



"Commissionaire Arrangement" – A costly affair for MNEs

STEEL USERS FEDERATION OF INDIA

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“Commissionaire Arrangement” – A costly affair for MNEs

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Background:

In 2013, the Base Erosion Profit Shifting (i.e. “BEPS”) Action Plan, encompassing 15 different actions, was sanctioned. In 2015, the Final Report on BEPS Action 7 was published. BEPS Action 7 targets the artificial avoidance of **permanent establishment** (herein referred to as “PE”) status by proposing changes to the wording of the articles of the **OECD Model Tax Conventions** (herein referred to as “Convention”) and its commentary. “**Commissionaire arrangements**” are common practice among certain multinational enterprises (popularly known as ‘MNEs’), whereby a non-resident enterprise enlists another entity to sell products owned by the non-resident. Under the proposals of BEPS Action 7, such an arrangement may result in the creation of a permanent establishment of the non-resident in other state.

What is the term “Commissionaire Arrangements”?

Technically, when a person concludes contracts on its own behalf and, to perform the contract, obtains goods or services from another enterprise, that person is not acting on behalf of that enterprise nor selling property that is owned by the enterprise. For e.g., A Low-risk distribution business, where goods are bought from foreign enterprise and sold to random customers for small margins. Similarly, some time, even the commercial agents used to enter in typical arrangements called “**Commissionaire Arrangements**”, where they act in their own name, apparently lacking the authority of bind the principal, but their obligations to satisfy sales commitments are dependent on principal. It has long been held that doing business through an independent agent, such as a commissionaire, in another state than the residence state is not reason enough to subject the enterprise to taxation in that state.

BEPS, a project of the OECD with the objective of countering base erosion of states’ tax bases and profit shifting, in 2015 submitted the Final Report on Action 7, an initiative to counter the avoidance of PE status in which they suggested various changes to the provisions governing the definition of a PE. According to the Final Report on BEPS Action 7, a *commissionaire arrangement can be loosely defined as “an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products”*.

Challenge before MNEs:

The term “commissionaire arrangement” is wider term than “Broker, Commission Agent etc”. Technically, the entity which sells the products cannot be taxed on the income it receives selling the products because it does not own them. Therefore, definition of “commissionaire arrangement” is going to be more substance oriented as well as subjective and accordingly, will require more clarity to avoid PE risk.

Changes effective after 31/03/2018:

With a view to prevent tax evasion, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to Implement Tax Treaty Related Measures (herein referred to as ‘MLI’), to which India is also a signatory. Consequently, these provisions will automatically modify India’s bilateral tax treaties (DTAA) covered by MLI (i.e. *Relevant Article 5 of most of India’s treaties*).

The expansion of the dependent agent provision found in article 5(5) proposed by BEPS Action 7 means that the definition of a dependent agent would apply to anyone who “habitually concludes contracts, or habitually plays the *principle role leading to the conclusion of contracts* that are routinely concluded without material modification...”.

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Section 90(2) of the Act provides that the provisions of the domestic law would prevail over corresponding provisions in the DTAA, to the extent they are *beneficial*. Since, in the instant situations, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAA, as modified by MLI, such wider provisions in the DTAA were ineffective unless amendment in section 9(1) of the Act was not made. Therefore, to align the scope of "business connection" with modified PE Rule as per MLI, explanation 2 of clause (i) of section 9(1) is amended w.e.f. 1/4/2018 to provide that "business connection" *shall also include* any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the *principle role leading to conclusion of contracts by that non-resident* and the contracts are:

- i. in the name of the non-resident; or
- ii. for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or
- iii. for the provision of services by that non-resident.

Impact of Amendment:

Before
Contracts concluded with third party on behalf of the principal but in the name of the agent (such as commissionaire arrangements)- No PE Risk[^]
[^] In most civil Law Countries.

Before reaching any conclusion, we need to examine basic Tests of PE taxation under Agency services as well as Commissionaire arrangements.

Test 1: Functional role of Indian Agent:

Analysis 1: "the person acts on behalf of a non-resident enterprise..."

- The term "act" implies that a business activity must be performed by the agent in India.
- A passive presence to the business activity of the principal has no role to play.
- The term "on behalf of" indicates 'to be able to conduct the business, the agent would be subject to instructions to a varying degree'. Such an instruction could be to provide the principal with information about the business operations.
- Providing the principal with general information about the business operation is not sufficient to qualify as a dependent agent and thus forming an agency PE, unless the information is provided in a business approval process, where the agent seeks permission of how to conduct its business.

Analysis 2: Interpretation of term "Principle role leading to conclusion of contract..."

Commentary on BEPS action plan provide certain guidance on what may constitute principal role leading to conclusion of contract. It may encounter following situation:

"Concludes Contracts"-

- The phrase focusses on situations where a contract is legally concluded by an Agent in India.

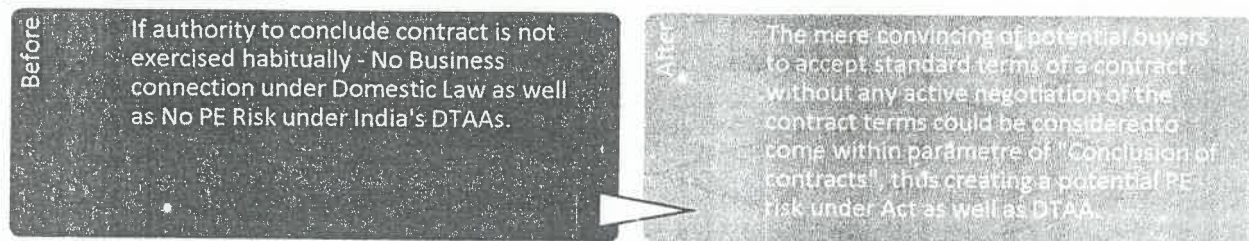
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- A contract may be concluded without any active negotiation of the terms of that contract; for example, where a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise. The fact that Agent's employees cannot vary the terms of the contracts does not mean that there is no negotiation but rather means that the negotiation of the material elements of the contracts is limited to convincing the customer to accept the standard terms.

"Negotiates material elements of Contracts"-

- "Negotiates the material elements of contracts" is aimed at situations where contracts are essentially being negotiated by a person in India are subject to formal conclusion, possibly with further approval, outside India by principal.
- Since key ingredients of the contractual relationship have been determined in India, it is sufficient to treat such contracts in the same way as if they had been concluded in India (*Deeming fiction*).
- "Material elements of contracts" may vary depending on the nature of the contract but would typically include the determination of the parties between whom the contract will be concluded as well as the price, nature and quantity of the goods or services to which the contract applies.

Impact of Amendment:



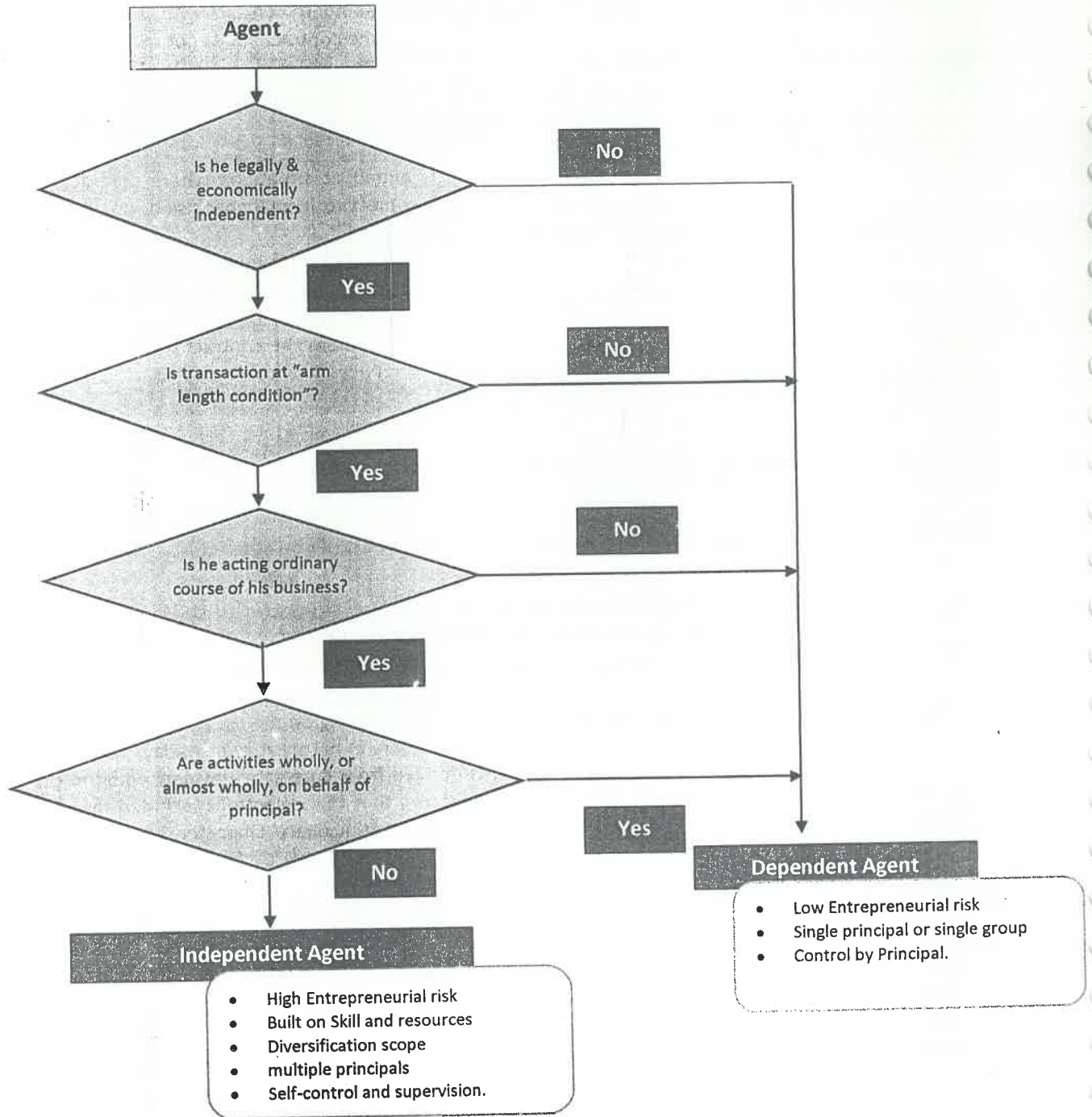
- There is a possibility that agent's role may be restricted to preparatory or auxiliary role and in such case, the commentary to convention states that: 'Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities. To ensure that profits derived from core activities performed in such country can be taxed, Article 5(4) is modified to ensure that the exceptions included therein is restricted to activities that are otherwise of a 'preparatory or auxiliary' character. To avoid undue tax advantages, it clarified that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Art. 5(4).

Test 2: Spotting the difference in interpretation behind "Independent Agent" in both the versions:

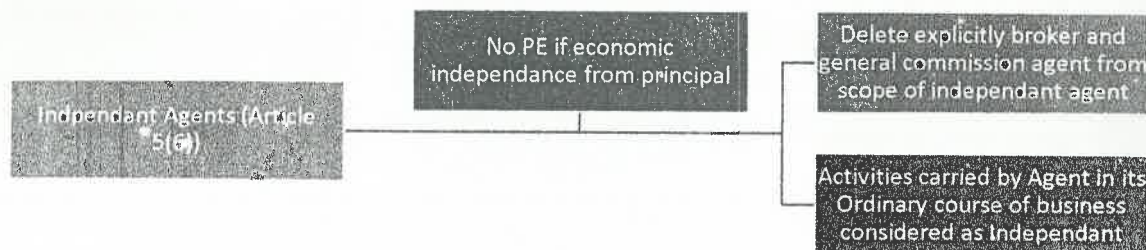
To avoid PE risk, word "Independent Agent" is necessary to understand. In its original form, it identifies two conditions that must be met for the agent to qualify as an independent agent, and thus exempted from creation of a PE.

(1) the person must be legally and economically independent of the enterprise on whose behalf he acts;
and

(2) he acts in the ordinary course of his business when acting on behalf of the enterprise.



Impact of amendment:



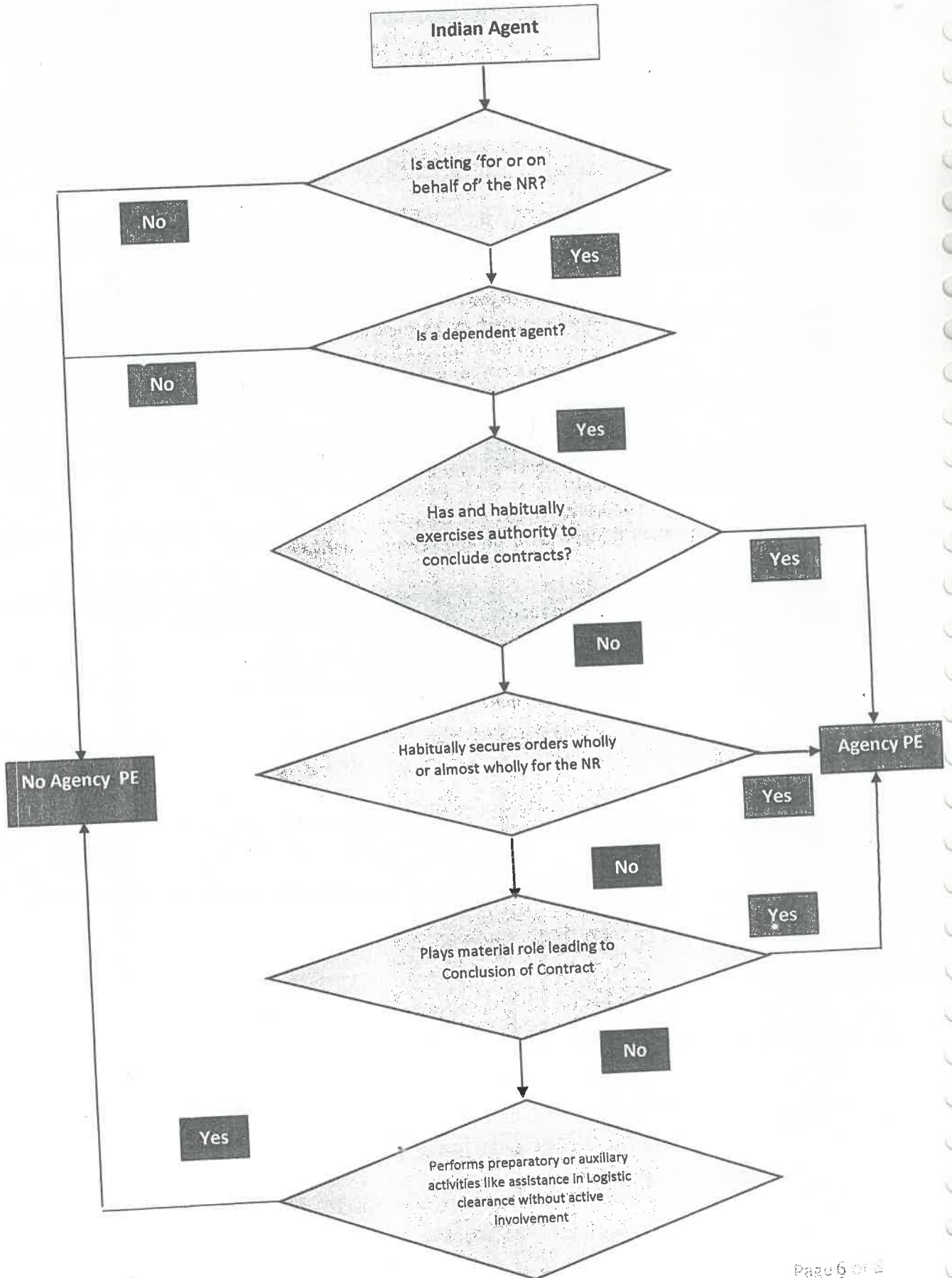
The proposed amendment requires that the person must be carrying on a business as an independent agent with economic independence and he shall be acting in the ordinary course of that business.

Dependency status depends on the extent of the obligations the agent has vis-a-vis the principal:

- The independence should be determined by examining how the obligations are divided in the relationship with the enterprise such as basic feature like freedom to choose principal.
- 'Legal independence' is important criterion for independent agencies; and it has nothing to do with the ownership structure of the relationship.
- As a rule, an independent agent normally bears responsibility for the result of his work; but is not subject to wide-ranging control with regards to the way he accomplishes it. If the agent is subject to "detailed instructions and comprehensive control of the work process" for activities on behalf of principal, it can't be independent.
- Commercial arrangement within Agent can also be used for Dependency test. For example, if Agent's employees' remuneration is dependent on the revenues derived by principal from the portfolio managed by the Agent.

Will "Dependency" always lead to PE creation?

Mere Dependent Agency don't lead to creation of Dependent Agency PE (DAPE). 'Legal Independence' is must to avoid DAPE. If Agent in India functions or acts exclusively or almost exclusively on behalf of its principal and binds him for its acts, then principal will be deemed to have a PE in India.



In nutshell, Agency service rendered on behalf of Non-Resident Principal would attract tax implication as follows-

Type of Services	Dependent Agent		Independent Agent	
	FY 17-18	FY 18-19	FY 17-18	FY 18-19
- Conclusion of contract	Taxable	Taxable	Non-taxable	Non-taxable
- Stocking and merchandising	Taxable	Taxable	Non-taxable	Non-taxable
- Habitually securing orders	Taxable	Taxable	Non-taxable	Non-taxable
- Only negotiation of principal Contractual terms	Non-taxable	Taxable	Non-taxable	Non-taxable
- Playing principle role leading to the conclusion	Non-taxable	Taxable	Non-taxable	Non-taxable

PE Tax implication:

The proposed changes to the wording of article 5(5) of the Convention entails that situations where no authority to conclude contracts is vested in employees, associated enterprises or agents can also lead to the establishment of the PE, if they habitually negotiate the contracts, and even if no significant change is made to the contracts by the enterprise. As this represents a significant change because actors with new functions may now constitute a PE, this has consequences for the attribution of profits to the PE because an integral part of profit attribution is based on the functions performed by it.

If either one of the enterprises participates in the management, capital, or control of the other directly or indirectly, they are considered 'associated' under the article 5(5) of Convention. If by being associated enterprises, commercial or financial circumstances arise between them that would not have arisen had they not been associated, then any profit they would have made had they not been associated may be added and taxed by India. This situation calls for attribution of Profits between associated enterprises (based on PE taxation rules).

As per India Conventions, that prevents India from taxing the business profits of a Non-resident, except for profits attributable to its PE in India. Under the treaty, the profits attributable to a PE are the profits that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, considering the functions performed, assets used, and risks assumed (**popularly known as FAR analysis**) by the enterprise through the PE and through other parts of the enterprise and deriving price based on Arm's Length principle.

As far as the attribution of profits is concerned, if sufficient mark-up is attributed as per the Transfer Pricing Law, then even if PE exists, there is no further attribution required. To avoid PE tax, the PE "A" should be remunerated at arm's length.

Tax rate applicable on PE:

- @40% basic tax on net profits earned by Foreign Enterprise attributable to Business activities carried out in India through PE after reduction of remuneration paid/payable to PE in India for its

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services. Further, surcharge to be attracted (if net income exceeds Rs. 1 crore) plus 4% Education Cess.

- Indian Agent would be taxed on remuneration @30% / 25% (depending upon turnover threshold) plus surcharge and cess.

Way forward:

With various options and reservations accorded to the countries, the interpretation of the MLI would be subjective and more prone to litigation. Foreign enterprises operating across the jurisdictions may have to re-construct/re-structure their existing transactions/deals. A thorough analysis would be required as the claiming of the treaty benefits has become more and more of a factual exercise. However, it is better to keep the transactions between related parties of the MNEs simple and transparent with "reasonable profits" left for the entity performing the services.

But, the question remains unanswered especially when conclusion of contracts is increasingly done remotely through digital means without any involvement of a physical presence or intermediate in the form of an agent.

In next part of this article, we will analyse PE implication in some commonly followed trade practices.