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HAPPY New Year

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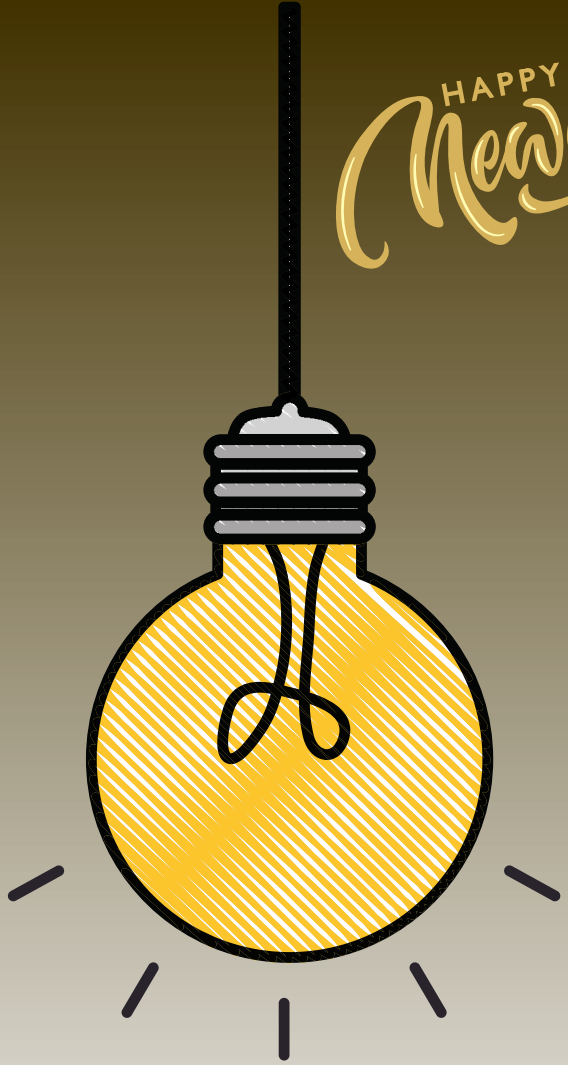
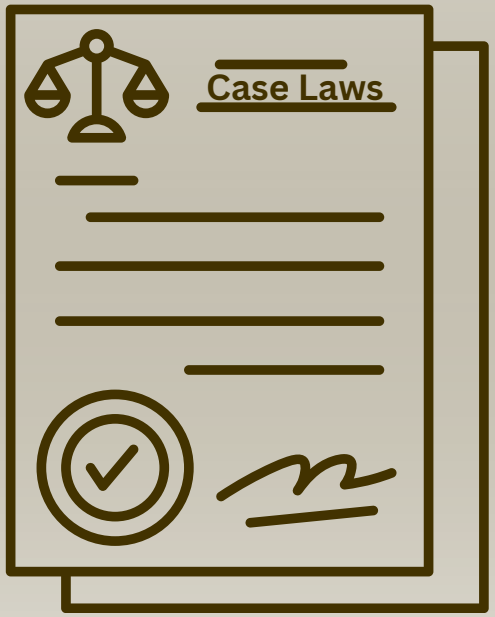


Nominee of a shareholder

Permanent Establishment



SBS AND COMPANY LLP

CHARTERED ACCOUNTANTS

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January 2024

Foreword

Dear Readers,

Wishing all of you a very Happy and Prosperous and Knowledge gaining New year, 2024, from SBS. Only the calendar has changed, but the zeal, effort and passion at SBS, to share knowledge continues to withstand all odds.

In this edition, we have come up with an article on recent judgement of the Hon'ble Apex Court in **Shakti Yezdani & Another vs. Jayanand Jayant Salgaonkar & others**, deciding whether a Nominee of Securities under Section 109A, is its Real Owner, or is he only a custodian, and whether the Section 109A is a third mode of succession that the scheme of the Companies Act, 1956, (pari-materia provisions in Companies Act, 2013), and Depositories Act, 1996 aims or intends to provide.

The next article is on the concept of permanent establishment. Article 5 of the DTAA deals with the concept of permanent establishment. In this Article, how a person can avoid the permanent establishment in the country of source and OECD/G20 measures to curb such practices have been discussed.

We have also collated certain important judgments under direct tax and provided our comments wherever necessary.

I hope that you will have good time reading this edition and please do share your feedback.
Thanking You,

Suresh Babu S
Founder & Chairman

Contents

Corporate Laws

Is a Nominee of Securities, its Real Owner?

All of us are aware that Nomination is a process, whether the same be while opening of a Bank account or a Fixed Deposit or Insurance, through a person is Nominated by the other as Custodian in respect of the said facility in case of death of the person making the nomination, and later, the Nominees takes steps to transfer or distribute the same to the Legal Heirs of the deceased person. Having said this, the provision as to "**Nomination**" as stipulated under the Companies Act, 1956 [Section 109A] as well its 2013 counterpart [Section 72], spell a different tone, by vesting the rights on the Nominee, thereby overriding the Succession laws. The Hon'ble Supreme Court in the matter of **Shakti Yezdani & Another vs. Jayanand Jayant Salgaonkar & others**[1], has put on to the ambiguity and settled the law in relation to the rights of the Nominee in case of Securities. In this article, we look into the legal intricacies involved in this regard.

-Contributed by CS D.V.K. Phanindra
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Introduction:

Before proceeding in to the case study, let us understand the terms "Nominee", "Nomination" and "Legal Heir" in general:

Nominee and Nomination:

A **Nominee** is a person who has been nominated by the other to receive and hold the property until the nominee is legally bound to transfer or distribute the same to the Heirs of the deceased person.

Nomination is only a provision for the claiming of property by the Nominee as '**Custodian**', in case of the death/ demise of the owner of the property. A Nominee compulsorily need not be Legal Heir, but may be a legal heir if nominated for assets/ wealth, and his name forms part of the will. So, a Nominee:

(a) Will only be the trustee/ custodian for a temporary duration, until the establishment of the legal heir to the property/ estate, as per the Succession laws or on the basis of a Will of the deceased person.

(b) Has to hand over the property/ estate to the legal heir/ heirs, as per the Succession laws or on the basis of a Will of the deceased person.

Legal Heir:

Legal Heir is a person who is entitled to succeed to the property of a deceased person in accordance with the Succession laws or on the basis of a Will of the deceased person. In case of Will the details of the person who will inherit the properties of the

deceased person, are mentioned as the key inheritor, which either can be single or multiple persons.

In circumstances where there is no will or stated legal heir, the property will be equally distributed among the heirs as per Section 8 r/w Section 9, Section 29 and the Schedule to the Hindu Succession Act[1] in the following manner:

- Equally distributed among all Class 1 heirs;
- If there are no Class 1 heirs, then equally distributed amongst Class 2 heirs;
- If there are no Class 2 heirs, then distributed amongst Agnates[2];
- If there are no Agnates then distributed amongst Cognates[3];
- If there case of no one being present, the Government takes the property/ estate of the person deceased.

Background of the case on hand:

The Appellants and Respondents are the legal heirs and representatives of Mr. Jayant Shivram Salgaonkar.

Mr. Jayant Shivram Salgaonkar, executed a will on 27.06.2011 making provisions for the devolution of his estates upon the successors. Apart from the properties mentioned in the will, the testator had certain fixed deposits (FDs) for the sum of Rs. 4,14,73,994/- in respect of which the Respondent Nos. 2, 4 and Appellant no. 2 herein were made nominees. Additionally, there were certain mutual fund investments (MFs) of the amount of Rs. 3,79,03,207/- in respect of which the Appellants herein and one M/s Jay Ganesh Nyas Trust, Respondent no. 9, were made nominees. Mr. Jayant Shivram Salgaonkar passed away on 20.08.2013.

A Suit[4], was filed on 29.04.2014, by the Respondent no. 1, herein with the prayer for declaration *inter alia* that the properties of the testator may be administered under the court's supervision and seeking absolute power to administer the same, and also prayed for permanent injunction restraining all other respondents and appellants from disposing, transferring, alienating, assigning and/or creating any third-party interests in respect of the properties of the testator.

In reply it was the contention of the Appellants' herein that nominations in the subject matter, were made as per Section 109A & 109B of Companies Act, 1956 and bye-law 9.11.7 of the Depositories Act, 1996. Section 109A and 109B of the Companies Act, 1956, and must be read as a code in themselves, wherein the meaning of words '**Vest**' and '**Nominee**' are to be seen from the statute alone bearing in mind the non-obstante

[1] Hindu Succession Act, 1956 (Act 30 of 1956); for a general understanding, reference is restricted only to the Hindu Succession Act.

[2] "**Agnate**" – one person is said to be an "agnate" of another if the two are related by blood or adoption wholly through males; Section 3 (1) (a) of the Hindu Succession Act, 1956

[3] "**Cognate**"- one person is said to be a cognate of another if the two are related by blood or adoption but not wholly through males; Section 3 (1) (c) of the Hindu Succession Act, 1956.

[4] No. 503/2014, Bombay High Court.

clause contained therein. Therefore, the provisions should be interpreted without reference to any outside consideration.

For the purpose of understanding the subject, the text of Section 109A of the Companies Act, 1956, is reproduced below:

Section 109A-Nomination of Shares:

"(1) Every holder of shares in, or holder of debentures of, a company may, at any time, nominate, in the prescribed manner, a person to whom his shares in, or debentures of, the company shall vest in the event of his death.

(2) Where the shares in, or debentures of, a company are held by more than one person jointly, the joint holders may together nominate, in the prescribed manner, a person to whom all the rights in the shares or debentures of the company shall vest in the event of death of all the joint holders.

(3) Notwithstanding anything contained in any other law for the time being in force or in any disposition, whether testamentary or otherwise, in respect of such shares in, or debentures of, the company, where a nomination made in the prescribed manner purports to confer on any person the right to vest the shares in, or debentures of, the company, the nominee shall, on the death of the shareholder or holder of debentures of, the company or, as the case may be, on the death of the joint holders becomes entitled to all the rights in the shares or debentures of the company or, as the case may be, all the joint holders, in relation to such shares in, or debentures of, the company to the exclusion of all other persons, unless the nomination is varied or cancelled in the prescribed manner.

(4) Where the nominee is a minor, it shall be lawful for the holder of the shares, or holder of debentures, to make the nomination to appoint, in the prescribed manner, any person to become entitled to shares in, or debentures of, the company, in the event of his death, during the minority."

It would not be out of place to mention that a similar provision with regard to the Power to Nominate, is also present under Section 72 of the Companies Act, 2013.

While passing the order[5] in the suit, the Single Judge mainly considered whether the law laid down in the case of **Harsha Nitin Kokate v. The Saraswat Co-operative Bank Limited and Others**[6] was ***per incuriam***.

In the case of **Harsha Nitin Kokate,** the Nominee was held to be the Original Owner, and also that it would be a valid discharge to the Insurance Company or the Co-operative Society without vesting the ownership rights in the Insurance Policy or the membership rights in the Society upon such nominee:

[5] Passed on 31.03.2015

[6] Notice of Motion No.2351 of 2008 in Suit No.1972 of 2008; (2010) SCC Online Bom 615.

*" **14.** The meaning and definition of the word "Vest" is required to be considered. Black's Law Dictionary 8th Edition at page 1594 shows the meaning of "Vest" thus :—*

*"**Vest**.—*

(1) To confer ownership of (property) upon a person.

(2) To invest (a person) with the full title to property.

(3) To give (a person) an immediate, fixed right of present or future enjoyment.

(4) Hist. To put (a person) into possession of land by the ceremony of investiture.

***Vested.—**Having become a completed, **consummated** right for present or future enjoyment; not contingent; unconditional; absolute ."*

Further the meaning of vested right is given in the aforesaid Dictionary at page 1349 thus :—

*"**Vested right**.—A right that so completely and definitely belongs to a person that it cannot be impaired or taken away without the person's consent."*

***15.** The meaning of Vested Interest in the said Dictionary is explained at page 829 thus :—*

*"**Vested interest**.—An interest the right to the enjoyment of which, either present or future, is not subject to the happening of a condition precedent."*

***17.** Advanced Law Lexicon by P. Ramanatha Aiyar 3rd Edition 2007 at page 2677 when explains the term Vested Legacy thus :—*

*"**Vested legacy**.—A legacy the interest in which is so fixed as to be transmissible to the personal representative of the legatee."*

…….

***25.** …..Section 109A of the Companies Act and 9.11 of the Depositories Act makes it abundantly clear that the intent of the nomination is to vest the property in the shares which includes the ownership rights thereunder in the nominee upon nomination validly made as per the procedure prescribed, as has been done in this case. These sections are completely different from section 39 of the Insurance Act set out (supra) which require a nomination merely for the payment of the amount member the Life Insurance Policy without confirming any ownership rights in the nominee or under section 30 of the Maharashtra Co-operative Societies Act which allows the Society to transfer the shares of the member which would be valid against any demand made by any other person upon the Society. Hence these provisions are made merely to give a valid discharge to the Insurance Company or the Co-operative Society without vesting the ownership rights in the Insurance Policy or the membership rights in the Society upon such nominee. The express Legislature intent under section 109A of the Companies Act and section 9.11 of the Depositories Act is clear.*

26. *Since the nomination is shown to be correctly made by her husband who was the holder of the Suit shares, the Plaintiff would have no right to get the shares of her deceased husband sold or to otherwise deal with the same."*

Accordingly, it was observed that the word '**vest**' is a word of variable import under Indian statutes. Intention of the Legislature is of primary importance in considering effect of 'vest' in a given legislature. In this case, it was held that nominee of securities become full and absolute owner of securities when these are transmitted in his name.

The learned single judge rejected the contentions of the Appellants herein and observed that S. 109A & S. 109B of the Companies Act, 1956 cannot be read in a vacuum and it is permissible for the court to look at pari materia provisions in other statutes. The court, while considering the argument of a 'statutory testament' raised in Sarbati Devi v. Usha Devi[7] (with regard to claim over proceeds of Insurance policy by heirs instead of Nominee) expressly negated those and opined that it would not be proper to limit the ratio in Sarbati Devi (supra) to the narrow confines of Section 39 of the Insurance Act, 1939. The same was thereafter reaffirmed in Vishin N. Khanchandani and Anr. v. Vidya Lachmandas Khanchandani & Anr.[8],(with regard to claim over proceeds of National Saving Certificates) and plethora of other judgements.

The Learned Single Judge opined that the decision in Kokate (supra) failed to consider the decision of the Supreme Court in Khanchandani (supra) and other judgements, although each of these decisions were binding on the court, while it was deciding Kokate, the same was per incuriam. The learned Judge also opined that the fundamental focus of Section 109A of the Companies Act, 1956 and also of the Bye-law 9.11.7 of the Depositories Act is not the law of succession nor it is intended to restrict the law of succession in any manner, and the intention was to afford the company or the depository in question, a legally valid quittance so that it does not remain answerable forever to succession litigations and endless slew of claims under the succession law. Accordingly, the statutory provisions allow for the liability to be moved from the company or the depository to the nominee but the nominee continues to hold the shares/securities in fiduciary capacity and is also answerable to all claims in the succession law.

The judge also opined that the inconsistencies in the decision of **Kokate (Supra),** will render a nomination under the Companies Act, a "**Super Will**", where as in reality the Companies Act or the Depositories Act, does not displace the law of succession nor does it stipulate a third line of succession, and accordingly disposed off the Suit No.503/2014.

[7] Civil Appeal No.96 of 1972; (1984) 1 SCC 424; [1984] 17 Taxman 1 (SC)

[8] Civil Appeal No.4538 OF 2000; [2001] 29 SCL 44 (SC); (2000) 6 SCC 724

Before the Division Bench of Bombay High Court:

Aggrieved by the decision of the Learned Single Judge, the Appellants herein preferred appeals[9].

The following questions were formulated for the decision in the Appeals.

"(i) Whether a nominee of a holder of shares or securities appointed under Section 109A of the Companies Act, 1956 read with the Bye-laws under the Depositories Act, 1996 is entitled to the beneficial ownership of the shares or securities subject matter of nomination to the exclusion of all other persons who are entitled to inherit the estate of the holder as per the law of succession?

(ii)Whether a nominee of a holder of shares or securities on the basis of the nomination made under the provisions of the Companies Act, 1956 read with the Byelaws under the Depositories Act, 1996 is entitled to all rights in respect of the shares or securities subject matter of nomination to the exclusion of all other persons or whether he continues to hold the securities in trust and in a capacity as a beneficiary for the legal representatives who are entitled to inherit securities or shares under the law of inheritance?

(iii) Whether a bequest made in a Will executed in accordance with the Indian Succession Act, 1925 in respect of shares or securities of the deceased supersedes the nomination made under the provisions of Sections 109A and Bye Law No. 9.11 framed under the Depositories Act, 1996?"

The Division Bench after perusing the matter and also the ratio as decided in **Kokate (Supra),** inter-alia observed and answered the framed questions as follows:

(a) Companies Act, 1956 is not to either provide a mode of succession or to deal with succession at all.

(b) The object of S. 109A Companies Act, 1956 is to ensure that the deceased shareholder is represented, as the value of the shares is subject to market forces and various advantages keep on accruing to the shareholders, such as allotment of shares & disbursement of dividends. Moreover, a shareholder is required to be represented in the general meetings of the Company and therefore, the court opined that the provision is enacted to ensure that commerce does not suffer due to delay on part of the legal heirs in establishing their rights of succession and then claiming shares of a Company.

The Division bench expressly opined that the so-called '**vesting**' under S. 109A of the Companies Act, 1956 does not create a third mode of succession and the provisions are not intended to create another mode of succession. In fact, the

[9] Appeal No.313 of 2015 and Appeal No.311 of 2015, before the Division Bench, Bombay High Court; [2016] 76 taxmann.com 161 (Bombay).

Companies Act, 1956 has nothing to do with the law of succession.

Accordingly, the Division Bench declared that the nominee of a holder of a share or securities is not entitled to the beneficial ownership of the shares or securities which are the subject matter of nomination to the exclusion of all other persons who are entitled to inherit the estates of the holders as per the law of succession.

The Division Bench held that a bequest made in a Will executed in accordance with the Indian Succession Act, 1925 in respect of shares or securities of the deceased, supersedes the nomination made under the provision of S. 109A of Companies Act and Bye-law 9.11 framed under the Depositories Act, 1996.

The division bench also observed that the object of S. 109A(3) of the Companies Act, 1956, is not materially different from S. 6(1) of the Government Savings Certificates Act, 1959 and S. 109B of the Companies Act, 1956 is likewise similar to S. 45-ZA (2) of the Banking Regulation Act, 1949. The law relating to S. 6(1) of the Government Savings Certificates Act, 1959 has already been settled in the case of **N. Khanchandani (supra)** where the Supreme Court upheld the law declared in **Sarbati Devi (supra).**

The Division Bench interpreting the provisions under S. 109A & S. 109B Companies Act, 1956, declared that they do not override the law in relation to testamentary or intestate succession. Accordingly, the judgment in **Kokate (supra)** was declared to be incorrect as it failed to consider the law laid down in **Khanchandani (supra)** and other cases, as these cases preceded **Kokate (supra).**

Appeal[10] to Supreme Court:

Challenging the Order of the Division Bench, the matter reached the Apex Court.

On behalf of the Appellants, it was argued that scheme of nomination as provided in the Companies Act, 1956 is not analogous to nomination as provided under other legislations. Unlike in other legislations, the term 'vesting' & 'to the exclusion of others' along with a 'non-obstante clause' are placed together in the Companies Act, 1956. It was further argued that the provisions relating to Nominating, as contained in the other legislations, cannot be the basis for interpretation of the term Nomination under the provisions of the Companies Act. The introduction of the provision, the hierarchy in which shares will vest in case the individual shareholder, joint shareholding, clearly demonstrated that nomination would trump any disposition, whether testamentary or otherwise.

The provisions of as nomination under Companies Act, 2013, vide Form SH-13 provided under Rule 19(1) of the Companies (Share Capital & Debentures) Rules, 2014, was also submitted during the argument, which indicates that the shareholder or joint shareholder may nominate

[10] Civil Appeal No.7107 of 2017; decided on 14.12.2023; [2023] 157 taxmann.com 364 (SC)

one or more persons as nominee in whom all rights of the holder shall vest. Since such nomination can also be in the favour of a third party or a minor (who can never be a trustee or executor), it was submitted that the legislature under the Companies Act intended to give complete ownership to the nominee. Provisions relating to Regulation 29A of SEBI (Mutual Funds) Regulations, 1996, were also submitted before the court.

It was argued that the interpretation accorded by the High Court in the matter under appeal, is not in sync with the developments of law intended by insertion of S. 109A & S. 109B to the Companies Act, 1956, and that the ease of succession planning which the legislature intended would be rendered otiose if the interpretation given by the High Court on the implication for the nominee under S. 109A & S. 109B of the Companies Act is accepted.

In contrast, the arguments were submitted on behalf of the Appellants, who vehemently objected to the interpretation of the Respondents and submitted that the introduction of S. 109A & S. 109B merely provides for facility of nomination aiding in the process of transfer of Securities. Therefore, no third mode of succession by way of nomination has been contemplated and the position has remained unaltered, despite numerous amendments made to the Companies Act from time to time.

It was further argued that the legislature in no uncertain terms recognised a transfer being made by a legal representative as a valid mode of transfer and the legal representative is vested with the properties of the deceased as a custodian subject to devolution in terms of the applicable law. Indian Succession Act, 1925 provides to consolidate and amend the law applicable to intestate and testamentary succession.

Decision of the Supreme Court:

The Apex Court, discussed and deliberated on the object of introduction of the nomination facility and opined that provision of nomination within the Companies Act, 1956 with the broadest possible contours, it is not possible to say that the same deals with the matter of succession in any manner. There is no material to show that the intent of the legislature behind introducing a method of nomination through the Companies (Amendment) Act, 1999 was to confer absolute title of ownership of property/shares, on the said nominee.

Precedents similar to the matter before the Apex court and also various High Courts, in relation to the concept of Nomination under various legislations were deliberated.

The Apex Court stated that it was not persuaded by the presence of the three elements i.e., the term '*vest*', the provision excluding others as well as a *non-obstante* clause under *S.*109A of the Companies Act, 1956, in the interpretation to be accorded vis-à-vis nomination, in any different manner.

The Apex Court held that there is a complex layer of commercial considerations that are to be taken into account while dealing with the issue of

nomination pertaining to companies or until legal heirs are able to sufficiently establish their right of succession to the company. Therefore, offering a discharge to the entity once the nominee is in picture is quite distinct from granting ownership of securities to nominees instead of the legal heirs. Nomination process therefore does not override the succession laws. ***Simply said, there is no third mode of succession that the scheme of the Companies Act, 1956 (pari-materia provisions in Companies Act, 2013) and Depositories Act, 1996 aims or intends to provide.***

The Apex Court held that Companies Act, does not deal with the law of succession. Therefore, a departure from this settled position of law is not at all warranted.

Accordingly, the Apex Court upheld the Division Bench Order, that the nominee of a holder of a share or securities is not entitled to the beneficial ownership of the shares or securities, which are the subject matter of nomination to the exclusion of all other persons who are entitled to inherit the estates of the holders as per the law of succession, and dismissed the Appeal.

Provision under Companies Act, 2013:

The provisions Section 72 of the Companies act, 2013 which is pari-materia to that of Section 109A of the Companies Act, 1956, are reproduced below:

Section 72- Power to Nominate

(1) Every holder of securities of a company may, at any time, nominate, in the prescribed manner, any person to whom his securities shall vest in the event of his death.

(2) Where the securities of a company are held by more than one person jointly, the joint holders may together nominate, in the prescribed manner, any person to whom all the rights in the securities shall vest in the event of death of all the joint holders.

(3) Notwithstanding anything contained in any other law for the time being in force or in any disposition, whether testamentary or otherwise, in respect of the securities of a company, where a nomination made in the prescribed manner purports to confer on any person the right to vest the securities of the company, the nominee shall, on the death of the holder of securities or, as the case may be, on the death of the joint holders, become entitled to all the rights in the securities, of the holder or, as the case may be, of all the joint holders, in relation to such securities, to the exclusion of all other persons, unless the nomination is varied or cancelled in the prescribed manner.

(4) Where the nominee is a minor, it shall be lawful for the holder of the securities, making the nomination to appoint, in the prescribed manner, any person to become entitled to the securities of the company, in the event of the death of the nominee during his minority.

It is clearly evident from the provisions of Sub-section (3) of Section 72 read along with rule 19 of

the Companies Share Capital rules[11], that notwithstanding anything contained in any other law or in any disposition, whether testamentary or otherwise, **the nominee shall, on the death of the holder of securities or, as the case may be, on the death of the joint holders, become entitled to all the rights in the securities, of the holder or, as the case may be, of all the joint holders, in relation to such securities, to the exclusion of all other persons, unless the nomination is varied or cancelled in the prescribed manner.**

In a much recent judgement by the Apex Court, in Aruna Oswal v. Pankaj Oswal[12], the matter being the case of maintainability of an Application regarding Oppression and Mismanagement of affairs of the Company, by a person holding only 0.03 % shared, and on the pretext that he legal heir of deceased shareholder, and was entitled to percentage of share of the deceased shareholder. Whereas, the wife of the deceased was the nominee for the said shares. There was a civil suit pending for maintaining status-quo as to the shares and securities. In this case, the Apex court held that in view of non obstante clause, the vesting of the shares on the nominee, with him becoming the absolute owner, till the out of the Civil Suit.

Comments:

The Apex has cleared the confusion with regard to the rights of the Nominee under Section 109A of the Companies Act, 1956. However, as regards the provision under Companies Act, 2013, which is much more crisply spelt-out, with overriding provisions, though it is clear that there is no third mode of succession that the scheme of the Companies Act, 1956 (pari-materia provisions in Companies Act, 2013) and Depositories Act, 1996 aims or intends to provide, amendment to the Companies Act, 2013 would be of utmost importance, to remove any further ambiguity.

[11] The Companies (Share Capital and Debenture) Rules, 2014 as amended from time to time

[12] Civil Appeal No's. 9399, 9340 and 9401of 2019; [2020] 117 taxmann.com 563; decided on 06.07.2020

Income Tax – International Taxation

Artificial avoidance of Permanent Establishment – Effect of MLI

Under the provisions of the DTAA, income from business is taxable in the country of sources only when such persons establishes permanent establishment in the country of source. Article 5 of the DTAA defines the term PE. However, in certain circumstances, permanent establishment has been avoided by artificially arranging certain transactions. To curb such practices, OCED along with G20 nations brought MLI. In this Article, changes made to PE by way of MLI has been discussed.

-Contributed by CA Narendra
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1. Introduction:

As per Article 7 of the OECD MTC[13], profits of an enterprise of CoR[14] is taxable only in that country unless the enterprise carries on business in CoS[15] through a PE[16] situated therein. Which means that unlike other items of income, business profits are taxable in the CoS only if such enterprise establishes PE in the CoS. Hence, determination of a PE is essential for taxing the business profits in the CoS.

Determination of a PE in the CoS is governed by Article 5 of OECD MTC. Article 5 of OECD MTC provides mechanisms for determination of PE in the CoS. However, it was observed that, by committing certain tax avoidance measures, certain MNEs are avoiding PE in the CoS in order to avoid the tax liability in such country. This issue has been certainly discussed in Action Plan 7 OECD/G20 BEPS[17] Action Plans. The main objective of Action Plan 7 is to avoid artificial avoidance of PE in the CoS by taking recourse to various tax mitigation measures.

The above objective can be achieved by making changes to the definition of PE in Article 5 of OECD MTC, and into a treaty by virtue of Part IV i.e., Article 12-15 of MLI[18]. In this Article, concerns raised by BEPS package in relation to artificial avoidance of PE and subsequent changes to the definition of PE in OECD MTC, 2017, with regard to MLI, have been discussed.

[13] OECD Model Tax Convention on Income and Capital, 2017
[14] Country of Residence
[15] Country of Source
[16] Permanent Establishment
[17] Base Erosion and Profit Shifting
[18] Multilateral Instrument

2. Artificial Avoidance of PE through Commissionnaire Arrangements and Similar Strategies – Changes to Article 5(5) and Article 5(6) (Corresponding Article 12 of MLI): Action 7 of OECD BEPS Final Report[19] provides detailed discussion on artificial avoidance of PE and measures to be taken to address such concerns.

2.1. Concern under the BEPS Actions Plans – Commissionnaire Arrangements:

Action 7 – Final report states that by resorting to commissionnaire arrangements, it is possible to shift profits from CoS to CoR. Under the commissionnaire arrangements, a foreign company may sell its products in the CoS though a commission agent without establishing a PE that state accordingly, profits earned by the foreign company may not be taxable in CoS. The above concern has been explained by an example in Action Plan – Final Report.

"6. BEPS concerns arising from commissionnaire arrangements may be illustrated by the following example, which is based on a court decision that dealt with such an arrangement and found that the foreign enterprise did not have a permanent establishment: -

- *XCO is a company resident of State X. It specialises in the sale of medical products.*
- *Until 2000, these products are sold to clinics and hospitals in State Y by YCO, a company resident of State Y. XCO and YCO are members of the same multinational group.*
- *In 2000, the status of YCO is changed to that of commissionnaire following the conclusion of a commissionnaire contract between the two companies. Pursuant to the contract, YCO transfers to XCO its fixed assets, its stock and its customer base and agrees to sell in State Y the products of XCO in its own name, but for the account of and at the risk of XCO.*
- *As a consequence, the taxable profits of YCO in State Y are substantially reduced.*

7. Similar strategies that seek to avoid the application of Art. 5(5) involve situations where contracts which are substantially negotiated in a State are not concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Art. 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting."

2.2. Addressing the above BEPS concerns – Changes made to Article 5(5) and Article 5(6) of OECD MTC:

In order to address the above concerns, it was proposed to make the following changes to Article 5(5) and Article 5(6) of the OECD MTC. The revised/modifies Article 5(5) (post amendment) states that where a person is acting in CoS ***on***

[19] Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report

behalf of an enterprise and, in doing so, ***habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts*** that are routinely concluded without material modification by the enterprise, and these contracts are:

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise;

that shall be deemed to have PE in the CoS in respect of any activities which that person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through fixed place of business does not constitute PE for such enterprise.

Further, Article 5(6) (post amendment) states that Article 5(5) shall not apply where the person acting in a CoS on behalf of an enterprise of the CoR carries on business in the CoS as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

Given the above, in order to invoke the provisions of Article 5(5), the following conditions needs to be satisfied[20]:

a) a person (agent) acts in CoS on behalf of an enterprise (ex. foreign company);

b) in doing so, such agent habitually constitutes contracts, or habitually plays the principal role leading to the conclusion of contacts;

c) these contracts are either in the name of the foreign company or for the transfer of the ownership of, or for the granting of the right to use, property owned by the foreign company, or for the provision of service by the foreign company.

After the amendment, though the agent is not signing the contracts but habitually concluding the contracts, or habitually plays the principal role leading to the conclusion of contracts then, the act as such agent may give raise to PE in the CoS for the foreign company. However, it is required to note that Article 5(5) contains the word ***'on behalf of'***. A person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person[21]. Further, Commentary on OECD MTC states that contract is to be understood from the domestic laws of CoS.

[20] Reference to para 84 of the Commentary on OECD MTC.

[21] Reference to para 86 of Commentary on OECD MTC.

'The phrase 'concludes contract' has to be understood to mean how under the relevant law governing contracts, a contract is considered to have been concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract, where the law governing contracts provide that a contract is concluded by reason of a person accepting, on behalf of enterprise, the offer made by a third party to enter into a standard contract with the enterprise.'

Further, Commentary on OECD MTC provides a detailed discussion on 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in para 88, para 89 and para 90.

However, Article 5(5) states that if the above activities were exercised by the enterprise through fixed place of business does not constitute PE for such enterprise under Article 5(4), then such activities cannot be considered as PE under Para 5(5). Further, Article 5(6) states that if a person is CoS acts as independent agent, such person cannot be considered as PE in the CoS.

3. **Artificial Avoidance of PE through the Specific Activity Exemptions – Changes to Article 5(4) of OECD MTC (Corresponding Article 13 of MLI):** Article 5(4) provides exception to PE in the CoS if the activities constitute preparatory or auxiliary character.

3.1. Concern under the BEPS Actions Plans – Commissionnaire Arrangements:

Article 5(4) states that following activities do not constitute a PE in the CoS:

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

b) the maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) The maintenance of fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

However, post digitalization and by virtue of other technological changes, the way of doing

business has changed significantly. For example, R Co a resident of Country R is engaged in the business of sale of electronic goods. In order to sell its goods in Country S, R Co has opened a warehouse in country S for storage and delivery to the customers. In this scenario, the activity of storage and delivery goods is excluded from the ambit of PE, such activity does not constitute a PE in country S.

However, after the digitization, R Co has entered into e-commerce business and started selling its goods though online flatform. In order to fulfil its customers' orders across various countries, R Co has opened a warehouse in Country S and employed huge number employees in its warehouse. The activity of warehousing, which used to be preparatory or auxiliary activity has now become core activity which gives raise to profits. However, R Co may still state that such activities are in the nature of preparatory or auxiliary activities and continue to fit in with the specific activity exemption, which would give raise to BEPS concerns.

Further, in addition to the above, there are scenarios wherein the core activities of the business have been fragmented into smaller activities by virtue of which each individual activity fits in the exception provided above though the overall activity does not constitute preparatory or auxiliary character.

3.2. Addressing the above BEPS concerns – Changes made to Article 5(4) of OECD MTC:

In order to address the above BEPS concerns, changes have been made to Article 5(4) of the OECD MTC. Article 5(4) (post amendment) of OECD MTC states that in order to fall under the exception under Article 594), specific activity [mentioned in subparagraph a) to e)] or, in the case of subparagraph f), the overall activity of the fixed place of business, shall be of a preparatory or auxiliary character.

Further, Article 5(4.1) states that exception provided in Article 5(4) does not applicable to the fixed place of business if same enterprise or closely related enterprise carries on business activities at the same place or at another place in the same country and

a) that place or other place constitutes a PE for the enterprise or the closely related enterprise or

b) the overall activity resulting from the combination of activities carried on by the two enterprises at the same place, or the same enterprise or closely related enterprise at the two places, is not of a preparatory or auxiliary character.

Provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places ***constitute complementary functions that are part of a cohesive business operations.***

4. **Splitting of Contracts – Article 5(3) of the OECD MTC (Corresponding Article 14 of MLI):** Article

5(3) states that a building site or construction or installation project constitutes a PE only if it lasts more than 12 months.

4.1. *Concern under the BEPS Actions Plans – Splitting of Contracts:*

Under Article 5(3) of the OECD MTC, a building site or construction or installation project constitutes PE only if such activity lasts more than 12 months. However, in order to avoid the PE in the CoS, contracts have been split into several contracts between different entities within the same MNE group thereby period of each activity does not exceed 12 months.

4.2. *Addressing the above BEPS concerns – Changes made to Article 5(3) of OECD MTC:*

Para 52 of Commentary on OECD MTC states that 'the twelve-month threshold has given rise to abuses; it has sometime been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti avoidance rules, these abuses could also be addressed through application of the anti-abuse rule of para 9 of Article 29. Some states may nevertheless wish to deal expressly with such abuses. Moreover, states that do not include para 9 of Article 29 in their treaties should include an additional provision to address contract splitting. Such a provision could, for example, be drafted along the following lines:

for the sole purpose of determining whether the twelve-month period referred to in paragraph 3 has been exceeded,

a) Where an enterprise of a Contracting State carries on activities in the other Contracting State as the place that constitute a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding twelve months, and

b) Connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

these different periods of time shall be added to the period of time during which the first-mentioned enterprise has caried on activities at that building site or construction or installation project.'

Further, for the purpose of Article 5, closely related person defined under Article 5(8) which states that a person or enterprise is closely related to an enterprise if:

- One has control of the other or both are under the control same persons or enterprises.

- One possesses 50 percent of the beneficial interest in other or a third person possesses 50 percent of the beneficial interest in both the person and enterprise or in both enterprises.

Summary of Income Tax Decisions

Hon'ble Bangalore Tribunal in the case of Toyota Kirloskar Motor Private Ltd[22] - Payment of royalty needs to be benchmarked by aggregating the transactions under the TNMM, and no separate benchmarking is required.

1. The assessee had adopted TNMM at the entity level, in which process, the royalty payment is considered as closely linked transaction and part of operating cost in the TP study Report. The assessee has considered the aggregation concept as the transactions are closely linked.

2. After considering the both the arguments and after perusal of previous years' decisions in the assessee's own case, the Tribunal has held that royalty payment is included by the TPO for computation of operating expenses and margin of the assessee is higher than the margin of comparable companies after inclusion of royalty payment. Hence, no separate benchmarking is required for royalty payments.

Our Comments:

Under the transfer pricing regulations, for benchmarking a transaction, an aggregation principle can be applied. Under the aggregation principle, a set of closely linked transactions are benchmarked together rather than separately. The OECD Guidelines states that *"another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually".*

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Hon'ble Delhi Tribunal in the case of EXL Service.Com INC[23] -

1. The assessee is a company incorporated under the laws of Delaware, USA and its primary business is to develop and deploy business process outsourcing solutions including transaction processing services and Internet/ voice-based customer care services for its clients. The assessee is stated to be providing such services to customers located in the United States of America and the United Kingdom.

2. EXL India has entered into a service agreement with EXL Inc under which, EXL India provides internet and voice-based customer care services and backroom operation services to the customers of EXL Inc.

3. Assessee provided marketing, sale support, strategic directions, client relationship to the group and significant part was provided from the US. and the Assessee's primary function was delivery of the agreed outsourced services from India.

4. The AO has considered that the assessee has a PE in India under Article 5 of DTAA and business in

[22] IT(TP)A Nos.421 & 422/Bang/2023

[23] [TS-786-ITAT-2023(DEL)]

India as per section 9(1)(i) of the Income Tax Act.

5. In this regard, the Hon'ble Tribunal has held that a "fixed place of business" should satisfy, amongst others, the "power of disposition" test to qualify as PE under Article 5(1). The 'core business' of the foreign enterprise should be conducted through the place of business which means that there should be a nexus between the place of business and carrying on of business.

6. The Tribunal has further held that an Agency PE is constituted where a person, other than an agent of an independent status, is acting on behalf of a US enterprise in India and such person has authority to conclude contracts on behalf of the US enterprise and such authority habitually secures orders in India wholly or almost wholly for the foreign enterprise. Merely because the assessee owns 100% of share capital of EXL India does not have effect or consequence of EXL India becoming the PE of the assessee in India.

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Hon'ble Mumbai Tribunal in the case of Carlisle Trading & Manufacturing India Private Limited[24]

1. The assessee has received share capital/premium to the amount of Rs.2,23,92,400/- from its Netherland entity M/s Carlisle Europe BV (CUBV) by issuing of share at a face value of Rs.10 and premium of Rs.90 per share.

2. During the scrutiny, the assessee was asked to prove the identity of the party, genuineness of the transaction and creditworthiness of the party. In response the assessee has filed copy of Board Resolution of allotment of shares, valuation report of the chartered accountant, certificate from Company Secretary under FEMA Act, copy of FIRC, KYC and copy of intimation of receipt of money. However, the AO has not agreed with the submission of the assessee and stated that assessee has not filed proof of the source of share capital/premium received by it, and identity creditworthiness and genuineness of the transaction could not be proved. Therefore, amount of Rs.2,23,92,400/- was treated as unexplained cash credit in the hands of the assessee company u/s 68 of the Act.

3. TAT observes that Revenue has not contrary disproved the genuineness of the various documents; Observes that Assessee placed on record all the documents to demonstrate that the transactions of investment in the share capital by the share subscriber company was carried out in accordance with the regulations of RBI; Observes that CIT(A) rightly placed reliance on CBDT Instruction 2/2015 dt. Jan 29, 2015 to hold that premium on share issue was on account of capital account transaction which does not give rise to income and is not liable to transfer pricing adjustment.

[24] [TS-735-ITAT-2023(Mum)]

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