Essay on International Taxation - Permanent Establishment

**INTERNATIONAL TAXATION** is the study or determination of tax on a person or business subject to the tax laws of different countries or the international aspects of an individual country’s tax laws.

Taxation in cross-border situation is influenced by a number of interrelated factors. This can be well understood from the following conceptual map of the international tax environment.

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**INTERNATIONAL ARENA** – OECD Model OR UN Model OR Case Law OR Literature

**INTERNATIONAL AGREEMENTS** – Bilateral Treaties (treaty between two different states viz. X-Y Treaty / State Y-Z Treaty / State Z-X Treaty OR Tax Information Exchange Agreement (between two or more states)

**DOMESTIC TAX LAW** – State X Domestic Law / State Y Domestic Law / State Z Domestic Law

The above conceptual map consists of three levels. The **first level** is the one where the domestic law of individual states designs their own tax system on the basis of which it imposes taxation. It is the same first level where the issues concerning taxation of cross border income and capital arises. This is where the **Second & the Third level** in our above conceptual map comes into picture. It attempts to resolve the issues popped up in the very first level. Tax treaties in the **Second level** is an important element in finding solutions to the issues created. Treaties between two states are concluded to bring about a balanced allocation of taxing rights between the concerned states thereby preventing double taxation or non taxation of income or capital. The **Third & Final level** covers International Organizations that deal with tax law, & the International Community of specialists in the field who produce an extensive body of literature.

**Introduction to Permanent Establishment (PE)**

**Existence of the PE Concept**

Due to increasing globalization, it has become common for a *business enterprise* resident in one state to *carry out business activities outside its state of residence*. This is normally done in the following two important ways:

1. Business enterprises may either *establish* a new business or *take up an existing one* outside the state of residence. Here it *forms a new separate legal person* who would be responsible for its own tax liability on its profits.

2. Business enterprises decides to carry on activities *on its own* in the other state either by opening a sales office in other State and sending his sales staff to work over there or employing new staff in that region OR equally by having a production facility built up in the other State and employing staff to work over there without establishing a new subsidiary.
Here it does not form a new separate legal person and hence would not be responsible for its own tax liability on its profits.

Where Business Enterprises carries out business activities in the way mentioned in (2) above, PE concept comes into existence.

The same can be true in the case of Individual Entrepreneurs carrying on business activities in other States.

**Importance of the PE Concept**

The speciality about the PE concept is that there is only one person responsible for paying taxes in respect of business carried out in more than one state. It is very important here for the jurisdiction to know whether Resident state or Source state has a right to tax and collect revenue from the income generated by a person carrying out business activities in more than one state. Also it becomes equally important for the person carrying on business to know where to pay tax and where to file the return.

**Role of the PE Concept**

Domestic laws of different states adopt different approaches to constitute threshold level for the taxation of business activities carried on by nonresident enterprises. Many states such as Netherlands and Germany uses PE concept whereas states like US uses conduct of business concept and India is having Business Connection as its threshold level. However, this threshold level is flexible i.e. state can switch from one concept to another like UK which switched from the concept of carrying on trade through branch or agency to PE concept threshold level.

According to the domestic law, the taxation of business profits of non-residents in India is kicked off with a business connection in India. The inference of business connection in India as per the Income Tax Act is quite wide and would lead to deeming the Income ‘to accrue or arise’ for the foreign enterprise in India. The existence of PE in India neither means that there is business connection for the foreign enterprise in India nor that there is Income deemed to accrue or arise in India. PE in India would mean an outcrop of the foreign enterprise in India and is specifically defined in the Double Taxation Avoidance Agreements (DTAA). Article 7 of the DTAA stipulates that only the profits directly or indirectly attributable to the PE in India would be taxed in India. Hence the PE that generates income with a business connection in India will be taxable in India. The PE of the foreign enterprise in India may use its assets and resources to earn income both in India and outside India, but only the segment of Income that relates to the business connection in India is taxed. In the absence of business connection in India, the PE would just be a taxable entity and not a tax paying entity.

Absence of any treaty between the states – resident and source, where business activities are carried out by a resident enterprise, would create a situation of either double taxation or non-taxation. Treaty says that the profit derived from carrying out business activities in one state is to be taxed in that state only. However, it also says that profits derived from carrying out business activities through a PE in other state can be taxed by that other state also but only to the extent of the profit attributable to that PE. On the other hand, it also says that where the other state taxes the profits attributable to the PE, the resident state of enterprise is to provide tax relief under Article 23 for the taxes paid in the other state. The following diagram will make the picture clearer.
**Definition of Permanent Establishment**

As per Article 5 – paragraph 1 of the OECD Model, the term ‘Permanent Establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried out.

The definition incorporates six basic elements for an enterprise to be termed as PE which are as follows:-

1. **Place of Business:**
   
   Place should be a tangible one say an office premises or a stall in a market i.e. an open space or any piece of equipment say vending machine. However, business not carried on through any specific place does not constitute a PE say business carried on through a cell.

2. **At the Disposal of the Enterprise:**

   The enterprise should have some control over the place of business from where the business activities are carried on. It is not necessary that the place should be rented or owned. Even space factually available to the enterprise would be sufficient enough to meet this basic element say vacancy of a room by a client company to allow the enterprise to send its staff and carry out activities over there. Even illegal occupation of the place would meet the basic element as long as the enterprise have some control over the space. However, mere
presence of the enterprise staff at a particular place does not meet the basic condition of PE say enterprise staff occupying clients metting room for discussing business proposal as the enterprise does not have enough control over that space.

3. **Fixed (Geographically):**

Place of Business should be fixed geographically. Places which are attached to earth say office building or factory or any heavy machinery meet this criterion. However, what about the one which is not fixed to earth but can be moved around i.e. is movable in nature say person setting his stall in a market place at different places every day?? In this case, as discussed in point (1) above, since market stall is capable of constituting a PE it does constitute a fixed place geographically. Now, suppose if the same person sets his stall in two different market place, what would be the answer to that – will it constitute one or two fixed places? The answer to that depends whether the location/s under review constitutes a coherent whole commercially and geographically with respect to that business. To clarify the point let us take a simple example of a painter undertaking contract to paint the offices of two clients coincidentally having their offices in the same building. Here, even though both the contracts are carried out at the same place i.e. there is a geographical coherence; they do not constitute commercial coherence and therefore each contract to be considered separately to come to the conclusion whether a PE is created by the painting work or not.

4. **Fixed (Permanence):**

Fixed place discussed in point (3) above deals with physical aspect whereas the one to be discussed in point (4) deals with temporal (of time) aspect of the word fixed. Permanence is normally measured by a six month period in practice but however there is no hard and fast rule for the same. Even commentaries are not consistent in this respect. This element is in fact decided on case-to-case basis and hence faces many interpretation issues which can be well understood with the help of the following few illustration/s:

a) CCo, a computer company, enters into a contract to redesign the entire computer system of one of his client. The contract work was estimated to get completed within 4 months. Over here the concerned client gives the entire room at the disposal of the CCo’s staff for carrying out the assigned work. However, due to complications involved, CCo was able to complete the contract within 7 months period. Now, since as per the commentaries actual period spent should be taken into account for the purpose of determining PE, in the given situation the room at the disposal of CCo would constitute PE retrospectively i.e. from the very beginning.

b) Mrs. F, a fashion designer, enters into a long term leave & license agreement of a shop in another state. However, due to non popularity of her designs in another state, she close downs her business within 4 months period. In the given case, since the intention at the time of starting the business in another state i.e. at initial stage was to run the shop for long term, as per the commentaries the shop becomes fixed
in temporal sense and hence PE is created even though Mrs. F runs the shop for a short period of only 4 months.

c) ACo, a firm of auditors, audit books of a client on a quarterly basis. At the end of each quarter, the concerned client makes available a room to carry out the audit work. ACo continues to audit books for a long period of time i.e. it constitutes recurrent activities. As the activities are of recurrent nature, the room used to carry out the audit work does have some durability factor in it and hence constitute a PE.

d) Mr. B, an individual, just with an intention to make more money, buys stock of clothes from a shop which is closed down and sells the same, during a festive season, from a rented stall in a market in another state. Even though in the given situation the business is of a short term nature, as per the commentaries it does create a PE as it constitutes a one-off business venture.

Thus, it is very clear from the above discussed illustration/s that certain permanency is necessary for a fixed place to create a PE. Hence, it becomes very easy for a company to avoid creating PE by splitting up their activities into many segments say by forming more than one subsidiary in such a way that each subsidiary actively carries on business for a period which is less than that required to create a PE. However, the domestic law of source state may have an anti abuse provisions against taxpayers who split up their activities in the way mentioned hereby. In such a situation, the commentary says that the same approach could be by the source state for tax treaty purpose. As a result of this provision the aggregate of period taken by each subsidiary would be taken into account for determining the PE status and each subsidiary would have its own PE in the source state.

5. Business carried on:

MCo, a manufacturing company, in State R manufactures goods at a factory situated in State S. Now, suppose if the manufacturing process stops permanently MCo still has the factory place at its disposal but no business is carried on through that fixed place and therefore MCo has no longer a PE in State S.

It is therefore very important to know at which point PE comes into existence and at which point it ceases to exist. Let us understand this by means of an example:

An individual entrepreneur, dealing in fruits and vegetables in State R decides to open a shop in State S.
At which point do you think that the shopkeeper has a PE in State S??

In the above example, PE comes into existence when the enterprise starts carrying on the business. It is very important here to have a clear distinction between Setting up of the place of business and Preparation for the business activities to be carried on there. As per the commentaries, Setting up of the place of business does not fall under business activities constituting PE whereas Preparation for the business activities do form part of the business activities forming PE. Hence in the given situation, PE does not come into existence unless and until the shopkeeper starts preparing for the business activities i.e. he starts deciding about the product/s and its prices. However, there is no hard and fast rule that is followed for the same as in the discussed case some can argue that the PE come into existence only when the shopkeeper starts to serve the customer/s.

At which point do you think that the shopkeeper no longer has a PE in State S??

In the above illustration, PE ceases to exist either on the disposal of the fixed place or when the business activities are no longer carried on through that fixed place, including winding
up of the business transaction and closing down of the fixed place. Hence, in the discussed situation PE ceases to exist when the shop is abandoned after all the winding up and cleaning including final repairs of the shop is done with.

It is to be noted here that the point where PE ceases to exist is not exactly the opposite of the point where PE comes into existence. PE ceases to exist when all the activities related to PE are terminated whereas PE does not come into existence by itself from the very point of the setting up of a place of business. Thus, it can be seen from the discussion that no distinction has been made between the regular business activities and the activities related to the structure of the fixed place when it comes to deciding at what moment PE ceases to exist.

Now suppose the shopkeeper, in the above given situation, after carrying on the business activities in the shop for a period of 4 months stops the activities for a period of 3 months due to uncontrolled circumstances and again restart the activities. After restarting the activities for a period of 3 months the shopkeeper feels that the business is not yielding enough profit and decides to close down the business. Over here, how can one determine the period during which the activities are carried on through the shop?? Is the 4 months and 3 months period, during which the shop was open, being seen separately?? Or Are the 4 months and 3 months period of business activities to be added together?? Or simply, are all the 3 periods i.e. 4 months, 3 months and 3 months be taken together?? The answer to our question is that the aggregate 10 months period constitutes PE, as the closure of business activities for a period of 3 months is just a temporary one and which does not stop the existence of PE.

Also, business activities carried on through a fixed place with very little human intervention do constitute a PE say for example gaming business carried on through machines.

6. Through:

The usage of the word “Through” in the definition of the PE makes it very clear that the place, where the business activities are to be carried on, do create a PE even though that place is used only as a base i.e. work is not actually carried on by sitting in the office premises. Say for example: the opening of sales office in State S, wherein salespersons are
employed to visit customers personally and deal with them on one-to-one basis. Over here there may be instances where the sales office may be empty for days together as they are often roaming around visiting customers.

The basic definition and their six basic elements discussed above are often known as Basic Rule PE or Physical PE, as it requires some tangible presence.

In addition to the above discussed basic definition of PE, as per Article 5 – paragraph 2, the term “Permanent Establishment” also includes specifically a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. However, one must note that the requirements as specified in paragraph 1 must be met.

**Scope of PE Allocation Rule**

The PE concept is very crucial in determining the allocation of taxing rights over the profits of the enterprise in many cross-broader situations. However, Article 7(4) of the OECD Model says that where profits includes items of income which are dealt with separately in other Articles, then the provisions of those Articles shall not be affected by the provisions of this Article.

**Exclusions:** The following illustrative diagram will make the picture clearer:

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  Residence State               Source State
  Person A                      Rent
                                  Art.6
      Taxable with               Taxable - no limit
      Double Tax Relief          on amount of Tax

  Person A                      Appearance
                                  fee
      Taxable with               Art.17
      Taxable - no limit
      Double Tax Relief          on amount of Tax

  Effective Management
      Taxable - no
      Art.8
      Not Taxable
      Double Tax Relief necessary

Immovable Property

Independent Artist or Sportsman

Operation of Ships / Aircraft
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PERMANENT ESTABLISHMENT - BY PRAGNA PATEL
Types of Permanent Establishment

Various Types of PE are as follows:

1. Basic Rule PE or Physical PE
2. Construction Project PE
3. Services PE
4. Agency PE
5. Special Cases
6. Exceptions

1. Basic Rule or Physical PE:

As discussed above under the definition of PE.

2. Construction Project PE:

Paragraph 3 of Article 5 of OECD Model deals specifically with construction project PE. It states that a building or installation project constitutes a PE only if last more than twelve months. The word “only” is very important as it gives more clarity. It means that even if all the basic requirements to create a PE is met by a project but lasts for less than 12 months PE does not comes into existence. However, a common administrative office in State S, used by more than one project - each project lasting for a period of less than 12 months and being carried on in State S; do constitute a PE by virtue of a basic/physical rule concept. Over here each project has to be considered separately for PE purpose as it is carried on at different sites.

As can be seen that the provision stated above specifically lists construction project, building project and installation project but nowhere the terms are defined. Hence, it becomes necessary to know what all types of projects are covered. The examples given in the OECD commentary suggest that the intention of this provision is to cover structural work on a building whereas mere maintenance and redecoration are explicitly excluded. Accordingly, laying a foundation for a new building gets covered whereas replacing the roof tiles on a building does not get covered at all. However, replacing an entire roof of a building gets probably covered as renovation of a building is covered as per the commentary. Also, replacing the entire roof would probably fall more on the side of construction rather than maintenance. Moreover, the projects covered under Art. 5(3) do not have to be connected with a building. Other structural projects are also covered. Accordingly, laying a pipe gets covered whereas fixing garden tables to the terrace of a café do not get covered. Further whether painting a bridge gets covered or not depends on the details of the project. Again there is an implicit requirement that the installation project concerns something tangible and that is substantial. Accordingly, installing a piece of heavy machinery in a factory gets covered whereas installing new intranet software in an office does not get covered. Finally, the scope is expanded by stating that activities relating to excavation and dredging having a structural nature also gets covered under this article. Even assembly of offshore oil or gas
platform gets covered; however, manufacturing does not get covered. Also, on-site planning and supervision of the erection of a building are also covered by paragraph 3.

Another important aspect is how to identify a single project in order to apply the 12 months threshold. As per the commentary, the nature of some construction project is such that they are relocated from time to time or even sometimes continuously, say for example the construction of a road. In such cases it does not matter that the workforce is not for 12 months at a particular location. Also, building site which forms a coherent whole commercially and geographically do constitute a single project.

Once a single construction project is identified, one has to decide whether it exceeds the 12-month threshold. To do this, one has to very well understand various timing issues such as the start and the end point of the project. Also, one has to know how the interruption is to be dealt with. As per the guidelines given in the commentaries, the calculation of the 12-month period starts from the point the contractor begins to carry out the project. This also includes preparatory activities such as preparing the location, installing a planning office etc.; which is unlike the Basic rule PE where preparatory activities are not considered. The calculation continues until the work is completed or permanently abandoned. Temporary interruptions do not stop the counting of the days.

Above discussion was based on the assumption that there’s only a single contractor who performs all the work by itself. So now, what will be the position if a project is partly carried on by a subcontractor or more than one subcontractor? Over here the time spent by the subcontractor/s on the project would be taken into account while calculating the time spent by the main contractor.

Timing issues are also raised by partnerships. Some States treat partnership as transparent for tax purpose i.e. they impose tax on each partner on its/his share of profits derived from partnership firm rather than taxing the partnership firm as a separate taxpayer. In such situation, the sum total of time spent by each partners on the project is to be taken into account while calculating the 12 month threshold. However, since it is the partners who are taxable, once the project exceeds the 12 month threshold each of the partners is treated as having a PE in the source state, even though when looked separately none of the partners have spent more than 12 months in the source state.

Whatever was discussed above was as per OECD Model. Let’s now have a look at the UN model approach, as it is a little different. Paragraph 3(a) of Art.5 of the UN Model says that a building site, a construction, assembly or installation project or supervisory activities in connection therewith constitutes a PE, but only if such site, project or activities last more than six months. Thus it can be seen that the provision in UN model is much wider than the OECD model in two respects. First of all it explicitly includes assembly project and supervisory activities and secondly it stipulates a lower time threshold of only 6 months thereby attributing more of the taxing rights to the source state.
India does not agree with the words “the 12 month test applies to each individual site or project”. It considers that a series of consecutive short term sites or projects operated by a contractor would give rise to the existence of a PE in the country concerned India has reserved its right to replace construction or installation project with construction, installation or assembly project or supervisory activities in connection therewith and reserves its right to negotiate the period of time for which they should last to be regarded as a PE.

3. Service PE:

As stated above, an enterprise can be carried on by either a company or an individual. The said sentence is particularly important to keep in mind while talking about the service sector.

Suppose CCo, an enterprise specialist in providing advice on organizational structures in State R, enters into a contract with BCo in State S.

Now, if all the information needed is sent by BCo via mail or post and similarly all advice in the form of a report is given by CCo via mail or post, no PE comes into existence as the basic requirement of fixed place by the basic definition of PE is not met.

But if CCo opens a branch office in State S and writes the report for BCo in that branch office, it becomes clear that CCo do have a PE in State S, provided all basic elements of PE definition is met by the branch office.

Suppose CCo does not its own office in State S but regularly uses a room in BCo’s office to do the work, what would be the position? The same issue is discussed in a Canadian case, the Dudney case. This Canadian case concerned an individual computer consultant, Dudney, resident in the US, who provided training for the employees of his client company in Canada, and was allowed to use rooms in the client company’s office building in order to do so. One of the issues addressed in this case was whether the client’s offices constituted a fixed place of business at the disposal of the consultant? The court considered various aspects of the arrangements between Dudney and the client, and concluded that the rooms in the client’s office were not at the disposal of Dudney.

Say if CCo is always on the move, what would be the answer? Over here the itinerant nature of the business says nothing except about their profitability nor is it necessarily a good indicator of the level of engagement with any particular state. Although CCo, who is running from one business meeting to another, has no fixed place of business in State S but since all its meetings are in State S it may well carry on a substantial portion of its business in State S. In such a situation many States, in the position of State S, wish to be able to tax the CCo on the profit made from the activities there. It is this situation, in which services are not rendered through a fixed place of business and the Dudney situation, that are the focus of most treaty provisions on service PEs.
The OECD Model does not deal explicitly with the issue of service providers in the context of the PE definition. However, the text of a specific provision on this issue can be found added to the commentary for those states that wish to use it. OECD Commentary on Art. 5 paragraph 42.23 says that an enterprise is deemed to have a PE in a state where it renders services in situations defined in subparagraphs (a) and (b) i.e. the services enterprise becomes taxable in a state even though it does not actually have any fixed place of business there. This optional provision on services PEs applies as an alternative to the paragraph 3 on the construction project PEs, whereby construction services lasting for less than 12 months do create a services PE as it falls within subparagraph (a) or (b) of the optional provision. The optional provision even includes an exception for preparatory and auxiliary activities i.e. activities which are not an essential or significant part of the business of the enterprise.

First condition in subparagraph (a) of the optional provision on services PE focuses on an enterprise that performs services through a specific individual. In order to create a PE, the individual must be present in the source state for an aggregate exceeding 183 days in any 12 month period. The same method of counting days is to be used as in case of Art. 15(2)(b). Also, to be noted that the 12 month period does not apply to a separate project or assignment but as a whole i.e. to say that even days of holidays spent in that other state would form part of the 12 month period.

Second condition in subparagraph (a) is that more than 50% of the gross revenues from active business activities of the enterprise are derived from the service performed by that individual. The application of this part, however, tends to limits itself to individual entrepreneurs, partners of partnership firm and small companies with a limited number of staff.

Large enterprises are more likely to fall well within subparagraph (b), which also relies on a time period. The time period in subparagraph (b) applies to separate projects or groups of connected projects, not to the aggregate days of presence of one individual. It looks only at working days spent carrying out the service activity as compared to subparagraph (a) where other days of presence of the individual is also looked into. Also the importance of the project to the gross revenue of the enterprise is not there. It is also clarified by the commentary that standby periods are included in the count of working days if these are charged to the customer. In case of deemed service PEs, there is a single project or the projects are connected if they are coherent commercially.

As a general principal, the days of activity of the subcontractor is not counted when deciding whether main service provider has a deemed PE in other State. But the answer is different if main service provider supervises the subcontractor staff, or gives them direction or controls the manner in which they do their work.

The UN model on the other hand includes a special provision on service PEs. The text of this provision corresponds to a large extent with subparagraph (b) of the optional article of service PEs included in the OECD Commentary. However, UN Model has no provision on subcontracting but it contains Art.14 on Independent personal services. Subparagraph (b) of
Art.14 has some similarities with subparagraph (a) of the optional services provision. The differences concern the persons covered and the absence of any criterion related to the revenue derived from performing services in the other state.

STEWARDSHIP services are rendered to protect the interest of the customer. Principal Stewards are typically not involved in the day-to-day management or in rendering the services undertaken by the service provider. Their function is essentially of quality control and ensuring confidentiality. Usually, the foreign enterprise does not receive fees from the recipient of such services and the costs of the personnel performing these services are also borne by the foreign enterprise. Given the above, stewardship activities do not lead to the constitution of a service PE.

4. Agency PE:

Agency PE recognizes that an enterprise can also have a substantial business engagement in a state even though it has no fixed place in a state and hence it is generally said that an enterprise is “deemed” to have a PE in this case.

Agents are persons who act on behalf of another person, referred to as the principal. In common usage agency is a very general term but in legal usage the term means very different things in different jurisdictions.

Here it is very important to know the difference between dependent and independent agents. The activity of a dependent agent is regarded as activity carried on by the principal and therefore the agent is capable of creating a PE for his principal. This is the case if the agent has a sufficient level of authority and his activity is carried on with a certain degree of permanence. The concept of dependence in this respect implies that the agent is acting as an extension of the principal rather than carrying on his business. Independent agent, by contrast, are not regarded as carrying on an activity belonging to the principal but only as providing a service to the principal. Here the principal is regarded only as buying a service and hence does not have a PE in the state where the agent is active.

Paragraph 5 and 6 of Art 5 deals with these two different types of agency. As per paragraph 5, a number of elements are required in order to find a dependent agency PE. The first element is that the agent must be a person – an individual or a company or a body of persons such as a partnership, the members whereby could also be companies or individuals. There is also no condition about the residence of the agent i.e. the dependent agent need not be resident in the state where they act on behalf of the enterprise. The second element is that the person or agent should act in the interest of, or for the benefit of, the enterprise that is the principal. However, simply acting is not enough to create a PE, there must be authority to conclude contract. This authority does not have to be a general one. Also, authority could be granted in a formal agreement or informally. An informal authority may appear from the facts, especially if the principal is not actively involved in the contract making process. Moreover, contract should be concluded in the name of the enterprise. In this respect we often make a distinction between direct and indirect
representation. **Direct representation** refers to an agent that acts in the name of the principal whereas **indirect representation** refers to an agent that acts in his own name. In **common law legal systems** a properly authorized agent can generally bind the principal in both situations whereas in **civil law systems** the agent can generally bind the principal only in the case of direct representation. Further we have to see whether the agent **habitually exercises that authority**. This requirement is the equivalent of the permanence requirement in the case of the physical PE. It ensures that an enterprise does not become taxable in a state just because it has an incidental engagement with that state. However, there is **no hard and fast rule** for determining what constitutes a habitual exercise of the agent’s authority. It depends on the nature of the business. Also, activities of a **preparatory and auxiliary nature** i.e. one which are not an essential or significant part of the business of the enterprise are excluded from the agency PE concept.

It is to be noted here that the **definition of a dependent agent PE acts as a threshold only**, once the threshold has been passed i.e. once a person is considered to act as a dependent agent for the enterprise, all the activities carried out by the agent are taxable in the PE state.

Let’s now look at the exclusion of independent agents in **paragraph 6 of Art 5**. Paragraph 6 states the core feature of this exclusion, in the words “agent of an independent nature” i.e. one acting on his own account. It goes on to add that the agent must be acting in the **ordinary course of his business**. In other words, it is not enough for the agent simply to be a commission agent; this paragraph applies only when the agent is acting in his capacity of commission agent. For example, a commission agent sells diaries, calendars and year planners in State S for a number of principals. He could also step outside of that role, and assist one of his principals with the negotiations for the sale of some printing machinery in State S. This help with the negotiation is clearly not part of the regular business of a commission agent and this part of the agent’s work is not covered by paragraph 6. A separate determination would have to be made of whether this activity does create a PE for this one principal.

Paragraph 6 applies only to agents who are independent, and the OECD commentary states that this means **independence in both a legal and an economic sense**. **Legal independence** means that the agent is not subject to detailed instructions or comprehensive control by the principal i.e. he is legally responsible for the results of his own work. Detailed reporting to the principal is not, of itself, a bar to independence. **Economic independence** depends on the facts and circumstances of each case. The most important aspects are whether the agent’s reward depends on his own entrepreneurial skills and knowledge, and whether he bears his own business risks. For example, if a principal grants a loan to the agent in circumstances when third parties, such as banks, would refuse the loan that is a very strong indication that the agent is not economically independent. It is possible for an independent agent to have **only one principal for a short time** due to business circumstances, but the longer this situation lasts the more likely it is that the agent is becoming dependent on his sole principal. On the other hand, having **more than one principal is not a guarantee of independence**, particularly if the principals act in a coordinated way.
Let’s now look at the three major differences between the OECD and the UN Models. The first one relates to the dependent agent acting as a stock agent. This provision is included in Art. 5(5)(b) of the UN Model. For example, GCo sells goods in State S over the internet. It takes too long to transport goods from the company’s warehouse in State R to the customers in State S, so it needs to have a stock of goods ready for delivery in State S. Rather than setting up its own warehouse in State S; it engages Mr. Leaf to store the goods in his own warehouse and make the deliveries on its behalf every time he is told of the new order in State S. Mr. Leaf has no authority to conclude any contracts for GCo, but under the UN model he may nevertheless be deemed to create a PE for GCo. The second one is the special provision for insurance activities in paragraph 6. The provision says that, except for reinsurance, an enterprise is deemed to have a PE in another state if it collects premiums or insures risks there through an agent who is not independent, but who do not have an authority to conclude contracts on behalf on an insurance company. Finally UN Model takes a different approach as to what constitutes independence. It states explicitly that an agent who acts wholly, or almost wholly, for one enterprise is not considered to be independent of that enterprise. Further, it states that, it applies only if the agent and the enterprise do not act “at arm’s length” with each other.

Thus, it can concluded that, under the UN Model an enterprise engaging an agent to act for it in another state is generally more likely to have a deemed agency PE then under the OECD Model, and therefore more likely to be taxable in the source state on the profits it derived there.

5. **Special Cases:**

Here we will look at a number of situations that are not specifically covered by the text of the PE definitions in the model treaties. These are the leasing of equipment, electronic commerce and the exploration for, and exploitation of, natural resources. We will also look at whether corporate group relationships can create a PE.

**Our first special case is the leasing of equipment**

We will study by looking at an example. Assume that LCo, resident in State R, leases cranes to a construction company BCo, resident in State S. BCo uses the cranes on its building sites, which are all in State S. The question here is whether the use of the cranes in State S creates a PE for LCo. Let’ take three different situations and decide whether it creates a physical or construction project PE?

<table>
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<tr>
<th>Situations</th>
<th>Outcomes</th>
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<td>1. LCo simply transports the cranes to the building sites and leaves them there to be used by BCo employees.</td>
<td>LCO does not maintain a fixed place of business in State S where it carries on its leasing business. The cranes themselves do not constitute a PE, as there are only put at the disposal of BCo. Hence, no PE comes into</td>
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2. LCo transports the cranes to the building sites, and also sends some of its own employees to operate the cranes as directed by the BCo project site manager. LCo is not carrying on business in Sate S because the employees operating the cranes are under the supervision of BCo and therefore it is BCo that is using the cranes to carry on business. Here also PE is not created.

3. LCo transports the cranes to the building sites and sends some of its own employees to operate them. Here, the agreement between the two companies is that LCo will carry out certain specified tasks, and the LCo employees receive their instructions from a LCo supervisor who decides how those tasks are to be performed. LCo now carries out an activity in State S that goes beyond simply putting the cranes at the disposal of the client there, since the employees who operate the cranes are under the direction of a LCo supervisor. This situation could create a PE if the permanence requirement is met. As the work is carried out in connection with a building site, the permanence threshold would be the time period specified in the definition of the construction project PE.

If LCo finds that it has an increasing number of clients in state S it may decide to open an office there to manage the business in State S. If this office concludes the leasing contracts with State S clients, hires new employees to operate the cranes, and carries out the direction and supervision of those employees, then the office would certainly create a PE.

Our Second special case is the E-Commerce.

2000: Application of PE definition to E-Commerce

1990s: Growth of E-commerce

E-Commerce

2003: Addition to OECD Commentary

Let’s take the example of CCo, resident in Sate R, which produces cycles and sells them over the internet. Its web pages are hosted through WCo, resident in State S. The site is visited by customers who place orders via the web. The question here is whether CCo has a PE, physical or agency, in State S via the website? The answer to both the possibilities is no. CCo has no physical PE as there is no place in State S that is at its disposal. The website consists only of software and data, so it does not constitute a tangible presence of CCo. The server is a tangible fixed place, but it is not at the disposal of CCo. CCo receives a service form WCo through the serve, but that does not put the server at the disposal of CCo. There is also no person who is acting in State S as an agent of CCo. The website cannot be an agent, as it is not a person. WCo is a person but it has no authority to conclude contracts on behalf of CCo, and therefore cannot be an agent.
Would our answer change, if CCo leases or buys a server located in State S and operates the website itself? Probably it would. Let us see the answer with the help of a diagram:

As can be seen from the diagram, CCo does have a fixed place available to it in State S. A place of business need not be a building; it could be a piece of machinery also. The server would also be at the disposal of CCo and it is probably fixed in both the geographic and temporal sense. The issue over here is whether CCo is carrying on the business through the server. CCo has no personnel in State S, but there is no absolute requirement that a PE has to have personnel. The important point is whether there are substantial business functions being carried on through the server. If the functions of the server were, for instance, limited to displaying a catalogue or providing information and advertising, there would be no PE, as these activities are not substantial enough. On the other hand, if the server concluded contracts with customers and processed payments, it would probably constitute a PE for CCo. This conclusion would be even clearer in the case of a business that, for example, processes and analyzes information supplied by the client, if the server carried out the analytical work and also delivered the results to the client.

**Our third special case is the exploration for, and exploitation of, natural resources.** Extraction of natural resources can create a PE if the extraction activity has the necessary geographical and temporal permanence. Extraction of natural resources encompasses of two phase viz. the exploration and the exploitation activity. Exploration activities such as seismological research, exploratory drilling, measuring and analysis, precede the extraction...
of natural resources. It can be carried out either offshore or onshore. It is for a very short duration and normally spread over a wide area. On the other hand, exploitation activities generally make use of substantial equipment for a long time in one place. Whether exploratory activities constitute a PE, has to be determined on a case-to-case basis.

**Corporate Group Relationship / PE**

It is quite common that within groups of companies, group members perform activities for each other or act together in carrying on their business. In such cases, question may normally arise as to whether these activities create a PE for one of the group members. The answer to this question is dealt with paragraph (7) of Art 5 of the OECD Model and paragraph (8) of Art 5 of the UN Model. It clearly says that control of one company by another does not, by itself, make either company a PE of the other company. However, it does not say that it can never ever create a PE for each other. If the facts do create one of the types of PE as discussed above, it can create PE for each other.

The following illustrative diagram says that a subsidiary can create a PE of its parent company.

State R

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State S

- Office Subsidiary S at disposal of R
- Subsidiary S Subcontractor Services PE
- Subsidiary S as dependent agent of R

The following illustrative diagram says that when a subsidiary does not constitute a PE.

State R

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State S

- Parent Company R
- Payment
- Service
- Subsidiary S
6. **Exceptions:**

These exceptions apply to all of the various types of PE, even to special cases. In these cases, despite having some business presence in the other state, an entrepreneur is not regarded as having a PE in another state. Hence over here the source state is prohibited from taxing the entrepreneur and the entrepreneur’s residence state has the sole right to tax over the profits derived from those business activities.

The exceptions are dealt with in Art 5(4) of the OECD Model. This is a deeming provision i.e. these situations do create a PE as a result of applying the PE definition, but they are treated as if they do not create a PE. The provision starts with the wordings “notwithstanding the preceding provisions of this Article...” saying that it applies to the physical PE defined in Art 5(1), examples given in Art 5(2) and construction project PE defined in Art 5(3). Paragraph 5 makes it clear that the exceptions also applies to paragraph 4, which deals with agency PE concept, when carried out by a dependent agent. Similarly commentary to Art 5 says that the exceptions apply to services PE.

The following are excluded from the definition of PE:

a) Use of facilities solely for storage, display or delivery of goods or merchandise belonging to the enterprise

b) Maintenance of a stock of goods or merchandise solely for the purpose of storage, display or delivery

c) Maintenance of a stock of goods or merchandise solely for the purpose of processing by another enterprise

d) Maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise.

e) Maintenance of a fixed place of business solely for any combination of activities provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Activities generally regarded as preparatory or auxiliary character are mere advertising, provision of information to customers and business relations, purely scientific research, servicing of patent and know-how contracts and the like.

UN Model is almost the same except for (a) and (b) as mentioned above. The word “Delivery” is not included. Accordingly, the use of facilities for delivery may be PE. Also maintenance of stock for delivery may be PE.

However, if separate activities are carried out through different places point (e) mentioned above does not apply i.e. each activity is to be evaluated separately to decide whether it creates a PE.
On the other side, some activities are so essential in any business that they are never ever regarded as preparatory or auxiliary character such as:

1. **Sales activities except** for the goods or merchandise, solely used for display at an exhibition, are sold at the end of the exhibition.

2. **Management activities except** management of the preparatory and auxiliary activities themselves. **Example** manager of an office carrying scientific research, if not the main activity of the enterprise.

3. **After-sales activities. Example** delivery of spare parts for machines in addition to the maintenance and repair of the machine supplied.

A PE could be constituted if a foreign enterprise maintains an office with employees that are involved in the maintenance of goods/machinery supplied to customers. **India** is of the view that even the maintenance of an office and employees that are substantially involved in the negotiation of contracts for the import of products or services will form a PE. India would not include scientific research in the list of examples of activities indicative of preparatory or auxiliary nature.