OECD releases 2017 update to the Model Tax Convention

November 28, 2017

In brief

The OECD has released the 2017 update to the Model Tax Convention and the related Model Commentary, largely incorporating the changes approved as part of the Base Erosion and Profit Shifting (BEPS) Package. The 2017 update also includes the changes and additions to the reservations and observations of OECD member countries and the positions of non-OECD member countries, including India.

In detail

The key changes to the OECD Model Tax Convention (MC) and the related Model Commentary are discussed below. India's position on the said changes is also included.

Article	Change in MC	Key change in Commentary	India's position
Title and Preamble	• The title of MC is changed to "Convention for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance." • Preamble changed to clarify that the intention of MC is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.	NA	No specific position.

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Article 1	• Para 2 has been added which indicates that the Convention applies to wholly or partly fiscally transparent entities under the tax law of either Contracting State to the extent the income is treated for purposes of taxation, as income of a resident. • The Convention shall not affect the taxation by a Contracting State of its residents, except with respect to specified paras.	• Treaty benefit not to be granted where the States cannot verify whether a person is truly entitled to the benefits (e.g. in the absence of exchange of information). • Clause applies to income derived by or through an entity regardless of view taken by each State as to who derives that income for tax purposes. • This clause applies to an entity established in a third State to the extent under the domestic tax law of one of the States, the entity is treated as fiscally transparent and income is attributed to resident of that State. • Anti-abuse provisions in domestic tax laws would not conflict with the MC as long as the principles for denial of treaty benefits are in line with the principal purposes test in the tax treaty. • Provisions suggested for denial of treaty benefits or renegotiation of tax treaty introduced in case of following change of circumstances: – Special tax regime availed in residence country; or – Subsequent change in corporate tax rate in the residence country	• India has reserved the right not to include the para 2 of the Article with respect to benefit to a fiscally transparent entity in its tax treaties. • Additionally, in respect of the Commentary, it has been indicated that India considers the term "*income derived by or through an entity or arrangement*" includes only such income that is derived by or through entities that are a resident of one of the Contracting States.
Article 3	• Definition of international traffic amended to include operation of ship or aircraft by an enterprise of a third State. • Definition of recognised pension fund included. • For the purpose of definition of a term not defined, Article 3(2) is modified to also include "the competent authorities agree to a different meaning".	NA	• India has reserved the right not to include in the definition of a recognised pension fund, a fund that is established and operated exclusively or almost exclusively to invest funds for benefits of entities or arrangements established to administer or provide retirement benefits. • With respect to the change in Article 3(2), please refer to India's position under Article 25.
Article 4	• The criteria for the tie-breaker test for companies has been	• Competent authorities to determine PoEM through mutual agreement procedure taking into	No specific position.

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	changed from Place of Effective Management (PoEM) to as mutually decided by the competent authorities having regard to the PoEM, place of incorporation and any other relevant factors. • In the absence of mutual agreement, such person shall not be entitled to any relief under the Convention, except as agreed upon by the competent authorities.	account various factors (such as place where board meetings are held, where the CEO and other senior executives usually carry on their activities, where senior day-to-day management is carried on, where the entity's headquarters are located, where accounting records are maintained).	
Article 5	***Disposal test*** No change in language of MC	• Disposal test to be satisfied depends on the Foreign Enterprise (FE) having effective power to use the location as well as the extent of the presence of FE at that location and the activities that FE performs there. • Disposal test is met if FE has an exclusive legal right to use a particular location, which is used only for carrying on the FE's business activities. • Disposal test will not be met if the FE's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the FE. • Generally, home office of employees will not be considered as a location at the disposal of FE, as the use of home office is generally intermittent and incidental. However, if the FE requires the individual to use that location to carry on its business (by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of FE.	• India disagrees that where the FE does not have a right to be present at a location and, in fact, does not use that location itself, that location cannot be considered as being at the disposal of the FE. India considers that such a location can, in certain circumstances, be considered as being at the disposal of the FE. • India also disagrees on home-office not constituting a PE where an office was made available to the employee but the employee performs the work out of his home office.
	Short duration business No change in language of MC	• Where activities are of a recurrent nature, each period of time during which the place is used will need to be considered in combination with the number of times during which	India disagrees with the view expressed that operation of catering facilities by the FE does not meet the time requirement for constituting a PE.

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		that place is used (which may extend over a number of years). • Illustratively, if the FE carries on drilling operations at a remote arctic location and the seasonal conditions prevent such operations from going on for more than three months each year but the operations are expected to last for five years. In such cases, the threshold can be said to have been met for constituting a fixed place PE. However, where the FE carries on catering facilities in its State and sets-up a facility in other State for four months during the period of the production of a documentary will be treated as temporary and may not qualify as a PE.	
	Secondment No change in language of MC	Individuals who are formally employed by the FE may be seconded to other enterprises and actually be carrying on the business of another enterprise, and therefore, the FE should not be considered to be carrying on its own business at the location where these individuals will perform that work.	
	Contractors and sub-contractors No change in language of MC	Premises where sub-contractor works can be at the disposal of the contractor if such premises are at the disposal of contractor. The same will have to be substantiated on the basis of factors showing that the contractor clearly has effective power to use that site.	
	Construction PE No change in language of MC	• Generally, a building site or construction or installation project constitutes a PE only if it lasts for more than 12 months. Such test of threshold applies to each individual site/ project. The OECD has observed that it is found that contractors, etc., divide their contracts up into several parts, each covering a period of less than 12 months and attribute to a different company, which was, however, owned by the same group. Connected activities will be viewed holistically to ascertain if the same is part of the same	India disagrees on post construction activities as any work undertaken on a site shortly after the construction work has been completed, including repair works undertaken pursuant to a guarantee, may be taken into account as part of the original construction period, for determining whether a PE exists.

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		activity based on some illustrative factors. • Post construction activities such as repair (under guarantee), may be included, based on facts and circumstances.	
	Relevance of VAT / GST registrations on PE No change in language of MC	There should be no impact on an FE from a PE perspective merely because the FE obtains VAT/ GST registration in the source State.	India has disagreed with this view and considers that treatment under VAT/ GST can be a relevant factor from a PE perspective.
	Website as a PE No change in language of MC	NA	• India disagrees with this and is of the view that a website may constitute a PE where it leads to significant economic presence of the FE. • India is of the view that depending on the facts, an enterprise can be considered to have acquired a place of business through a website on any equipment, if opening the website on that equipment includes downloading of automated software, such as cookies, which use that equipment to collect data from that equipment, process it in any manner or share it with the enterprise.
	Extension of requirement of preparatory or auxiliary to all clauses in Article 5(4) The MC text has been amended to provide that every activity mentioned in Article 5(4) should be preparatory or auxiliary in nature to be excluded from the definition of PE	• As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. • As a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an	India has disagreed with the interpretation in the illustration, as it believes that the collection of data for the determination or quantification of risk by the FE in the business of managing risks, such as insurance, is not an activity of preparatory or auxiliary nature.

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		activity that requires a significant proportion of the assets or employees of the enterprise can be considered as having an auxiliary character. • With respect to the clause on maintenance of premises for collection of information, the OECD has provided an illustration, wherein an office set up by an insurance enterprise solely for collection of information, such as statistics on risks in a particular market would amount to preparatory or auxiliary activity.	
	Anti-fragmentation rule - new Article 5(4.1) inserted Exclusion under Article 5(4) shall not apply to a fixed place of business, which is used by the same enterprise or a closely related enterprise to carry on business at the same place or at another place if: (a) such place constitutes a PE, or (b) the overall activity resulting from the combination of the activities carried on by the two enterprises is not preparatory or auxiliary, provided such activities constitute complementary functions that are part of a cohesive business operation.	• Additional clause inserted to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a "preparatory or auxiliary" activity. • Illustratively, a FE has number of branches that constitute PE. The FE also has a separate office where few employees verify information provided by clients that have made loan applications at the different branches and the result of verifications are forwarded to the FE. The FE, in turn, provides reports to branches where decisions to grant loans are made. In this scenario, such activity will not constitute preparatory or auxiliary, as the activities of granting loan and screening information of potential clients is complementary in nature. • Unless the anti-fragmentation rule applies, each place of business should be looked at separately and in isolation to determine if a PE exists.	India does not agree that unless the anti-fragmentation rule is applied, each place of business should be looked at separately and in isolation.
	Dependent agency PE (DAPE) Article 5(5) and 5(6) have been amended with the key changes as under: • Test of "habitually concludes contracts" has	• There should be no DAPE if the activities of the agent are preparatory or auxiliary in nature. • The term "concludes contract" also includes contracts that are concluded by a customer accepting the offer made by a third party to	• India has reserved the right to exclude the word "routinely" in the newly added provision. • India disagrees with the interpretation dealing with distributors because it

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	been extended to "***habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification***" • Contracts may either be concluded in the name of the enterprise or 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 for provision of services by the enterprise. • The agent deemed not to be independent where the activities of agent are exclusively or wholly exclusively performed for a person to whom the agent is closely related.	enter into a standard contract with FE (irrespective of the place from where the contract is signed). Further, a person who negotiates all elements and details of a contract in a way binding on FE is said to have concluded the contract in India. • The phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification" is aimed at covering situations in which the conclusion of contract directly results from the actions that a person exercises in a State and are intended to result in the regular conclusion of contracts to be performed by the FE, i.e., where the person acts as the sales force of the FE. • However, where a person merely promotes and markets goods or services of the FE in a way that does not directly result in the conclusion of contracts, a PE should not be constituted. • In respect of resellers/ distributors, the cases to which Article 5(5) applies must be distinguished from situations where a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from an FE or arranges for an FE to deliver such goods or services, e.g., distributor including a low-risk distributor as long as title of goods passes from the FE to the distributor and from the distributor to the customer.	considers that the distribution of goods owned by an FE through an associated enterprise or a closely connected enterprise, particularly in a case where the risks are not borne by such enterprise, such as the "low risk distributor," may give rise to a PE of FE (i.e. whose goods are being sold).
Article 10	Condition of holding at least 25% of capital of company required to be fulfilled throughout a 365 day period, which includes the date of payment of dividend - change on account of corporate reorganisation to be ignored.	Alternative provisions suggested for REIT's	No specific position.

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Article 13	Gains from alienation of shares or comparable interests, such as interest in partnership or trusts are taxable in other States, if at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50% of their value directly or indirectly from immovable property in that other State.	Alternative provision provided for cases where the underlying immovable property was transferred prior to transfer of shares.	No specific position.
Article 25	• The time limit for reaching an agreement changed from two years from presentation of case to two years from date when all information requested by competent authorities in order to address the case has been provided to both competent authorities. • Footnote in para 2 suggesting that States may choose to remove the condition for arbitration has been deleted.	• The competent authorities may enter into a MAP to define a term that is not defined under the tax treaty or to clarify the definition of a defined term, if need be. • The MAP can be set in motion by a taxpayer without waiting for the taxation considered by him to be "not in accordance with the Convention" to be charged against or notified to him. To be able to set the procedure in motion, he must, and it is sufficient if he does, establish that the "actions of one or both of the Contracting States" will result in such taxation, and that this taxation appears as a risk that is not merely possible but probable. • The tax treaty should provide for circumstances where access to MAP will be denied.	• India disagrees and is of the view that the definition of an undefined term should be as per its domestic tax law and cannot be resolved by the MAP. • India disagrees and is of the view that the MAP can be initiated only where taxation appears as a risk that is certain (and not probable). • India is of the view that wordings of Article 25 would permit access to the MAP to be denied in certain cases.
Article 29	• New Article on "Entitlement of Benefits" introduced in line with BEPS Action Plan 6 • Benefits to be denied unless the person is a qualified person or falls within prescribed exceptions. • Alternatively, only a limited principal purposes test may be included, wherein the benefits shall not be granted if it is reasonable to conclude that obtaining the benefit of the tax treaty was one of	• This article will be subject to the manner and mode in which parties to the tax treaty decide to introduced. • The various tests have been explained in detail.	India reserves the right to restrict the derivative benefit to equivalent beneficiaries that directly own shares of the resident.

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	the principal purposes of the arrangement or transaction that resulted directly or indirectly in that benefit.		

The takeaways

- Most changes in the 2017 update to the MC have also been included in the Multilateral Convention to implement Tax Treaty Related Measures (MLI). Since India is a signatory to the MLI, India may not sign any new tax treaty incorporating the changes and may choose the MLI route to include these changes.
- The tax authorities generally draw reference to India's reservations while interpreting the OECD Commentary in the context of tax treaties. However, Tax Tribunal(s) in India have held that such reservations only apply to tax treaties signed by India after the positions have been provided.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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