Introduction to

Permanent Establishments

Significance of Permanent Establishment

- Decisive condition for the taxation of income from **business activities**

- This rule is designed to ensure that business activities will not be taxed by the state unless and until they have created **significant economic bonds** between the enterprise and that state

Significance of Permanent Establishment

“In our opinion, the words ‘permanent establishment’ postulates existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country”

Article 5(1) – OECD Model Convention

As per Article 5(1) of the OECD MC-

“For the purpose of this Convention, the term ‘permanent establishment’ means **a fixed place of business** through which the business of an enterprise is wholly or partly carried on” (Basic Rule PE)

Article 5(1) – OECD Model Convention

- The existence of an enterprise
- Its carrying on a business
- Existence of place of business
- Which is fixed
- Through which the business is carried on

Article 5(1) – OECD Model Convention

- Distinct place with a certain degree of permanence and continuity
- Permanence is not synonymous with everlasting
- There has to be a link between the place of business and a specific geographical point
- No linkage in the case of floating facilities at sea
- Ships permanently moored to the bank serving as restaurant etc. are fixed

Article 5(1) – OECD Model Convention

- A place of business of a temporary nature would not amount to PE
- Generally no PE unless the period exceeds 6 months
- Activity of recurrent nature
- Temporary interruptions (seasonal business, holidays) to be ignored while determining permanency

Article 5(1) – OECD Model Convention

- PE with retrospective effect if a place meant for short period maintained for longer period
- Travelling circuses, ice skating shows or other such enterprises which keep on travelling do not constitute PE
- The activity carried on must be a business activity
- Social facilities such as rest homes or living quarters for the staff do not constitute PE

Article 5(1) – OECD Model Convention

- Even if activity not permanent but operations carried out regularly – PE?
- If entire business carried on in other State but for short period – PE?

Article 5(1) – OECD Model Convention

- Place of business which forms a coherent whole connectivity and geographically may constitute a PE
- No commercial coherence
  - Painter working for different clients in a building
- No geographical coherence
  - Consultant working at different branches for the same company on a project

Article 5(1) – OECD Model Convention

Examples of coherent whole commercially and geographically

- A very large mine
- Office hotel
- Outdoor market or fair

Article 5(1) – OECD Model Convention

- The place need not be owned or hired by the enterprise
- The place should be at the **disposal** of the enterprise
- The enterprise need not have a legal enforceable right to use the place of business
- If the place is at the **disposal** of more than one person then it would be PE for all of them

Article 5(1) – OECD Model Convention

- A fixed place owned by A placed at the **disposal** of B is not PE of A
- Salesman regularly visiting a company and meeting the purchase director in his office - No PE
- Employee of parent company occupying a cabin in the subsidiary's office - PE

Article 5(1) – OECD Model Convention

- Human intervention is not necessary for business activity
- Fully automatic vending machines and pumping stations may constitute PE
- No PE if after setting up the machine the enterprise lets the same to someone else
- If equipment, building, other property are let out from or through a fixed place of business then such fixed place becomes a PE
- The building let out does not become a place of business for the lessor but instead is PE of lessee

Article 5(1) – OECD Model Convention

- PE begins to exist from the time the enterprise begins business activities through the fixed place
- The period for setting up the PE is to be ignored
- PE ceases to exist when the enterprise stops carrying on business from such fixed place

Article 5(2) – OECD Model Convention

Includes especially [Article 5(2)]:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop

Article 5(2) – OECD Model Convention

- The list contained in 5(2) is only indicative and not exhaustive
- Places mentioned in 5(2) must satisfy the requirements of 5(1) to constitute a PE
- An office for a short period in a fair or exhibition would not constitute a PE

Article 5(4) – OECD Model Convention

- Para 4 is an exception to Para 1
- Para 4 takes precedence over Para 1
- Exceptions in Para 4 - Activities not included as PE
- List refers to activities of general,preparatory and auxiliary character
- List is exhaustive
- Para 4 cannot be invoked when activity is performed for a third party
- Scope of Para 4 is to restrict PE taxation in the other state
- LOs exemption is usually sought under Para 4

Article 5(3) – OECD Model Convention

- A Building site or construction or installation project constitutes a P.E. only if it lasts for more than 12 months
- “Permanent / Fixed Place of Business” element replaced by test of minimum length of time
- 12 Months time applied to each individual site or project if they are unconnected
- Activities may extend over more than one Calendar year or Assessment year
- Legal Acts are excluded in calculating the time limit

Article 5(3) – OECD Model Convention

- Time taken by sub-contractor will be included in the minimum period
- Temporary interruption of work to be added for period determination
- Example of temporary interruptions
  - Construction of a road begins on 1st January
  - Work stopped on 1st July due to weather conditions or shortfall in material
  - Resume work on 1st November
  - Work Completed on 28th February
- PE of sub contractor if his project exceeds 12 months
- No PE even if ‘office’ setup for a project lasting less than 12 months

Article 5(5) – OECD Model Convention

Notwithstanding the provisions of paragraph 1 and 2, where **a person - other than as agent of an independent status** to whom paragraph 6 applies – is **acting on behalf of an enterprise** and **has, and habitually exercises**, in a Contracting State an **authority to conclude contracts** in the name of the enterprise, the **enterprise shall be deemed to have a permanent establishment** in that State **in respect of any activities which that person undertakes for the enterprise**, **unless** the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Article 5(5) – OECD Model Convention

Activity to conclude contracts-

- If the contract negotiated upto finalisation and ready for signature - signing at the enterprise HO outside the State will not help - substance over form - authority granted
- If agent solicits and receives orders (but not formally finalises) which are sent directly to warehouse for delivery where enterprise approves routinely - authority granted

Article 5(5) – OECD Model Convention

Activity to conclude contracts-

- Right to conclude major contracts reserved - Authority Not Given
- Contracts are all standard - only signed by HO - without scrutinising - Authority Given
- Contract terms and provisions - standard - contract only signed by agent - Authority Given
- Thus not necessary for agent to negotiate contract

Article 5(5) – OECD Model Convention

Authority – habitually exercised

- ‘Habitually’ is repeatedly and regularly
- Single contract is not ‘habitual’ even if agency exists for a long time
- Frequency will depend on the nature of the contract and business of the principal

Article 5(5) – OECD Model Convention

Authority – habitually exercised

Not necessary :

- for agent to stay in the contracting state for long period of time or be residing there
- that continuous activity of business be exercised by one or same agent

Necessary:

- that he is engaged for a long period of time for concluding contracts
- that the post of agency is continuous

Article 5(5) – OECD Model Convention

Agency PE – Miscellaneous

- Agency contracts to constitute PE must be **related to business proper** and not internal management or administration
- Contracts related to activities in 5(4) (exceptions to PE) will not constitute an Agency PE
- In some DTCs eg. Austria "general authority to conclude contracts" is mentioned - then, if price, credit, volumes fixed by HO – general authority not given
- If there is PE by virtue of Articles 5(1) & 5(2) then no agency tests required for agents operating / working from that PE
- Agents residence / office not FPB / PE for enterprise **as not at enterprises disposal**

Article 5(6) – OECD Model Convention

Independent Agent

- **Independent**
  - **materially & personally**
  - **legally & economically**
  - **entrepreneurial risk by person**

- Not Independent if
  - **commercial activities** of the person are
    - subject to **detailed instructions** or
    - under **comprehensive control**

Article 5(6) – OECD Model Convention

Independent Agent

- Materially:
  - follow instructions
  - not specific but comprehensive instructions
- Personally dependent:
  - like in employment
  - services comprehensively available - all or almost all the time
  - personal independence - independent entrepreneur, self employed, own responsibility, own trade name

Article 5(6) – OECD Model Convention

Independent Agent

- Economically
  - whole of the business from **one principal**
  - therefore economically dependent - **income related**

Article 5(6) – OECD Model Convention

Independent Agent

- If dependent
  - not necessary to know whether in ordinary course of business
- If independent
  - not necessary to know whether binds the principle

Gearing up to the challenges of E-com

Servers a PE if:

- it is located at a certain place for a sufficient period of time so as fulfill the condition of 'fixed';
- business of the enterprise can be said to be wholly or partly carried on at that location (presence of personnel is not a pre-requisite);
- the activities are not restricted to the preparatory and auxiliary activities covered by Article 5(4)

However servers belonging to ISPs would not be a PE for the foreign enterprise which has arranged to host its website on the same

Websites not a PE:

- in itself do not constitute tangible property so as to be termed as a PE
- not a 'person', accordingly cannot constitute an agency PE

Thank You