

The Chamber of Tax Consultants

Preparatory or Auxiliary activities exemption, Anti- fragmentation Rules and Splitting of Contracts

- Article 13, 14 & 15 of MLI
- BEPS ACTION 7

Yogesh A. Thar

October 12, 2018

ARTICLE 5 OF MTC – PERMANENT ESTABLISHMENT

BASIC STRUCTURE of Art. 5

1

Fixed Place PE

2

Illustrative list
of PE

3

Construction,
Installation or
Service PE

4

*Specific
Activities
Exemption*

5

6

Agency PE

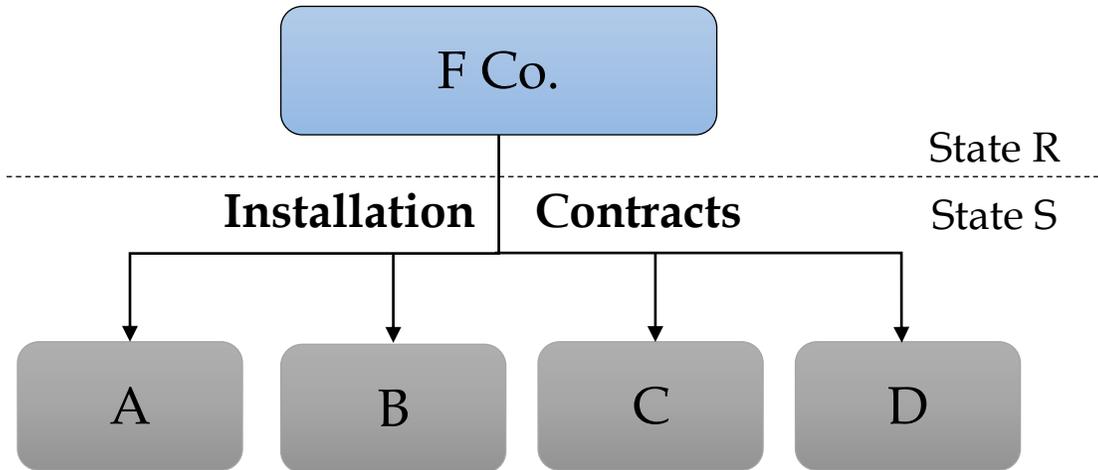
7

Mere control in other
entity does not lead
to PE

SPLITTING-UP OF CONTRACTS

- Illustrations;
- OCED Commentary;
- Indian Judicial Precedents;
- Action 7 Recommendations;
- Article 14 of MLI;
- Impact of Article 14

ILLUSTRATION (1/3)



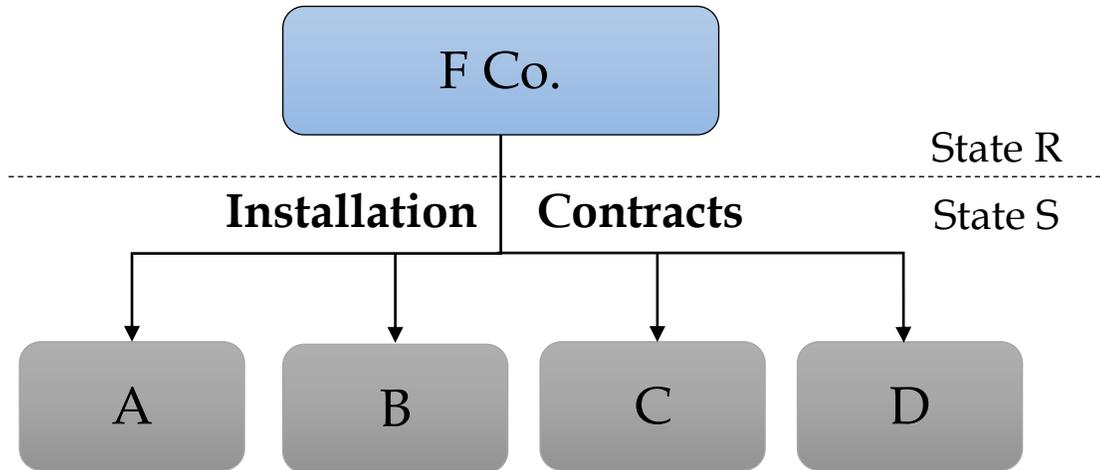
Contract	Duration (in months)	
A	April - Aug	5
B	Sep - Oct	2
C	Nov - Jan	3
D	Feb	1

- F Co. is engaged in installation activities in relation to mineral oil exploration;
- It has executed four different contracts across State S with unrelated parties;
- All the four contracts are not interdependent or interconnected;
- The installation activity has been carried out in FY 2017-18;
- As per Art. 5(3) of the R - S DTAA, *“a building site or construction or assembly project or supervisory activities in connection therewith constitutes a Permanent Establishment , where such site, project or supervisory activity continues for a period of more than **nine months.**”*

Whether F Co. has a PE in State S

**Refer India's DTAA with Singapore, Japan, France*

ILLUSTRATION (2/3)



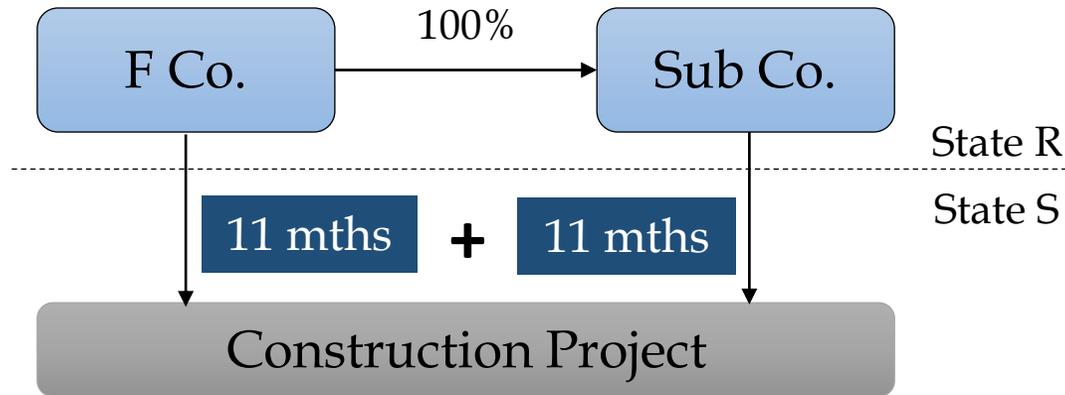
Contract	Duration (in months)	
A	April - Aug	5
B	Sep - Oct	2
C	Nov - Jan	3
D	Feb	1

- F Co. is engaged in installation activities in relation to mineral oil exploration;
- It has executed four different contracts across State S with unrelated parties;
- All the four contracts are not interdependent or interconnected;
- The installation activity has been carried out in FY 2017-18;
- As per Art. 5(3) of the R - S DTAA, *“a building site or construction or assembly project or supervisory activities in connection therewith constitutes a Permanent Establishment , where such site, project or supervisory activity (together with other such sites, projects or activities, if any) continues for a period of more than nine months.”**

Whether F Co. has a PE in State S

**Refer India's DTAA with Australia, Canada, Denmark, Spain, USA*

ILLUSTRATION (3[#] / 3)



As per Art. 5(3) of the R - S DTAA, “a building site or construction or assembly project or supervisory activities in connection therewith constitutes a Permanent Establishment , where such site, project or supervisory activity continues for a period of more than **twelve months.**”

#P. 182/Example J - OECD, 2017 Commentary on Art. 5 of MTC

- F Co. is engaged in construction activities;
- It successfully submitted a bid of construction of power plant in State S;
- Construction project is expected to last for 22 months;
- The project is split into two having duration of 11 months each;
- 1st contract is concluded with F Co. and 2nd with Sub Co., a recently incorporated WOS of F Co.;
- The contractual arrangement is such that F Co. is jointly and severally liable with Sub Co. for the performance of Sub Co.’s contract.

Whether F Co. has a PE in State S

OECD COMMENTARY – Pre-BEPS Observations

“18...The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.”

INDIAN JUDICIAL PRECEDENTS

- ❑ For the purpose of determining ‘construction, installation or service PE’, courts and appellate authorities in India have generally analysed the aspect of splitting-up of contracts:
 - **CIT vs. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC);**
 - **J Ray McDermott Eastern Hemisphere Ltd. vs. JCIT Mumbai [2010] 130 TTJ 121 (Mumbai);**
 - **DCIT vs. J. Ray McDermott Eastern Hemisphere Ltd. Mumbai [2012] 54 SOT 363 (Mumbai);**
 - **ADIT vs. Valentine Maritime (Mauritius) Ltd. [2010] 130 TTJ 417 (Mumbai);**
 - **Valentine Maritime (Gulf) LLC vs. ADIT [2011] 45 SOT 359 (Mumbai);**
 - **Sumitomo Corporation vs. DCIT [2014] 162 TTJ 46 (Delhi - Trib.)**

ACTION 7 RECOMMENDATIONS

- ❑ Principal Purpose Test (“PPT”) Rule as recommended by Action 6 will address BEPS concern related to abusive splitting-up of contracts
- ❑ To address the issue more specifically alternative provisions have been recommended which now form part of Article 14 of MLI

PRINCIPLE PURPOSE TEST [Art. 7 (Para 1)] OF MLI

*“Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that **obtaining that benefit was one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit,*

unless

*it is established that granting that benefit in these circumstances would be **in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement**”*

PRINCIPAL PURPOSE IS TO OBTAIN TREATY BENEFITS – HOW TO DETERMINE IT?

- ❑ Undertake an objective analysis of aims and objects of **all persons involved** in putting arrangement / transaction in place
- ❑ Why are all of them a party to it?
- ❑ Conclusive proof – not required
- ❑ “reasonable to conclude” after objective analysis
- ❑ Looking merely at the “effect” is not sufficient
- ❑ What is a reasonable explanation of:
 - *“Why you have done what you have done?”*
- ❑ Mere denial is not sufficient

HOW TO DETERMINE OBJECT AND PURPOSE OF RELEVANT PROVISION OF TREATY?

❑ Title of the Treaty

- *Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and tax avoidance*

❑ Preamble of a Treaty

- *“Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions),”*

❑ Reading the Treaty as a whole

❑ Commentary on Model Convention (if no reservations)

ARTICLE 14 of MLI – Splitting-up of Contracts

1. *For the sole purpose of determining whether the period (or periods) referred to in a provision of a Covered Tax Agreement that stipulates a period (or periods) of time after which specific projects or activities shall constitute a permanent establishment has been exceeded:*

- a) *where an enterprise of a Contracting Jurisdiction carries on activities in the other Contracting Jurisdiction at a place that constitutes a building site, construction project, installation project or other specific project identified in the relevant provision of the Covered Tax Agreement, or carries on supervisory or consultancy activities in connection with such a place, in the case of a provision of a Covered Tax Agreement that refers to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant provision of the Covered Tax Agreement; and*
- b) *where connected activities are carried on in that other Contracting Jurisdiction at (or, where the relevant provision of the Covered Tax Agreement applies to supervisory or consultancy activities, in connection with) the same building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,*

these different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement.

ARTICLE 14 of MLI - SIMPLIFIED

Art. 5(3) - MTC (Pre - MLI)
"A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

For the sole purpose of determining whether 12 months has been exceeded:

(a) where an enterprise of State R carries on activities in State S at a place that constitutes a building site, construction project, installation project, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding 12 months

AND

(b) where **connected activities** are carried on in State S at the same building site, construction or installation project, each exceeding 30 days, by **one or more enterprises closely related to the first-mentioned enterprise,**

these different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site, construction or installation project,

CONNECTED ACTIVITIES – P. 53 OCED, 2017 COMMENTARY

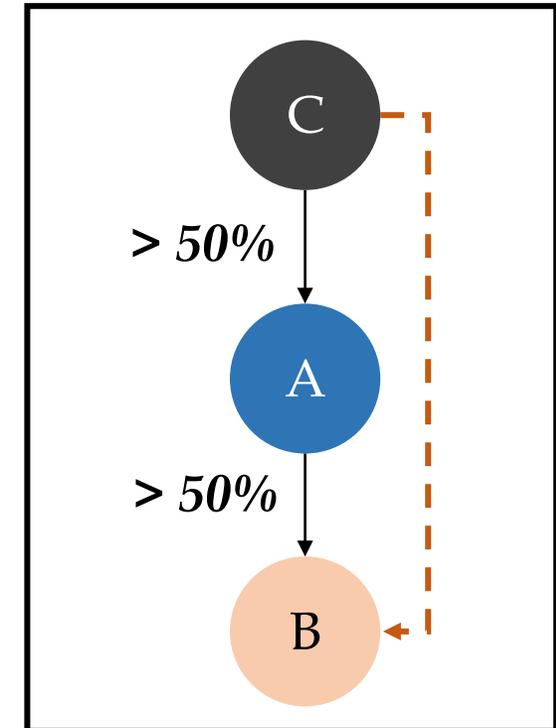
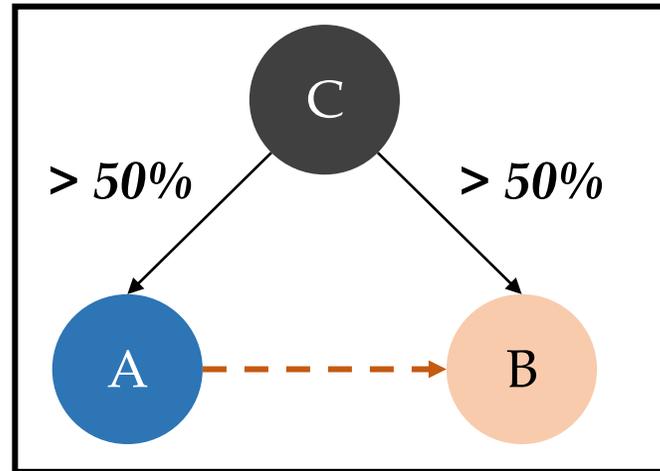
The determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:

- whether the contracts covering the different activities were concluded with the same person or related persons;
- whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;
- whether the activities would have been covered by a single contract absent tax planning considerations;
- whether the nature of the work involved under the different contracts is the same or similar;
- whether the same employees are performing the activities under the different contracts.

CLOSELY RELATED ENTERPRISES – ARTICLE 15 of MLI

A person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has **control** of the other or both are under the **control** of the same persons or enterprises.

In any case,



- In case of a company, > 50% of the aggregate vote and value of the company's share or beneficial equity interest in the company
- In case of others, > 50% of beneficial interest of other

SIMILAR PROVISIONS IN INDIAN DTAA_s

□ Indo-Columbia DTAA - Art 5(3)

“3. The term "permanent establishment" also includes:

- (a) a building site or construction, installation or assembly project or supervisory activities in connection therewith only if such site, project or activities last more than six months.*
- (b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or connected project) within the country for a period or periods aggregating more than six months within any 12 month period.”*

PROTOCOL

“With reference to paragraph 3 of Article 5, its understood that, for the purposes of computing the time limits referred to in that paragraph, such activities performed by an enterprise related to another enterprise within the meaning of Article 9, shall be added to the period during which activities are performed by the enterprise, provided that the activities of both enterprises are identical or substantially similar for the same or connected project.”

SIMILAR PROVISIONS IN INDIAN DTAA's (cont'd)

□ Indo-Norway DTAA - (Art. 21)

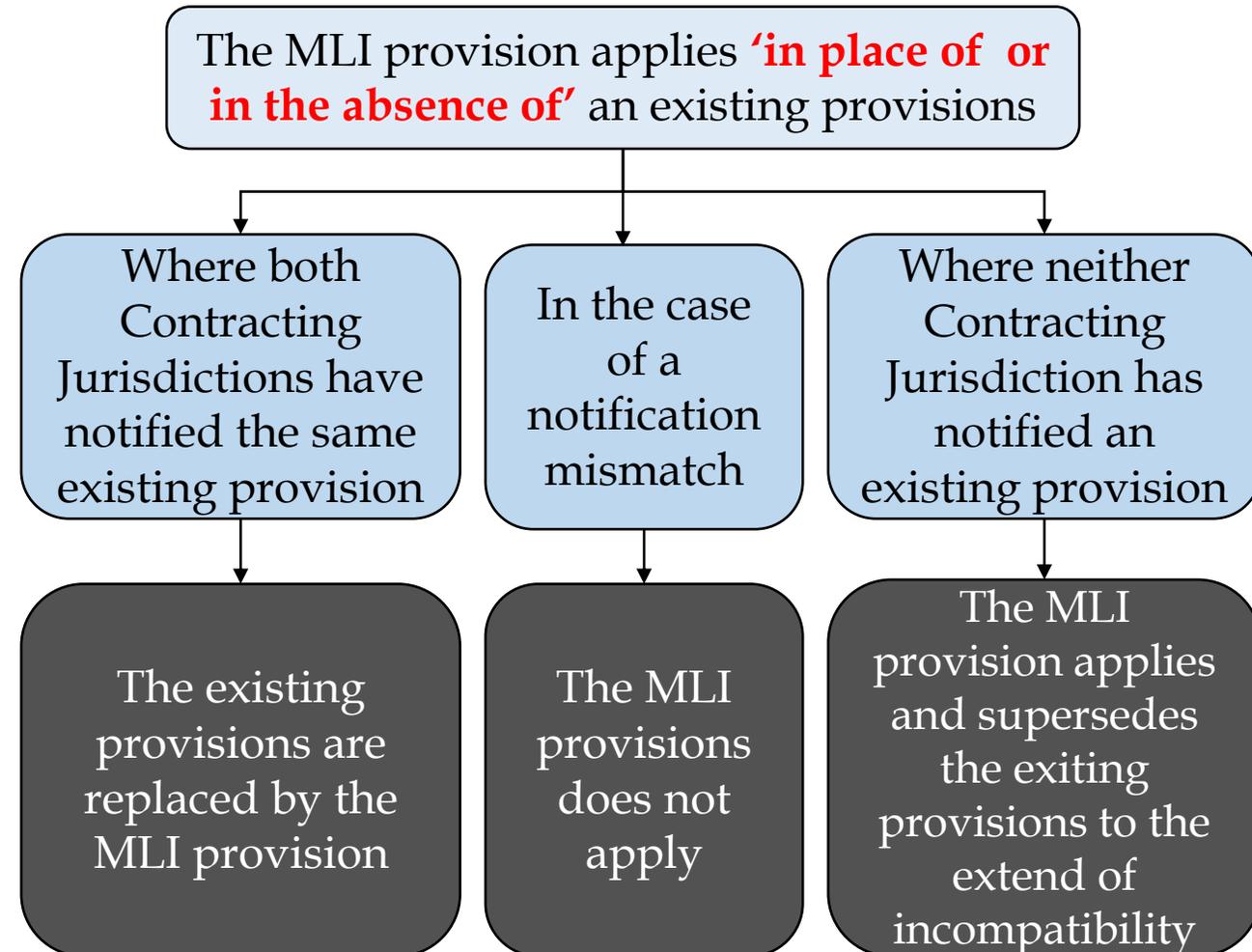
2. *A person who is a resident of a Contracting State and carries on activities offshore in the other Contracting State in connection with the exploration or exploitation of the seabed or subsoil or their natural resources situated in that other State shall, subject to paragraphs 3 and 4 of this Article, be deemed in relation to those activities to be carrying on business in that other State through a permanent establishment or fixed base situated therein.*

3. *The provisions of paragraph 2 shall not apply where the activities are carried on for a period not exceeding 30 days in the aggregate in any twelve months period commencing or ending in the fiscal year concerned. However, for the purposes of this paragraph :*

- a) *where an enterprise of a Contracting State carrying on offshore activities in the other Contracting State is associated with another enterprise carrying on substantially similar offshore activities there, the former enterprise shall be deemed to be carrying on all such activities of the latter enterprise, with the exception of activities which are carried on at the same time as its own activities; and*
- b) *two enterprises shall be deemed to be associated if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by a third person or persons;*

COMPATIBILITY CLAUSE [Art. 14(2) of MLI]

*“2. Paragraph 1 shall apply **in place of or in the absence of** provisions of a Covered Tax Agreement to the extent that such provisions address the division of contracts into multiple parts to avoid the application of a time period or periods in relation to the existence of a permanent establishment for specific projects or activities described in paragraph 1.”*



RESERVATION & NOTIFICATION

Out of 84 signatories, 54 have made reservation in entirety & 8 have made reservation w.r.t. exploration for or exploitation of natural resources.



Reservations and Choices of Optional Provisions

Status as of 27 September 2018



MLI Matching Database beta
© OECD 2017/18

Reservation Art. 14(3)

A Party may reserve the right:

- a) for the entirety of this Article not to apply to its CTA;
- b) for the entirety of this Article not to apply with respect to the exploration for or exploitation of natural resources.

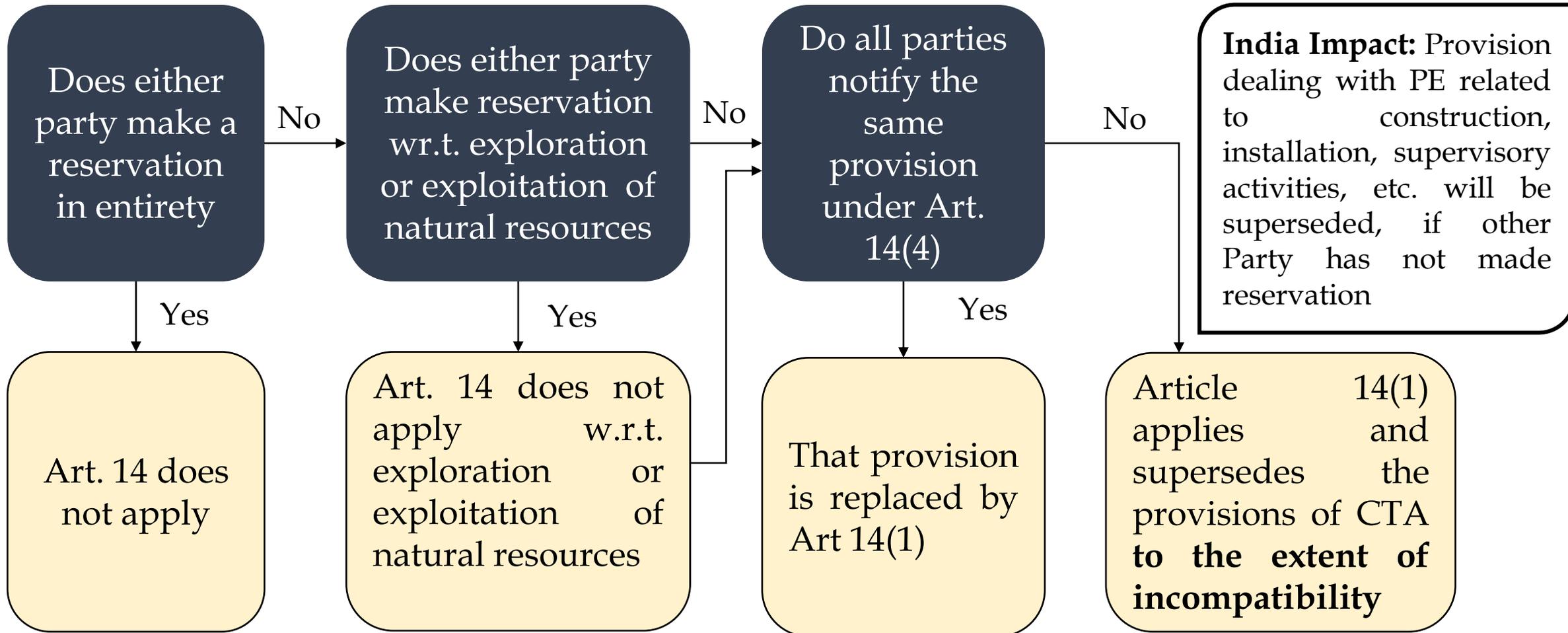
India has not made any reservations

Notification Art 14(4)

Parties that have not made reservation in entirety, shall notify the Depository about existing provisions related to anti-splitting of contracts

India has not notified any of its existing provisions

INTERPLAY BETWEEN RESERVATION & NOTIFICATION



IMPACT OF ARTICLE 14

- ❑ Article 14 reinforces PPT Rule;
- ❑ Until now judicial anti-avoidance precedents have taken care of BEPS concern from abusive splitting contracts
 - Post Article 14, legislature also provides for anti-abuse measures;
- ❑ From the perspective of taxability, there doesn't appear to be any significant change *per se* except that the contractee will have to be more vigilant while entering into installation contracts, construction contracts and like

CASE STUDY

- ❑ F Co. a tax resident of State R is engaged in construction activities;
- ❑ It has received a proposal for construction of a building in State S;
- ❑ Estimated duration for completion of the construction is approximately 20 months;
- ❑ The construction activities have been split-up amongst the group entities;
- ❑ Each entity has executed an independent contract for their respective activities;
- ❑ Under both, S-A DTAA & S-R DTAA, construction activities constitutes a PE, if such activities last for a period exceeding 12 months

Entities	Activities	Period
AE1 - State A	Demolition	25days
AE2 - State A	Excavation & Site clearance	2 months
AE3 - State R	Foundation work - Sewage facility	2 months
AE4 - State R	Foundation work - concrete forms & pour foundation walls	4 months
AE5 - State R	Construction	11 months
F Co. - State R	Supervisory - Foundation & Construction	7 months

- **Whether F Co. has a PE in State S;**
- **If F Co. constitutes a PE, whether all other entities will also have a PE in State S;**
- **Whether A Co. has a PE in State S**

PREPARATORY or AUXILIARY (“PoA”) ACTIVITIES EXEMPTION

- Pre-BEPS Scenario;
- Indian Judicial Precedents;
- Current Controversy on PoA;
- Action 7 Recommendations;
- MLI Provisions

SPECIFIC ACTIVITIES EXEMPTION – Art 5(4) of OECD Model Tax Convention (“MTC”)

“4. 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;

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;

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;**

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 of the fixed place of business resulting from this **combination is of a preparatory or auxiliary character.**”

MEANING OF 'PREPARATORY' & 'AUXILIARY'

- ❑ The terms 'preparatory' and 'auxiliary' has not been defined in OECD or UN Convention;

- ❑ 'Preparatory' means:
 - **done in order to prepare for something** - *Columbia Sportswear Co., In re 2011] 337 ITR 407 (AAR)*;
 - as some job concerned with the preparation of the main task to be undertaken - *GE Energy Parts Inc. vs. ADIT [2017] 184 TTJ 570 (Delhi Trib.)*

- ❑ 'Auxiliary' means:
 - Providing extra help and support - *Columbia Sportswear Co. (supra)*;
 - **Aiding or supporting the core income generating activity** - *GE Energy Parts Inc. (supra)*

CRITERION TO DECIDE PoA CHARACTER OF ACTIVITIES

□ OCED, 2014 Commentary:

“24..... The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.”

CRITERION TO DECIDE PoA CHARACTER OF ACTIVITIES (cont'd...)

□ KLAUS VOGEL Commentary:

- The activities of a Place of Business (“POB”) qualify as being ‘of a PoA character’, as compared to the overall activities of the enterprise if they have **not more than a marginal relevance** within the enterprise’s overall business plan.
- It should be noted that it is not the share in actual profits or losses on which comparison should be based.
- Rather, the characterisation of an activity as PoA depends on the type, sector or intensity of the activity, as compared to the core business of the enterprise as a whole

CRITERION TO DECIDE PoA CHARACTER OF ACTIVITIES (cont'd...)

□ GE Energy Parts Inc. (supra):

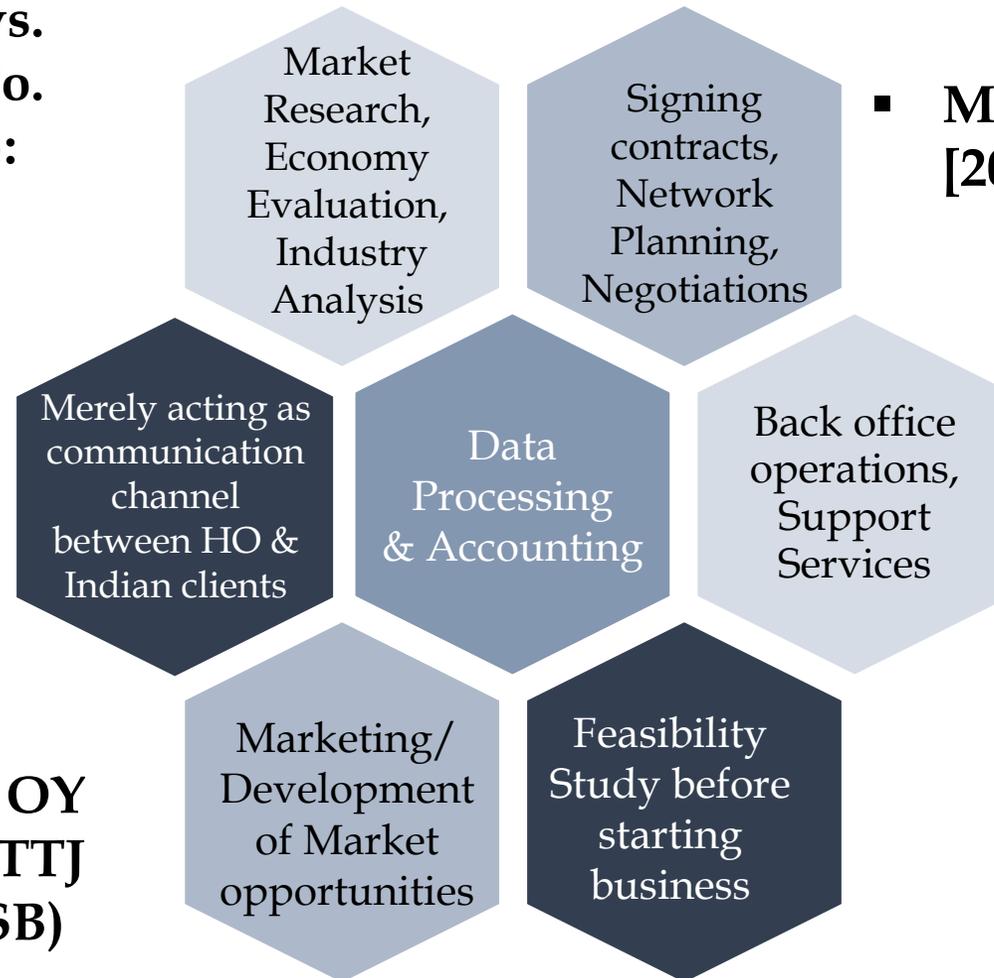
“test for determining a preparatory or auxiliary activity is not to see if the core activity can or cannot be performed without it. Rather, the test is that such activity merely supports the core activity and does not per se lead to earning of income. If the activity carried on from a fixed place in India is simply in aid or support of the core income generating activity and is remote from the actual realization of profits, the same assumes the character of a preparatory or auxiliary nature”

INDIAN JUDICIAL PRECEDENTS ON PoA

- **DIT (Int. taxn) vs. Morgan Stanley & Co. [2007] 292 ITR 416 (SC):**

- **U.A.E. Exchange Centre Ltd. vs. UOI Delhi/[2009] 313 ITR 94 (Delhi HC)**

- **Nokia Networks OY vs. JCIT [2018] 194 TTJ 137 (Delhi - Trib.) (SB)**



- **Motorola Inc. vs. DCIT [2005] 96 TTJ 1 (Delhi) (SB)**

- **DIT vs. Mitsui & Co. Ltd. [2018] 96 taxmann.com 371 (Delhi HC)**

- **ADIT vs. E-Funds IT Solution Inc. [2017] 399 ITR 34 (SC)**

UNCERTAINTY w.r.t. to PoA

- ❑ Clause (a) to (d) refer to exclusion of specific activities, whereas clause (e) & (f) refer to PoA activities

Where the activities fall under clauses (a) to (d) of Art. 5(4), is that POB automatically exempted from PE

OR

Do the activities need to fulfil the condition of being of a PoA character for the enterprise, so as to be exempted from PE status?

View 1: Additional test of PoA activities not to be applied to clause (a) to (d)

View 2: PoA character is common attribute of all activities specified in Art 5(3)

ILLUSTRATION

- ❑ A non-resident parent company is engaged in selling automobiles and spare parts;
- ❑ It has a branch in India, acting as a storage facility for spare parts;
- ❑ The activities of the storage facility will be limited to storage, relocation & distribution of the spare parts, which will be ordered directly from the parent by the customers.

Whether the non-resident has a PE in India?

Activities carried out by branch fall under Art. 5(4)(a)
→ Thus, excluded from PE

OR

Activities carried out by branch fall under Art. 5(4)(a) + additional condition of PoA satisfied
→ Thus, excluded from PE

Source: OECD Report - Issues arising under Article 5 of the Model Tax Convention" (2002)

DISCUSSION ON PoA SINCE 1922

OCED, 1922 Commentary:

“21.....The common feature of these activities is that they are, in general, preparatory or auxiliary activities.....Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.”

DISCUSSION ON PoA SINCE 1922 (cont'd)

OECD Report - Issues arising under Article 5 of the Model Tax Convention" (2002):

“These activities [(a) to (d)], unlike other activities described in sub-paragraph (e), are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary. These conclusive presumptions were initially adopted to provide certainty to taxpayers that their income from these activities would be taxable, if at all, only in the country of residence.”

DISCUSSION ON PoA SINCE 1922 (cont'd)

OECD TAG Report - Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce? (2004):

“Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary

.....

190. *The alternative option to make all the exceptions subject to the “preparatory or auxiliary” condition would reduce certainty by subjecting the existing exceptions that currently apply automatically and therefore provide a bright line test to a condition that is inherently more subjective. The change would therefore increase the potential for disputes between taxpayers and tax authorities. In light of paragraph 21 of the Commentary on Article 5, it could be argued, however, that there is already some uncertainty as to whether or not all the existing exceptions are implicitly subject to this condition (PoA).”*

View 1
discussed

DISCUSSION ON PoA SINCE 1922 (cont'd)

OECD TAG Report - Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce? (2004) ...cont'd

- ❑ Better option to subject the activities to overall limit of PoA, as it implicitly restricts the exceptions to activities that contribute only marginally to the profits of the enterprise.
- ❑ *“194. To the extent that it is considered efficient to exempt from source taxation places of business where only minor business activities are performed, the alternative option to apply the preparatory or auxiliary condition to all the exceptions that appear in the paragraph would seem to be a more flexible approach. Indeed, the option would allow greater flexibility by not ruling out that certain activities (e.g. delivery) could be more than a preparatory or auxiliary activity in certain cases.”*

View 2
discussed
&
concluded

DISCUSSION ON PoA SINCE 1922 (cont'd)

OECD MTC: Revised proposals concerning the Interpretation and Application of article 5 (Permanent Establishment) (2012-13):

- ❑ Specific issue raised – “12. Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature? (paragraphs 21 and 23 of the Commentary)”
- ❑ Observations under 2004 OECD TAG Report considered;
- ❑ The Working Party agreed that the activities specified under **clause (a) to (d) are not subject to the additional condition of PoA character, which is expressly a condition under clause (e) and (f);**
- ❑ The commentary should be amended **to clarify** that subparagraphs (a) to (d) should apply automatically and it is not subject to the extra condition of the activities being PoA in nature.

Even after taking into consideration the extract from OECD, 1992 Commentary, Working Group furnished a dissenting view.

KLAUS VOGEL COMMENTARY ON PoA:

- ❑ P&A is a subordinate character being the common denominator for all the POB listed therein;
- ❑ The difference in wording first four sub-paras (a) to (d) can be regarded as **exemplifications of a homogenous concept of subordinate POBs, as described in Art. 5(4)(e)** and confirmed and amalgamated in Art. 5(4)(f)
- ❑ All the activities listed in Art. 5(4)(a) to (f) have to be P&A. This follows from the use of the word **'other'** in Art. 5(4)(e). This word not only relates to the subsequent word 'activity' but to the entire phrase 'activity of P&A character'
 - **Otherwise, one should expect an 'if' clause or a 'provided that' clause after 'activity', like in Art. 5(4)(f)**

ACTION 7 – BEPS CONCERN

- ❑ The exceptions to the definition of PE, since first introduced, sought to cover activities generally considered to be PoA in nature;
- ❑ Dramatic change in the way business is conducted, especially with the growth of digital economy has given rise to BEPS concern;
- ❑ Classic example is 'online shopping portals'(Covered under Case Studies)

ACTION 7 - RECOMMENDATION

- ❑ *“Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a ‘preparatory or auxiliary’ character.”*
- ❑ Indicate that each of the exception included in that provision is restricted to activities that are otherwise of a ‘PoA’ character;
- ❑ Provide additional guidance in commentary clarifying the meaning of the phrase PoA using number of examples

PROPOSED AMENDMENT in Art 5(4) of MTC

OPTION A

“4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- a)*
- b)*
- c)*
- d)*
- 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;~~*
- 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 of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~*

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.”

PROPOSED AMENDMENT in Art 5(4) of MTC

OPTION B

“4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

a)

b)

c)

d)

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not listed in subparagraphs a) to d), provided that this ~~any other activity of~~ has a preparatory or auxiliary character, or

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 of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

P & A EXPLAINED IN ACTION 7

- Based on the recommendation under Action 7, commentary of OECD on MTC has been updated, explaining the meaning of the terms 'preparatory' & 'auxiliary'

Preparatory character is one that is carried on on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole.

Auxiliary character generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

ILLUSTRATIONS – Whether activities are PoA

- ❑ An office maintained in State S for advertising own product;
 - Would the answer be different if such office also advertises on behalf of other enterprises;
- ❑ A bonded warehouse in State S for storage of perishable fruits during custom clearance;
- ❑ Fixed POB in State S solely for delivery of spare parts to customers for machinery sold to those customers;
 - Would the answer be different if POB also carried out after-sale services for maintenance and repair of machinery, on behalf of the supplier;
- ❑ An investment fund sets up an office in a State S solely to collect information on possible investment opportunities in that State S;
- ❑ A newspaper bureau set-up in State S solely to collect information on possible news stories without engaging in any advertising activities

ILLUSTRATIONS – Whether activities are PoA

- ❑ RCO is a large buyer of agricultural products produced in State S, which RCO sells from State R to distributors situated in different countries:
 - RCO maintains a purchase office in State S;
 - The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO

- ❑ Would the answer be different if RCO was a manufacturer and the purchase office solely acquired raw materials from State S?

MLI PROVISIONS – Art. 13(2) – Option A

“2. Notwithstanding the provisions of a Covered Tax Agreement that define the term “permanent establishment”, the term “permanent establishment” shall be deemed not to include:

a) the activities specifically listed in the Covered Tax Agreement (prior to modification by this Convention) as activities deemed not to constitute a permanent establishment, whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character;

b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a);

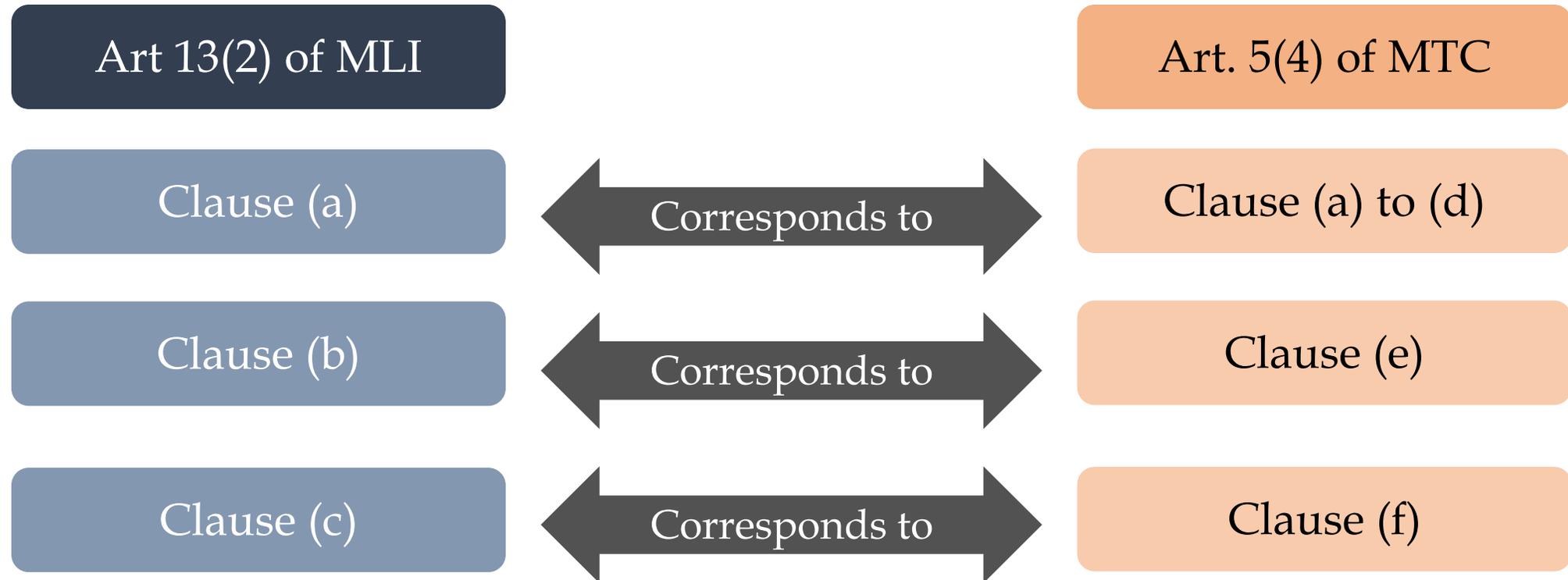
c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b),

provided that such activity or, in the case of subparagraph c), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.”

Under
provisional
list, India
has opted
for
Option A

EXPLANATORY STATEMENT TO Art 13(2)

- ❑ In the case of a CTA with text identical to that of Article 5 of OECD MTC, 2014 or UN MTC, 2011



POST MLI READING OF Art 5(4) of MTC

4. 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;

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;

whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character;

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~~ **not described in subparagraph a) to d);**

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 of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~”

provided that such activity [i.e. (a) to (d) & (e)] or, in the case of clause f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.”

COMPATIBILITY, NOTIFICATION & RESERVATION

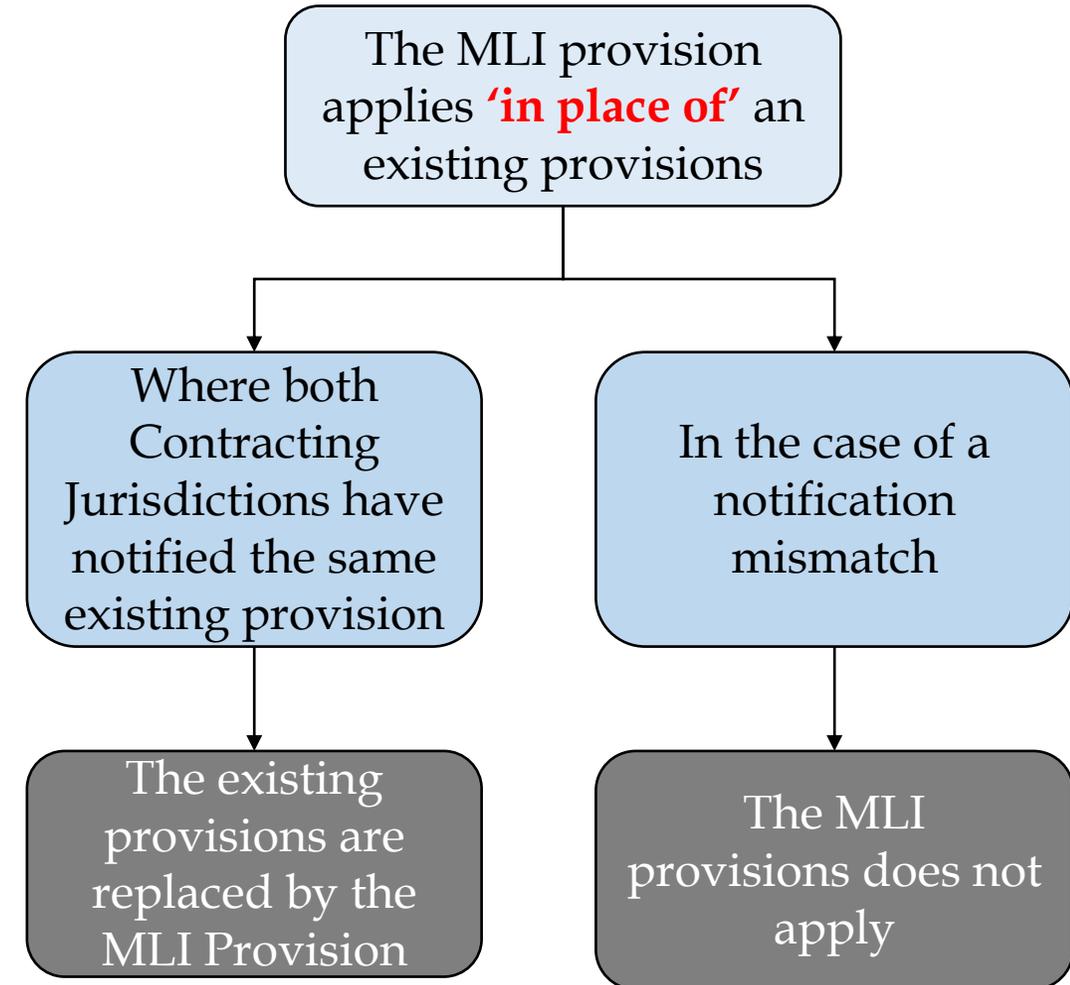
Compatibility Clause - Art. 13(5)(a)

*“Paragraph 2.....shall apply **in place of** the relevant parts of provisions of a CTA that list specific activities that are deemed not to constitute a permanent establishment even if the activity is carried on through a fixed place of business (or provisions of a CTA that operate in a comparable manner).”*

Reservation Clause - Art. 13(6)(a) & (b)

A Party may reserve the right:

- for the entirety of Art. 13 not to apply to its CTA;
- for Option A not to apply to its CTA

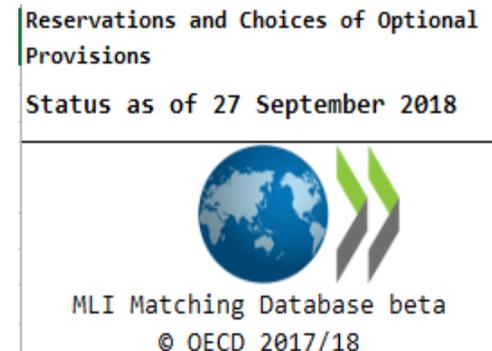


FACT SHEET

- ❑ Out of 84 signatories to MLI, **31** have reserved their right for Article 13 not to apply to its CTA in entirety
 - Canada, Denmark, Finland, Georgia, Poland, Sweden, Switzerland, UAE, etc.

- ❑ Only **2** signatories have reserved rights for application of Option A
 - Argentina & Australia

- ❑ Option A has been opted by **43** countries, whereas only **7** countries have opted for Option B [namely, Belgium, France, Ireland, Lithuania, Luxembourg, San Marino, & Singapore]



ANTI- FRAGMENTATION RULE

- Illustrations;
- OCED Commentary;
- Action 7 Recommendations;
- Article 13 & 15 of MLI;

ILLUSTRATION (1/1)

- ❑ A producer of orange juice in State A sets-up a number of subsidiaries in in State B.
 - Sub Co. 1 receives delivery and stores the juice;
 - Sub Co. 2 distributes it to outlets; and
 - Sub Co. 3 delivers it to customers

Does the producer have a PE in India?

Source: OECD Report - Issues arising under Article 5 of the Model Tax Convention (2002)

OECD, 2014 COMMENTARY - Pre-BEPS OBSRVATIONS

*“27.1 Subparagraph f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs a) to e) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. **An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.**”*

ACTION 7 RECOMMENDATIONS

- ❑ BEPS concerns arises where there is fragmentation of activities between closely related parties;
 - It is relatively easy to use closely related enterprises in order to segregate activities which, when taken together, go beyond that threshold;
- ❑ Anti-fragmentation referred to in Para 27.1 of OECD Commentary should not be restricted to cases where the same enterprise maintains different places of business in a country but should be extended to cases where these places of business belong to closely related enterprises;
- ❑ New Anti-Fragmentation Rule recommended, which is logical consequence of the decision to restrict the scope of Art. 5(4) to activities that have a PoA character

MLI PROVISIONS – Art 13(4)

“4. A provision of a CTA (as it may be modified by paragraph 2 or 3) that lists specific activities deemed not to constitute a permanent establishment shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting Jurisdiction and:

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of a CTA defining a permanent establishment; or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.”

PARAPHRASING Art. 13(4)

- ❑ Specific activities exclusion provided under Art. 5(4) of MTC shall not apply to **fixed POB used or maintained by R Co. in State S** if the following conditions are satisfied:

- R Co. or its closely related enterprise carry on business activities at such POB or at another place in State S;

AND

- Such POB or other place constitutes PE of R Co. or the related enterprise;
- OR
- Overall activity resulting from combination of activities carried out by the two enterprises in not PoA in nature,

provided that such business activities carried on by the two enterprises, constitute **complementary functions that are part of a cohesive business operation.**

COMPATIBILITY & RESERVATIONS

❑ **Compatibility clause - Art. 13(5)(b):**

“Paragraph 4 shall apply to provisions of a CTA (as they may be modified by paragraph 2 or 3) that list specific activities that are deemed not to constitute a permanent establishment even if the activity is carried on through a fixed place of business (or provisions of a Covered Tax Agreement that operate in a comparable manner).”

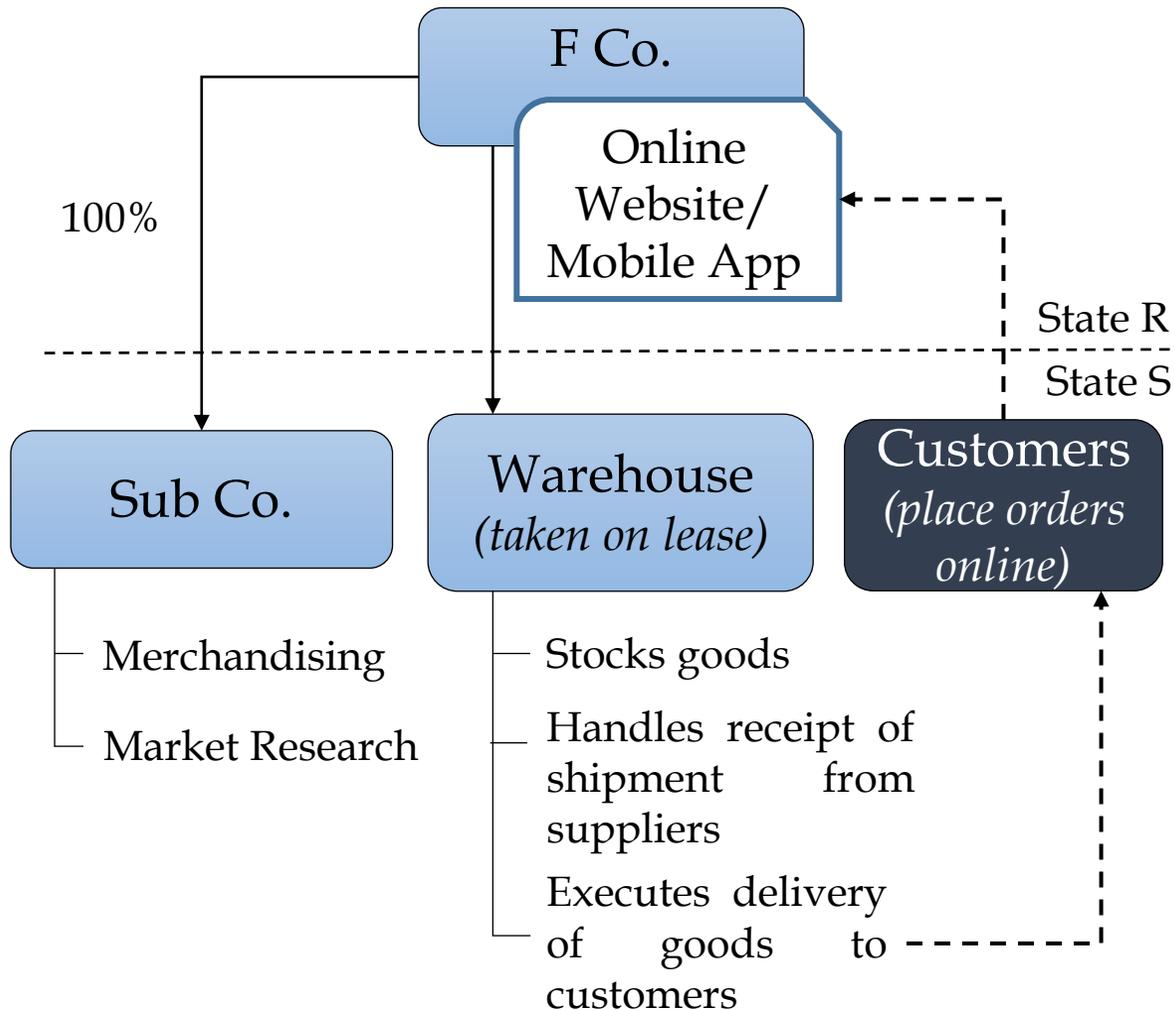
❑ **Reservations - Art. 13(6)(c):**

- A party may reserve its right for Para 4 not to apply to its CTA;
- Four signatories have made reservations w.r.t. Art Para 4 of Art. 13 namely, Austria, Germany, Luxembourg & Singapore

PoA ACTIVITIES & ANTI- FRAGMENTATION RULE

CASE STUDIES

CASE STUDY (1[#] / 4)



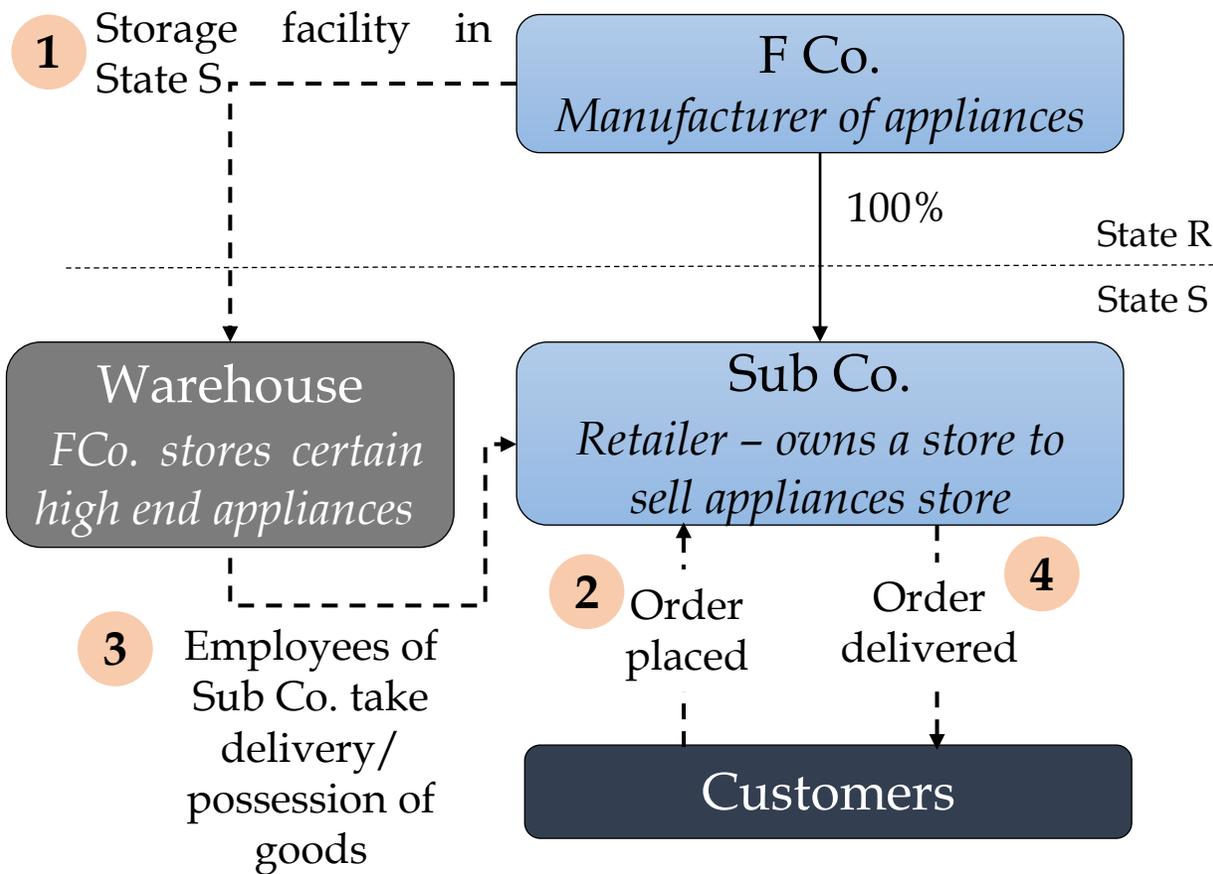
- F Co. owns a website & online shopping app;
- It acquires goods from unrelated suppliers and stores the same in a leased warehouse in State S;
- F Co.'s employees in the warehouse facilitate delivery of goods from warehouse to customers using independent delivery service providers;
- F Co. also has a WOS in India viz. Sub Co. carrying out merchandising and market research activities;

State R & State S have opted for Option A (i.e. Art. 13(2) of MLI)

Whether F Co. has a PE in State S

OECD, March 18 - Additional Guidance on Attribution of Profits to PE

CASE STUDY (2# / 4)

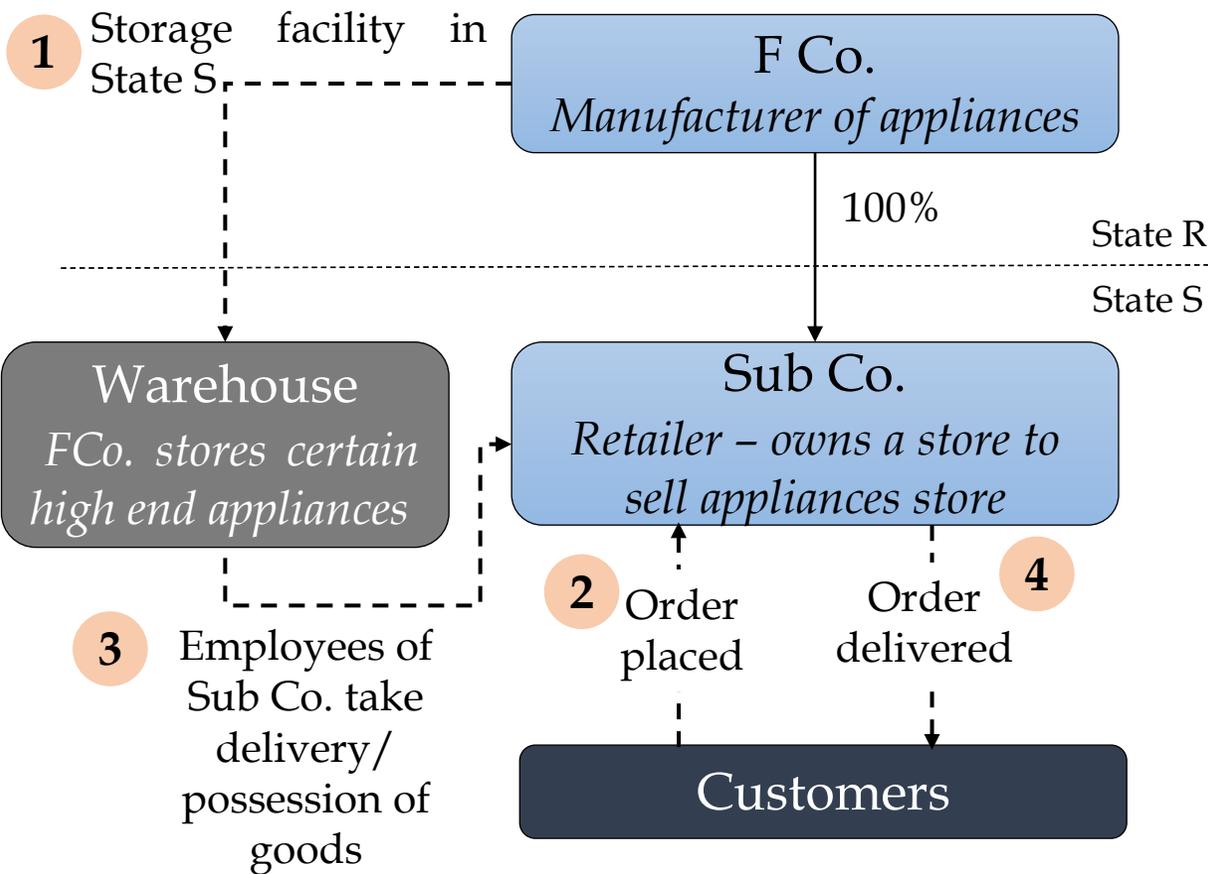


- F Co. is a manufacturer and trader of appliances;
 - S Co., a WOS, owns a retail store in State S for selling appliances;
 - F Co. also owns a warehouse in State S where a few high end appliances, identical to those sold by S Co., are stored;
 - When a customer places large orders for such high-end appliances, employees of S Co. take delivery/possession of the same from the warehouse and in turn delivers the same to its customers
- State R has made reservations w.r.t. Art 13 in entirety
 - State S have opted for Option A (Art 13(2) of MLI)

Whether F Co. has a PE in State S

#P. 81/Example B - OECD, 2017 Commentary on Art. 5 of MTC

CASE STUDY (3# / 4)

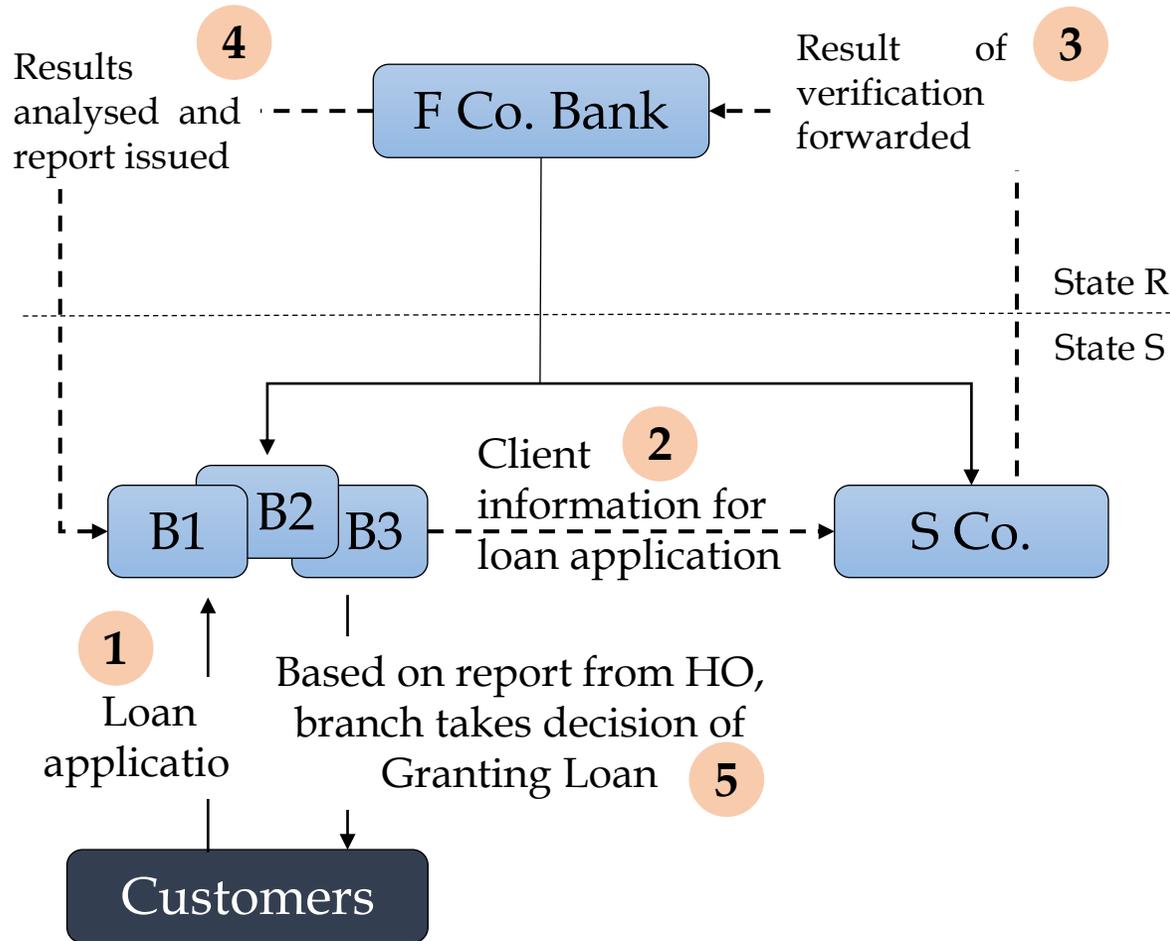


- F Co. is a manufacturer and trader of appliances;
 - S Co., a WOS, owns a retail store in State S for selling appliances;
 - F Co. also owns a warehouse in State S where a few high end appliances, identical to those sold by S Co., are stored;
 - When a customer places large orders for such high-end appliances, employees of S Co. take delivery/possession of the same from the warehouse and in turn delivers the same to its customers
- State R has opted for Option B (Art. 13(3) of MLI)
 - State S has opted for Option A (Art 13(2) of MLI)

Whether F Co. has a PE in State S

#P. 81/Example B - OECD, 2017 Commentary on Art. 5 of MTC

CASE STUDY(4# / 4)



- F Co., a bank has various branches in State S, which constitute PE of F Co. in State S;
- F Co. also has a verification office (“S. Co”) in State S;
- Basically, S. Co verifies the information furnished by clients to the branches while making loan application;
- S Co. verifies the data and forwards the results of verification to F Co.;
- F Co. analyses the results and issues a report to the branches where decisions to grant the loan are made.

- State R has neither opted for Option A nor Option B
- State S have opted for Option A (i.e. Art. 13(2) of MLI)

Whether S Co. is a PE of F Co. in State S

#P. 81/Example A - OECD, 2017 Commentary on Art. 5 of MTC



THANK YOU!!!