

## 4. Permanent Establishment Perspective

### 4.1. Existence of a permanent establishment

Article 5 of the Indian income tax treaties defines the term permanent establishment (PE). For a foreign enterprise earning business income, in order to be liable to tax in India, such enterprise must have a PE in India. Under the treaty, there are a variety of PEs. However, for the purpose of analysis, the scope of discussion has been restricted to the types of PE that could arise given the activities contemplated in this chapter.

If a foreign enterprise is tax resident of a country with which India does not have an applicable treaty, the provisions of the ITA would apply to such enterprise. Section 90(2) of the ITA provides that where India has entered into an income tax treaty with any country, the provisions of the Act or the applicable treaty, whichever is more beneficial to the taxpayer, will apply.

The Finance Act 2012 amended sections 90 and 90A of the ITA, making it mandatory for every non-resident/foreign enterprise to obtain a certificate in the specified format (namely a tax residency certificate, TRC) from the government of the country or specified territory in which such person is a resident for evidencing such person's residency in that country. A TRC has been made a mandatory proof (but not the only sufficient proof) of the tax residence of non-residents to avail tax treaty benefits (a *de minimis* condition). While the authenticity of a TRC would not be questioned, the revenue authorities could ask non-residents to submit additional information as deemed necessary.

The OECD's final report on BEPS Action Plan 7 recommended multiple changes to article 5 of the OECD Model Tax Convention on Income and Capital (OECD Model), inter alia regarding the scope of "preparatory and auxiliary activities", agency PEs, etc. The said changes are also incorporated in the [2017 update to the OECD Model](#). The impact of such changes on India's income tax treaty would need to be assessed once the treaty partners renegotiate the income tax treaty with the tax treaty partner and the Multilateral Convention (to implement the BEPS tax treaty related measures) is ratified by India.

#### **Fixed place permanent establishment**

Article 5(1) of the Indian income tax treaties defines a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried on. A fixed place PE is said to have been created if two conditions are fulfilled.

First, there should be a fixed place of business. The term "fixed" has two aspects, namely the space/location test and the time/permanence test.

The *space/location test* has three main pillars, namely:

- specific situs – the location of the place of business should be a “single place”. If a foreign enterprise does not operate in the source state at a “distinct” place, then it does not constitute a PE, even if it operates for a long period of time;
- specific place – the place of business should be a specific place. It is not necessary that the equipment constituting the place of business be affixed to the ground; it is enough that the equipment remains on a particular site; and
- geographical and commercial coherence – the expression “fixed place” does not require that the place of business be stationary and not moving.<sup>[69]</sup> This involves identifying a “definite place” as the place from which a business is carried on. Hence, a “single fixed place of business” exists where, in light of the nature of the business, a particular location within which the activities are moved, constitutes a coherent whole commercially and geographically with respect to that business. For example, a mine or oilfield would constitute a single place business even though the activities may move from one location to another in the field.

Also, it is generally contended that a place of business may be regarded as a fixed place of business only if it satisfies the *permanence test*. Under the OECD Commentary, this period of permanence is generally considered to be 6 months, although such period needs to be determined based on the facts of each case.

However, the Authority for Advance Ruling, in the case of *Golf in Dubai, LLC*,<sup>[70]</sup> indicated that the period for determining permanence of a PE will depend on the nature of activities or business, and that there is no hard and fast rule regarding the number of days which can impart a degree of permanence to the place of business so as to render it a “fixed” place.

The Income Tax Appellate Tribunal, in the case of *Fugro Engineers BV v. ACIT*,<sup>[71]</sup> held that undertaking business activities from a fixed place in India would constitute a PE, irrespective of the time period for which such place of business was in existence during a financial year. The Supreme Court in the case of *Formula One World Corporation v. Commissioner of Income-tax, Delhi*,<sup>[72]</sup> held that the Buddh International Circuit, Greater Noida, should be construed as a PE within the meaning of the India UK DTAA and that all business income attributable to such a PE would be liable to tax in India. The Supreme Court held that even though Formula One World Corporation had full access to the Buddh International Circuit through its personnel for only a limited period (i.e. the access period) as part of its business model, this would not have any bearing on the characterization of this circuit as a fixed place PE of FOWC in India as the necessary ingredients for the creation of a PE had been met.

The second requirement for the deemed existence of a PE in India is that the place of business should be at the disposal of the person using it and that person must be in a position to exercise some rights, dominion or control to use a place for constituting a PE. The fixed place need not be owned or leased by the enterprise, provided that it is at its disposal in the sense of having some right to use it for the purposes of its business. A place used solely for purposes of the project undertaken on behalf of the owner of the premises will not constitute a PE.<sup>[73]</sup>

As stated in section 2.2., under domestic Indian tax law, the term “business connection” is akin (albeit broader in scope) to the concept of “PE”. While the term “business connection” admits of no precise definition, the courts have typically interpreted it to exist if there is a relation between a business carried on by a non-resident which yields profits or gains, and some activities in India which contribute directly or indirectly to the earning of those profits. The term “business connection” predicates an element of

continuity between the business of the non-resident and the activity performed in India. <sup>[74]</sup> However, with one distinction between a business connection and a PE being that the concept of “business connection” is wider or broader, a business connection may exist even without a PE. This is on account of the fact that the concept of “business connection” takes its character from the domestic tax law, whereas “PE” takes its character from the respective tax treaty.

### **Agency permanent establishment**

The concept of an agency PE is contained in article 5(5) and (6) of the Indian income tax treaties. Further, the 2017 update to the OECD Model also provides that a person acting in a state on behalf of an enterprise of the other contracting state will be deemed to constitute a PE if:

- a person is acting in a contracting state on behalf of an enterprise;
- a person habitually concludes contracts or plays the principal role leading to conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:
  - in the name of the enterprise;
  - 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 the provision of services by that enterprise;
- habitually maintains a stock of goods or merchandise from which such agent delivers such goods or merchandise; or
- habitually secures orders for the enterprise or other companies under common control.

The concept of agency essentially describes a relationship by which the agent has the authority or capacity to create legal relationships between the principal and third parties. The primary test of agency is the legal ability to bind the principal to a third party. The agent acts on behalf of the principal with a view to creating, altering or terminating rights and obligations between the principal and third parties.

The relationship of agent and principal need not emanate only from a contract, and may even arise out of necessity, <sup>[75]</sup> by ratification <sup>[76]</sup> or in situations where the agent may operate within the apparent authority, but outside the actual scope of authority. Under the Indian Contract Act, an agent’s authority to bind the principal may be express or implied, i.e. inferred from the circumstances of the case. <sup>[77]</sup> The agent’s authority could be incidental to the due performance of the express authority. An agent could also exercise an authority emanating from custom or common business practice.

Further, the courts have consistently accepted the position in law that if an agent serves a number of clients in his ordinary course of business, the PE exposure is significantly mitigated, as he cannot be considered to be a dependent agent. For example, *In Re: Specialty Magazines (P) Ltd.*, <sup>[78]</sup> a British publisher of magazines engaged an Indian company as an advertisement concessionaire for which it obtained a percentage of the consideration received in respect of each advertisement that was obtained. The AAR held that although the Indian company obtained approximately 75% of its revenues from the British publisher, it could not be treated as a “dependent” agent because it catered to a number of clients on a similar basis.

Further, even if a dependent agent PE is alleged to be constituted and the agent is compensated on an arm's length basis, as per the decision of the Apex Court in the case of *Morgan Stanley and Co Inc*,<sup>[79]</sup> no further attribution would be required in India. Such principle has been followed by the Bombay High Court in the case of *SET Satellite (Singapore) Pte Ltd v. DDIT*,<sup>[80]</sup> the Delhi High Court in the case of *DIT v. BBC Worldwide Ltd*<sup>[81]</sup> and the Delhi bench of Tribunal in the case of *Amadeus Global Travel Distribution SA v. DCIT*.<sup>[82]</sup>

The Delhi Tribunal, in the case of *Daikin Industries Ltd v. ACIT*,<sup>[83]</sup> upheld the existence of a dependent agency PE owing to the role of the Indian entity in negotiating and finalizing the contracts, constituting the substance of the sale transaction. However, the Tribunal, for attribution purposes, estimated a 10% profit rate for sales made in India and assigned 35% of such profit to marketing activities in India. The Tribunal thereafter allowed a deduction of the commission paid to the Indian entity by the foreign company while holding that the balance represented profits attributable to the dependent agency PE of the foreign company in India.

The final report on BEPS Action 7 has suggested the following modifications to the definition of an agency PE in order to address issues of "commissionaire" arrangements, inter alia:

- replacing the phrase "concludes contracts" with "concludes contracts or negotiates the material elements of a contract"; and
- restricting the application of the independent agent exclusion to agents who act not only on behalf of the enterprise but also on behalf of the group.

The above changes have also been incorporated in the [2017 update to the OECD Model](#). The impact of the above changes would need to be assessed in case India's income tax treaties are renegotiated in this regard. It is to be noted that India is a signatory to the Multilateral Instrument (MLI) that also includes the Artificial Avoidance of PE under Action 7, although it is not a minimum standard. MLI provisions will, as a result, automatically modify India's tax treaties covered by the MLI (provided the treaty partner has also opted for the same). For 23 Indian bilateral tax treaties, the MLI has entered into force in India from 1 October 2019. However, the provision became effective from 1 April 2020. Further developments on this front will have to be observed in due course.

### **Service permanent establishment**

Certain Indian income tax treaties provide for the concept of a "service PE", which prescribes the conditions under which the activity of rendering services by an enterprise through its employees or other personnel in the source state constitutes a PE. Under the service PE rule, the mere furnishing of services in the source state through the employees could lead to the creation of a PE, even in the absence of a fixed base.

The time limit regarding the rendering of services, beyond which a service PE is deemed to exist, is generally much less than that for the constitution of a fixed place PE. This time limit is even less if the services are rendered to an associated enterprise. For example, under the India–United States income tax treaty, a foreign entity is treated as having constituted a service PE even if it renders services to an associated enterprise merely for a single day.

In the context of service PEs, the Supreme Court of India, in the *Morgan Stanley* case,<sup>[84]</sup> specified two important principles. First, so long as an arm's length remuneration is paid by the principal, no further profits may be attributed to such service PE. Second, while examining whether a foreign entity has a

service PE in India, the following factors must be borne in mind:

- deployment of personnel for “stewardship” activities in the interest of the enterprise itself does not constitute a PE; and
- in case of deputation of employees, one must consider whether:
  - the foreign entity continues to be responsible for the work of the assignee; and
  - the employee continues to be on the payroll of the foreign entity or the employee continues to have a *claim to his job* with the foreign entity.

Further, in the case of *Centrica India Offshore India Private Limited*,<sup>[85]</sup> the overseas parent entity outsourced its back-office support functions to third party vendors in India. To ensure that such vendors meet the required quality guidelines, Centrica India was incorporated to act as an interface between the overseas entities and the vendors under a cost plus 15% markup arrangement. The overseas entities had seconded some expatriates to Centrica India to train the employees of Centrica India. The expatriates were to work completely under the control, direction and supervision of Centrica India. The expatriates retained their right to participate in the social security schemes abroad and had lien on employment with the overseas entities. For administrative convenience, the overseas entities paid the salaries and Centrica India reimbursed the same without a markup. The Delhi High Court held that the act of secondment of technical personnel by overseas entities to Centrica India are “technical services”. It held that the expatriates “make available” their technical knowledge and skill to the local employees, during the course of training the Indian employees. The High Court further held that the seconded employees also create Service PE and accordingly, held that the amounts paid by Centrica India were chargeable to tax in India. Aggrieved by the order, the taxpayer filed a special leave petition before the Supreme Court, which was summarily dismissed without any comment or observation.

The Authority for Advance Rulings in the case of *Mastercard Asia Pacific Pte Ltd*<sup>[86]</sup> held that the applicant had multiple forms of PEs in India, namely a fixed-place PE, service PE and dependent-agent PE, in respect of services rendered with regard to the use of a global network and infrastructure to process card payment transactions for customers in India. The Authority also held that arm’s length remuneration to the PE on account of the Indian subsidiary for the activities (to be) performed in India would not absolve the applicant from any further attribution of its global profits in India, since the functional analysis of the Indian subsidiary does not reflect the functions/risks of the applicant performed/undertaken by it.

The possibility of a person being treated as an employee of a foreign entity is not mitigated merely by virtue of the fact that the payroll is transferred to an Indian company, especially if the employee has claimed his employment rights with the foreign entity and such entity continues to be responsible for his work.

Whether a PE is deemed to exist in a given situation is dependent on the facts and circumstances of each case. The description of activities as listed in section 2. is not sufficient to comment on the same with certainty.

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**Description**

**Fixed PE**

**Agency PE**

**Service PE**

<b>Description</b>	<b>Fixed PE</b>	<b>Agency PE</b>	<b>Service PE</b>
Full-fledged manufacturer	Unlikely unless foreign entity itself carries on manufacturing through a place of business in India	Unlikely	Not applicable
Contract manufacturer	Might be constituted if the place of business is under the control and disposal of a foreign entity	May be constituted if contract manufacturer is a dependent agent and delivers inventory in India on behalf of principal (probability is low)	Not applicable
Toll manufacturer	May be constituted if the place of business is under control and disposal of foreign entity. Possibility higher than that in case of a contract manufacturer	May be constituted if the manufacturer is a dependent agent and delivers inventory in India on behalf of principal (probability is low)	Not applicable
Manufacturer's representative	Might be constituted if place of business is under control and disposal of foreign entity	Likely if representative is not of independent status (probability is high)	Not applicable
Limited-risk distributor	Unlikely, except when place of business is under control and disposal of foreign entity	Unlikely, as distributor is unlikely to have functions/ authority necessary to create PE	Not applicable

Description	Fixed PE	Agency PE	Service PE
Service company/contract service providers	Likely if foreign entity provides services through a place of business in India	Unlikely	Likely if foreign entity renders services in India through its employees or other personnel and applicable treaty contains a service PE clause
Agent/commissionaire	Possible if place of business is under control and disposal of the foreign entity	Likely	Not applicable

## 4.2. Allocation of profits to a permanent establishment

### 4.2.1. General concept

Article 7(1) of the Indian income tax treaties provides the framework regarding the taxing rights of the source state and residence state, and allows the source state to tax only those profits which are economically attributable to the PE. Further, certain income tax treaties contain the force of attraction principle, under which the taxation right of the source state extends not only to the profits attributable to the PE, but also to profits earned through the sale of the same or similar goods or by undertaking the same or similar business activities (particularly for associated enterprises) as those carried out by the PE. Although article 7(2) through (5) contains broad guiding principles, there is no specific guidance in the income tax treaties as to the method to be employed for the allocation of profits to a PE.

Indian domestic tax law contains very broad and limited provisions with respect to profit allocation. Profits, which are reasonably attributable to the operations carried out in India, are deemed to arise in and are subject to tax in India.

Where the actual amount of the income of a non-resident, through or from any business connection in India, cannot be definitely computed, the taxable income may be computed as per Rule 10 of the Income-tax Rules, 1962:

- as a reasonable percentage of turnover from Indian operations;
- as total profits in proportion of receipts in India compared to total receipts; or
- in any other manner considered appropriate and reasonable by the tax authorities.

In some cases, the ITA contains specific provisions regarding the taxation of profits of a foreign entity on a presumptive basis, including for oil field services and the operation of ships or aircraft. The courts have taken the view that where arm's length remuneration is paid to the entity in India, no further attribution to the PE may be made. <sup>[87]</sup>

In this context, useful reference may be made to the Authorized OECD Approach (AOA), that advocates the adoption of the separate entity approach for the determination of profits attributable to a PE. This principle has been endorsed in recent Indian rulings. An APA in this context would also be relevant since under an APA, the authorized OECD approach would normally be followed instead of the aforementioned Rule 10, especially under a bilateral competent authority negotiation. The AOA can nevertheless reconcile with the Rule 10 approach in certain situations, such as those involving dependent agency PEs, and are compensated as a return on sales.

To increase clarity and predictability, in April 2019, the Indian Revenue released a draft report on the attribution of profits to a PE for public comment. The draft report contemplates a modification of Rule 10 and differs from the AOA. It concludes that both demand and supply of goods are integral contributors to business profits and a mixed approach that accounts for both these factors should be used to attribute profits. It recommends fractional apportionment, which takes into account only those profits that have been derived from India and apportions them based on certain factors. The report considers a "fractional apportionment approach" based on the apportionment of profits derived from India the best option for a uniform and consistent method of profit attribution under Rule 10, thus bringing clarity and objectivity to the attribution of profits. It seeks to ascribe the attribution of profits to a PE based on fractional apportionment involving a three-factor rule, namely sales, employees/wages and assets, with all the three factors having equal weightage. In addition, for addressing the aspects of significant economic presence arising from the digital economy, the draft report contemplates users as another factor, depending upon the intensity of user participation. Further, the Finance Act 2020 has expanded the scope of APAs and safe harbour provisions to cover cases related to the attribution of profits to a PE in India.

#### **4.2.2. Allocation of assets**

Indian domestic law does not contain specific mechanisms or guidance regarding the allocation of assets. As mentioned, profits may be attributed in any suitable manner, which in appropriate cases may take into consideration the assets reasonably allocable or attributable to the PE. The law contains provisions for claim of depreciation with regard to assets that are co-owned.

#### **4.2.3. Valuation and depreciation of assets**

As per section 32 of ITA, assets are ordinarily taken at actual cost for computing the written down value of assets, depreciation and other tax allowances. Where the assets have been transferred at enhanced cost primarily for claiming higher depreciation or where the transaction has been structured in such a way as to reduce taxable profits, the tax authorities are authorized to ignore such excess valuation. Rule 5 of the Income Tax Rules, 1962 prescribes the rates at which depreciation is allowable on various categories of assets.

#### **4.2.4. Capital gains**

Capital gains arising on the transfer of assets located in India are taxable in India as per section 45 of the ITA. However, under certain income tax treaties, such as that with Mauritius, capital gains on the transfer of certain assets are taxed only in the alienator's state of residence. India has notified income tax treaties with countries (like Mauritius, Cyprus and Singapore) to reclaim its taxing rights in respect of capital gains arising to non-residents on transfer of shares of Indian companies on a prospective basis.

#### **4.2.5. Allocation of risks**

Indian domestic law does not contain any specific guidance with regard to the allocation of risks. As mentioned, profits may be attributed in any suitable manner, which in appropriate cases may take into consideration the risk reasonably allocable or attributable to the PE.

#### **4.2.6. Intra-company dealings**

It is imperative that any intra-company dealings be undertaken at arm's length in order to compute the profits attributable to a PE. Under article 7(2) of certain Indian treaties, profits attributable to a PE are calculated as if the PE were a distinct entity. However, certain treaties contain restrictions on the deductibility of amounts paid to a head office (e.g. royalties).

Further, Indian treaties generally provide that the issue of deductibility of expenses is to be governed by the domestic laws of the contracting states, and hence, no deduction is allowable for expenses in respect of which domestic law places a monetary ceiling. Section 44C of the ITA provides for a cap on the deduction by a non-resident in India with regard to executive and general administrative expenditure incurred by a head office. However, certain courts have held that an applicable tax treaty overrides the provisions of section 44C of the ITA, and that head office expenses should be allowed by apportioning them on the basis of Indian net proceeds to the global net proceeds.

Payments made by a branch office to a head office of a foreign enterprise have been a subject matter of jurisprudence in the Indian legislation, specifically for issues regarding, deductibility, taxability and applicability of withholding tax provisions on such payments. Courts have given contrary decisions on the same at various instances.

However, the following two conflicting views emerge from various decisions:

- Any interest received from an overseas head office was taxable as income of the branch (thereby applying the functionally separate entity approach). <sup>[88]</sup>
- Interest paid to head office and overseas branches by the Indian branch of assessee bank cannot be taxed in India being a payment to itself which did not give rise to taxable income in India (thereby disregarding the functionally separate entity approach). <sup>[89]</sup>

#### **4.2.7. Difference with Authorized OECD Approach**

India's differences with the authorized OECD approach have been incorporated in the 2010 version of the OECD Model <sup>[90]</sup> in the form of India's reservations to the OECD Model and Commentary. The Indian position seems to be at odds with the approach advocated under the OECD Model and the Commentary in certain cases.

While the Commentary to the OECD Model rejects the force-of-attraction rule, Indian tax treaties contain such imputation. Further, India has also reserved its right to provide that any income or gain attributable to a PE during its existence may be taxable by the contracting state in which the PE exists, even if the payments are deferred until after the PE has ceased to exist.

The [draft report on Attribution of Profits to a PE](#) referred to in section 4.2.1. does, however, contemplate the deduction of any compensation paid to an AE engaged in the same or similar activities while determining the profits attributable to the PE, and to this limited extent, is consistent with the AOA.

#### 4.2.8. Specific industries

There is no guidance with respect to specific industries. As noted in section 4.2.1., in the context of significant economic presence, user participation based on intensity is considered to be a factor in the attribution of profits to a PE engaged in digital businesses in terms of the draft report.

#### 69.

Authority for Advance Rulings, In the matter of ABC, 17 Oct. 1996 (1999) 237 ITR 798 ITR 798.

#### 70.

IN: AAR, 13 Oct. 2008, AAR 770 of 2008, *Golf in Dubai, LLC*.

#### 71.

IN: ITAT, 2008, 2008-TIOL-502-ITAT-DEL, *Fugro Engineers BV v. ACIT*, 23 SOT 78.

#### 72.

IN: HC Delhi, 30 Nov. 2016, *Formula One World Corporation v. Commissioner of Income-tax, Delhi*, [2017] 80 taxmann.com 347 (SC); judgment dated 24 Apr. 2017.

#### 73.

IN: ITAT Delhi, 25 June 2005, *Motorola Inc. v. Deputy Commissioner of Income Tax*, 95 ITD 269 (Del) (SB).

#### 74.

IN: Supreme Court, 6 Oct. 1964, *RD Agarwal & Co v. Commissioner of Income Tax*, [1965] 56 ITR 20 (SC).

#### 75.

Sec. 188 Contract Act states that an agent is authorized to do every lawful thing that is necessary in the exercise of his scope of authority.

**76.**

Secs. 196-200 Contract Act state that even unauthorized acts of an agent may be expressly or impliedly ratified by the principal.

**77.**

Secs. 186 and 187 Contract Act.

**78.**

IN: AAR, 7 Feb. 2005, *In Re: Specialty Magazines (P) Ltd*, (2005) 274 ITR 310 (AAR).

**79.**

IN: SC, 9 July 2007, *Morgan Stanley and Co Inc*, [2007] 292 ITR 416 (SC).

**80.**

IN: HC Bombay, 22 Aug. 2008, *SET Satellite (Singapore) Pte Ltd v. DDIT*, [2008] 307 ITR 205 (Bombay).

**81.**

IN: Delhi, 2011, *DIT v. BBC Worldwide Ltd*, [2011] 203 taxmann.com 554 (Delhi).

**82.**

IN: ITAT Delhi, 2011, *Amadeus Global Travel Distribution SA v. DCIT*, [2011] 11 taxmann.com 153 (Delhi).

**83.**

IN: ITAT Delhi, 28 May 2018, ITA No. 1623/Del/2015, *Daikin Industries Ltd v. ACIT*.

**84.**

IN: SC, 9 July 2007, *Morgan Stanley and Co Inc*, [2007] 292 ITR 416 (SC).

**85.**

IN: SC, 2014, *Centrica India Offshore India Private Limited*, TS-642-SC-2014.

**86.**

IN: AAR, 6 June 2014, No 1573 of 2014, *Mastercard Asia Pacific Pte Ltd*, AAR 1573 of 2014, rendered on 6 June 2018.

**87.**

IN: SC, 9 July 2007, *Morgan Stanley and Co Inc*, [2007] 292 ITR 416 (SC).

**88.**

IN: ITAT Mumbai, *DCIT v. British Bank of Middle East*, [2008] 19 SOT 730.

**89.**

IN: ITAT Mumbai, 20 Oct. 2006, 108 ITD 375, *Dresdner Bank*; IN: ITAT Kolkata, 23 Dec. 2010, [2012] 343 ITR 81, *ABN Amro Bank v. CIT*; IN: ITAT Mumbai, *Sumitomo Mitsui Banking Corporation v. DDIT*, [2012] 16 ITR(T) 116 (Mumbai) (SB).

**90.**

The same applies for the [OECD Model Tax Convention on Income and on Capital: Commentary \(26 July 2014\)](#), Treaties & Models IBFD.