Concept of Permanent Establishment
Presentation by Vikram Surana
# Glossary of terms

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Taxability of NR
Taxability of NR

Worldwide income of NR taxable in country of residence

Income of NR also taxable in host country based on business activities carried therein

This could lead to double taxation of income of NR

Tax treaty entered into between two sovereign states to eliminate double taxation

Tax treaty is an agreement between government of two countries which allocates the taxing rights of a particular income between them

Tax credit method also exists for elimination of double taxation
Taxability of a NR

- Section 5 of the Act provides for taxability of a non resident in respect of income:
  - Which is received or is deemed to be received in India
  - Which accrues or arises in India or is deemed to accrue or arise in India

- Section 9(1)(i) of the Act provides that a non resident would be taxed in India to the extent of income accruing or arising, whether directly or indirectly, through or from any business connection in India

- Treaty benefits - While determining the tax liability of the non resident, the provisions of the Act or the tax treaty, whichever is more beneficial, apply [Sec 90(2)]

- Concept of Permanent Establishment under the treaty is analogous to concept of BC under the Act
  - Term BC has wider connotation than the term PE
Concept of PE
Concept of PE

- Business profits, under Article 7 of the treaty, are taxable only if the non resident has a PE in India.

- Generally, business profits taxable in the country of residence. Business profits can also be taxed in the source country i.e. country in which they arise if:
  - Business is carried on through a PE in the source country.
  - Only those profits which are attributable to the PE can be taxed in the source country.

- Existence of PE also enables the Source State to tax capital gains, dividends, interest and royalties that are effectively connected/attribution to such PE.

- Please note that the business profits of a NR in India would not be taxable in case where there is no PE in India even if there exists a BC under the Act.

- It is imperative to note that PE is not defined in Section 2 of the Act.

- However, section 92F(iiiia) of the Act defines PE to include “a fixed place of business through which the business of the enterprise is wholly or partly carried on” (definition of PE is limited to TP provisions and Section 44DA of the Act).

- Under all Tax treaty models, Article 5 of Tax treaty covers PE related provisions which is discussed in detail in the ensuing slides.
Various types of PE
Various types of PE

- Article 5(1) - Fixed Place PE
- Article 5(2) - Specific inclusions
- Article 5(3) - Construction PE
- Article 5(4) - Exclusions from PE
- Article 5(5) - Dependent Agent PE
- Article 5(7) - Independent Agent
- Article 5(8) - Subsidiary company

Types of PE

- Basic / fixed place PE
- Construction PE
- Dependent Agent PE
- Subsidiary PE
- Service PE (Not present in OECD MC)
Article 5(1) - Basic Rule for PE (Fixed Place PE)

Under Article 5(1), PE exists if following conditions are satisfied -

- There is a place of business ("place of business test")
- Such place of business is at the disposal of enterprise ("disposal test")
- Such place of business is fixed ("location test" and "permanence test")
- The business of the enterprise is carried on ("business activity test") wholly or partly through such fixed place of business

A PE can be constituted under “Basic Rule” only if ALL of above tests are cumulatively satisfied
Fixed Place PE - case study

Facts

- Employee of a F Co is using an office of its subsidiary co I Co, since 4-5 months
- It ensures that I Co complies the obligation under the contract
- During this period it also carries on activities related to the business of F Co

Issue

Does the employee constitute PE of F Co in India?

Conclusion

The employee is carrying on activities related to the business of the F Co and the office of I Co is at his disposal and hence I Co will constitute a permanent establishment of F Co, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a “fixed place of business”
Fixed Place PE - case study

**Facts**

X Travels, a road transportation enterprise uses a customer’s warehouse every day for a number of years as a delivery dock to deliver the goods purchased by that customer.

**Issue**

Does the warehouse constitute PE of the X?

**Conclusion**

The presence of the road transportation enterprise at the delivery dock would be so limited that the enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.
Fixed Place PE - case study

Facts

A painter has been awarded with the contract to paint Tidel Park building within a period of two years.

The painter spends three days a week in Tidel Park for the painting work which is the premises of his main client.

Issue

Does the building constitute PE of the painter?

Conclusion

Yes. The presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) would constitute a permanent establishment of that painter.
Article 5(2) - Specific inclusions
Article 5(2) - Specific Inclusions

- Paragraph 2 of Article 5 contains a list, by no means exhaustive, of examples, each of which can be regarded, *prima facie*, as constituting a permanent establishment.

- Please note that these examples would be considered as places of businesses that would constitute a permanent establishment only if they meet the requirements of paragraph 1 of Article 5.

- Specific Inclusions - OECD MC
  - A place of management
  - A branch
  - An office
  - A factory
  - A workshop
  - A mine, an oil & gas well, a quarry or any other place of extraction of natural resources

- Additional inclusions - Indian Treaties
  - Warehouse in relation to person providing storage facilities for others - Treaties with Singapore, USA, Mauritius, Netherlands, etc
  - A store or premises used as a sales outlet - Treaties with USA, Netherlands, Germany, etc
Article 5(3) - Construction and Service PE
Article 5(3) - Construction PE

- Building site or construction or installation project constitutes a PE only if it lasts more than
  - 12 months (OECD MC)
  - 6 months (UN MC)

Consideration in calculation duration of Construction PE

- Site exists from the day from which work begins, including any preparatory work
- A site exists until the work is completed or permanently abandoned
- Twelve month test applies to each individual site or project - *Sumitomo Corp. Vs. DCIT* (2007) 110 TTJ 302 (Del)
- A building site should be regarded as a single unit, even if it is based on several contracts
Construction PE - case study

Facts

- A contractor started work on a road on 1 May 2013
- The work was stopped on 1 November 2013 because of bad weather conditions or a lack of materials
- However, he resumed work on 1 February 2014, completing the road on 1 June 2014

Issue

Can the construction project be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1 May 2013) and the date he finally finished (1 June 2014)?

Conclusion

Yes. A construction site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site.

Seasonal interruptions include interruptions due to bad weather and temporary interruption could be caused, for example, by shortage of material or labour difficulties.
Construction PE - case study

**Facts**

- A Co (general contractor), has undertaken the performance of a comprehensive project
- A Co initially subcontracts parts of such a project to other enterprises (subcontractors) who carry on their work for a period of 5 months ie from January 2014 to May 2014
- Post which A Co would continue the project to complete the same by January 2015

**Issue**

Should the period spent by a subcontractor working on the building site must be considered as being time spent by A Co on the building project?

**Conclusion**

Yes, If the part of the contract is subcontracted - Period spent by sub-contractor also to be considered - CIT Vs. Visakhapatnam Port Trust (1983) [144 ITR 146] (AP). Further, the subcontractor would himself have a permanent establishment at the site if his activities there last more than twelve months
Article 5(3) - Service PE

- Service PE is included in UN MC, whereas OECD MC has no such provisions for service PE.

- Service PE would exist if the following conditions are satisfied:
  - Services, including consulting services, are furnished by NR.
  - Services are furnished through employees or other personnel engaged by the NR for such purpose.
  - Activities of that nature continue (for the same or a connected project) within a contracting state.
  - Such activities continue for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned.
Service PE - case study

**Facts**

- UK Ltd, a company resident in UK, enters into a contract with an Indian customer - I Ltd for undertaking a management consultancy assignment in India
- For this purpose, the employees of UK Ltd frequently visit India and operate from the facilities of I Ltd
- Employees of UK Ltd work in India for more than 100 days in a year

**Issues**

Whether UK Ltd constitutes a PE in India?

**Conclusion**

Yes, UK Ltd will constitute a service PE since, the Service PE clause under article 5(2)(k) of the India- UK tax treaty provides that a service PE shall be constituted where the activities continue for a period or periods aggregating to more than 90 days within any twelve-month period. In the instant case, the employees of UK Ltd are working for more than 100 days in a year.

Further, there is also risk of constitution of fixed place PE since the facilities of I Ltd, through which the employees operate, are at the disposal of UK Ltd.
Article 5(4) - Exclusions from PE
Article 5(4) - Exclusions from PE

- Use of facilities solely for purpose of storage, display or delivery of goods or merchandise belonging to the enterprise
- Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of:
  - storage or display or delivery
  - processing by another enterprise
- Maintenance of a fixed place of business solely for the purpose of:
  - purchasing goods or merchandise or of collecting information, for the enterprise
  - carrying on for the enterprise any other activity of a preparatory or auxiliary character
- Maintenance of fixed place solely for any combination of activities mentioned above

It is imperative to note that the above activities are excluded from the definition of PE since such activities are so remote from actual realisation of profits that it is difficult to allocate any profits to PE
Article 5(4) - Exclusions from PE

Meaning of preparatory or auxiliary activities

- Dictionary meaning
  - Preparatory – something that prepares or serves to prepare for something following; preliminary or introductory
  - Auxiliary – an activity that involves helping, assisting or supporting main activity

- Analysis to be done on a case by case basis

- The decisive criterion is whether the activity of the fixed place of business in itself is an essential part of the activity of the enterprise as a whole

- If the purpose of the fixed place of business is identical to the purpose of the general enterprise then it is not preparatory or ancillary
Article 5(5) & 5(7) - Agency PE
Article 5(5) - Dependent Agent PE

Why an Agency PE clause?

An enterprise considering performing business in a host country may:

- Perform the activity by itself;
- Perform the activity through a separate legal entity; or
- Consider outsourcing that same activity to an agent (resident or not in the host country).

The mere absence of an Agency PE clause in a Tax treaty would represent the possibility of avoiding source taxation just by interposing an agent between the NR and the local customer.

Conditions to be satisfied - (Satisfaction of all the conditions are necessary)

- Should be a ‘Person’
- Agent other than an agent of independent status as per Article 5(7)
- Acting on behalf of NR
- Has an authority to conclude contracts in a contracting state
- Habitually exercises such authority in contracting state in name of NR
- No auxiliary activities
- UN MC - Habitually maintains stock of goods or merchandise and regularly delivers goods for and on behalf of NR
Article 5(7) - Independent Agent

A PE will NOT include:

- Carrying on of business in the other contracting state through:
  - A broker,
  - General commission agent, or
  - Any other agent of an INDEPENDENT status acting in the ordinary course of their business - legal and economic independence

- UN MC - An agent will not be considered as ‘independent’ if:
  - His activities are devoted exclusively or almost exclusively on behalf of his principal; and
  - Transaction between them are not made at arms length price

An example of Independent Agent

A newspaper publishing company, whose principal business is publication of newspapers in India also carries on business of collection of advertisements for NR publishers would be considered as agent of independent status as it acts in the ‘ordinary course’ of business
Agency PE - case study

Facts
- A Luxembourg company - F Co has appointed an Indian company - I Co as its sales agent in India
- I Co is not affiliated to F Co and undertakes similar services for a number of other multinational companies in India
- I Co’s role is limited to scouting customers in India, final agreement being executed directly by F Co with Indian customers

Issues
- Does I Co constitute a PE for F Co in India?
- Will your position change if:
  - The I Co is a wholly owned subsidiary (‘WOS’) of F Co and its activities are limited to agency arrangement?
  - The Indian WOS provides warranty and AMC services to the Indian customers of F Co under its independent arrangement with the customers?

Conclusion
- Ans 1: No PE in absence of economic dependence
- Ans 2: Although there may be a case of economic dependence, there would be no PE since I Co is not habitually concluding contracts for F Co.
- Ans 3: Warranty services are being undertaken independently by the I Co with its customers and not on behalf of F Co. Hence, provision of warranty services in the present case will not result in establishment of a PE of F Co in India.
Agency PE - case study

Facts

- F Co, a French company, engaged in the business of operation of ships in international traffic has an Indian agent who is remunerated at arm’s length for his services.

- F Co contended that as it did not have a PE in India as defined in the India-France Tax treaty, its business profits could not be taxed in India.

- Specifically, Article 5(6) of the India-France Tax treaty provides that where a person’s activities are devoted wholly or almost wholly for the enterprise, the person will not be regarded as an agent of independent status, if it is shown that the transactions between the agent and the enterprise were not made under arm’s length conditions.

Issues

Whether Indian agent could constitute PE of F Co in India?

Conclusion

- Agent of an independent status cannot create a PE.

- The India-France Tax treaty specifically provides that even when an agent is wholly or almost wholly dependent on F Co, it would still be treated independent agent, unless, transactions are not at arm’s length.

- Unless this negative finding is recorded, cannot be inferred that it is not independent agent. Onus is on tax authorities.
Article 5(8) - Subsidiary PE
Article 5(8) - Subsidiary PE

- Existence of a subsidiary by itself does not constitute PE
- Enterprise under the same control need not be a PE
- Subsidiary company will constitute PE only if it satisfies any of the basic conditions for creating a PE
- Parent Company may constitute a PE under Article 5(1) or Article 5(2) in a State where it has a place of business

Examples

- Indian arm of NR’s group engages in marketing and distribution of products manufactured by its group entities does not constitute subsidiary PE by itself - Varian India Pvt. Ltd. Vs. ADIT [2013] I.T. Appeal Nos. 4672 to 4676 of 2011 (Mum ITAT)

OECD Commentary (2010):

- Subsidiary company constitutes an independent legal entity- Para 40
- Existence in one State of a PE of one company of the group will not have any relevance as to whether another company of the group has itself a PE in that State- Para 41.1
Implications of PE
Key Tax Implications if PE is formed

- Profits attributable to the PE in India would be taxable in India @ 42.36% on a net income basis
  - Profits would need to be justified using a transfer pricing analysis

- Undertake compliances such as:
  - Obtain a Permanent Account Number (‘PAN’)
  - Maintain books of account
  - Withhold tax on expenses to be claimed as a deduction to compute profits
  - Undertake tax withholding compliances such as obtaining Tax Deduction Account Number, filing quarterly returns, issuing annual certificates, etc
  - Pay advance-tax, if/ as required
  - File annual tax return declaring taxable income

- Salary income of the employees working for the PE would also become taxable and compliances would be required for them as well:
  - Obtain PAN
  - Filing annual tax returns
Questions ???
Thank You