

# Permanent Establishment Concept – An Indian Perspective

**The authors examine the basic permanent establishment concept before analysing relevant case laws in order to provide the state of play in India today.**

## 1. Introduction

Globalization and the consequent international integration, together with rapid technological progress have affected both the ability of countries to collect taxes and the distribution of the tax burden. There have been considerable changes in business models which have affected the way multinational corporations (MNCs) structure their operations. The liberalization and globalization of the world economy has created issues concerning taxation of income earned by MNCs.

The most rational justification for taxation was propounded by Justice Holmes almost 90 years ago when he said that “Taxes are what we pay for civilized society ...”<sup>1</sup> He linked taxation with the benefits of civilization. His proposition is more relevant today when modern civilization has made cross-border businesses virtually independent of national boundaries, or residence. His justification for taxation points to source-based taxation saying that no one likes to do business in an anarchic place and therefore, only the country providing the source of income is justified to collect the tax.

## 2. International Principles of Taxation

Internationally, two basic principles of taxation are followed, i.e. residence-based taxation and source-based taxation. Most countries, including India, tax their residents on their global income applying residence-based taxation rules and tax non-residents on their income sourced in that country applying source-based taxation. In general, where a resident of one country earns income from a source in another country, the possibility of double taxation arises. This is because one country may tax that income on the source-based taxation principle whereas

the other country may tax it on the residence-based taxation principle.

Most often, domestic laws of countries prescribe the threshold for taxing business profits of a foreign enterprise carrying on business within their taxable territory. For instance, India has a concept of a “business connection” (BC), which is akin to the concept of a permanent establishment (PE) found in tax treaties, and is a source rule found on the premise that if a non-resident has sufficient (economic) nexus with India, so as to postulate a real and intimate relation between an activity carried on outside India and a business activity undertaken in India, and the relation between the two contributes to the earning of income by the non-resident, such income attributable to a BC should be taxed in India.<sup>2</sup>

The threshold for establishing a BC under Indian laws is relatively lower than that of establishing a PE under various treaties which India has entered into. Considering the fact that a taxpayer in India has an option to choose the beneficial provisions of the treaty over the Income Tax Act 1961 (ITA),<sup>3</sup> the concept of PE gains greater significance in the Indian context. The concept is relevant, because if a PE is deemed to exist in a country, then the profits attributable to that PE are taxable in the source country. In practice, the concept can also be elusive, because the definition together with the corresponding commentary does not address every situation, leading to inevitable “grey areas”. It may be possible for an enterprise with overseas business operations to avoid foreign taxes by carefully structuring its operations to avoid constituting a PE in the foreign country. The OECD seeks to address such base erosion resulting from the artificial avoidance of a PE status by formulating an action plan under its Base Erosion and Profit Shifting (BEPS) project.

## 3. Permanent Establishment – Basic Concept

The concept of a PE finds its reference in the model tax conventions (OECD, United States and United Nations) and forms an integral and indispensable part of the tax treaties entered into by various countries for taxing various streams of interconnected and interrelated incomes. The existence of a PE is the decisive criterion for determining taxation of business income arising from an economic transaction. This concept has been developed to ensure that business activities are not taxed in a foreign country unless such activity has sufficient economic bond with such a country, failing which, the country of residence is

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This article is not intended to comprehensively cover all issues pertaining to permanent establishment exposure. It is also not intended to be a substitute for legal advice, and readers are advised to not rely on this article without seeking prior professional advice.

1. *Compañia General de Tabacos de Filipinas v. Collector of Internal Revenue* (275 U.S. 87, 100 (1927)).

2. *CIT v. R.D. Aggarwal & Co* ((1964) 56 ITR 20 (SC)).  
3. Sec. 90(2) ITA.

given the sole right to tax the income arising out of such economic transaction. The PE criterion is often used as the litmus test for determining the taxability of a foreign resident performing activities/carrying on business operations in India.

The PE 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 as compared to when it is trading with a country. As the Indian judiciary puts it, 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 a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

The primary use of the PE theory is to determine the right of a country to tax the profits of an enterprise of another country. It defines the requisite level of nexus in a country to support taxation of business income at source. According to the concept of a PE, the profits of an enterprise of one contracting state are taxable in the other state, only if the enterprise constitutes a PE in the latter state and only to the extent that the profits are attributable to the PE. Thus, as a legal concept, a PE is a compromise between the source state and the residence state for purposes of taxation of business profits. The term must be understood so as to arrive at that degree of economic penetration which, according to the treaty partners, justifies a nation in taxing business income of a foreign person in a similar manner as taxation of business income of a domestic person.

The basic PE rule is found in article 5(1)<sup>4</sup> of the various tax treaties which India has entered into with many countries. The rule requires a foreign entity to have a fixed place in India at its disposal, through which the business of the foreign entity is carried out in India. Apart from the basic rule, furnishing of services by a non-resident in India through employees or other personnel may result in creation of a “service PE” provided the duration of such services exceeds a specified threshold period. An “agency PE” may be constituted inter alia in the event that the foreign entity has a dependant agent in India who habitually exercises an authority to conclude contracts on behalf of the non-resident, or who habitually secures orders on behalf of the non-resident.<sup>5</sup> The facts of each case need to be analysed in detail to determine the PE exposure for the foreign entity.

4. The term “permanent establishment” has been defined in the Indian tax treaties in article 5(1) as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.  
5. Article 5(4) of the India-United States (US) tax treaty.

## 4. Indian Jurisprudence on PE Issues

### 4.1. Foreign company(ies) outsourcing business operations to India

Globalization has led many MNCs to outsource business process and information technology services to low-cost jurisdictions for undertaking business operations in such jurisdictions. Channelizing back-end operations into such low-cost jurisdictions helps in achieving tremendous cost efficiencies. Secondment/deputation of employees of a foreign company to Indian affiliate(s) for ensuring quality control over such operations is another regular feature of such structures. India is ranked highly amongst globally preferred jurisdictions for channelizing back-end operations due to easy availability of an immensely talented workforce as well as the tremendous cost efficiencies.

The Indian affiliates are typically set up as captive service providers, contractually insulated from significant risks and entitled to a stable return for their services. Whether such outsourcing arrangements could result in a PE for the foreign enterprises and the attribution of profits if a PE exists in such scenario have been contentious issues in India. A PE exposure could arise depending on the following:

- *Fixed place PE*: Exposure would depend on the criticality and complexity of operations undertaken by the Indian affiliate, nature of rights (unrestricted/restricted) enjoyed by the foreign company to access premises of its Indian affiliate, control exercised by the foreign company over Indian operations, etc.
- *Service PE*: Exposure would depend on the extent of control exercised by the foreign company over the employees seconded/deputed to the Indian affiliate, combined with the right over their original employment by such employees.
- *Dependent agent PE*: Exposure would depend on the degree of authority available and exercised by the Indian affiliate for entering into contracts on behalf of the foreign company.

In respect of outsourcing arrangements, the Indian tax authorities have in general been of a view that contract service providers operating in India, whether providing information technology (IT), IT-enabled service, business process outsourcing, contract manufacturing or toll manufacturing services, on a stand-alone basis or by themselves, constitute a PE of their foreign principal companies. Such a viewpoint is directed towards creating taxable income, which is over and above the income being generated by the contract services providers (being associated enterprises), and is despite the fact that their operations are structured on a principal-to-principal basis.

In view of the backdrop, a recent ruling of the Delhi High Court in the case of E Funds Corporation *and its group entities*<sup>6</sup> comes as a silver lining for contract service providers in India. In this case, E-Funds Corporation, US and e-Funds IT Solutions Group, Inc., US (hereinafter collectively referred to as “the foreign companies”) were engaged

6. *DIT v. E-Funds IT Solution* 9[2014] 42 taxmann.com 50 (Delhi).

in providing IT and IT-enabled services, in respect of which back-office contract services were performed by e-Funds International India Private Limited for the foreign companies, under a “cost-plus” remuneration model. In the said ruling, the High Court has ruled against constitution of PEs of the foreign companies in India and held that the premises or facility of the Indian affiliate that provides services to its foreign group company under a sub-contract arrangement does not by itself result in a PE of the foreign enterprise. The ruling clarifies that even if the core activities of the foreign enterprise are outsourced to an Indian affiliate under a sub-contract arrangement, with the Indian affiliate bearing limited risk, it should not create a PE for the foreign enterprise if the foreign enterprise does not have right of use of the premises or facility from which the services are delivered. The ruling also confirms that visits by personnel of the foreign enterprise for stewardship activities or secondment of personnel who work under the direction and control of the Indian affiliate should not result in a PE under the service PE rule. This ruling also seems to be (correctly) at variance with the landmark Supreme Court ruling in the *Morgan Stanley* case (discussed at section 4.2. below) wherein the Supreme Court held that a secondment of personnel to Morgan Stanley India resulted in a service PE of Morgan Stanley US since the personnel had a lien on their employment with Morgan Stanley US, even if they were working under the control and supervision of the Indian entity.

Further, in the e-Funds case, it was held that the Indian subsidiary, rendering back-office functions for the foreign principal, did not constitute a dependent agency PE of the foreign principal, since it did not satisfy any of the conditions of dependent agency PE, as enshrined in the India-US treaty, being more or less similar as other treaties signed by India, namely (i) concluding contracts, (ii) stocking and delivering goods, or (iii) securing orders, on behalf of the foreign principal.

Equally important to bear in mind is an adverse ruling pronounced by the Delhi Bench of the Income Tax Appellate Tribunal (ITAT) in the case of *Convergys Customer Management Group Inc.*,<sup>7</sup> wherein a US-based company (the Taxpayer) had procured IT-enabled call-centre/back-office support services of its Indian subsidiary, on a principal-to-principal basis, to service its customers. The ITAT in the said case held that the Taxpayer had a “fixed place PE” in India as the employees of the Taxpayer frequently visited the premises of the Indian subsidiary to provide supervision, direction and control over the operations of the Indian subsidiary and such employees had a fixed place of business at their disposal. It was held in this case that the Indian subsidiary was practically the projection of the taxpayer’s business in India and carried out its business under the control and guidance of the Taxpayer and without assuming any significant risk in relation to such functions.

7. *Convergys Customer Management v. ADIT* (ITA No. 1443/Del/2012 & 5243/Del/2011).

In light of the rulings (discussed above), foreign MNCs need to be mindful of the PE risks that could arise as a result of outsourcing their operations to the Indian affiliate(s) in India and structure these arrangements carefully. The PE risk would vary depending upon the specific fact pattern of each case.

#### 4.2. Secondment arrangements

With the increasing advent of globalization, mobility of employees has become an integral part of business activities. For various commercial reasons, companies endeavour to benefit from their existing employees’ skills and experience when expanding abroad by seconding them to new offices.

Secondment is the temporary “loaning” of an employee to another entity for a fixed period of time (i.e. the assignment period). In a typical secondment arrangement, the employee makes available his capacity to work to the entity or establishment in the other country (host country). While doing so, the employee retains a lien on the home employment contract (also typically for continuation of social security benefits). The entity or establishment in the host country becomes the economic employer, since it bears the responsibility or risk for the result produced by the employee rendering the service. The remuneration in relation to services of the employee in the host country is typically disbursed and borne by the entity in the host country. Alternatively, the remuneration may be disbursed to the employee by the foreign employer and claimed as a reimbursement from the entity in the host country.

Service PE exposure on account of secondment of employees has been a subject matter of litigation in India. The Indian tax authorities in select cases have contended that by sending their employees to work in India (although under the control and supervision of Indian entity), the foreign entities are actually rendering services to the Indian companies and thus carrying out their business in India. Accordingly, it is typically argued by the tax authorities that the foreign entities have a PE in India by virtue of the employees’ presence in India.

On the other hand, foreign companies contend that merely by seconding their employees to work under the supervision and control of Indian companies, they are not rendering any services in India, or carrying out any business in India through such employees.

In context of secondment arrangements, the Indian courts in select cases,<sup>8</sup> have held that where the seconded employees retain their lien on employment with the foreign entity and the foreign entity is responsible for the work of such employees, the seconded employees render their services to the Indian entity as employees of the foreign entity. Accordingly, in such cases, the foreign entity has been held to render services in India and such rendition of services by a foreign entity through its employees, has resulted in a service PE risk under the relevant tax treaty.

8. Discussion on select cases in ensuing paragraphs below.

In this regard, the Supreme Court judgment in the case of *Morgan Stanley & Co Inc*<sup>9</sup> merits consideration wherein the US-based foreign parent (MS US) had deputed certain employees to work under the control and supervision of its Indian subsidiary (MS India). Based on the facts of the case, it was held that the MS US had a service PE in India on account of secondment of its employees to MS India. The primary reason that the Court deemed a PE to be triggered by such secondment was the lien that such secondees had on their employment with the foreign parent. It is to be noted that under the India-US tax treaty, a service PE is constituted on day one, in the case that the services are rendered to a related party.

However, in the case of *DDIT v. Tekmark Global Solutions LLC*,<sup>10</sup> the Mumbai ITAT held that where a US company deputed certain employees to an Indian company on a hire-out basis, the said personnel were working under the control and supervision of the Indian company, which reimbursed the salary cost for such personnel to the US company; no service PE of the US company was constituted in India. This ruling, interestingly, though adjudicated post *Morgan Stanley*, did not make any reference to the concept of “lien” over employment with the foreign entity, it instead concentrated on the control and supervision aspect, which clearly lay with the Indian company.

While the *Morgan Stanley* ruling coming of the Apex Court has become the law of the land, the issue with respect to secondment of employees continues to remain a tricky issue since in most cases foreign expatriates prefer to retain their employment with the foreign parent for the purpose of continuing their social security contributions.

The issue has become further complicated in light of the recent ruling pronounced by Delhi HC in the case of *Centrica India Offshore Pvt Ltd*.<sup>11</sup> This ruling follows the *Morgan Stanley* ruling (*supra*) and has, inter alia, held that so long as there is a lien on employment with the foreign employer and the right of termination of the seconded employees vests with the foreign employer, a “service PE” exists for the foreign employer in India.

Secondment arrangements need to be structured carefully and adequate safeguards need to be built therein, to ensure mitigation of service PE exposure for the foreign entity considering the *Morgan Stanley* and *Centrica* rulings (discussed above).

### 4.3. E-commerce transactions

With the advent of technology and e-commerce, the extensive use of the Internet has led to shrinking of the global market place in recent times. The term “Digital Economy” has become the new age buzz-word and the concept, which is currently in a nascent stage, is slowly evolving.

Rapid technological growth has challenged the adequacy and fundamental validity of traditional principles of international taxation such as physical presence, place of business, etc. which formed the basis for assessing tax liability. There are divergent views regarding taxation of e-commerce transactions and particularly on the issue whether it satisfies conditions for creation of a PE, as the attributes and intricacies of such transactions are “virtually complex”.

Taxation of business income on the basis of the source rule requires the presence, in the country of source, of a PE of the enterprise sought to be taxed. But when it comes to e-commerce, a lot of questions are raised. For instance, whether international trading by an enterprise through e-commerce will result in the enterprise creating a taxable PE in the other countries in which customers are located; whether the existence of a website and server in a country where no employees are located is sufficient to create a taxable PE; whether a third-party service provider or an Internet service provider can be considered to be a dependent agent, etc. Secondly, e-commerce gives rise to new issues concerning the characterization of payments under tax treaties. It is often difficult to distinguish whether payments for activities such as searching a computer database and downloading a document represent payment for the sale or lease of property, payment for the provision of services, or royalty payments.

In addition, the challenges in business practices due to advent of e-commerce affect taxation in the following ways:

- *No means to identify the location of activity*: As the physical location of an activity becomes less important, it becomes more difficult to determine where an activity is carried out and hence the source of income from such activity.
- *No means of identification of users*: In general, proof of identity requirements for Internet use is very weak. The pieces of an Internet address (or “domain name”) only indicate who is responsible for maintaining that name. It has no relationship to the computer or user corresponding to that address or even where the machine is located.

The Technical Advisory Group (TAG) was constituted by the OECD in 1999 to examine 28 categories of e-commerce taxation transactions and issue a comprehensive report on the same. The interpretation of the OECD for each of these transactions more or less followed its Commentary, with the objective of providing more clarity on each of these transactions.

In response, India set up a High Powered Committee (HPC) to examine tricky taxation issues arising from characterization of such licensing payments. The HPC Report analysed all categories of payments discussed in the TAG Report. However, the HPC did not agree with the TAG’s recommendations with respect to the characterization of payments made for use of software.

However, the above report and technical literature does not address complex issues on establishment of a PE in a virtual world.

9. *DIT v. Morgan Stanley and Co. Inc* ((2007) 292 ITR 416 (SC)).

10. *DDIT v. Tekmark Global Solutions LLC* ((2010) 131 TITJ 173; 2010 38 SOT 7 (ITAT Mumbai)).

11. *Centrica India Offshore Pvt Ltd v. CIT* ([2014] 44 taxmann.com 300 (Delhi HC)).

For example, a person situated in one contracting state may carry on a business/sell goods through a website. A website is nothing but a set of related web pages and is hosted on one (or more) servers which control the website. Through the server located in the home (and at times a third) jurisdiction, the owner of the website can carry out its business, inter alia, accept orders, disburse orders, check status, etc. Depending on the business, a server may not even need human intervention at all times, and control can be maintained from another jurisdiction. Thus, a foreign person may virtually carry on its business in another contracting state without having a physical presence in that state.

The OECD in its Commentary to the Model Tax Convention has stated that a website is a combination of software and electronic data, and hence cannot constitute a tangible property and therefore cannot be regarded as a “place of business” for a foreign enterprise. However, the same may not be true of a server, which is a piece of equipment, accessible at a physical location, and hence capable of constituting a PE of the enterprise which operates such a server in the foreign jurisdiction where it has been based.

While India has its reservations on the above Commentary, at the same time, Indian judiciary has made offhand references to constitution of a PE in a virtual world. For instance, the Supreme Court in the *Morgan Stanley* ruling<sup>12</sup> made a reference to a “software PE” without giving any description as to what that would entail. In its recent ruling, the Madras High Court in the case of *Verizon Communications Singapore Ltd*<sup>13</sup> while deciding whether payments made to Verizon Singapore from India resulted in royalty income, stated that physical presence of an entity had become insignificant in a virtual world. Factors such as presence of equipment, the rights and the responsibility of the foreign entity vis-à-vis its customer could be relevant in deciding whether the foreign entity had a virtual presence and, consequently, PE in India.

There exists now a larger debate as to whether the traditional concepts of PE have outlived their utility, and considering the manner in which businesses are run in a technologically fast-paced and developed world, whether new PE concepts need to be brought in to keep up with the ever evolving business models.

Such traditional concepts of PE have also resulted in foreign enterprises having the ability, at times to fragment their business activities across multiple jurisdictions in a manner so as to avoid constituting a PE in those jurisdictions, and minimize global taxes. The OECD in its BEPS initiative, through its Action Plan on addressing the tax challenges of a digital economy, combined with its action plan on preventing the artificial avoidance of PE status, seeks to address and try to come up with a solution which deals with such complex issues.

## 5. Indian Jurisprudence on the Taxability of E-Commerce Transactions

### 5.1. Whether existence of a computer server can result in creation of a PE?

In the case of *Galileo International Inc and Maruthi Info. and Tech Centre*,<sup>14</sup> Galileo, a US company which was in the business of maintaining and operating computerized reservation system (CRS) services, entered into an agreement with Interglobe (an unrelated Indian entity) to exclusively market its CRS services to travel agents/subscribers in India. Despite the fact that the server of Galileo was placed outside India, the ITAT held that since part of the CRS existed in the premises of the subscribers where the computers are placed, such premises constituted a fixed place of business for Galileo in India. The ITAT also observed that since the equipment, connectivity and configuration (provided by Galileo) was through a continuous, seamless process being made available to travel agents in India, a portion of the reservation activity was taking place in India and hence there existed a business connection of Galileo in India.

Further, the ITAT also held that since Interglobe was functionally and financially dependent on Galileo, it constituted a dependent agent PE for Galileo in India. Though on the issue of attribution, the ITAT held that since payment to Interglobe was at an arms’ length price, nothing further could be attributed to India, the finding of the ITAT that Galileo had a PE in India has been upheld by the Delhi High Court.

In the case of *Amadeus Global Travel Distribution SA*,<sup>15</sup> the ITAT had adopted a similar position based on a fact pattern broadly similar to that of the *Galileo* case. Amadeus, a foreign company had entered into a distributorship agreement with Amadeus India for canvassing travel agents and undertaking enabling services at the premise of such travel agents in respect of CRS services offered by Amadeus. The ITAT held that the CRS, which was the principal source of revenue was partially existent in the computer machines installed at the premises of such travel agents and thus, such computers constituted a fixed place PE for Amadeus, even though the mainframe computer was situated in Germany.

Further, the ITAT held Amadeus India to be functionally as well as financially dependent on Amadeus while also having the authority to conclude contracts on behalf of Amadeus. Accordingly, Amadeus India was held to be a dependent agent PE of Amadeus in India. With respect to attribution of profits to Amadeus India, it was held that since a major share of activity was performed at the mainframe computer in Germany, only 15% of profits were attributable to Amadeus India. The ITAT observed that the compensation paid to Amadeus India was more than

12. *Supra* n. 9.

13. *Verizon Communications Singapore Pte Ltd v. ITO, International Taxation-I* ([2013] 39 taxmann.com 70 (Madras)).

14. *Galileo International Inc. and Maruthi Info. and Tech Centre v. DCIT* ((2007) (114 TTJ 289) (ITAT Delhi)).

15. *Amadeus Global Travel Distribution S.A. v. DCIT and DDIT* ((2007) 113 TTJ 767 (ITAT Delhi)).

the revenue attributable to India territory and thus, no further attribution was required to be made.

In the background of aforementioned decisions, as also supported by the view adopted by the High Court in the *Galileo* case, the tax authorities' contention that computers/equipments in a CRS model constitute an equipment PE (read as fixed place PE) seems to have found favour with the Indian judicial authorities. The Supreme Court while ruling on the *Morgan Stanley* case, made a passing reference to a "software PE". Thus, in the Indian context, a more certain or definite outcome with respect to establishment of fixed place PE/dependent agent PE would depend on the infrastructure facilities extended to Indian counterparts, and the nature and scope of operations actually undertaken by the foreign company's counterpart in India, etc.

## 5.2. Whether virtual presence through a website can result in creation of a PE?

In the recent case of *Right Florists Pvt Ltd*,<sup>16</sup> the Kolkata Bench of the ITAT held that the presence of search engines of Google and Yahoo through websites, when servers are located outside India did not constitute a business connection or PE in India. In this case, the taxpayer made payments in respect of online advertising to non-resident entities, i.e. Google Ireland and Yahoo US without withholding taxes from these payments. Relying on the OECD Commentary (and rejecting India's reservations on "website PE" in the OECD Commentary), it was held that a search engine having its presence through a website cannot create a fixed place (basic rule) PE, unless web servers are located in the relevant jurisdiction. The ITAT further noted that the government may take a policy decision on whether suitable remedial measures to protect the revenue base were needed as conventional PE tests fail in the virtual world.

The OECD Commentary clarifies that mere existence of a website cannot create a PE and that a person may not have a "place of business" merely by hosting a website on a particular server situated at a particular location. As an observer on the OECD, India does not agree with this interpretation; it is of the view that a website may constitute a PE in certain circumstances. In a virtual world, traditional concepts of PE constitution may soon become outdated and source countries may soon demand their share in taxes based on a virtual presence of an enterprise in the source state.

## 6. Attribution of Profits to a PE

Attribution of profits to a PE has long been debatable within the context of international taxation. The international tax principles for attributing business profits to a permanent establishment are provided in article 7<sup>17</sup> of the OECD Model Tax Convention.

16. *ITO v. Right Florists (P) Ltd* ([2013] 32 taxmann.com 99 (Kolkata Tribunal)).

17. Article 7 of the MTC provides that the business profits of an enterprise may only be taxed in the state of residence unless that enterprise carries

Historically two approaches for attribution of profits under article 7 have emerged (although with a number of variations to each approach). These two approaches are broadly referred to as the "functionally separate entity" and "relevant business activity" approaches, i.e.:

- *Functionally separate entity approach*: This approach involves treating the PE as if it were a self-contained entity that is legally separate from the rest of the enterprise of which it forms a part. This exercise involves identifying the "functions" of the PE within the enterprise and then allocating assets, risk and capital of the enterprise that relate to those functions. Under this approach, profits can arise from deemed transactions between the PE and the rest of the enterprise, which are valued at arm's length prices in accordance with the transfer pricing principles.
- *Relevant business activity approach*: In contrast, although the relevant business activity approach also attempts to isolate the PE's business activity from the rest of the enterprise, profits can only arise from real transaction with third parties. Essentially, the PE's "relevant business activity" is identified and, based on that activity, an appropriate proportion of the enterprise's overall profits (or losses) is allocated to that PE.

The OECD's concern has been that treaty partners may apply different attribution methods to the same PE and double taxation or non-taxation could arise. The OECD therefore endorses a single method of attribution, the "functional separate entity" approach, which is also known as authorized OECD approach or "AOA" approach. Under the AOA approach, profit allocation to a PE is based on the principle that the PE is a separate enterprise engaged in the same or similar activities, and is independent from the rest of the enterprise of which it is a part and any other legal person, which means that its profits must be determined by the arm's length principle.

Under the AOA approach, the profit allocation between the PE and the head office is done using the following two steps:

- Step 1: Consider the PE as a "separate" entity and determine the economically significant activities that it carries out and functions it performs. Once these functions are determined, the PE is allocated assets, risks and capital of the enterprise by reference to those functions.
- Step 2: The dealings that the separate PE would have had with the remainder of the enterprise are valued on an arm's length principle in accordance with the transfer pricing principles. Profits are then attributed to the PE by reference to both actual transactions with third parties and also deemed transactions with the rest of the enterprises.

on business in another state through a PE. If a PE exists, the profits of an enterprise may be taxed in another state, to the extent that the profits "are attributable to that permanent establishment".

*Attribution of profits under the domestic tax law in India*

Under the Indian tax law, attribution of profits to PE is outlined in Rule 10 of the Income Tax Rules 1962, also referred to as the “rule of thumb”. Basically, there are three methods prescribed as per which the profits can be attributed to a PE:

- *Presumptive method*: Under this method, income of the PE is computed at a certain percentage of the turnover which the tax authorities may consider reasonable, i.e. to say ad hoc profits (based on percentage of turnover) are estimated as profits attributable to operations in India.
- *Proportionate method*: Under this method, proportionate profits based on worldwide income are attributed to the PE based on the ratio that the Indian receipts bear to the total receipts of the business. This method is a slightly difficult method as worldwide income of the enterprise is to be computed under the ITA before applying the proportionate method. Further, in the case of different businesses, relevant business income needs to be considered.
- *Discretionary method*: Under this method, tax authorities may devise any mechanism for attribution of profits on facts and circumstances of the case as may be deemed fit.

## 7. Indian Jurisprudence on Attribution of Profits to a PE

The attribution of profits to a PE is complex since it involves the interplay of domestic legislation vis-à-vis the provisions of tax treaties. Also, subjective interpretations and understanding of the business and industry have led to protracted litigation between taxpayers and tax authorities with respect to what reasonable attribution of profits should be.

The Indian courts have in general adopted the “single entity concept” for applying the attribution principles and calculation of tax liability. As per this approach, Indian courts have held that once a PE has been remunerated by the foreign company at arm’s length price, no further profits are required to be attributed to such PE. This principle was first laid down by the Supreme Court in the *Morgan Stanley* case (discussed at section 4.2. above) and followed subsequently by the High Court of Bombay in cases like *SET Satellite (Singapore) Pte Ltd.*,<sup>18</sup> *BBC Worldwide Ltd.*<sup>19</sup> and the *Galileo* case (discussed at section 5.1. above). While the above principles have been followed in the context of attributing profits to a dependant agent PE, Courts have more or less followed the rule of thumb (as discussed above) while attributing profits to other types of PEs.

With respect to attributing profits to a dependent agent PE, the principles enshrined in the AOA appear to be logical. In contrast to the AOA, “single taxpayer” approach would

not result in fair division of taxing rights between the source state and the residence state as it ignores assets and risks that relate to activities carried on in the source state merely because those assets and risks legally belong to the non-resident enterprise. Such an approach goes against the fundamental rationales behind a PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source state.

Another apparent flaw under the “single taxpayer” approach is that it is premised on the logic that arm’s length compensation to the dependent agent enterprise is considered to adequately reward the dependent agent enterprise for its functions performed, assets used and risks assumed, and since there are no other functions performed, assets used and risks assumed in the source state, there can be no further profits to attribute. However, there could be certain risks (e.g. inventory and credit risks under a sales agency arrangement) which belong to the non-resident enterprise and not to the dependent agent enterprise which technically warrants further profits to be attributed if the dependent agent performed the significant people functions relevant to the assumption and/or subsequent management of those risks.

Thus, the attribution principle is intrinsically connected to and dependent on calculation of arm’s length price which serves as the litmus test for establishing the reasonability of profits attributable to the PE and for determining consequential tax implications. With respect to transactions between related foreign companies in general and with PE in specific, the adherence to benchmarked prices satisfying the arm’s length test as per transfer pricing regulations is of pivotal importance to mitigate the tax exposure arising from potential PE classification.

However, it is useful to note that recently the courts in India have adopted different methodology(ies) for determining profits attributable to a foreign enterprise’s PE in India. For instance, the Delhi Bench of the ITAT in the case of *Convergys Customer Management Group Inc*<sup>20</sup> (after upholding that the attribution to the PE must be done as per the transfer pricing principles) adopted a formulary apportionment approach for attribution of residual profits to the PE, which is a deviation from the conventional arm’s length approach used in India. The ITAT laid down a step-by-step methodology for attribution of profits to a PE, applying the said methodology, the (residual) profits of the Indian PE were determined as the operating income from Indian operations less operating income of Indian subsidiary. In facts of the subject case, 15% of the residual profits of the Indian PE were held to be taxable in India.

It is also useful to note that while most arms’ length price determination methods work on a case-to-case basis, a formulary apportionment approach seeks to apply a pre-determined formula for all taxpayers. Under the Indian tax law, an approach similar to a global formulary approach has been envisaged under Rule 10 (discussed at section 6.

18. *SET Satellite (Singapore) Pte Ltd. v. DDIT* ((2008) 307 ITR 205 (Bombay High Court)).

19. *BBC Worldwide Ltd. v. DDIT* ((2010) 128 TTJ 411; 2010 SOT 253 (ITAT Delhi)).

20. *Supra* n. 7.

above), wherein the tax officer has been given the power to use such approach where he feels that the actual amount of income accruing or arising (from whatever source it may be) cannot be ascertained.

It seems that the rule of thumb (e.g. attributing profits using a global profit percentage of the foreign enterprise, project completion method in case of turnkey contracts, etc.) has outlived its life. The AOA should be the preferred approach for computing profits attributable to a PE as

it is consistent with the arm's length principle. Further, with advance pricing agreements to include requests for determination of profits attributable to a PE,<sup>21</sup> the scope of transfer pricing provisions in India is set to expand multifold.

21. A booklet titled *Advance Pricing Agreement Guidance with FAQs* issued by the Indian tax authorities.

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