

Harmonious Interpretation of DTAA on Principles of PE



Principles of constitution of a Permanent Establishment (PE) have been elaborately discussed in UIN Model Commentary, Organisation of Economic Development (OECD) Commentary as well as the various International Tax Commentaries by acclaimed authors. Judiciary has also contributed in defining the important principles of taxation as well as determination of a PE. PE constitution/determination need comprehensive and holistic analysis of various factors and the judicial precedence in this context should be relied upon keeping into consideration the different factual matrix of each case. Recently, the Hon'ble Delhi High Court in the case of National Petroleum Construction¹ while determining the taxability of the taxpayer's project office has dealt with various kinds of PE and has intricately clarified on the critical concepts which needs consideration while undertaking PE analysis. The article attempts to provide an analysis of this ruling. Please read on...

I Background

1. Facts of the Case

- National Petroleum Corporation (the 'taxpayer'), a company, incorporated in the UAE, entered into contracts with ONGC Ltd. for installation of petroleum platforms and submarine pipelines.
- The said contracts included various activities. While the survey, installation and commissioning activities were done entirely in India, the platforms were designed, engineered and fabricated at Abu Dhabi.
- The taxpayer computed its income on presumptive basis as per section 44BB of the Income-tax Act, 1961 by taxing the gross receipts pertaining to its activities in India less verifiable expenses at the rate of 10% and the receipts pertaining to activities outside India at the rate of 1 %.
- The Assessing Officer (AO) held that the taxpayer had a fixed place Permanent Establishment (PE) in India in the form of a Project Office (PO). It was held that Arcadia Shipping Ltd. (ASL), a consultant, constituted a DAPE of the taxpayer in India. The AO held that the taxpayer also had an installation/construction PE in India.
- The AO held that the contract was a turnkey and a composite contract and, therefore, the entire contractual receipts including the activities performed outside India were taxable in India. The AO held that the consideration received by the taxpayer for design and engineering to be Fees for Technical Services (FTS). The order of the AO was upheld by the Dispute Resolution Panel (DRP) and the Income-tax Appellate Tribunal (the Tribunal).

(Contributed by the Committee on International Taxation of the ICAI. Comments may be sent to citax@icai.in.)

¹ National Petroleum Construction (2016) 66 taxmann 16 (Delhi) dtd 29th January'16

2. High Court's Ruling²

A. Interplay of Article 5(1), 5(2) and 5(3) of India-UAE Treaty

- **Article 5(1)** of the tax treaty provides an overarching general definition of the expression PE and entails satisfaction of two conditions i.e. there should be a fixed place of business and the business of the enterprise should be carried on wholly or partially through the said fixed place of business. It may be relevant to note that the word 'permanent' in the term PE indicates that there should be some degree of permanency attached to the fixed place of business before the same can be construed as a PE of an enterprise. The word 'permanent' does not imply for all times to come but merely indicates a place which is not temporary, interim, short-lived or transitory.
- **Article 5(2)** of the tax treaty provides for an inclusive definition of PE and specifically lists out the places of business that fall within the meaning of that expression. The use of the word 'especially' underscores the intention that the places enlisted therein fall within the definition of PE. Though an inclusive definition is generally used to expand the width of the term sought to be defined, read in the context of the other provisions of Article 5, paragraph 2 clearly indicates that it has been used as an explanatory provision to specifically include the species of places of business that would constitute the PE of an enterprise.
- **Article 5(3)** of the tax treaty is an exclusionary clause and is intended to exclude certain places of business from the scope of the expression PE. Paragraph 3 begins with a non-obstante clause and therefore, even if a place of business squarely falls within the definition of Article 5(1) and is specifically listed in 5(2) of the said Article, the same would not be construed as the PE of an enterprise, if it falls within any of the exclusionary clauses contained in sub-paras (a) to (e) of paragraph 3 of Article 5 of the tax treaty.
- **Article 5(4)** of the tax treaty provides for a legal fiction to include an agent (other than an agent of an independent status) to be a PE of the principal enterprise. Paragraph 4 also begins with a non-obstante clause. Thus, even though an agent may not *stricto sensu* fall within the definition of a PE as defined in paragraph 1 and/or paragraph 2 of Article 5 of the tax treaty, yet it would be deemed that a PE of an enterprise exists if the business of an enterprise is carried out through an agent as described in Article 5(4) of the tax treaty.

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This is a welcome ruling of the Delhi High Court laying down sound principles in relation to determination of a PE, which have been internationally accepted as also by several benches of the Income Tax Appellate Tribunal. The High Court has taken a well-considered view clarifying certain ambiguous concepts surrounding the issue of PE.

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² Though the ruling discusses issues of taxability of offshore and onshore supplies and also on attribution in spite of the fact that PE is not formed, for the sake of brevity the article draws reference to the finding of the Court on Article 5 only.

- **Interplay of Article 5(1), Article 5(2) & Article 5(3)**- All classes of PEs as enlisted in paragraph 2 of Article 5 of the tax treaty would be construed as a PE subject to the essential conditions of paragraph 1 of Article 5 being met. Thus, provisions of Article 5(1) and 5(2) complement each other. Further clause (h) and (i) of Article 5(2)³ additionally require satisfaction of a specified minimum period of nine months. Thus, places of business as specified under sub-paras (h) and (i) of Article 5(2) of the tax treaty cannot be construed as the PE of an enterprise, unless it exists for a period of at least nine months. Thus, even though the taxpayer's PO established in India falls within the definition of PE in terms of paragraph 1 and 2 of Article 5 of the tax treaty, it would still have to be seen whether it stands excluded under paragraph 3 of Article 5 of the tax treaty. In the case of the taxpayer also, it is not disputed that it carried out part of its business through its PO and, therefore, the conditions as spelt out in paragraph 1 and paragraph 2(c) of Article 5 of the tax treaty are satisfied. However, the matter does not rest here, and it is required to be seen whether any of the exclusionary clauses of Article 5(3) of the tax treaty are applicable.
- **Preparatory & Auxiliary Exclusionary clause**-The rationale for excluding a fixed place of business maintained solely for carrying out an activity of a preparatory or auxiliary character has been explained by Professor Dr. Klaus Vogel. In the context of Article 5(3) (e)⁴ of the tax treaty, the expression would necessarily mean carrying on activities, other than the main business functions, that aid and support the business of the enterprise. In the context of the contracts in question, where the main business is fabrication and installation of platforms, acting as a communication channel would clearly qualify as an activity of auxiliary character-an activity which aids and supports the taxpayer in carrying out its main business. Thus, where the main business is fabrication and installation of platforms, the activity of the taxpayer's PO in acting as a communication channel would clearly qualify as an activity of auxiliary character-an activity which aids and supports the taxpayer in carrying out its main business and would clearly fall within the

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A plain reading of Article 5(2) indicates that a PE may well exist, however, it is not provided that it will necessarily exist. In light of the facts of the instant case, though the project office of the taxpayer categorically falls under Article 5(2)(c), yet it would not result in a PE if the conditions specified under Article 5(1) are not satisfied.

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exclusionary clause of Article 5(3)(e) of the tax treaty.

B. Installation PE

- Exclusionary clause of Article 5(3)(e) of the tax treaty would equally apply to a place of business falling within Article 5(2)(h) of the tax treaty as it would be an office falling within the scope of Article 5(2)(c) of the tax treaty. Thus, in terms of article 5(2)(h) of the tax treaty, 'a building site or a construction or assembly project or supervisory activities in connection therewith' would also constitute a PE of an enterprise subject to that site, project or activity continuing for a period of at least nine months. Clearly, the purpose of the said clause is also to include a building site or construction or an assembly project as a PE by itself.
- On a harmonious reading of Article 5(2)(h) with Article 5(1) of the tax treaty which necessarily entails a fixed place of business from which the business of an enterprise is carried on, a building site or an assembly project could be construed as a fixed place of business only when an enterprise commences its activity at the project site. An activity which may be related or incidental to the project but which is not carried out at the site in the source country would clearly not be construed as a PE as it would not comply with the essential conditions as stated in Article 5(1) of the tax treaty.
- In order to apply Article 5(2)(h) of the tax treaty, it is essential that the work at a site or the project commences. It is not relevant whether the work relates to planning or actual execution of construction works or assembly activities. The duration of a PE would commence with the performance of business activities in connection with the building site or assembly project.

³ 5(2)(h) of India-UAE Treaty refers to a building site or construction or assembly project or supervisory activities in connection therewith, if such activities continue for a period more than 9 months

⁴ Article 5(3)(e)- maintenance of a fixed place of business solely for the purpose of carrying out preparatory or auxiliary services

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- In the present case, the initial activities at the site were carried out by an independent subcontractor appointed by the taxpayer and was carried for a very short duration. An interruption in the normal course of activities such as a weekly day off would undoubtedly be included in the duration of the PE but in cases where the interruption exceeds substantial periods which represent cessation of the activities at site, it would be difficult to accept that the building/project site continues to represent the fixed place of business of an enterprise.
- In the facts of the present case, where the taxpayer did not have access to the site, the same cannot be construed as its PE under Article 5(2)(h) of the tax treaty. If the period during which the taxpayer did not have access to the site in question is excluded, the aggregate period would be less than nine months, and this would exclude the applicability of Article 5(2)(h) of the tax treaty.
- Even if the time spent by the sub-contractor in conducting the pre-engineering and predesign survey is included, the duration of the project activities in India would not exceed nine months. The taxpayer's PO is inextricably linked to the project. Therefore, if the duration of the project activities in India was less than nine months, it cannot be held that the taxpayer had a PE in India under Article 5(2)(h) of the tax treaty.

C. Dependent Agent PE

- The director's report and the final accounts of ASL evidently indicate that ASL's activities were not limited to providing services to the taxpayer but extended to various other activities. The scope of services were also extended to various companies other than the taxpayer.
- Although ASL had agreed to act as a 'sole and exclusive' consultant for the taxpayer in India and had further agreed not to represent any competitor of the taxpayer or act in a manner

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The primary litigation in the context of installation PE revolves around the manner in which the time threshold is computed. It has been held in various cases that PE shall come into existence when the foreign enterprise begins to carry on its business through a fixed place of business. However, the activities which are carried on by the foreign enterprise also play a crucial role in determining existence of PE or otherwise.

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detrimental to the taxpayer's interest, the consultancy agreement did not fetter ASL to carry out its regular activities including providing consultancy services to persons other than the taxpayer's competitors. Thus, the Tribunal's conclusion that ASL was working 'wholly and exclusively' for the taxpayer is clearly not sustainable.

- The consultancy agreement clearly indicates that the contracts would be tendered for and executed by the taxpayer. The presence of ASL at such a meeting was clearly in pursuance of the services agreed to be rendered by them. However, this by itself cannot lead to an inference that ASL constituted a DAPE of the taxpayer in India.
- By virtue of paragraph 5 of Article 5 of the tax treaty, an independent agent who acts outside its ordinary course of business would fall outside the scope of Article 5(5) of the tax treaty. Therefore, in order to consider whether an agent of an enterprise falls within the ambit of Article 5(5) of the tax treaty, it is necessary to consider whether (a) the agent is one of an independent status and (b) whether he/she is acting on behalf of the enterprise in the ordinary course of its business.
- Applying the aforesaid tests in the facts of the present case, it is clear that ASL has not acted on behalf of the taxpayer in its normal course of business. ASL in its regular course of business provides logistics and consultancy support to various entities including the taxpayer. It is also apparent from the final accounts of ASL for the relevant year that it carries on substantial business other than the services provided to the taxpayer.
- Although the correspondence between the taxpayer and ASL indicated that ASL was involved in the project since the pre-bid meeting and had also acted on behalf of the taxpayer, it cannot be concluded that ASL was habitually authorised to conclude contracts on behalf of the taxpayer. Thus, ASL cannot but be considered as an agent of independent status to whom Article 5(5) of the tax treaty applies. In this view, ASL would not constitute a DAPE of the taxpayer in India.

II. Some Annotations & Conclusion

1. This is a welcome ruling of the Delhi High Court laying down sound principles in relation to determination of a PE, which have been

internationally accepted as also by several benches of the Income Tax Appellate Tribunal. The High Court has taken a well-considered view clarifying certain ambiguous concepts surrounding the issue of PE.

2. Article 5(2) states that a PE includes a number of items within the meaning of the term 'PE' such as a place of management, a branch, an office, a factory, etc. There are divergent views on the relationship between Article 5(1) and 5(2). One view holds that provisions of Article 5(2) does not stand alone but has to be read in conjunction with Article 5(1).⁵ The other view, based on the principle of interpretation that an inclusive definition is clarificatory and adds to the primary meaning, holds that the Article 5(2) is independent of Article 5(1).⁶

A plain reading of Article 5(2) indicates that a PE may well exist, however, it is not provided that it will necessarily exist. In light of the facts of the instant case, though the project office of the taxpayer categorically falls under Article 5(2)(c), yet it would not result in a PE if the conditions specified under Article 5(1) are not satisfied. The principle has been upheld in various judicial precedents⁷. The High Court, in this case, has also held that Article 5(1) and 5(2) should be read harmoniously which appears to be a better view.

3. Article 5(3) lists a number of business activities such as use of facility, maintenance of stocks for storage or supply, etc. which are treated as exceptions to the general definition laid down in paragraph 1 and which when carried on through fixed places of business, are not sufficient for these places to constitute a PE. The Court has laid down the law that the PO by merely rendering auxiliary services through a fixed place shall fall in the exclusionary clause of Article 5(3)(e) and hence shall not constitute PE of the foreign enterprise. There are no unique features associated with the PO being reckoned as a PE. The determination of whether a PO is engaged in auxiliary activities, constitutes a PE or not shall have to be examined based on facts and circumstances of each case, and it cannot be presumed that a PO will always be excluded from the purview of Article 5. The mode and manner in which functions are carried out by the PO would certainly go a long way in determining /fighting a PE situation.

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4. The primary litigation in the context of installation PE revolves around the manner in which the time threshold is computed. It has been held in various cases that PE shall come into existence when the foreign enterprise begins to carry on its business through a fixed place of business. However, the activities which are carried on by the foreign enterprise also play a crucial role in determining existence of PE or otherwise. There are numerous factors which needs consideration (viz. time spend by previous contractor, aggregation of sites, treatment of time spend on unconnected sites, etc.) while determining the period of commencement in case of an Installation PE.

As per OECD MC and commentary by Prof. Vogel, a site does not cease to exist when the work is temporarily discontinued. Interruptions, which are usual in the normal course of activity, constitute part of minimum period. However, intentional interruptions have been held to not suspend the time limit. At the same time, interruptions caused by extraordinary circumstances have been held to be excluded for the purpose of computing the threshold. Since each case is peculiar, the above-discussed factors need to be borne in mind while determination Installation PE.

Analysing the factual matrix of the case, the Delhi High Court has held that the existence or otherwise of the Installation PE would have to be tested from the time the activities are actually commenced at the site by the foreign company itself and time spent at the site by the sub-contractor for carrying out survey activities would not be reckoned for the purpose of determination of existence or otherwise of the PE. ■

⁵ *Fugro Engineers BV vs. ACIT (2008) 26 SOT 78 (Del)*; *R&B Falcon Offshore Ltd vs. ADIT (2010) 42 SOT 432 (Del)*

⁶ *DDIT vs. Western Union Financial Services Inc (2012) 50 SOT 109(Del)*; *Samsung Heavy Industries Co. Ltd. vs. ADIT 2011 TII 140 ITAT Del*

⁷ *Metal One Corporation vs. DDIT (2012) 22 taxmann 77 (Del Trib)*; *Linklators LLP vs. ITO (2010) 132 TTJ 20 (Mum)*