BMR Legal

ADVOCATES

Overview of PE Article and its Relevance, Fixed Place PE

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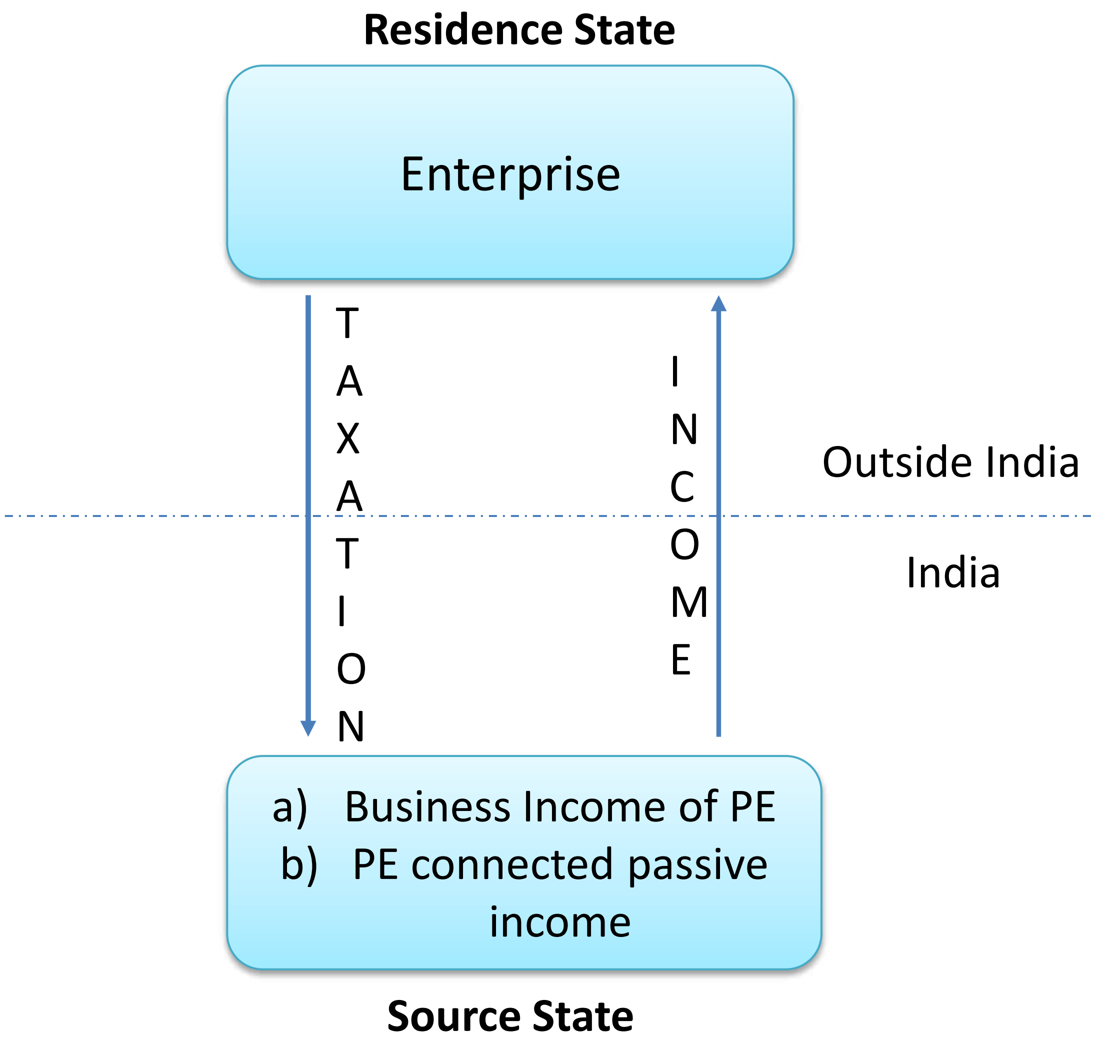
Concept of Permanent Establishment (PE)



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."

PE under Income-tax Act, 1961

- The **concept of PE was introduced** in the Act as part of the statutory provisions of transfer pricing by the Finance Act, 2001 under Section 92F of the Act, under the definition of "enterprise" *[means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, ……]*
- Circular No. 14 of 2001 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) *["permanent establishment", referred to in clause (iii), 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

Bare text of OECD Model Tax Convention and UN Model Tax Convention

- OECD Model Tax Convention 2017

https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

- UN Model Tax Convention 2021

https://desapublications.un.org/file/914/download

Overview of Article 5 of OECD Model Tax Convention

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

Article 5(1): Fixed place PE

- Article 5(1) of the OECD Model Tax Convention governs basic rule for Fixed place 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

Article 5(1): Fixed place PE (Contd.)

Elements of Fixed Place 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

What is the place of business?

Reasonable degree of permanence and continuity

- 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

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)

Test of place of business at disposal

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	

Article 5(2) of the OECD Model Tax Convention provides inclusive definition of PE

- Article 5(2) of the OECD Model Tax Convention provides inclusive definition of PE . 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 quarry or any other place of extraction of natural resources
- This list is inclusive and not exhaustive and the definition is identical under UN and US Model

Formula One World Championship Ltd. V CIT [2017] 394 ITR 80 (SC)

FACTS

- Formula One World Championship Limited (FOWC), a UK tax resident, acquired commercial rights in the F1 Championship
- FOWC entered into a race promotion contract with Jaypee Sports International Limited (Jaypee)
- Jaypee also had the right to host, stage and promote the Formula One Grand Prix racing event in India for a payment to FOWC.
- An Artworks license Agreement contemplated in Race Promotion Contract was also entered into between assessee and Jaypee the same day permitting the use of certain marks and intellectual property belonging to assessee for a consideration of USD 1

ISSUES

1. Whether FOWC was having any *'Permanent Establishment'* (PE) in India in terms of Article 5 of DTAA?

Formula One World Championship Ltd. V CIT [2017] 394 ITR 80 (SC)

Held

Not only the Buddh International Circuit is a fixed place where the commercial/economic activity of conducting F-1 Championship was carried out, one could clearly discern that it was a virtual projection of the foreign enterprise, namely, Formula-1 (*i.e.* FOWC) on the soil of this country. It is already noted above that as per Philip Baker (A Manual on the OECD Model Tax Convention on Income and on Capital), a PE must have three characteristics: *stability, productivity* and *dependence*. All characteristics are present in this case. Fixed place of business in the form of physical location, *i.e.* Buddh International Circuit, was at the disposal of FOWC through which it conducted business. Aesthetics of law and taxation jurisprudence leave no doubt in our mind that taxable event has taken place in India and non-resident FOWC is liable to pay tax in India on the income it has earned on this soil.[Para 76]

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)

Power of Disposition - judicial precedents

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)

Article 5(3): Construction / Installation PE

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"

Article 5(5)/5(6): Agency PE (DAPE)

Article 5(5) of the OECD Model Tax Convention

"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 Tax Convention is identical to Article 5(5) (a) of UN Model Tax Convention & Article 5(5) of US Model Tax Convention**

Article 5(5)/5(6): Agency PE (Contd.)

- 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…"

- **Arvind 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 – Relevant Judicial Precedents

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)

Article 5(7): Subsidiary PE

- **Article 5(7) of the OECD Model Tax Convention**

  "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**

Subsidiary PE - 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)

Subsidiary PE - Judicial Precedents

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)*

Service PE

- OECD / US Model Convention does not have an Article governing this
- No service PE clause in some Treaties – Netherlands, France, Mauritius, etc.
- 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)

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)

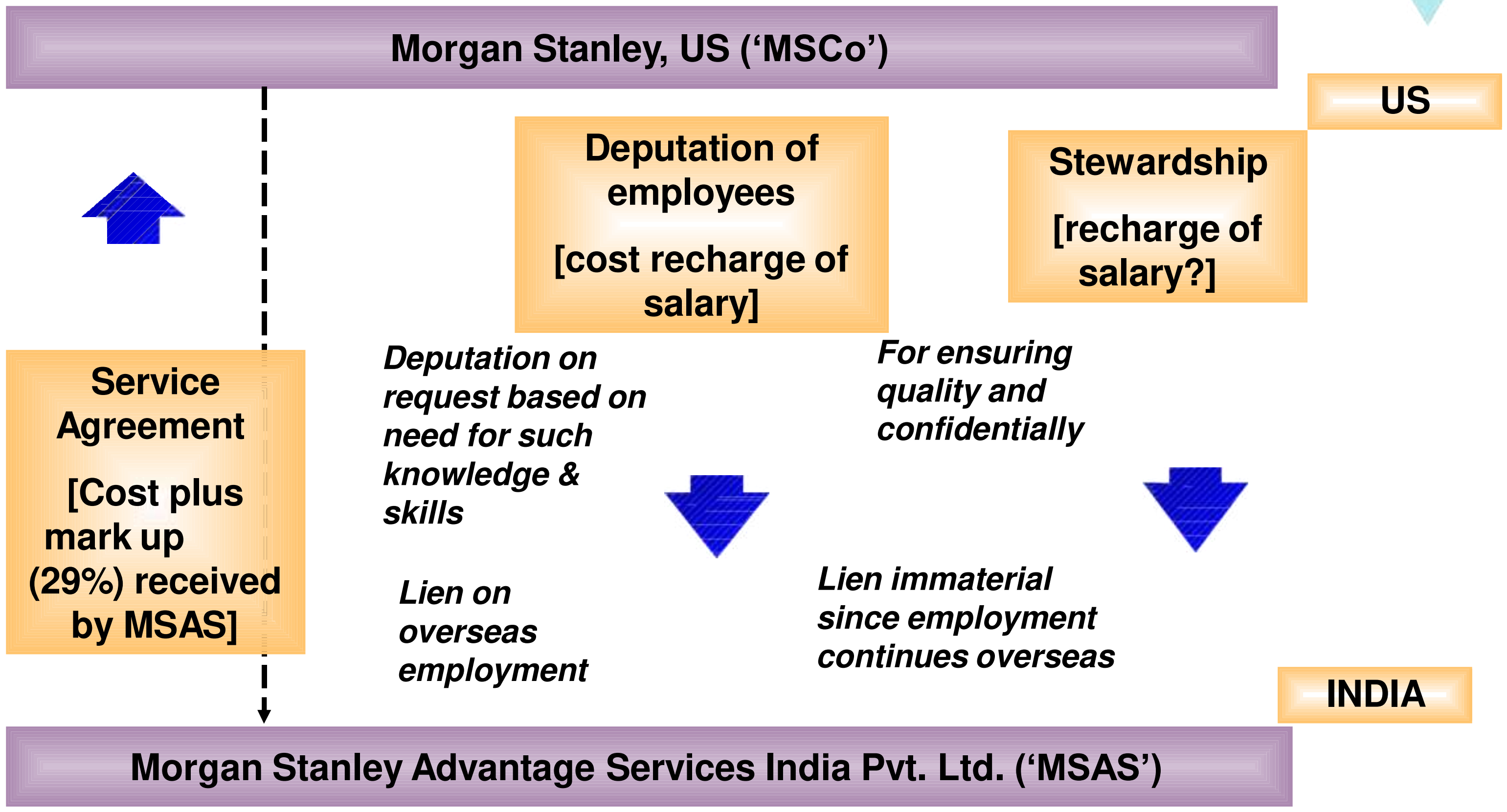
Illustration

Facts

- A is a non-resident-company incorporated in USA. It is an investment bank engaged in the business of providing financial advisory services
- B is a group company of A which is incorporated in India, B entered into an agreement dated for providing certain support services to A
- A outsourced some of its activities to B, in pursuance of that sends some its employees to India on request of B for supervision
- Seconded employees were highly skilled individual at senior positions .
- Employees deputed to India still retained there employment with A

In the above-mentioned, whether PE would be constituted in India, if yes then which PE?

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

Consequences of establishment of PE

Once it is determined that a foreign firm has a PE in India, profits linked to its activities in India will be taxed as "Business Income" in accordance with Article 7 of the treaties. Along with the following compliances:

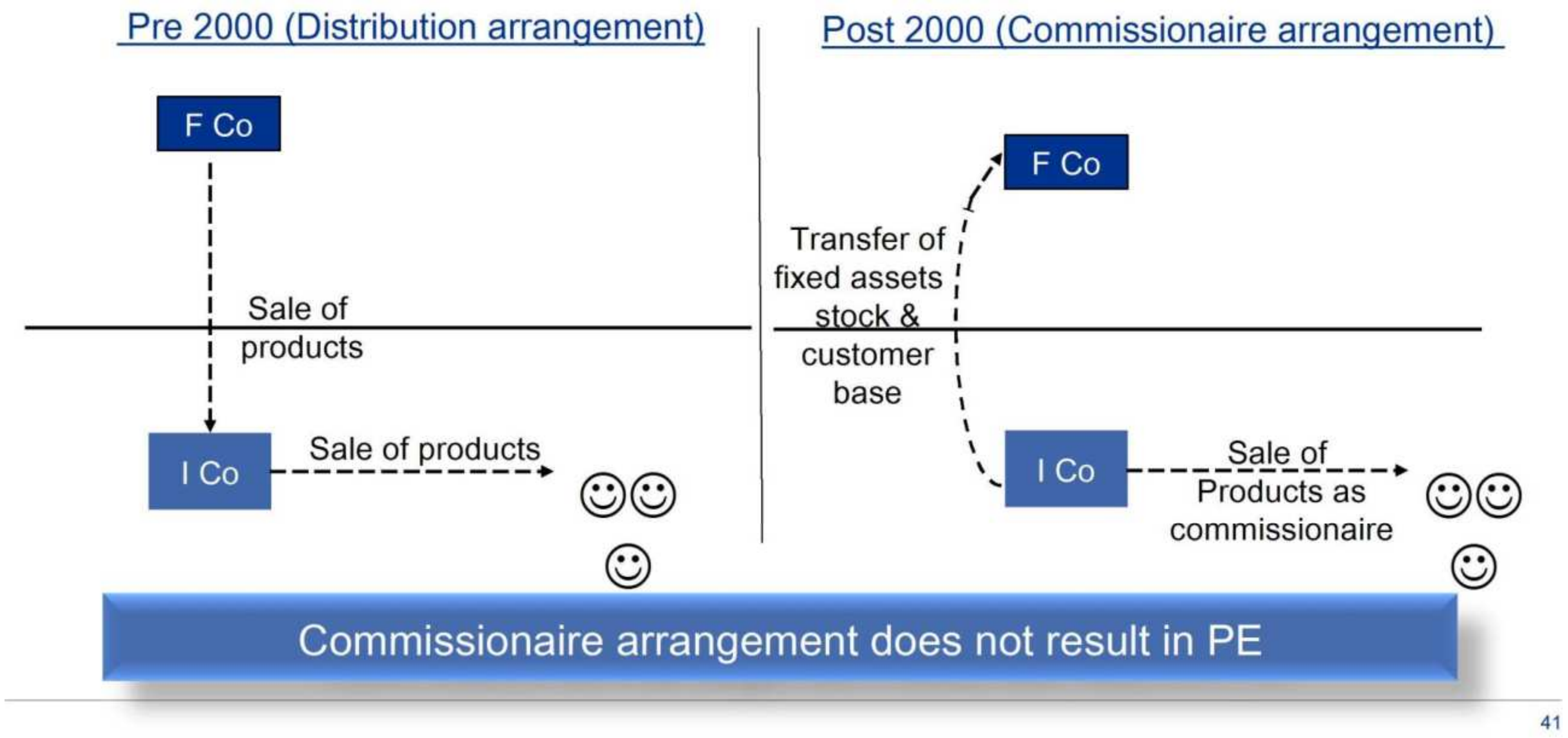
- Profits due to a PE are the profits that the PE would have made if it had operated independently in the same or comparable activities within the same or similar conditions as the rest of the company.
- They have to compulsory maintain books of accounts.
- They must apply for PAN, TAN and should be registered under regulations of Indirect tax.
- The Net Profits will subsequently be subject to the taxation that a foreign company would face in India.
- Mandatory compliance of With-Holding Tax (WTH).

BEPS Action 7 – Important Changes

Agency PE	Article 5(5) and Article 5(6) amended to broaden the scope of PE
Preparatory and Auxiliary rule and Fragmentation of activities	Exemption from PE status as provided under Article 5(4) of the OECD Model Tac convention has been amended New anti- fragmentation rule provide that the above said exemption will not be granted in specific circumstances
Splitting of contract	Application of Principle Purpose Test or 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



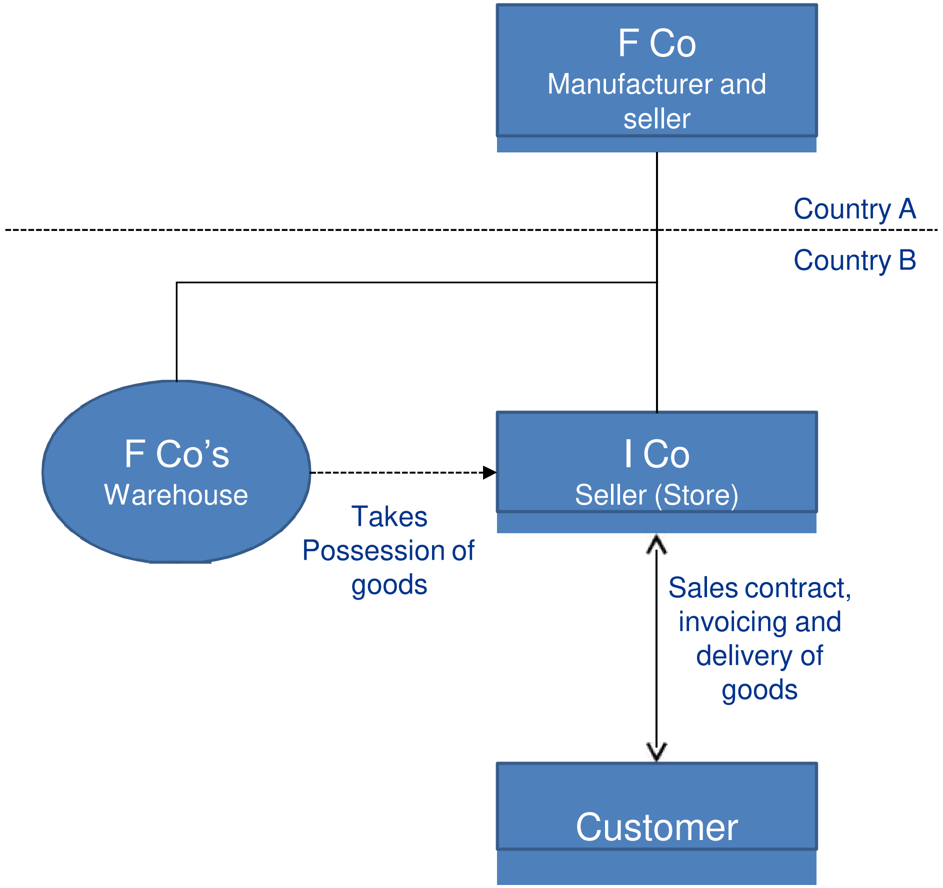
Impact of Proposed Changes to Article 5(5)

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**

Proposed changes to Article 5(4)

Existing	Proposed
.5(4) – PE shall not be deemed to include:	A.5(4) – PE shall not be deemed to include:
(a) use of facility for storage, etc	– (a) use of facility for storage, etc
(b) maintenance of stock of goods	– (b) maintenance of stock of goods
(c) processing of goods	– (c) processing of goods
(d) purchasing goods or collecting info	– (d) purchasing goods or collecting info
(e) any other activity of a prep or aux character	– (e) any other activities
(f) combination of above mentioned	– (f) combination of above activities
	provided that such activity or in the case of (f) the overall activity is of prep or aux character

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