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EY Tax Alert

OECD's proposed changes to the Model Commentary on permanent establishments: An Indian perspective



Executive summary

The Organization for Economic Cooperation and Development (OECD), on 12 October 2011, released a public Discussion Draft on the proposed changes to the Commentary on Article 5 (Permanent Establishment or PE) of the OECD Model Convention (OECD MC). The highlights of the Discussion Draft include clarification on the application of the 'at the disposal of' test, exceptions to the PE definition which may be particularly relevant in the context of limited risk distribution and contract manufacturing models, application of the PE concept in the context of joint ventures and partnerships, authority to conclude contracts by an agent and confirmation that the PE analysis should be unaffected by any prior business restructurings. The proposed changes to the Commentary by way of this Discussion Draft, if accepted, may be examined for possible inclusion through the next update to the OECD MC, which is currently planned for 2014. The OECD has invited comments on the Discussion Draft before 10 February 2012.

Background

The notion of PE contained in Article 5 of the OECD MC is used in bilateral tax treaties for allocation of taxing rights when an enterprise of one country derives business profits from another country. The existence of a PE of a foreign enterprise (FE) in a country determines, whether or not, the business profits of the FE can be taxed in that country. The definition of PE in most of India's tax treaties is largely based on the definition contained in the OECD MC, with some

deviations. India is currently not an OECD member country. India was granted an 'Observer Status' in 2006 and, thereafter, was offered enhanced engagement in 2007, with a view to possible membership. India's positions, as a non-member country, on the OECD MC and its Commentary were included for the first time in the 2008 update to the OECD MC^[1]. The 2010 update contained additional positions of India on the amendments introduced in the 2008 Update^[2]. In recent times, India has enhanced its cooperation on taxation with the OECD^[3].

In the Discussion Draft, the OECD presents proposals aimed at clarifying the interpretation and application of the PE concept in the OECD MC. Some highlights of the Discussion Draft are discussed below.

Fixed place PE: Meaning of 'at the disposal of'

For a PE under the fixed place rule of Article 5(1), there should be: (1) A place of business of an FE. (2) That place of business should have a degree of permanence. (3) The business of the FE should be carried on through that place. The third requirement implies that the place of business is 'at the disposal of' the FE. Presently, the Commentary on Article 5 suggests that a place of business may constitute a PE if that place is 'at the disposal of' the FE. While the Commentary recognizes that no formal or legal right to use a particular place is required, it is also recognized that the mere presence of an FE at a

particular location would not necessarily mean that the location is at the disposal of the FE. Hence, this determination would need to be made based on facts and circumstances.

The Discussion Draft seeks to clarify that, whether or not a place of business can be considered to be at the disposal of the FE, should depend on the extent of that FE's presence at the location and the activities it performs. Thus, a certain location would be considered to be 'at the disposal of' the FE where:

- (1) The FE has an exclusive legal right to use that location and that location is used for carrying on the FE's own business activities; or
- (2) The FE carries on its business activities on a continuous and regular basis at a location that belongs to another enterprise during an extended period of time; or
- (3) The FE carries on its business activities at a location of another enterprise that is used by several enterprises.

Furthermore, a location will not be considered to be 'at the disposal of' the FE where the FE's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the FE. In general, a location where an FE does not have a right to be present, and which it does not use itself, is not 'at the disposal of' the FE. By way of an example, the Discussion Draft explains that a plant that is owned and used exclusively by a supplier or contract manufacturer cannot be said to be at the disposal of the FE that will receive the goods produced at that plant merely because all the goods will be used in the business of the FE.

The Discussion Draft goes on to apply this concept in the context of various instances such as consultant

^[1] Kindly refer EY Tax Alert dated 22 July 2008 for further details.

^[2] Kindly refer EY Tax Alert dated 26 July 2010 for further details.

^[3] Kindly refer EY Tax Alert dated 23 June 2011 for further details.

working at the client's premises, home office situation and contract manufacturing.

Business restructurings

With respect to situations involving post-business restructurings, the Discussion Draft notes that, for purposes of a PE analysis, it is insignificant whether the relevant facts and arrangements resulted from a business restructuring. For example, whether the premises of a converted local entity, that manages risks or performs activities on behalf of an FE constitutes a PE of the FE, should be analyzed solely on the basis of Article 5, irrespective of whether or not a business restructuring had taken place. This is consistent with the approach adopted for transfer pricing aspects of business restructurings. For these reasons, no additions or changes to the Commentary were proposed in this respect.

FE's seconded employees

Temporary intra-group secondment of employees to another country often gives rise to PE implications. Generally, activities of business enterprises are carried out by way of employees who are in a paid employment relationship with the enterprise or other personnel like agents. In both cases, however, the instructions are received from the employer enterprise. The powers of such personnel in relationship with third parties are irrelevant.

The Discussion Draft clarifies that, for the purposes of the PE analysis, it is important to make a distinction between cases where: (1) Employees of an FE, while

being formally employed by that enterprise, actually perform the business activities of another (resident) enterprise. (2) Employees of an FE carry on the business activities of that FE. In particular, the Discussion Draft observes that, under the first scenario, the FE cannot be considered to carry on its business activities at the location where the employees in question are based and, accordingly, no PE issues are likely to arise in that context. The proposed change seeks to align the PE interpretation with the discussion in Article 15 (Dependent Personal Services) for the purpose of making the above distinction.

Main contractor who subcontracts all aspects of a contract

The Discussion Draft suggests changes that would clarify whether a main contractor, that subcontracts all aspects of a project, can have a PE in the state where the subcontracted activities take place. The Discussion Draft notes that an enterprise may be deemed to carry on business activities in another country, even where such activities are carried on through subcontractors, acting alone or together with employees of the enterprise. In that case, a PE may be found to exist if the conditions under Article 5 are met (i.e., the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where the general contractor has overall responsibility for the site and the site is made available to that general contractor for the purposes of carrying on its business). This suggested change would

apply to PEs generally as well as construction/installation PEs.

Joint ventures and partnerships

The Discussion Draft would add to the Commentary statements clarifying that the term 'enterprise of a contracting state', as used in Article 5, refers to any form of enterprise carried on by a resident of a contracting state, including a company, partnership, sole proprietorship or other legal form. Whether or not the collaboration of different enterprises on the same project will amount to a separate enterprise depends largely on the relevant domestic law. In many cases, a separate company will not be set up to carry on the enterprise but the parties agree to each carry on a separate part of the business and, although they will share the overall output from the project, they will not necessarily jointly carry on business activities or share the profits from such activities. Thus, it would be difficult to treat such an arrangement as a separate enterprise in the context of Article 5 (even though it may be considered a 'joint venture' under local law).

The Discussion Draft also proposes adding language that, where the enterprise is organized as a fiscally transparent partnership, the enterprise is carried out by each partner. Accordingly, where the partnership has a PE, each partner's share of the profits attributable to that PE will be considered to be derived by an enterprise of the state in which each partner is resident.

Exceptions to the PE definition – Article 5(4) of the OECD MC

Article 5(4) of the OECD MC contains a number of exceptions to the PE definition. By way of example, the use of facilities for storage, display or delivery of goods and merchandise or the maintenance of a stock of goods or merchandise for the purpose of processing by another enterprise, does not normally result in the creation of a PE. In addition to specifically listed activities, Article 5(4) provides that the exception to the PE definition also applies to any other unspecified activities, as well as to any combination of the activities listed in Article 5(4), provided that the (resulting) activities are of a preparatory or auxiliary character. The Discussion Draft suggests the Commentary be changed to clarify the following:

- ▶ The relevant exceptions apply where the goods and merchandise belong to the enterprise. For example, whether the storage or delivery takes place before or after a sale contract has been concluded with customers is irrelevant for the application of these exceptions, as long as the title to the goods and merchandise has not passed to the customers and the goods are still at the location of the enterprise.
- ▶ Immovable property under development and data cannot be classified as 'goods and merchandise' because this term refers to tangible property. Accordingly, the exceptions for storage, display and delivery would not cover these cases.

- ▶ The exceptions in question can be relied on where the place of business is used for any combination of storage, display and delivery of goods and merchandise or for maintenance of stock for these purposes

Finally, the proposed clarifications in the Discussion Draft provide that the maintenance of an office whose employees are involved in the negotiation of the essential parts of contracts for the sale of goods to buyers in that country cannot qualify as an activity of a preparatory and auxiliary nature and cannot benefit from the exceptions. Whether or not such an office constitutes a PE should, thus, be assessed against the background of Article 5(1).

Dependent agent PEs – Article 5(5) of the OECD MC

According to the Discussion Draft, the Working Party has extensively discussed two recent court cases concerning commissionaire arrangements where a French court and a Norwegian court have reached conflicting conclusions as to whether or not a commissionaire under civil law, who cannot legally bind its (undisclosed) principal^[4], may, nevertheless, constitute a dependent agent PE for that principal. The Discussion Draft proposes to add a new example to the Commentary on Article 5(5) which would indicate that, in some countries, an enterprise could be bound by an agent, even where the agent did not formally

^[4]See CE 31 March 2010, Zimmer Ltd., Nos. 304715 and 380525 conclusions Julie Burguburu, BDCF No. 6/2010; Borgarting Lagmannsrett, dated 2 March 2011, Dell Products v Skatt Ost, ref 10-032855ASD-BORG/03

disclose that it was acting for the enterprise and the name of the enterprise was not stated in the contract.

Other clarifications in the Discussion Draft

In addition, the Discussion Draft seeks to clarify the following:

- ▶ Certainty on the time requirement for existence of a PE.
- ▶ Clarification that, in respect of a construction PE, work undertaken on the site after the construction work has been completed, pursuant to a guarantee, would not normally be included in the original construction period.

Comments

Even though India is not a member of the OECD, courts in India have recognized the influence that the OECD MC and its Commentary have in interpreting India's tax treaties. Though the proposed additions and changes to the Commentary on Article 5 will not be finalized until the OECD completes its public consultation process, the Discussion Draft is an indicator of the OECD's current thinking on some of the contentious issues in the definition of a PE. As these changes, once incorporated in the OECD Commentary, are likely to be viewed as clarifying the existing definition, it would be useful for taxpayers to analyze the impact the changes could have on their existing cross-border arrangements and business models involving India, in light of current Indian case laws that address some of these issues.

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
HITECH City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi

9th Floor, Abad Nucleus
NH-49, Maradu PO
Kochi -682304
Tel: +91 484 3044000
Fax: +91 484 2705393

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby,
Dadar, Mumbai - 400 028.
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000

6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E), Mumbai - 400 063.
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

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