

**Artificial avoidance for PE  
status through specific activity  
exemptions and anti  
fragmentation rules**

**Article 13 & 15 of MLI**

# Specific activity exemptions

## Article 5(4) of OECD MTC – Framing the issue

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“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”

Ambiguity on whether exemptions under sub-paras (a) to (d) are subject to condition of being preparatory or auxiliary character

# Specific activity exemptions

## India treaty context

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- Most of the Indian treaties do not exclude 'delivery' activity from PE (eg. India DTAA with France, Japan, Australia, Belgium, Brazil, Denmark etc; Canada – Occasional delivery)
- Section 9(1)(i)(b) of domestic law specifically exempts income arising in India from purchase activity for purpose of exports
- India DTAA with Canada, China, Denmark, Spain, Australia etc does not contain the cumulation clause ie clause (f)
  - exemption may be available where the place of business is carrying on only activities listed under specific sub-para of Article 5(4) and not under more than one sub-para

# Preparatory or Auxiliary activities

## Must-have factors

i.	PoA Characterisation
ii.	Insignificant, not general purpose of FE
iii.	Non-revenue generating
iv.	'Solely' for the FE
v.	Fixed POB 'solely' to carry on PoA activity

## Good to have factors

i.	RBI approval
ii.	Duration of agreement
iii.	Past assessments

## Negative, neutral factors

i.	Large Scale of activities undertaken at fixed POB
ii.	Organizational set up in India
iii.	Activity is necessary for completion of contract
iv.	Enormity of expenditure
v.	Ownership of Assets

# Illustrations of activities which are preparatory or auxiliary in nature

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## a) Pre-Set up Activities

- Market Survey
- Establishing and maintaining contacts with FIs, business entities, Government agencies on industrial policy and regulations, etc.
- Acquisition of operating assets
- Collecting of capital for the start-up of an industrial or commercial enterprise

## b) Promotional, advertising, etc.

- Technical presentations/ Providing information to prospective customers
- Holding seminars, advertising and create awareness/ supply information about products
- Purchase and activities preliminary to purchase
- Identification of customers

## c) Pure Support and Other activities

- Provision of IT enable services, back end functions such as data processing, support services to front office functions, account reconciliation
- Remittance and Money transfer Services
- Basic Operations, Accounting and Financial Services
- Servicing patents or know-how contracts
- Invoicing and collection of claims

# Illustrations of activities which are NOT preparatory or auxiliary in nature

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## a) Sales Related

- Soliciting quotations, Procurement of orders, Fixing sale price, Conclusion of contracts, Activities which convert request for quotations into requests
- Follow up of payments from customers
- Negotiation of contracts/ sales and discussing every aspect of the contract
- After-Sales support services

## b) Administrative, management and other assistance

- Marketing, Advertising for other enterprises
- Management support services like call centre, Financial Shared Services and Data Entry, Software Development Services
- Supervision of testing and commissioning of equipment supplied
- Supply of spare parts and services to buyer of machinery supplied by enterprise

# Specific activity exemptions

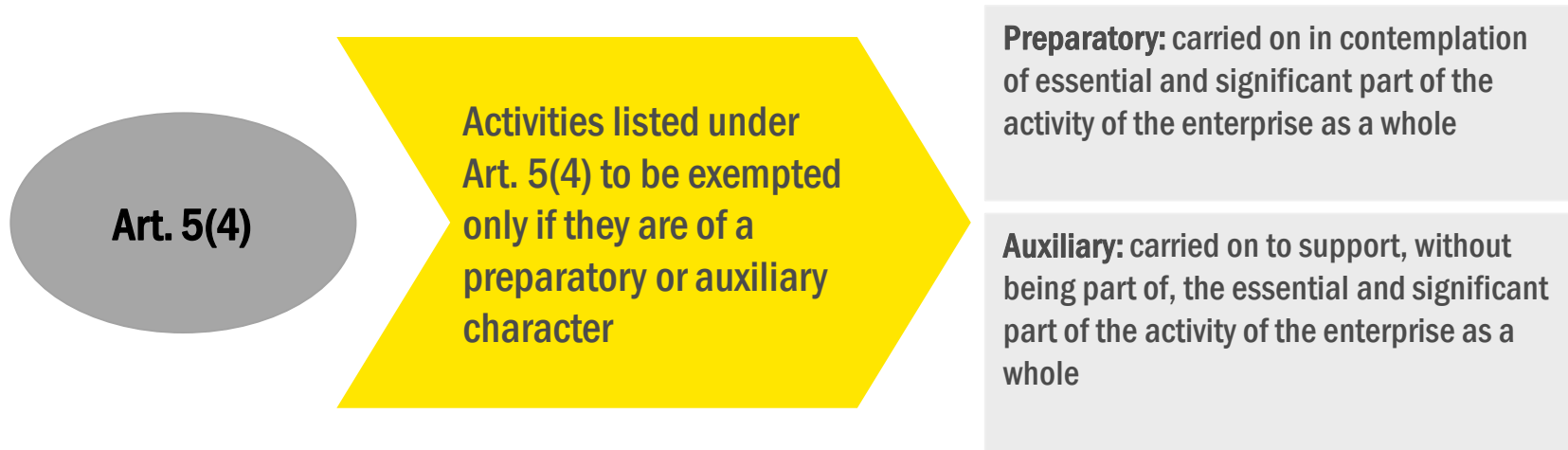
## Article 5(4) of OECD MTC – Framing the issue

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- Article 5(4) of the OECD Model Tax Convention allows an entity from state X to undertake specific exempted preparatory or auxiliary activities in state Y without creating a PE in state Y
- Why?
  - Preparatory or auxiliary activities were generally considered **non-value adding activities** and therefore little profit would be allocated thereto
- What is the OECD's concern?
  - Specific activity exemptions open to BEPS abuse - Activities performed in state Y may in fact be value-added for the taxpayer's business if
    - Delivery of goods, Purchasing of goods or collecting information is core function
    - Cohesive business activities are artificially fragmented
  - Profits that should be taxed in state Y are instead taxed in state X where the taxpayer is resident

# Proposed changes to Article 5(4)

- ▶ Modification to make all activities in Art. 5(4) subject to preparatory or auxiliary condition



- ▶ Activities are preparatory or auxiliary depending on whether or not the activity of the fixed place of business itself forms an essential and significant part of the activity of the enterprise as a whole
- ▶ Alternatively, OECD had proposed an option for States that consider the activities listed in subparagraphs a) to d) of paragraph 4 to be intrinsically preparatory or auxiliary and, therefore, should not be subject to that condition



# Specific activity exemption [Article 13]

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- Article 13 incorporates Action 7 changes to ‘specific activity exemptions’ given under Article 5(4) of the OECD MC providing a list of exceptions of PE status where a place of business is used solely for specifically listed activities
- Construct of Article 13

Article of MI	Provision
13(1)	Provides an option to choose either Option A as per Article 13(2) or Option B as per Article 13(3) or not to choose any
13(2)	Option A - PoA condition to qualify for Article 5(4) exclusion
13(3)	Option B - PoA condition not explicit to qualify for Article 5(4) exclusion
13(4)	Anti-fragmentation rule
13(5)	Compatibility Clause
13(6)	Reservations allowed Article 13
13(7)	Notifications required in respect of option chosen under Article 13(1)
13(8)	Notifications required in respect of 13(4)

# Specific activity exemption [Article 13]

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- Article 13(1) of MI provides three alternates to countries

<b>Option A</b>	Specific Activity exemption only if listed activities are PoA Nature
<b>Option B</b>	Automatic exemption to listed activities irrespective of same being PoA in nature
<b>Not to choose any option</b>	Provision as existing under CTAs will remain in force

- Both options (A and B) preserves the specific variant of listed activities under each CTA
  - Does not replace the list of exempt activities under each CTA (including treaties modelled after Article 5(4) of OECD MC 2014/ UN MC 2011)
  - Indian treaties have varied list of PE exclusion under each of its treaties

# Specific activity exemption [Article 13]

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- Under option B, PE exemption will apply irrespective of PoA character, countries may opt to add the anti-fragmentation rule to address concerns of BEPS
  - Anti-fragmentation rule **not** mandatory under MI
  - Action 7 Report indicated application of anti-fragmentation rule for countries adopting Option B
- Comparative of provisions under MI and Action 7 report are as below

Options	Options available as per MI	Action 7 proposal
<b>A</b>	PoA condition + Anti-fragmentation Rule (optional)	PoA condition
<b>B</b>	Automatic exemption to listed activities + Anti-fragmentation Rule (optional)	Automatic exemption + Anti-fragmentation Rule
<b>C</b>	None + Anti-fragmentation Rule (optional)	N.A.

# Specific activity exemption [Article 13]

- Since the measures are optional and work only on a symmetrical basis to modify CTAs, any of the above can apply only if both CJs to CTA make the “same” choice of option and/or anti-fragmentation rule

Scenario	Country X	Country Y	Both opt-in anti-fragmentation rule	Implementation in X-Y tax treaty
Same option chosen by both CJs	Option A	Option A	No	Option A replaces current provisions
	Option B	Option B	Yes	Option B + Anti-fragmentation rule replaces current provisions
Different options chosen by both CJs	Option A	Option B	Yes	Anti-fragmentation rule added to current provisions
	Option B	Option A	No	No change
No option chosen by both CJs	-	-	Yes	Anti-fragmentation rule added to current provisions
	-	-	No	No change

# India MLI final position on Article 13

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- **Under the MLI, India has opted for option A ie wherein PE exemption to listed activities under Article 5(4) shall be subject to activities being PoA in nature**
- **For Anti-fragment rule, India is silent, suggesting that the said anti-fragment rule will be applicable**

# High level impact analysis for key India Tax treaties

MLI Provision	India's final position	Australia	France	Japan	Netherlands	Russia	Singapore	UK
Article 13 – Specific Activity exemptions	Opted for option A – PE exemption to listed activities under Article 5(4) to be subject to activities being PoA in nature	✓	✗ <sup>1</sup>	✓	✓	✓	✗ <sup>2</sup>	✗ <sup>3</sup>
Anti-fragment rule	Silent suggesting that anti-fragment rule will be applicable	✓	✓	✓	✓	✓	✗	✓

✗ – India's final position to be incorporated in treaty

✓ – treaty provision to remain unchanged

1. Since France has chosen option B, there is mismatch

2. Since Singapore has chosen option B, there is mismatch

3. UK has chosen neither of the options, hence there is mismatch

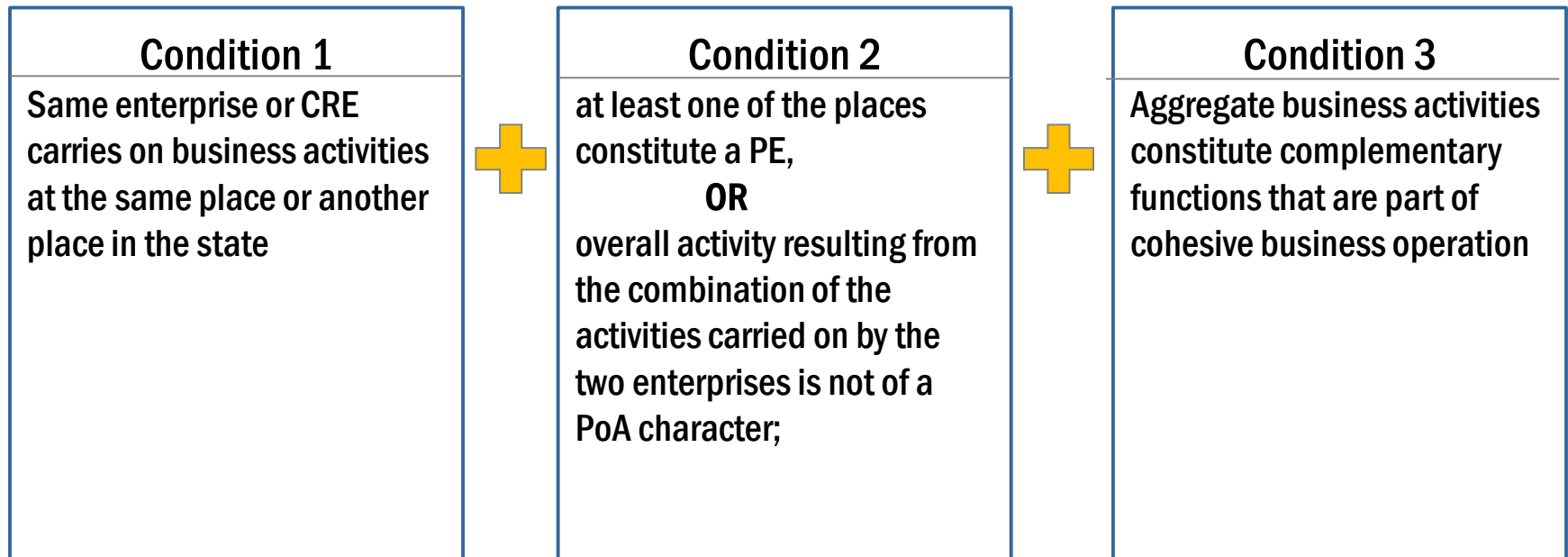
# Fragmentation of activities – Background

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- OECD commentary proposed safeguard measures against fragmentation of PE activities into preparatory or auxiliary by an enterprise in source state
  - No fragmentation of cohesive operating business into small operations
  - PE analysis for each place of business of enterprise separately if these are separated from each other ‘locally & organizationally’
  - Place are not ‘organizationally separate’ if they perform complimentary functions
    - Eg – receiving and storing goods in one place, distributing those through another
- BEPS Action 7 recommended to extend the analysis to activities carried on by ‘closely related enterprises’ at different place or same place
- Codified anti fragment rules as part of amendment to Article 5(4)
- **Some of the India’s tax treaties already contain a specific provision in Article 5(4) comparable to anti-fragmentation rule**
  - **India’s treaty with UK, Norway, Australia, Singapore etc, provide that 5(4) exemption will not be available if the foreign entity maintains any other fixed place of business in the source state**
  - **No Indian DTAA deals with fragmentation of activity with CRE / AE**

# New Anti-fragmentation Rule - Article 13(4)

- ▶ Anti-fragmentation provision covers situations where the combined activities of closely related persons at the same place or different places in the same country exceed what is considered to be preparatory or auxiliary
- ▶ Optional for parties to adopt, Article 13(4) may apply even if option A or B are not chosen
- ▶ Specific activity exemption under Article 13(2) and 13(3) not available where:





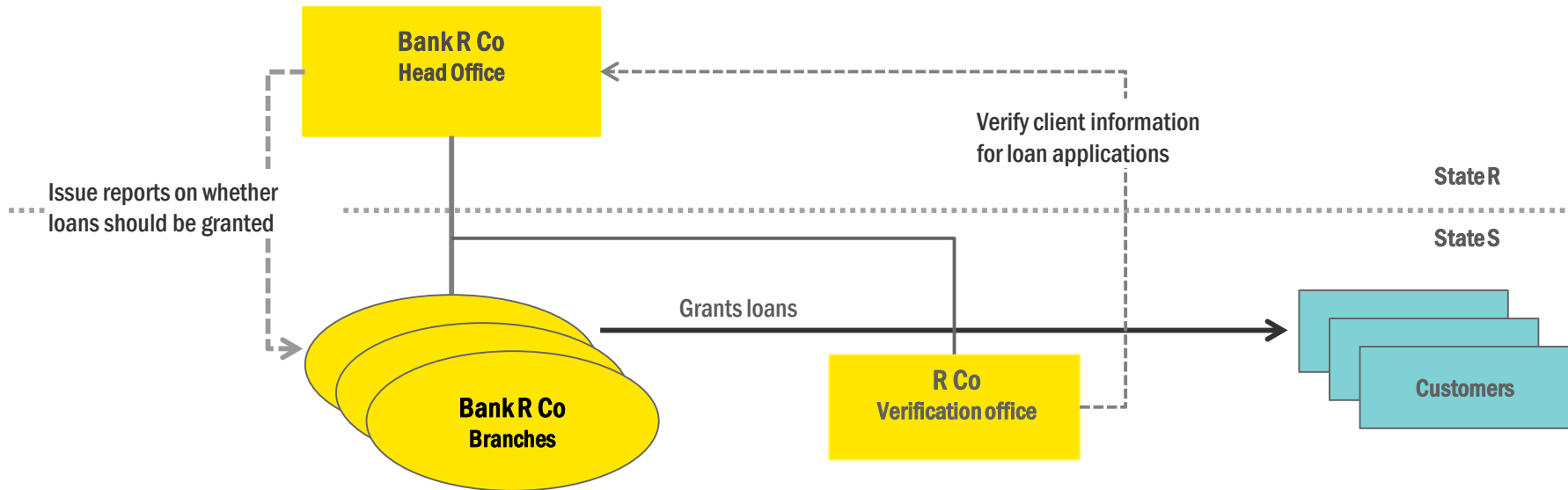
# Article 15 – Definition of CREs

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- **Article 15(1)- defines CRE with respect to control / beneficial holding ie commonly controlled entities with threshold of 50% voting / beneficial interest / equity interest**
- **In line with Action plan 7 report, except –**
  - **Reference given to relevant provisions of MLI instead of Article 5 of OECD MC**
- **Applicable for the purpose of**
  - **Article 12(2) of MLI – Provisions relating to Independent agent**
  - **Article 13(4) of MLI – Anti fragmentation rules**
  - **Article 14(1) of MLI – Automatic aggregation rule for evaluating PE threshold**
- **Parties can opt out of Article 15 only if reservations are made in the above articles**

# New Anti-fragmentation Rule - Article 5(4.1)

- ▶ Facts below would create a PE under new Article 5(4.1)



- ▶ The business activities carried on by Bank R Co at its branches and verification office constitute complementary functions that are part of a cohesive business operation (i.e., the granting of loans to customers)
- ▶ Hence, the verification office cannot make use of the specific activity exemption on the grounds that the verification activities are of a preparatory or auxiliary character

# Specific activity exemptions and Anti Fragmentation Rule

## Relevance in Indian context

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Each case to be separately examined based on facts to determine whether enterprise qualifies for PE exemption in view of narrowed scope of article

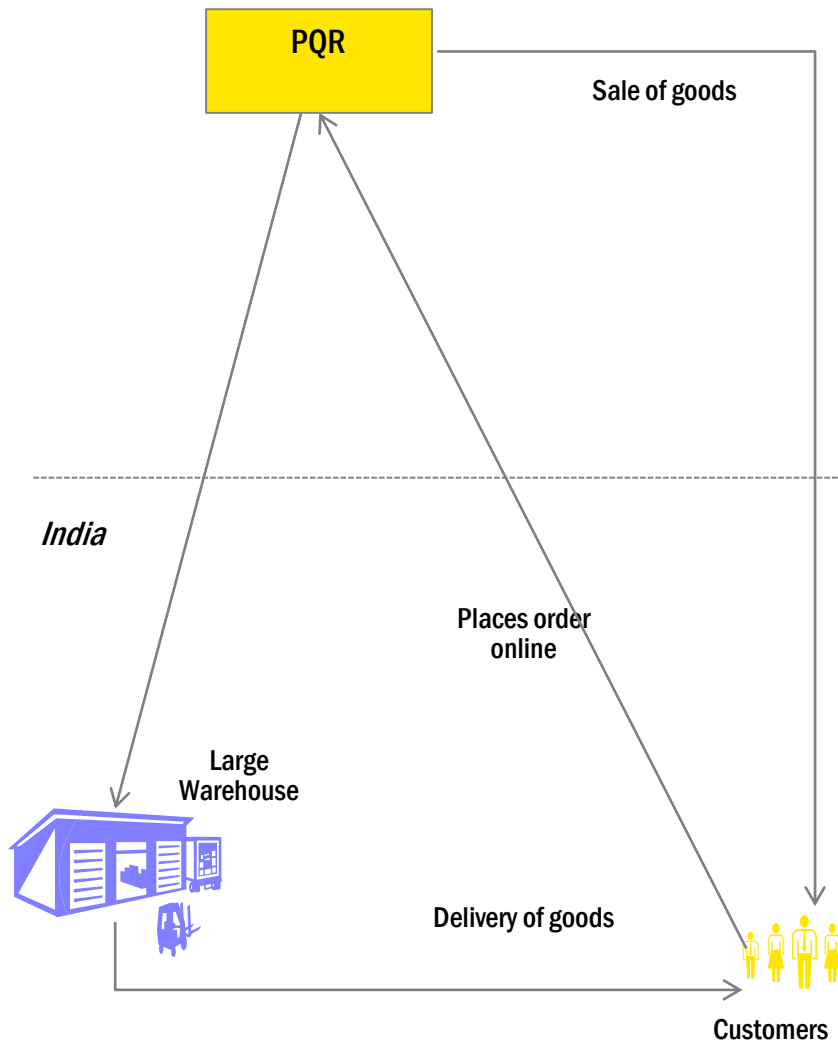
Preparatory and auxiliary judicially interpreted; Some principles already part of Indian jurisprudence

**Functions of LO** Proposed tightening of conditions relating to prep and aux activities, coupled with anti-fragmentation rule may involve greater scrutiny from the Revenue authorities

**Spurt of e-commerce in India:** Functions such as warehousing, display, delivery, and supply chain model may not be considered as 'prep or aux'

# Case studies

# Case Study 1



## Facts

- ❑ PQR is an online selling company.
- ❑ It maintains a large warehouse in India involving a significant number of employees who work for the main purpose of storing and delivering the goods.

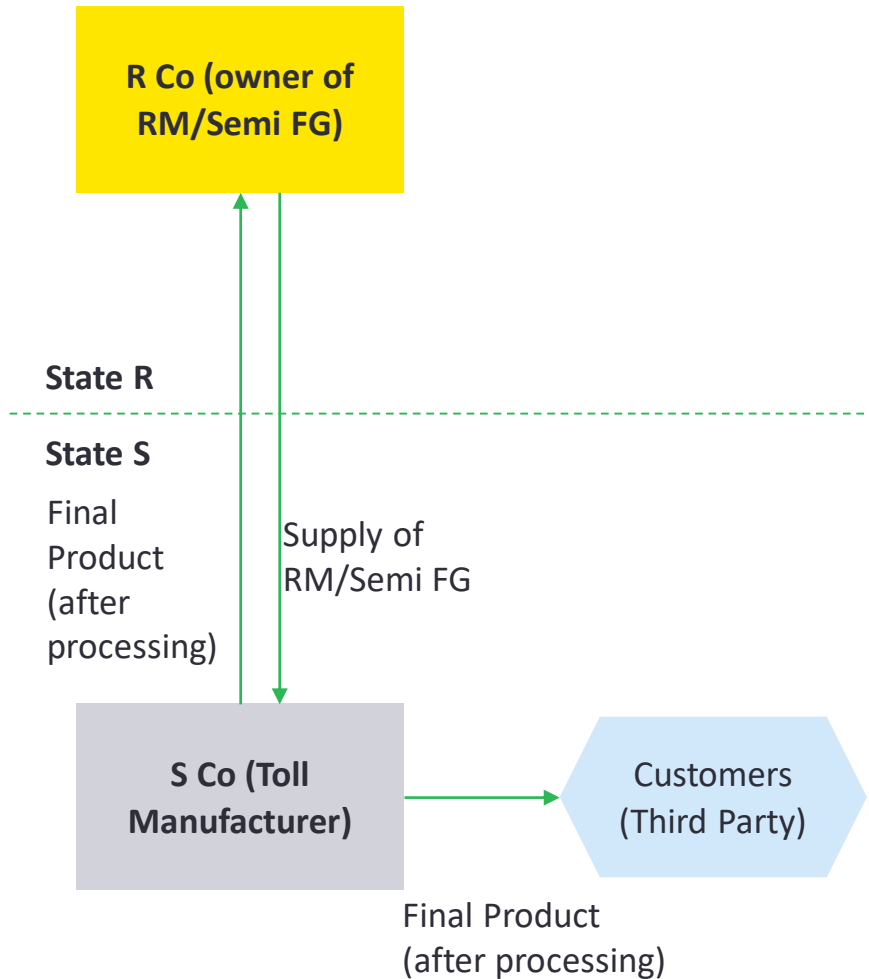
## Implication under current provisions

- ❑ Treaty between India and Country A based on OECD MC (eg Austria, Belarus, Germany)
- ❑ Storage function exempt under 5(4)(a)

## Implications under proposed provisions

- ❑ Whether P&A in nature under proposed provision of article 5(4)?
- ❑ Activities carried out at warehouse will not qualify as P/A activity, since:
  - ❖ Warehouse represents an important asset and requires a number of employees
  - ❖ Constitutes an essential part of sales and distribution function of PQR
- ❑ What if warehousing services were provided by an independent party?

# Case Study 2



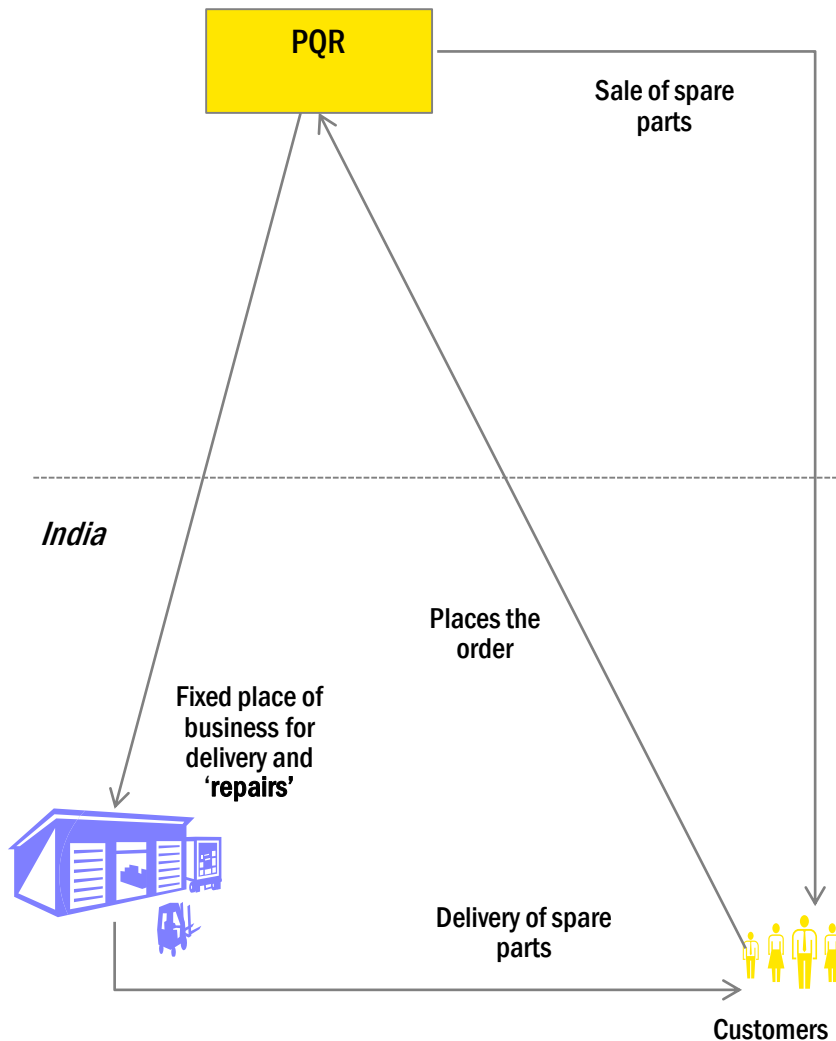
## Facts

- ❑ Arrangement in which a company (which has a specialized equipment and workforce) processes raw materials or semi-finished goods for another company
- ❑ Raw materials/semi-finished goods are supplied by the principal to the toll manufacturer
- ❑ Principal remains the owner of the raw materials/semi-finished goods
- ❑ After processing, the final product is either sent back to the principal or sold to third party on behalf of the principal
- ❑ Toll manufacturer receives a fee for his services

## Analysis

- ❑ R Co has no fixed place at its disposal – test of disposition not satisfied - No PE in State S
- ❑ If R Co is allowed unlimited access to separate parts of facilities (inspection etc), it needs to be examined whether it would fall under Pep & Aux activities
- ❑ If R Co acts as a distributor of products of other enterprises; The activity of mere maintenance of stock of goods belonging to an enterprise for processing by another enterprise would not form an essential and significant part of the activity of the distributor

# Case Study 3



## Facts

- ❑ PQR is a manufacturer of spare parts.
- ❑ It maintains a fixed place of business in India for the main purpose of delivering the goods and undertaking repairs

## Implication under current provisions

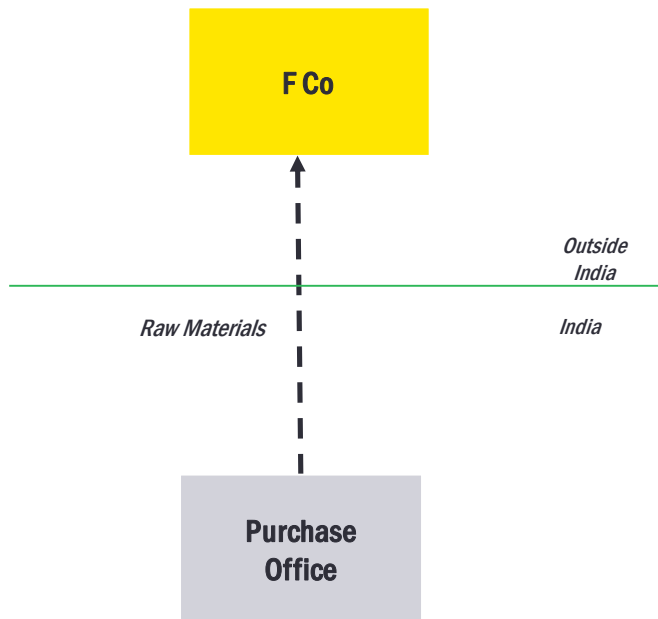
- ❑ Treaty between India and Country A based on OECD MC (eg Austria, Belarus, Germany)
- ❑ Delivery function exempt under 5(4)(a)

## Implications under proposed provisions

- ❑ Whether P&A in nature under proposed provision of article 5(4)?
- ❑ Activities carried out at the fixed place of business will not qualify as P/A activity, since 'repair' function is undertaken in addition to delivery of spare parts to customers

# Case Study 4

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## Facts

- ❑ F Co is a company engaged in the manufacture of textiles
- ❑ F Co has a purchase office in India which purchases the raw material from India required by F Co
- ❑ The employees who work at purchase office have special knowledge of the product and visit producers in India to determine the type/quality of the products according to international standards.

## Implication under current provisions

- ❑ Purchase activity exempt under most of Indian DTAA's

## Implication under proposed provisions

- ❑ Scope of purchase exclusion diluted significantly
- ❑ No exemption if purchase represents core function
- ❑ Purchase office likely to constitute a PE in India as it constitutes an essential function for F Co.



**Thank you**