PE in different Model DTAA and BEPS

- CA K Prasanna

Model DTAA's

Model Conventions - Types

OECD Model Convention

- Emphasis on residence based taxation
- Developed countries adopt this model in case of treaties with other developed countries
- Originally signed by 20 countries on 14 December 1960. Thereafter, 18 more countries have become members of the OECD
- OECD commentary although not binding, if persuasive value and is used by Indian Courts

Un Model Convention

- Emphasis on source based taxation (e.g. Services PE, force of attraction, etc.)
- Developing countries adopt his model in case of treaties with developed or developing countries.
- The panel of experts in UN Committee are in their individual capacity and it is not the view of the country they are representing.

US Model Convention

- Used by US for all its tax treaty negotiations
- It is predictably closer to the OECD model convention
- This model had influence on existing Treaty between India and USA
- Notable features - Limitation on Benefits; No Tax Sparing

Key distinction in the MC

Particulars	OECD MC	UN MC
Service PE	No specific article on Service PE	Specific article on Service PE – Aggregate 183 days during any 12 months period
Dependent Agency PE	Authority to conclude contract alone is present	Maintenance of Stock of goods or merchandise is also covered
Insurance PE	Absent in OECD Model	Included. Exception is re-insurance
Exclusions from PE	The activity of "delivery" has been included in Preparatory & Auxiliary activity in para 4(a) and (b)	The activity of "delivery" has been excluded from Preparatory & Auxiliary activity list in para 4(a) and (b)
Limited force of attraction rule	No such limited force of attraction rule in OECD Model	UN model provides taxation of such profits of an enterprise which are not directly attributable to a PE of an enterprise but pertain to same or similar kind of goods sale or same or similar kinds of business activity as the permanent establishment of the enterprise.
Independent Personnel Services	OECD model includes the definitions of "enterprise" and "business" which is not present in the UN model at all. The reason this has been done under the OECD is because the OECD model has done away with the separate provision on Independent Personal Services which the UN model retains.	Taxability of Independent Personal Services is covered under Article 14.

Key distinction in the MC

Particulars	OECD MC	UN MC
Building Site PE	Art. 5(3)(a) has a twelve months duration test for building sites	Art. 5(3)(a) has a six months duration test for building sites
Assembly Project	Not covered	Covered as part of building, construction clause
Supervisory PE	Not covered	Covered as part of building, construction clause
Drilling Rig, Ship used for exploration of nature resources	Not Covered	Not Covered

Specific Treaties – Additional inclusion in PE list

- Warehouse in relation to person providing storage facilities for others Tax treaties with Singapore, USA, Mauritius, Netherlands etc.
- A store or premises used as a sales outlet Tax treaties with UK, Netherlands, etc.
- Installation or structure used for exploitation of natural resources Tax treaties with US, Australia, Netherlands etc.
- Farm, plantation or any other place where agriculture, forestry, plantation or related activities are carried on Tax treaties with Australia, Singapore, UAE etc.

Base Erosion and Profit Shifting (‘BEPS’)

Need for BEPS

- Tremendous growth in international trade over the years has made the concept of globalization common
- MNEs try to achieve a "low tax or no tax jurisdiction". A few ways are listed below:
  - Treaty shopping
  - Hybrid entities;
  - Hybrid financial instruments and other financial instruments
  - Shifting of income through transfer pricing arrangements
- Double Tax Avoidance Agreements (DTAA) come out as a solution to minimize trade distortions and impediments to sustainable economic growth
- However, interaction of domestic tax systems and DTAA has also led to gaps that provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards

THE FINANCIAL EXPRESS

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Read to Lead

Apple, Starbucks and Fiat's tax affairs examined by European commission

Brussels is looking into the tax affairs of Apple, Starbucks and Fiat. "It is particularly important that large multinationals pay their fair share of taxes," said the European commission's top competition regulator, Joaquín Almunia.

THE FINANCIAL EXPRESS

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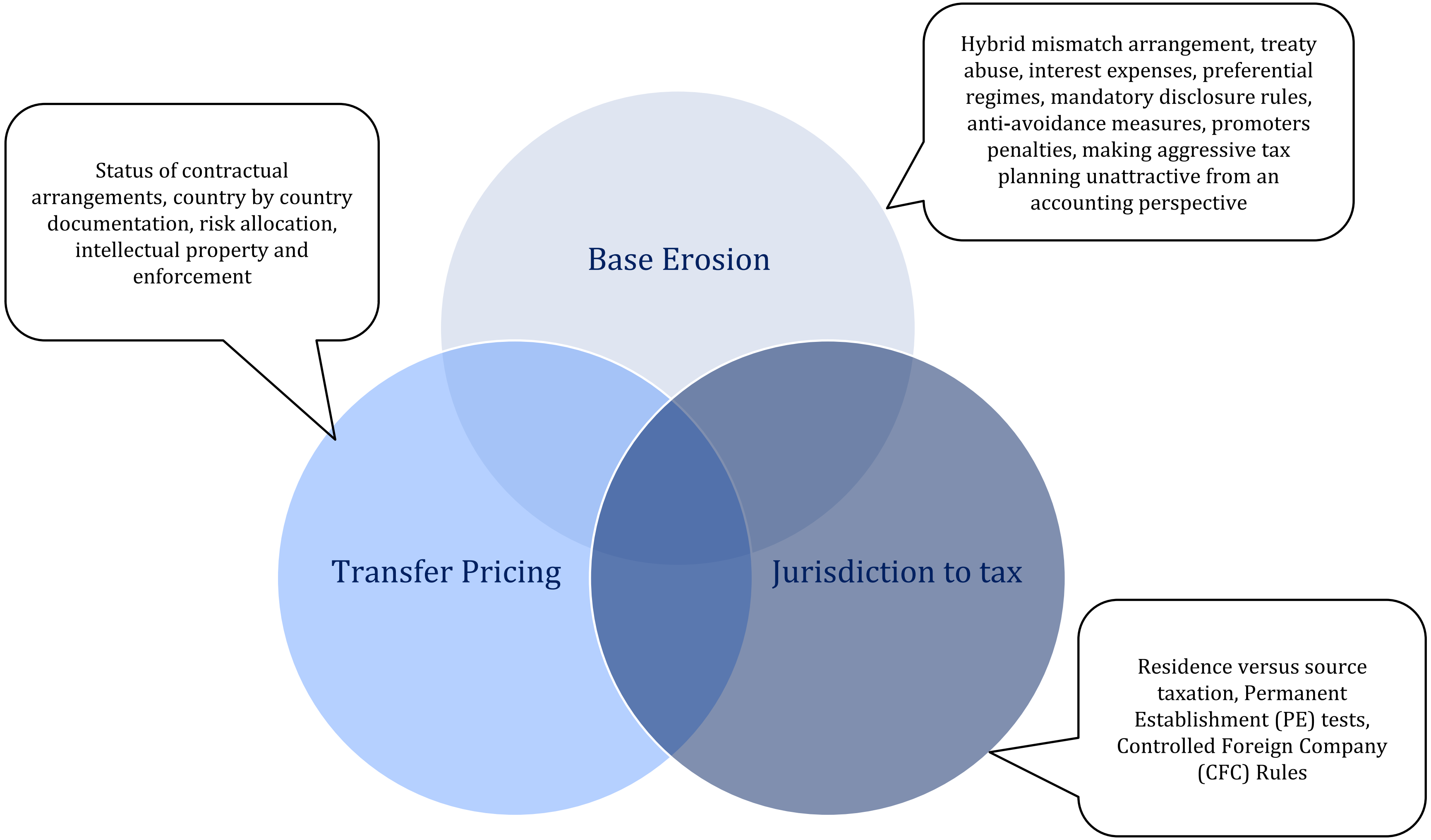
Read to Lead

Anger as Starbucks boss says: We may not pay UK tax for up to three years

- Chief Executive Mark Fox said chain aimed to be profitable by 2017
- Mr. Fox insisted there was 'nothing abnormal' about the way firm was run
- Starbucks slated in 2012 after paying just £8.6m in tax on £3bn of sales
- Coffee chain remains under investigation by the European Commission
- It volunteered to pay £20 million tax payment in 2012 after complaints

Key Focus Areas



OECD BEPS – In a Nutshell

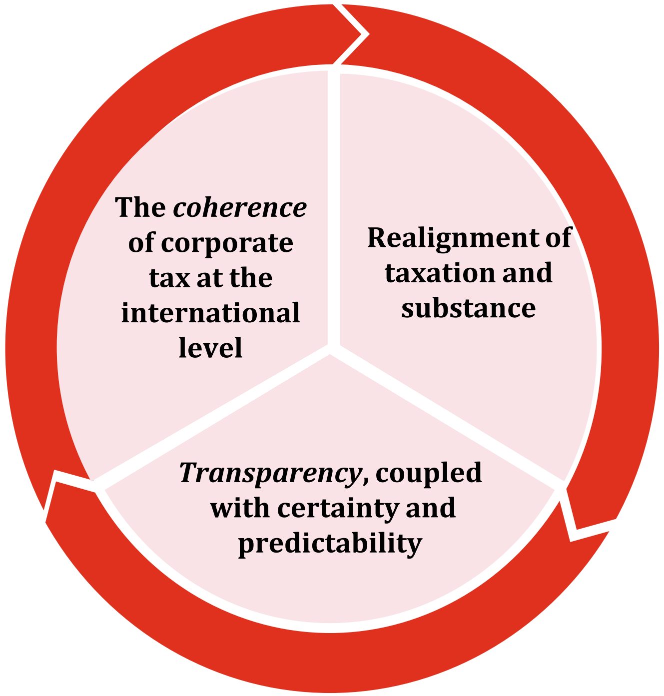
On 19 July 2013 the OECD released an *Action Plan on* BEPS which was presented to the meeting of G20 Finance Ministers in Moscow

The purpose of the Action Plan is "to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it."

The report indicates that "no or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it."

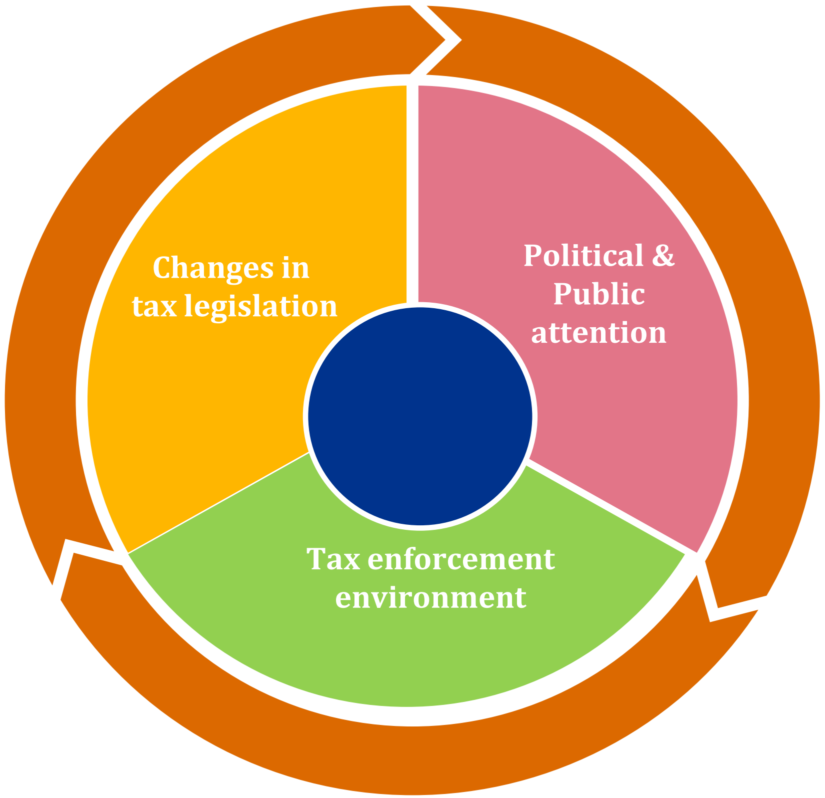
The Action Plan covered 15 specific Actions which were broadly to be achieved within a two year time frame (i.e. by the end of 2015). On 5 October 2015, OECD released its final set of recommendations on all the 15 Action Points

15 Actions organized around *three* main pillars



Why should business concern about BEPS

- Multinationals need to be aware of these developments and manage the risk of change in law



- Companies’ reputation at stake

- Tax Administrations closely scrutinize global structures to identify possible abuses

Action Plan 7 – Preventing the abuse of PE

BEPS Concerns

- Commissionnaire arrangement: A *commissionnaire* arrangement may be loosely defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales [Article 5(5) and Article 5(6)]

- Fragmentation of activities: Article 5(4) provides certain exceptions which are generally considered to be of preparatory or auxiliary nature. Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities

- Splitting-up contracts: Enterprises divide their contract into several parts, each covering a period of less than twelve months and attribute to a different group entities, to avoid create of PE [Article 5(3)]

In this Action Plan, recommendations has been made to broaden the scope, introduction of new rule in order to prevent artificial avoidance of PE

Recommendation – Dependent Agent

- Notwithstanding the provisions of paragraphs 1 and 2 ***but subject to the provisions of paragraph 6***, where a person ~~other than an agent of an independent status to whom paragraph 6 applies is acting in a Contracting State on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts~~, ***in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are***

  a) ***in the name of the enterprise, or***

  b) ***for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or***

  c) ***for the provision of services by that enterprise***

Mere "conclusion of contracts", not to form a basis to determine the PE status of foreign enterprise

Principal Role leading to conclusion of contracts

- The rule intends to include arrangements where the conclusion of a contracts **directly results** from the action that person performs in a Source State on behalf of the principal, though the contract is not concluded by the person in that state.

- The test focuses on **substantive activities** directly resulting in conclusion of contracts for FE. It is aligned with the persons who habitually plays the principle role in conclusion of contracts, which is linked to the sales force, persons who actually approach and convince the customer, notwithstanding lack of authorities with the agent to conclude the contract.

- Activities must be tested in light of the object and purpose of para 5, which is to cover where the activities of the persons are intended to result in regular conclusion of contracts being performed by the FE.

- The exercise is a fact sensitive one and must be determined on the basis of the commercial realities of the situation.

- A person who negotiates in a State all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that State even if that contract is signed by another person outside that State (Para 87 of OECD MC 2017)

Sales and Marketing Activities

- Actions of Dependent Agent should go beyond mere promotion or advertising and result in conclusion of contracts;

- The rule shall not apply where:

  - ✓ A person merely promotes and markets goods or services of an enterprise in a way that **does not directly result** in the conclusion of contracts;

  - ✓ Mere participation in negotiation insufficient to say that the agent has concluded contracts or played a principal role leading to conclusion of contracts (however, this may be a relevant factor in determining the exact functions performed by that person on behalf of the FE)

  - ✓ Representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs. Such marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity.

  - ✓ ***Philip Morris (Italian Court)* -** The participation of representatives or employees of a resident company in a phase of the conclusion of a contract between a foreign company and another resident entity may fall within the concept of authority to conclude contracts in the name of the foreign company

Recommendation – Independent Agent

Existing:

- Acting in the ordinary course of its business
  - ❑ 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

Recommendation:

- Acting in the ordinary course of its business
  - ❑ exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related

Recommendation – Preparatory & Auxiliary

Existing:

- 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

Recommendation:

- 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

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

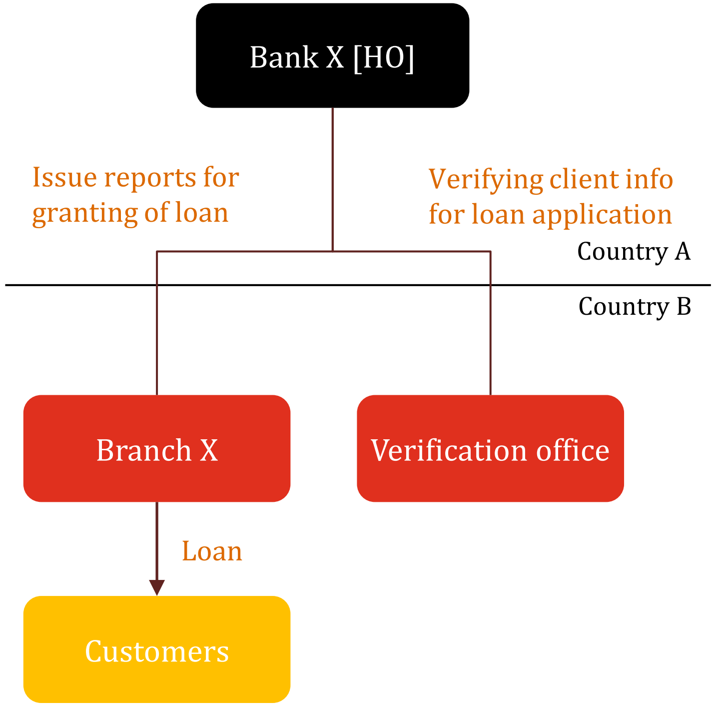
Auxiliary - Activity to support the essential and significant part of the activity of the enterprise

Recommendation – Anti Fragmentation

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

1) **Same enterprise or CRE** 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**



- The business activities carried on by Bank X Co at its branches and verification office constitute complementary functions that are part of a cohesive business operation (i.e., the granting of loans to customers)
- Hence, the verification office cannot be exempt from PE on the ground that verification activities are of a preparatory or auxiliary character

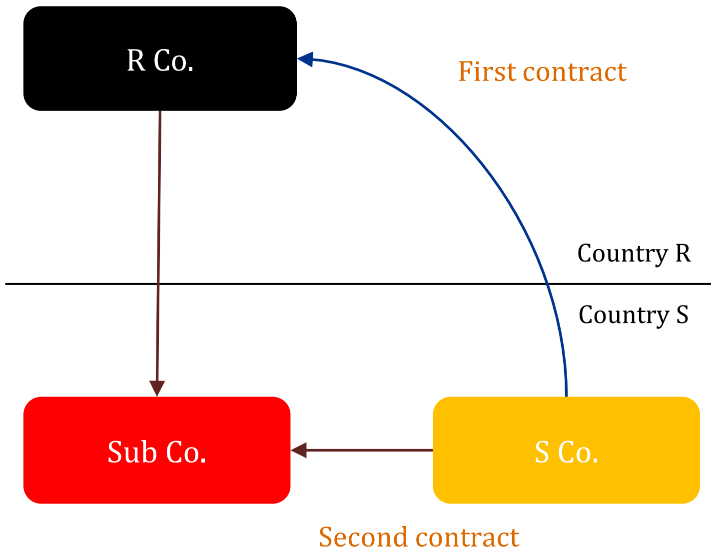
Impact

- Under Pre BEPS – Only fragmentation of activities by Foreign Enterprise is addressed.
- Post BEPS – Fragmentation between CRE is also covered

Recommendation – Splitting of Contracts

Existing:

- "Principal purpose test" proposed under Action Plan 6 [Preventing the Granting of Treaty Benefits in Inappropriate Circumstances] proposed to identify if the multiple contracts are a split of one single contract to willfully avoid PE provisions
- 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
- An illustration (discussed in next slide) is proposed to be introduced to the Commentary



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

Aggregate period exceeds 12 months period - construction PE of R Co. exists

Q & A