combination of activities so long as the overall activity is of a preparatory or auxiliary character. On the wording of the Model Article itself, it is only in connection with other activities, not specifically mentioned [paragraph (e)] and with a combination of activities [paragraph (f)] that it is necessary to decide if the activities are preparatory or auxiliary".*

View 2 - items listed under (a) to (d) should be also tested for PoA

- Klaus Vogel acknowledges that the list of the activities only of a PoA character. "*This synthetic approach is supported by the view expressed by the OECD MC Comm. that the common feature of all activities listed in Article 5(4) OECD and UN MC is that they are, in general, preparatory or auxiliary activities (no. 21 OECD MC Comm. on Article 5). It is particularly Article 5(4)(e) OECD and UN MC that ties the single elements in sub-paragraphs (a) to (d) together. In other words, Article 5(4)(a) to (d) OECD and UN MC do not constitute specific carve-outs of Article 5(1) OECD and UN MC, but are designate examples of one comprehensive carve-out."*

Amendment to OECD MC 2017

<u>OECD MC (Pre-amendment)</u>:

- PE shall not be deemed to include
  a) Use of facility for storage, etc.
  b) Maintenance of stock of goods
  c) Maintenance of stock of goods for the purpose of processing of goods
  d) Purchasing goods or collection of information
  e) any other activity of a preparatory or auxiliary character
  f) combination of above mentioned activities of a preparatory or auxiliary character

<u>OECD MC (Post-amendment)</u>:

- PE shall not be deemed to include
  a) Use of facility for storage, etc.
  b) Maintenance of stock of goods
  c) Maintenance of stock of goods for the purpose of processing of goods
  d) Purchasing goods or collection of information
  e) any other activity ~~of a preparatory or auxiliary character~~
  f) combination of above mentioned activities ~~of a preparatory or auxiliary character~~

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

BEPS AP 7 - Need ?

- To address tax avoidance strategies and structures put in place to circumvent creation of PE in source state.

- Changes to the PE definition necessary to prevent the exploitation of the specific exceptions to the PE definition currently provided for by Article 5(4) of the OECD MC.

- Action Plan 7 (BEPS) suggested changes to be made to the definition of PE in Article 5 of the OECD MC

- Action Plan 7 (BEPS) suggestions were reflected in OECD MC, 2017 and duly followed under UN MC, 2021.

BEPS AP 7 - Issues Addressed ?

Changes in Domestic tax law

COMMISSIONAIRE ARRANGEMENTS

Selling of goods in another State through ‘Commissionaire’ arrangements or similar strategies

SPECIFIC ACTIVITY EXEMPTION

Artificially avoiding PE status through specific activity exemptions

MLI

FRAGMENTATION OF ACTIVITIES

Fragmentation of activities through closely related parties

SPLITTING OF CONTRACTS

Splitting-up of contracts amongst group entities avoid a PE

AP7 does not suggest any change to Article 5(3). Proposes to address through Principal Purpose Test (PPT)

BEPS AP 7 - Issues Implemented through MLI

Options under MLI

- Art 13(1) of MLI provides two options

Option A - Exemption shall be available only if the activities listed in CTA meet the test of preparatory or auxiliary in nature on a standalone or overall basis

Option B - Allows countries to retain the automatic exemption to listed activities, irrespective of the same being preparatory or auxiliary in nature.

India has chosen Option A – However, treaty shall be modified subject to notification of same option by treaty partner

Additional factor (Anti fragmentation rule)

Adoption of anti fragmentation rule (even if the options are not chosen to deny specific activity exemption:

1) **Same enterprise or Closely related entity** carries on business activities at the **same place** or **another place** in the state ***and***
2) At lease **one of the place constitute PE *(or)* overall activity** resulting from the **combination of activities** carried on by the two enterprises **is not PoA character**

Aggregate business activity constitute **complementary functions** that are part of **cohesive business operations**

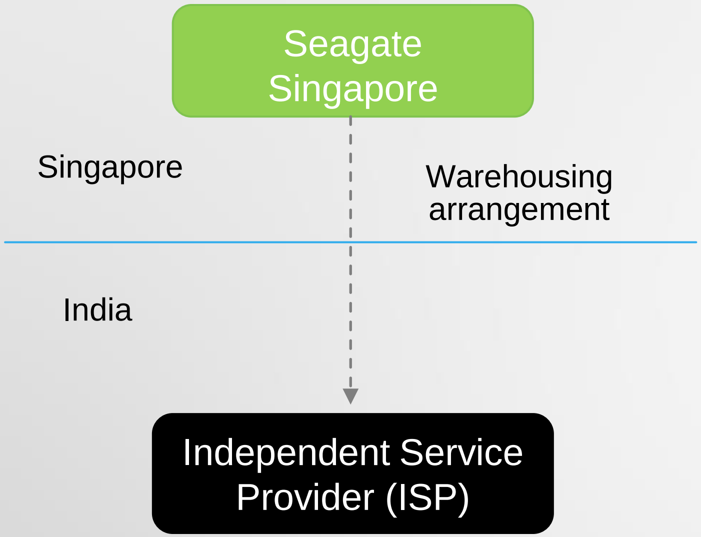
MLI Position of India and few other countries

Countries	Specific Activity
India	**Option A + Anti Fragmentation**
Australia	Option A + Anti Fragmentation
Canada	No - Reserved the article in entirety
Cyprus	No - Reserved the article in entirety
France	Anti Fragmentation
Netherlands	Option A + Anti Fragmentation
Singapore	No - Reserved the article in entirety
UK	Anti-Fragmentation
USA	Not a party to MLI
UAE	No - Reserved the article in entirety

Jurisprudence Pre-MLI

Seagate Singapore - AAR

India - Singapore
(Post MLI)



Facts in brief

- Seagate was engaged in the business of manufacture of Hard Disk Drives. It had been supplying Hard Disk Drives to OEMs in India.
- Seagate entered into an agreement with ISP who would stock disks in India on behalf of Seagate and deliver to the OEMs on a Just-in-Time basis
- Seagate claimed that it did not have any fixed place at its disposal in India nor did it have any other kind of physical presence in India.
- Goods are stored in India in a warehouse owned and operated by ISP and had restricted right to entry (for inspecting goods during business hours)

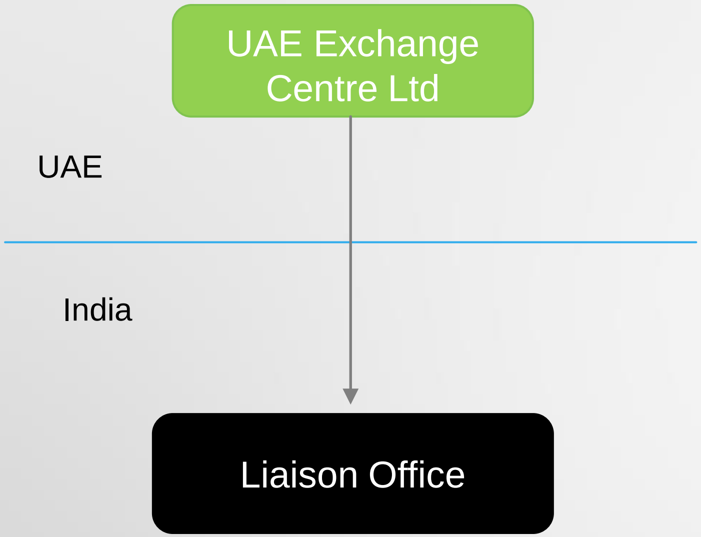
Ruling by AAR

- ISP provided earmarked space. Warehousing services include receiving applicant's pro electronic receipts. ISP complies with applicant's minimum-security requirem
- ISP maintains necessary operating system to support electronic data interchange advise and inventory receipts. ISP does inventory tracking and obtains insurance.
- Applicant's agent has the right to enter the warehouse for inspection, audit etc.

The fact that a ISP (not applicant's employees) carries out the operations leading to delivery of goods to customers does not rule out application of Article 5(1). Singapore excludes only occasional delivery under PoA.

UAE Exchange Centre Limited - SC

India-UAE (Post MLI)



Forum	Ruling
AAR	Not PoA
Delhi HC	PoA
SC	PoA

Facts in brief

- The assessee was a UAE company. It had opened liaison office (LO) in India. The UAE company collected funds and transmitted same to the beneficiaries of the NRI remitters in India through the following two modes:
  - either by telegraphic transfer through normal banking channels via banks in India; or
  - by dispatching through courier, cheque / drafts prepared by India LO
- The LO established in India performed the function of downloading the information which was contained in the server located in the UAE.
- Based on this downloaded data, cheques were drawn on banks in India and the said cheques were couriered or dispatched to the beneficiaries in India, as per the instructions of the NRI remitter.

Ruling by SC

Impact of MLI ??

- Article 5(3) of the tax treaty starts with a non-obstante clause. Thus, 5(1) and 5(2) would not [illegible] of the clauses in 5(3) are applicable. Took cognizance of RBI's permission to uphold the activities are [illegible] (viz., LO cannot enter into contracts in its own name etc.). Also observed that the transactions were completed with the remitters in UAE, and no charges could be collected by LO.

Columbia Sportwear - Karnataka HC

India-US DTAA

Facts in brief

- The assessee company was incorporated in USA. It established a liaison office in India for undertaking liaison activities in connection with purchase of goods from India
- The liaison office was engaged in identifying component manufacturers, price negotiation, discussion of material to be used, quality control and testing of products and coordination with supplier

Ruling by HC

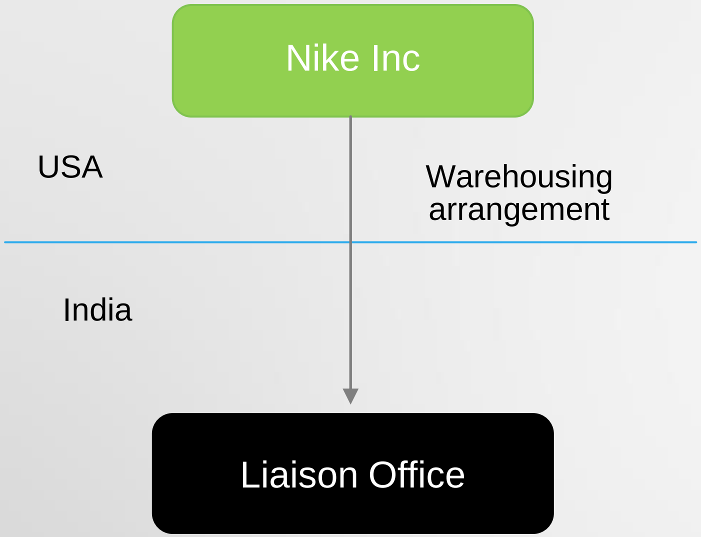
- The liaison office in India engaged in purchasing activity was not a permanent establishment under Article 5 of the India - USA DTAA as the activity falls under PoA. Refer Article 5(3)(d)

Impact of MLI ??

Nike Inc - Karnataka HC

Sec 9(1)(i) - Explanation 1(b)

Sec 9(1)(i) - lanation 2 - Fin Act



Facts in brief

- Nike Inc., a USA company, set up a liaison office in India.
- The main activity of the liaison office was to liaise with Indian manufacturers for purchase of apparels from India by the assessee's HO and overseas subsidiaries.
- It employed a large variety of staff whose task was to create awareness amongst the Indian manufacturers of the need to maintain quality control and adhere to standards.
- The price for each apparel was negotiated with the manufacturer and the samples were forwarded to the US office.
- The liaison office gave its opinion about the reasonableness of the price and all related issues etc. The US office decided about the price, quality, quantity, to whom to be shipped and billed.

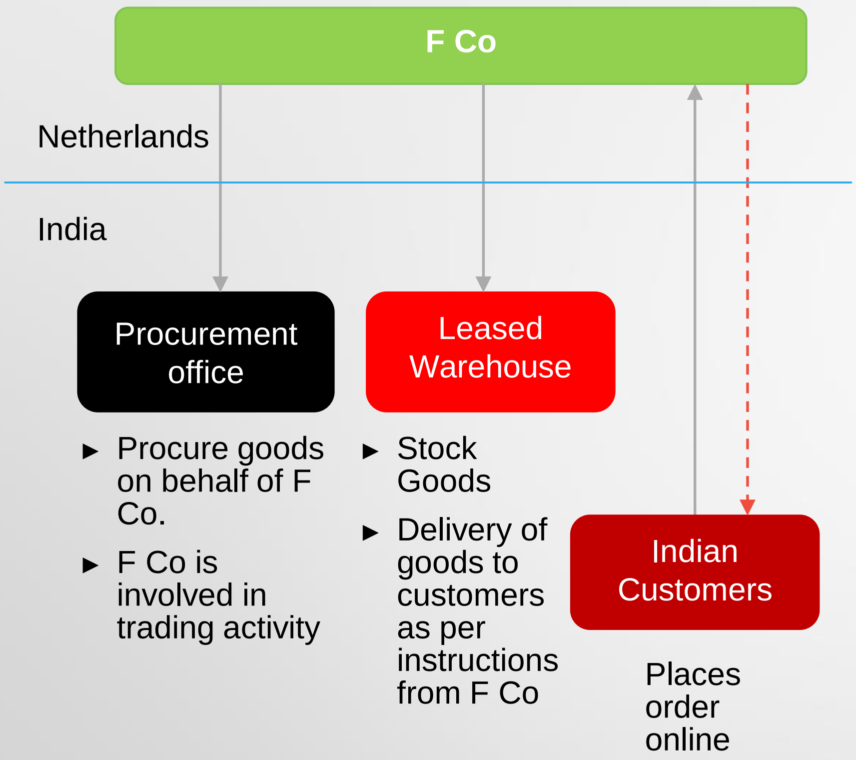
Ruling by HC

- Income derived from the activities performed at the LO cannot be deemed to accrue or arise in India. As the entire operations are confined to the purchase of goods in India for the purpose of export it would not constitute a business connection under Explanation 1(b) and Explanation 2 to Section 9(1)(i).

Explanation 2 amended

Case study - Impact of MLI ?

Para 68 of OECD commentary (2017).PNG



Issue

1) Whether F Co constitutes Fixed Place PE in India as per Article 5 (4) of India - Netherlands Tax Treaty read with MLI and whether Preparatory and Auxiliary services exemption available for purchasing and warehousing activity?

Key considerations

- Both India and Netherland had chosen Option A of article 13 to MLI - As a result existing article 5(4) is modified by MLI provisions.
- Stocking of goods and consequent delivery will be granted specific activity exemption only if it satisfies the test of preparatory or auxiliary in nature. Storage and delivery is essential activity in distribution business
- Similarly, purchasing activity may not get specific activity exemption under Art 5(4) - Purchasing part of essential and significant activity for F Co's overall activity - Para 68 of OECD MC, 2017.

Thank You

Q & A