

CASE STUDY ON SPLITTING OF
CONSTRUCTION CONTRACT—
MLI 14

Construction PE – Evolution

- During 1930's – attempt was made by tax department in Germany to characterise construction activity as a PE under the normal PE / fixed place PE rule.
- German Supreme Court held that construction / installation project **cannot** constitute a PE under the normal PE rules due to lack of attributes such as permanence.
- To address the above, some of the European countries in their tax treaties included a **duration test** within the basic PE rule to provide that construction/installation activity would constitute PE if the same is carried on for specified duration.

Construction PE in MC's

- Activities generally covered:
 - Building site
 - Construction project
 - Installation project
- Exceptions are:
 - Exploratory activities in US model
 - Supervisory and other related services in UN Model
- The duration varies [12 months in OECD and US; 6 months in UN]

Construction PE in MC's

- While OECD MC and US MC stipulate that a building site or construction or installation project etc., will not lead to a PE unless it lasts for more than 12 months, UN MC reduces the threshold period to 6 months.
- The UN MC is also different from other MC's as it covers furnishing of services.
- US MC makes a specific mention of exploratory services.
- Planning and supervision services are covered within the scope of the expression “building site or construction or installation project” under Article 5(3) despite the not being expressly stated therein – Para 51 of OECD MC 2017

Construction PE – Certain facets

- *Interplay between Construction PE and Fixed Place PE*
- *Interruptions*
- *Time spent by sub-contractor*
- *Relocation of site or project*
- *Duration of preparatory services*
- *Coherence*

Construction PE – Certain facets

- *Interplay between Construction PE and Fixed Place PE*
 - Two views
 - First view - Construction PE rule and Fixed Place PE rule are to be construed as two standalone provisions.
 - Especially where the applicable Treaty contains a specific provision deeming qua Construction PE viz., Article 5(3) of India France Treaty.
 - Second view - Irrespective of its placement under Article 5 [either as an example of PE under Article 5(2) or under a separate clause Article 5(3)], the Construction PE rule only modifies the Fixed Place PE rule to an extent.
 - The tests under the Fixed Place PE rule must be satisfied (in addition to duration test) in order to characterise a project or site as a Construction PE.
 - ADIT v. Valentine Maritime (Mauritius) Ltd. [IT Appeal No. 1532 (Mum)]
 - Cal Dive Marine Construction (Mauritius) LTD 315 ITR 334 (AAR)

Construction PE – Certain facets

- *Interruptions*

- Whether time lost due to the stoppage or temporary suspension of activities is to be counted while computing the threshold limit for the constitution of PE?
- A site does not cease to exist when the work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site/project – Para 55 OECD MC 2017

Construction PE – Certain facets

- *Time spent by sub-contractor*
 - Whether time spent by the sub-contractors on the site/project should be included to determine whether prescribed threshold for constituting a Construction PE?
 - Yes - Para 54 of the OECD MC 2017.
 - AAR in ***Pintsch Bamag In Re 318 ITR 190*** has however ruled that the time spent by a sub-contractor on a project **cannot** be included **if** the sub-contractor has worked at a place far away from installation site and run by it independent of any control of the main contractor.
 - A sub-contractor could itself constitute the PE if his activities last for more than prescribed threshold.

Construction PE – Certain facets

- *Relocation of site or project*
 - Contractor may be required to relocate the project site or construction work continuously or at periodical intervals.
 - For examining the ‘duration test’, one would have to aggregate the time spent on each location.
 - para 57 of the OECD MC Commentary 2017

Construction PE – Certain facets

- *Duration of preparatory services*
 - Whether time spent on preparatory work (like project planning) is to be added to the time spent on actual construction work?
 - No - Austrian Supreme Administrative Court in Czech Construction Project case, Technical Explanation to India-USA Treaty.
 - Yes - Para 54 of the OECD MC Commentary 2017

Construction PE – Certain facets

- *Coherence*

- Para 51 of the OECD MC - *A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit event if the orders have been placed by several persons (e.g. for a row of houses).*
- Thus, a project site should be treated as a single unit for application of duration test even if it is a result of multiple contracts provided such contracts form a commercial and geographical coherent whole.
- ‘Commercial coherence’ requires the work done at different sites constituting one business venture [consisting of one or more contracts].
- ‘Geographical coherence’ means that operations must take place within either a single place or a limited area if the business is of a mobile nature.

Construction PE – Abuse

- Being based ‘duration test’, entities began splitting of contracts with an objective of circumventing the prescribed time period.
- Under the “splitting-up” approach, a single contract is divided into parts among the entities belonging to the same group.
- Each of such entity carries out work in the source country for a period less than that prescribed for constituting a PE under the applicable DTA.
- Abuse through splitting-up recognised by OECD in MC – Para 52 of MC

Construction PE – Splitting-up – Existing Measures

- Legislative anti-avoidance rules
- Judicial anti-avoidance rules
- Bilateral negotiations
- Judicial anti avoidance rule - Splitting-up of a contract solely for tax purposes amounts to an abuse of Construction PE clause. However, the onus to prove artificial splitting-up of a contract is on the tax department - ***Orpak System Ltd v ADIT 176 TTJ 655 (Mum)***, ***J Ray McDermott Eastern Hemisphere Ltd v JCIT 39 SOT 240 (Mum)*** and ***Valentine Maritime (Gulf) LLC v ADIT 45 SOT 359***

Construction PE – Splitting-up – Remedy

- OECD noticed that the domestic and judicial anti avoidance rules in countries (including India) were not sufficient to address the issue of artificial splitting of contracts.
- Para 17 of Part C of the BEPS AP 7 addresses splitting-up of contracts.
- Para 17 recommends adoption of any of the following two measures for addressing the BEPS concerns related to the artificial / abusive splitting-up of contracts:
 - PPT rule
 - Incorporation of a specific provision in the Treaty – MLI 14

Construction PE – Splitting-up – Remedy

MLI 14

- Clause (a) Enterprise must carry on activities [including supervisory activities] at a building site, construction project, installation project or any specified activity in the DTA (project site) in source country for a period exceeding 30 days in aggregate but less than the prescribed days in the applicable DTA to constitute a PE; AND
- (b) connected activities are carried on at different times by one or more of closely related enterprises at the same project site or any other place identified in the relevant Tax treaty for a period exceeding 30 days THEN

the time periods under clause (a) and clause (b) would have to be added up to determine the number of days the first enterprise (main contractor) has carried on activities at the same project site.

Construction PE – Splitting-up – Remedy

- Applicability of Article 14(1) hinges on carrying out of ‘connected activities’ by ‘closely related enterprises (CRE)’ at the ‘same project’ site or other place identified in the relevant provision of the applicable Treaty.
- The time spent by main contractor as well as CRE’s on connected activities should exceed 30 days in the source country.
- Fact that connected activities have been carried out at different points of time is inconsequential.
- Irrespective of the time periods, time spent by CRE’s on connected activities would have to be aggregated with time spent by Contractor except the one which has been carried on for less than 30 days.

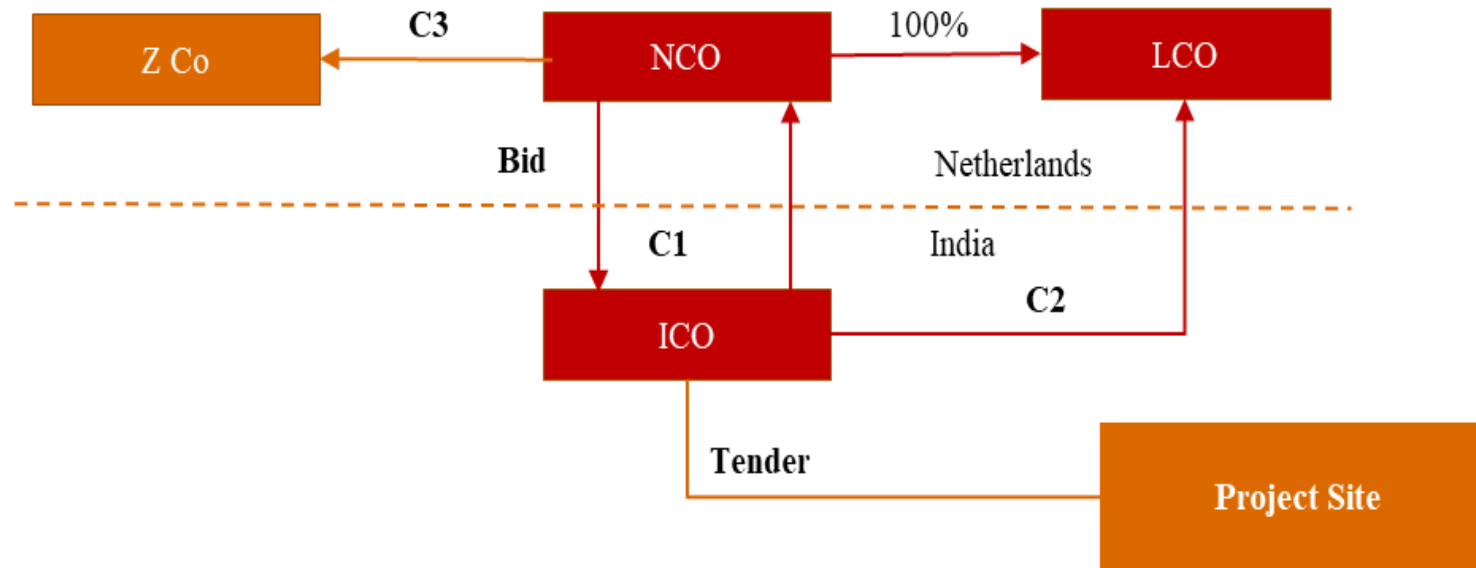
Construction PE – Splitting-up – Illustration

Situations	Time spent by main contractor on construction, installation etc in source country – clause (a)	Time spent by CRE on first connected activity in source country – clause (b)	Time spent by CRE on second connected activity in source country - clause (b)	Aggregate time under Article 14(1)	Existence of Construction PE under Article 14(1) of MLI
I	125 days	40 days	35 days	200 days	Yes
II	125 days	40 days	30 days	165 days	No
III	30 days	91 days	70 days	161 days	No
IV	31 days	91 days	70 days	192 days	Yes

Construction PE – Splitting-up – Illustration

- Note 1: In situation II, the time spent by CRE on second connected activity should not be aggregated as the same is not exceeding 30 days threshold.
- Note 2: In situation III, the time spent on main contractor should not be aggregated as the same is not exceeding 30 days threshold.

Case study



Case study

Facts

- NCO bids for the tender of the construction of a thermal power plant floated by ICO. Time line for completion of construction - 10 months.
- Post acceptance of the bid and after negotiation, project is divided into C1, C2 and C3.
- C1- contract for supply and assembly of equipment to be undertaken by NCO. Time line – 5 months. Supply of equipment on FOB basis from Netherlands.
- C2 – assignment of construction work to LCO. Time line – 5 months.

Case study

Facts

- C3 – sub-contract of supervision services by NCO to ZCO. Supervisory work involves presence of employees of ZCO in India.
- Sub-contract / assignment of supervision work would be at 80% of consideration to NCO.
- LCO is a wholly owned subsidiary of NCO. LCO was incorporated much before the date of tender.
- ZCO is not related to NCO.
- NCO is liable for performance of the entire contract.

Case study

- Construction PE Article in India Netherland Treaty:

“A building site or construction, installation or assembly project constitutes a permanent establishment only where such site or project continues for a period of more than six months.”

Case study

Queries

- Whether benefit under Art 5(3) of the Treaty with Netherlands would be available to NCO, LCO and ZCO?
- Would the conclusion vary if LCO is an independent entity?
- Whether work carried out by ZCO is to be considered as connected activity?

Case study

- What would be the tax implications if the timelines where to be:

No of days for which activities carried on in India	NCO	LCO	ZCO
AY 2018-19	130	15	45
AY 2019-20	21	136	39

Case study

- What would be the tax implications if the timelines were to be:

No of days for which activities carried on in India	NCO	LCO	ZCO
AY 2018-19	120	70	21
AY 2019-20	31	81	90

Case study

Answers to queries

- *Whether benefit under Art 5(3) of the Treaty with Netherlands would be available to NCO, LCO and ZCO?*
- **NCO Angle:** NCO would not have a PE on a standalone basis as the time spent by it in India would be less than 6 months. However, once the time spent by sub-contractor (ZCO) is added with the time spent by NCO, a PE would be created in India. Even under MLI14, NCO would have a construction PE in India as the time spent by LCO (being a CRE carrying connected activity) would be added to its time [viz., 5 months + 5 months].

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Answers to queries

- **LCO Angle:** Under MLI14, LCO would have a construction PE in India as the time spent by NLCO (being a CRE carrying connected activity) would be added to its time [viz., 5 months + 5 months].
- **ZCO Angle:** As per OECD MC 2017, a sub-contractor could have its own PE in a source State if time spent therein exceeds the prescribed threshold. Further, as per para 51 of the OECD MC 2017, planning and supervision services are covered within the scope of the expression “building site or construction or installation project” under Article 5(3) despite the not being expressly stated therein.

Case study

Answers to queries

- Supervisory services rendered by ZCO would therefore be covered under Art 5(3) of the India Netherland Treaty. The same would constitute a construction PE in India if the duration test prescribed therein is satisfied. [case study is silent about the time spent by ZCO in India]
- *Would the conclusion vary if LCO is an independent entity?*
- MLI 14 would not be applicable in this case as LCO is not a CRE of NCO. Therefore, while reckoning duration of LCO one cannot merge the duration of NCO. Similarly, while reckoning duration of NCO, the time span of LCO cannot be added. However, the addition of ZCO (as subcontractor) will remain.

Case study

Answers to queries

- Whether work carried out by ZCO is to be considered as connected activity?
- The question of whether an activity is 'connected' is dependent upon the facts and circumstances of each case. MLI 14 does not contain any guidance on this aspect. BEPS Action Plan 7 outlines the following factors that may be relevant for determining whether activities are connected or not:
 - Whether the contracts covering the different activities were concluded with the same or related person;

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Answers to queries

- Whether the conclusion of additional contracts with a person is 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.
- The above factors indicate deliberate attempts to split contracts to circumvent the threshold period. The term 'connected' is wide enough to encompass any activities carried out by same or related persons at such project site.
 - None of the above parameters, in our opinion, are satisfied in case of Z Co. Therefore, work carried out by ZCO cannot be characterised as a connected activity.

Case study

Answers to queries

- What would be the tax implications for NCO if the timelines where to be:

No of days for which activities carried on in India	NCO	LCO	ZCO	Answer
AY 2018-19	130	15	45	N co + Z Co (subcontractor rule) = 175. hence, NO PE
AY 2019-20	21	136	39	Step 1: 21 + 39 (subcontractor rule) = 60 Step 2: 60 + 136 (CRE+ connected activity, MLI14 rule) = 196 . Thus, PE

Case study

Answers to queries

- What would be the tax implications for NCO if the timelines where to be:

No of days for which activities carried on in India	NCO	LCO	ZCO	Answer
AY 2018-19	120	70	21	Step 1 = 120 + 21 (subcontractor rule) = 141 Step 2: 141 + 70 (MLI 14 rule) = 211. Thus, PE
AY 2019-20	31	81	90	Step 1 = 31 + 90 (subcontractor rule) = 121 Step 2: 121 + 81 (MLI rule) = 202. Thus, PE.

Thank you