THE LEGAL COMMENTARIES AND CASE LAW

22) **It is an undisputed fact that Article 5 of DTAA between India and the United Kingdom follows the Organisation for Economic Cooperation and Development's (OECD) Model of Double Taxation Convention. There are various commentaries on Double Taxation Conventions. Celebrated among those are: *"A Manual on the OECD Model Tax Convention on Income and on Capital"* by Philip Baker Q.C., and Klaus Vogel on *"Double Taxation Conventions"*. OECD has also given its *'condensed version'* on *"Model Tax Convention on Income and on Capital"*. What constitutes PE under various circumstances has also been the subject matter of judicial verdicts in India as well as in other countries. For better understanding of what may constitute a PE, it would be imperative to refer to these commentaries and judicial decisions. This discussion would disclose the principles enunciated to determine the existence of a PE, application whereof to the given facts would facilitate in answering the surging debate.**

23) **Philip Baker explains that the concept of PE is**

important for several Articles of the Conventions; the concept, or its cognate, also appears in the domestic law of some countries. According to him, the concept marks the dividing line for businesses between merely trading with a country and trading in that country; if an enterprise has a PE, its presence in a country is sufficiently substantial that it is trading in the country. He has quoted the following passage from the judgment of the Andhra Pradesh High Court, authored by Justice (Retd.) Jagannadha Rao (as

His Lordship's then was, later Judge of this Court) in *Commissioner of Income Tax, A.P.-I* v. *Visakhapatnam Port Trust* *(1983) 144 ITR 1461*:

> **"The words 'permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to afixed 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."**

24) **Emphasising that as a creature of international tax law, the concept of PE has a particularly strong claim to a uniform international meaning, Philip**

Baker discerns two types of PEs contemplated under Article 5 of OECD Model. First, an establishment which is part of the same enterprise under common ownership and control – an office,

branch, etc., to which he gives his own description as an *'associated permanent establishment'*. The second type is an agent, though legally separate from the enterprise, nevertheless who is dependent on the enterprise to the point of forming a PE. Such PE is given the nomenclature of *'unassociated permanent establishment'* by Baker. He, however, pointed out that there is a possibility of a third type of PE, i.e. a construction or installation site may be regarded as PE under certain circumstances. In the first type of PE, i.e. associated permanent establishments, primary requirement is that there must be a fixed place of business through which the business of an enterprise is wholly or partly carried on. It entails two requirements which need to be fulfilled: (a) there must be a business of an enterprise of a Contracting State (FOWC in the instant case); and (b) PE must be a fixed place of business, i.e. a place which is at the disposal of

the enterprise. It is universally accepted that for ascertaining whether there is a fixed place or not, PE must have three characteristics: *stability, productivity* and *dependence*. Further, fixed place of business connotes existence of a physical location which is at the disposal of the enterprise through which the business is carried on.

25) **Some of the examples of fixed place of business given by Baker are the following: The place of business must be fixed and permanent. Thus, a shed which had been rented for thirteen years for storing and preparing hides was held to constitute a PE[2]. Similarly, a writer's study has been held to constitute a PE[3]. A stand at a trade fair, occupied regularly for three weeks a year, through which the enterprise obtained contracts for a significant part of its annual sales, has also been held to constitute a PE[4]. A temporary restaurant operated in a mirror tent at a Dutch flower show for a period of seven months was held to constitute a PE[5]. An office,**

[2] *Transvaal Associated Hide & Skin Merchants (Pty) Ltd.* (1967) 29 S.A.T.C. 97 (Court of Appeal, Botswana).

[3] *Georges Simenon* (1965) 44 T.C. (US) 820 (US Tax Court)

[4] *Joseph Fowler* v. *M.N.R.* (1990) 90 D.T.C. 1834; (1990) 2 C.T.C. 2351 (Tax Court of Canada)

[5] Antwerp Court of Appeal, decision of February 6, 2001, noted in 2001 WTD 106-11

workshop and storeroom for the maintenance of aircraft, which were leased out by the enterprise, has been held to constitute a PE[6].

26) **On the other hand, possession of a mailing address in a state – without an office, telephone listing or bank account – has been held not to constitute a PE[7]. The mere supply of skilled labour to work in a country did not give**

rise to a PE of the company supplying the labour[8]. A drilling rig which, although anchored while in operation, was moved to a new site every few months, has been held not to constitute a PE[9]. Similarly, a remotely operated vessel which was used to inspect and repair submarine pipelines was held not to constitute a PE because a moving vessel is not a fixed place of business[10].

27) **The principal test, in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be *'at the disposal'* of the enterprise. For this purpose, it is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice. The place would be treated as *'at the disposal'* of the enterprise when the enterprise has right to use the said place and has control thereupon.**

6 Income Tax Appeals Nos. 759/KB to 761/KB of 1997-98 (Tarom SA), (1998) PTD (Trib.) 3749 (Income-tax Appellate Tribunal, Pakistan)

7 *Consolidated Premium Iron Ores Ltd.* (1959) 265 F 2d. 320

8 *Tekniskil (Sendirian) Bhd.* v. *Commissioner of Income Tax,* (1996) 222 I.T.R. 551 (Authority for Advance Rulings, India)

9 Lower Tax Court of the Hague, September 10, 1990, noted in (1991) Tax Notes Intl. 161

v. *Subsea Offshore Ltd.* (1998) 66 I.T.D. 296 (Income Tax Appellate Tribunal, Mumbai), noted in 17 Tax Notes Intl. 1795

28) **Some of the illustrative cases decided by courts of different jurisdictions given by Baker in his commentary are contained in the following passages from that book:**

(i) **In the Canadian case of *William Dudney* v. *R*[11], the taxpayer was a resident of the United States who was contracted to supply training to employees of a Canadian company. For the purposes of the training contract, the taxpayer was given various offices at the premises of the Canadian company, which he was only allowed to enter at normal**

[11] (1999) 99 DTC 147

office hours. He was allowed to use the client's telephone only on client's business. He spent 300 days in one tax year and 40 in the subsequent year at the premises. The Tax Court of Canada and the Federal Court of Appeal confirmed that he had no fixed base – which was treated as having the same meaning as PE – at the premises since he had no right to use the premises as the base for the operation of his own business.

(ii) **In a case generally referred to as *Hotel Manager*[12], the Bundesfinanzhof held that a UK hotel management company had a PE in Germany when it entered into a 20 year contract with a limited partnership which**

owned a hotel. The agreement required the UK company to supply a general manager: the general manager's office constituted the PE (and not the entire hotel) since the UK company had a secured right to use this office for the purposes of the agreement.

(iii) **A Swiss company was held not to have a PE when it contracted with a German company to produce salad**

[12] Bundersfinanzhof, February 3, 1993, IR 80-81/91, IStR 1993, p. 226, (1993) BStBl., II, 462.

dressings in the name of and in accordance with the recipe of the Swiss company. No employees of the Swiss company were present at the production facility to supervise production[13]. The Bundestinanzhof has also held that a scene painter who was commissioned to carry out a work in France for six weeks, and given special rooms for the purpose, did not have a fixed base at those premises.

(iv) **The Administrative Court of Appeal of Paris has held that a German travel agency did not have a PE in France[14]. A travel agency in Paris had made an office available to the German company from time to time, and the manager of the German company had a flat**

in Paris; the Court held that the German company had no PE at its disposal in France.

(v) **The Brussels Court of Appeal has held that a German resident engaged in the transportation of vehicles had a PE in Belgium[15]. The taxpayer had**

[13] Decision of the Lower Tax Court of Baden-Wurttemberg, May 11, 1992, decision No. 3K 309/91, RIW 1993, 81, IStR 1992, p. 104

[14] Decision of November 10, 1998, (199) Revue de Droit Fiscal, No. 25, comm.. 503, reported with translation in (1998) 1 ITLR 857

[15] Cour de Cassation of February 15, 1980 (1980) J1. De Droit Fiscal 321.

an office 3m by 6m at his disposal on the premises of his principal supplier in Belgium, together with telephone and telex, where the taxpayer and four of his staff worked.

29) **According to Philip Baker, the aforesaid illustrations confirm that the fixed place of business need not be owned or leased by the foreign enterprise, provided that is at the disposal of the enterprise in the sense of having some right to use the premises for the purposes of its business and not solely for the purposes of the project undertaken on behalf of the owner of the premises.**

30) **Interpreting the OECD Article 5 pertaining to PE, Klaus Vogel has remarked that insofar as the term *'business'* is concerned, it is broad, vague and of little relevance for the PE definition. According to him, the crucial element is the term *'place'*. Importance of the term *'place'* is explained by him in**

the following manner:

> **"In conjunction with the attribute 'fixed', the requirement of a place reflects the strong link between the land and the taxing powers of the State. This territorial link serves as the basis not only for the**

> **distributive rules which are tied to the existence of PE but also for a considerable number of other distributive rules and, above all, for the assignment of a person to either Contracting State on the basis of residence (Article 1, read in conjunction with Article 4 OECD and UN MC)."**

31) **We would also like to extract below the definition to the expression *'place'* by Vogel, which is as under:**

> **"A place is a certain amount of space within the soil or on the soil. This understanding of place as a three-dimensional zone rather than a single point on the earth can be derived from the French Version ('installation fixe') as well as the term 'establishment'. As a rule, this zone is based on a certain area in, on, or above the surface of the earth. Rooms or technical equipment above the soil may quality as a PE only if they are fixed on the soil. This requirement, however, stems from the term 'fixed' rather than the term 'place', given that a place (or space) does not necessarily consist of a piece of land. On the contrary, the term 'establishment' makes clear that it is not the soil as such which is the PE but that the PE is constituted by a tangible facility as distinct from the soil. This is particularly evident from the French version of Article 5(1) OECD MC which uses the term 'installation' instead of 'place'.**
>
> **The term 'place' is used to define the term 'establishment'. Therefore, 'place' includes all tangible assets used for carrying on the business, but one such tangible asset can be sufficient. The characterization of such assets**

under private law as real property rather than personal property (in common law countries) or immovable rather than movable property (in civil law countries) is not authoritative. It is rather the context

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(including, above all, the terms 'fixed'/'fixe'), as well as the object and purpose of Article 5 OECD and UN MC itself, in the light of which the term 'place' needs to be interpreted. This approach, which follows from the general rules on treaty interpretation, gives a certain leeway for including movable property in the understanding of 'place' and, therefore, the assume a PE once such property has been 'fixed' to the soil.

For example, a work bench in a caravan, restaurants on permanently anchored river boats, steady oil rigs, or a transformator or generator on board a former railway wagon qualify as places (and may also be 'fixed').

In contrast, purely intangible property cannot qualify in any case. In particular, rights such a participations in a corporation, claims, bundles of claims (like bank accounts), any other type of intangible property (patents, software, trademarks etc.) or intangible economic assets (a regular clientele or the goodwill of an enterprise) do not in themselves constitute a PE. They can only form part of PE constituted otherwise. Likewise, an internet website (being a combination of software and other electronic data) does not constitute tangible property and, therefore, does not constitute a PE.

Neither does the mere incorporation of a company in a Contracting State in itself constitute a PE of the company in that State. Where a company has its seat, according to its by-laws and/or registration, in State A while the POEM is situated in State B, this company will usually be liable to tax on the basis of its worldwide income in both Contracting States under their respective domestic tax law. Under the A-B treaty, however, the company will be regarded as a resident of State B only (Article 4(3) OECD and UN MC). In the absence of both actual facilities and a dependent agent in State A,
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income of this company will be taxable only in State B under the 1st sentence of Article 7(1) OECD and UN MC.

There is no minimum size of the piece of land. Where the qualifying business activities consist (in full or in part) of

human activities by the taxpayer, his employees or representatives, the mere space needed for the physical presence of these individuals is not sufficient (if it were sufficient, Article 5(5) OECD MC and Article 5(5)(a) UN MC and the notion of agent PEs were superfluous). This can be illustrated by the example of a salesman who regularly visits a major customer to take orders, and conducts meetings in the purchasing director's office. The OECD MC Comm. has convincingly denied the existence of a PE, based on the implicit understanding that the relevant geographical unit is not just the chair where the salesman sits, but the entire office of the customer, and the office is not at the disposal of the enterprise for which the salesman is working."

32) **Taking cue from the word *'through'* in the Article, Vogel has also emphasised that the place of business qualifies only if the place is *'at the disposal'* of the enterprise. According to him, the enterprise will not be able to use the place of business as an instrument for carrying on its business unless it controls the place of business to a considerable extent. He hastens to add that there are no absolute standards for the modalities and intensity of control. Rather, the standards depend on the type of**

business activity at issue. According to him, *'disposal'* is the power (or a certain fraction thereof) to use the place of business directly. Some of the instances given by Vogel in this behalf, of relative standards of control, are as under:

> **"The degree of control depends on the type of business activity that the taxpayer carries on. It is therefore not necessary that the taxpayer is able to exclude others from entering or using the POB.**

The painter example in the OECD MC Comm. (no. 4.5 OECD MC Comm. on Article 5) (however questionable it might be with regard to the functional integration test) suggests that the type and extent of control need not exceed the level of what is required for the specific type of activity which is determined by the concrete business.

By contrast, in the case of a self-employed engineer who had free access to his customer's premises to perform the services required by his contract, the Canadian Federal Court of Appeal ruled that the engineer had no control because he had access only during the customer's regular office hours and was not entitled to carry on businesses of his own on the premises.

Similarly, a Special Bench of Delhi's Income Tax Appellate Tribunal denied the existence of a PE in the case of Ericsson. The Tribunal held that it was not sufficient that Ericsson's employees had access to the premises of Indian mobile phone providers to deliver the hardware, software and know-how required for operating a network. By contrast, in the case of a competing enterprise, the Bench did assume an Indian PE because the employees of that enterprise (unlike Ericsson's) had exercised other

businesses of their employer.

The OECD view can hardly be reconciled with the two court cases. All three examples do indeed shed some light onto the method how the relative standards for the control threshold should be designed. While the OECD MC Comm. suggests that it is sufficient to require not more than the type and extent of control necessary for the specific business activity which the taxpayer wants to exercise in the source State, the Canadian and Indian decisions advocate for stricter standards for the control threshold.

The OECD MC shows a paramount tendency (though no strict rule) that PEs should be treated like subsidiaries (cf. Article 24(3) OECD and UN MC), and that facilities of a subsidiary would rarely been unusable outside the office hours of one of its customers (i.e. a third person), the view of the two courts is still more convincing.

Along these lines, a POB will usually exist only where the taxpayer is free to use the POB:

- **at any time of his own choice;**
- **for work relating to more than one customer; and**
- **for his internal administrative and bureaucratic work.**

In all, the taxpayer will usually be regarded as controlling the POB only where he can employ it at his discretion. This does not imply that the standards of the control test should not be flexible and adaptive. Generally, the less invasive the activities are, and the more they allow a parallel use of the same POB by other persons, the lower are the requirements under the control test. There are, however, a number of traditional PEs which by their nature require an exclusive use of the POB by only one taxpayer and/or his personnel. A small workshop (cf. Article 5(2)(e) OECD and UN MC) of 10 or 12

square meters can hardly be used by more than one person. The same holds true for a room where the taxpayer runs a noisy machine."

33) **OECD commentary on Model Tax Convention mentions that a general definition of the term 'PE' brings out its essential characteristics, i.e. a distinct *"situs"*, a *"fixed place of business"*. This definition, therefore, contains the following conditions:**

- **the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment.**
- **this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;**
- **the carrying on of the business of the enterprise through this fixed place of business.**

This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

34) **The term *"place of business"* is explained as covering any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. It is clarified that a place of business may also exist where no premises are available or required for**

carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. Further, it is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A certain amount of space at the disposal of the enterprise which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is required. Thus, where an enterprise illegally occupies a certain location where it carries on its business,

that would also constitute a PE. Some of the examples where premises are treated at the disposal of the enterprise and, therefore, constitute PE are: a place of business may thus be constituted by a

pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise. At the same time, it is also clarified

that the mere presence of an enterprise at a particular location does not necessarily mean that the location is at the disposal of that enterprise.

35) **The OECD commentary gives as many as four examples where location will not be treated at the disposal of the enterprise. These are:**

(a) The first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

(b) **Second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired**

subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a *"fixed place of business"* (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

(c) The third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal

so as to constitute a permanent establishment of that enterprise.

(d) Fourth example is that of a painter, who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

36) **It also states that the words *'through which'* must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location which is at the disposal of the enterprise for that purpose. For this reason, an enterprise engaged in paving a road will be considered to be carrying on its business *'through'* the location where this activity takes place.**