Permanent Establishments: Attribution of Business Profits

Introduction

In India, the taxability of any entity depends on its residential status. Pursuant to section 9 of the Income Tax Act, 1961 (**"Act"**), a resident taxpayer is subject to tax in India with respect to its global income. For the purpose of taxation of a foreign company's income arising in India, the Act differentiates between income from dividends, royalties and technical service fees, and adds the notion of "business connection" to cover other types of profits. If a company does not have a presence in India, but may potentially have some kind of activity or is present through an unincorporated structure like liaison office or branch office, the notion of a business connection will assume significance. And, if income is derived from such a business connection in India, it will be liable to pay tax on "such part of the income as is reasonably attributable to the operations carried out in India." The tax liability of such global companies is determined by the by the Double Taxation Avoidance Agreements (**"DTAA"**).

DTAA facilitate a fresh source of revenue for the income tax authorities in the form of Permanent Establishments (**"PE"**) by taxing the profits attributable due to the business activities carried out by it on behalf of the non-resident entity in India. PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. This newsletter shall focus on attribution of business profits of non-resident entities to different kinds of PE in India.

1. Creation of PE

Although, the existence of a PE is determined on a case to case basis, the concept of PE is ingrained in the concept of fixed base. PE, under Article 5 of the DTAA, means a fixed place of business through which business of an enterprise is carried on and includes, a place of management, a branch, an office, a factory, a workshop, a building site, a construction, installation or assembly project where such site or project continues for a period of more than six months. This notion of PE excludes **(i)** "Sporadic or isolated activities", but covers activities which have "continuity" or "durability", **(ii)** Enterprises engaged for specific other activities, which have a preparatory or auxiliary character for the enterprise, **(iii)** Business through a broker, commission agent or any third party intermediary of independent status provided that such person is acting in the ordinary course of their business.

There has to be a business connection between an entity in India and a non-resident entity for the existence of a PE in India. The term business connection in a nutshell is usually a business activity carried out by an entity, acting on behalf of a non-resident entity. The resident entity should either habitually exercise an authority to conclude contract on behalf of the non-resident entity or should habitually secure order on behalf of the non-resident entity. Alternatively, it should, with or without authority from the non-resident entity, maintain a stock of goods or merchandise from which they are delivered on behalf of the non-resident entity. The Supreme Court of India (**"SC"**) has explained business connection to mean something

more than a business activity wherein an element of continuity is presupposed. A stray or isolated transaction is normally not regarded as a business connection. A business connection must be real and intimate and through or from which income must accrue or arise whether directly or indirectly to the non-resident.[1] In consonance with the presence of fixed base and business connection, time is of essence in determining if an entity can be a PE as per Article 5(1) read with Article 5(3) of the DTAA. The requirement of time duration was affirmed in the case of *Re: Golf in Dubai LLC*[2], wherein an organiser of gold tournaments was exempted from tax liability in India on account of earnings through a contractor in India in less than 7 days. The applicable Indo-UAE DTAA mandated a business activity for at least 9 months. This was further affirmed by the SC in the cases of *Hyundai Heavy Industries*[3] and *Ishikawajma-Harima Heavy Industries Limited*[4] where it was ruled that the time expended for offshore activities under a contract would not be taken into account for meeting the time requirements under the applicable DTAA.

Hence, to establish a PE in India, the *first* requirement is to have a defined location for the operation in India,[5] the *second* one is to have a degree of permanence vis-a-vis business connection between a non-resident entity and its PE in India, with the *third* one being the essence of time. However, mere presence of all the three requirements does not entail the establishment of a PE in India. In other words, the concept of PE cannot be blindly applied. An example of such blind application would be a branch or office of a non-resident entity having no business activity. The fact that there is a physical establishment within the meaning of the definition of PE does not foist any liability. For e.g. many multinational companies as a matter of prestige have letter heads and postal heads of a country where they have no business activity. In such cases, there is no liability of a PE.

2. Attribution of Business Profits to a PE

Income attributable to a non-resident entity for its operations in India through its PE is regarded as *business profits*.[6] Computation of business profits should be in consonance with the principle of arm's length price.[7] Arm's length transactions are transactions carried out between two unrelated entities or as between *principal and principal*. It can be deduced that if transactions between the non-resident entity and the PE are at arm's length from the inception, there are no profits attributable to a PE from its work done on behalf of the non-resident entity. Calculation of business profits attributable to a PE is fact specific. Mentioned below are three fact situations where the courts have characterized the kind of PE in addition to the determination of *business profits* attributable to a PE.

[1] CIT v. R.D. Aggarwal & Co. (1956) 56 ITR 20
[2] MANU/AR/0012/2008
[3] (2007) 7 SCC 422
[4] (2007) 3 SCC 481
[5] In Re: P. No. 24 of 1996 [1999] 237 ITR 798 (AAR)
[6] Article 7(1) of the OECD model tax convention and Article 7 (1) of UN model tax convention
[7] Section 92C of the Income Tax Act, 1961 (Act)

Situation A: Attribution of Profits to a Fixed PE

It is a common practice that big transactions involving both resident and non-resident entities are carried out in parts under different contracts. In this regard, income tax authorities exercise caution while examining such transactions because there is a high possibility that income accruing to a non-resident entity under a particular contract of a transaction might not be taxable in India. In case of *Director of Income Tax v. LG Cable Ltd.*,[8] two contracts, one for offshore supply of equipments and the other for on-shore work regarding installation of fibre cables in India were entered into between LG, a South Korea incorporated company and Power Grid Corporation of India. The terms of the master agreement governing the two contracts specifically mentioned that the completion of one contract was dependent on the completion of the other. For the completion of the onshore contract, LG established a business office in India. It was held by the Assessing Officer and affirmed by the Commissioner of Income Tax (Appeals) that since both the onshore and offshore contracts were interdependent, profits earned by LG in Korea owing to supply of equipments (offshore contract) were taxable in India on the basis of business profits attributable to the business office, determined as a fixed PE in India. However, the Income Tax Appellate Tribunal (**"ITAT"**) and then the Delhi High Court reversed this finding by holding that the pre-requisites for a fixed PE are **(a)** business domain of the PE and non-resident entity are same/similar, **(b)** sole access of the non-resident entity to the premises of the PE, and **(c)** PE essentially caters to the needs and requirements of the non-resident entity. Mere interdependence of contracts does not result in attribution of profits of off-shore supply to the PE in India. Since the sale happened outside India, profits cannot be attributed to PE in India.

Situation B: Attribution of Profits to an Agency PE

The DTAAs have outlined that an employee would be considered as an Agency PE of a non-resident entity if **(a)** he regularly concludes contracts on behalf of the non-resident entity or **(b)** his job responsibilities include activities which are central to the functioning and operation of the non-resident entity in India. The establishment of Agency PE due to the activities and actions of employees in India was extensively discussed in *Motorola Inc. V. Deputy CIT.*[9] In this case; the employees of the company were in the habit of negotiating and concluding contracts in India while acting for the Indian subsidiary. Though the matter was disposed off due to want of clear evidence, the establishment of a PE in the form of an agency was admitted by the assessee later in an agreement with the tax authorities. Hence, the income generated by the non-resident entity on account of conclusion of contracts was attributable to the Agency PE.

Situation C: Attribution of Profits to a Service PE

Deputation of personnel to India, to render services to an Indian entity or its own affiliate or subsidiary creates a Service PE, either upon elapse of time or immediately upon the receipt of service. This issue was extensively discussed by the SC in the case of *DIT v. Morgan*

[8] (2011) 237 CTR (Delhi) 438
[9] (2005) 96 TTJ (Delhi) 1

Stanley and Co.[10] In the instant case, the appellant, a US company had deputed some of its personnel to its Indian subsidiary to maintain quality control and confidentiality. The question that arose was whether such employees deputed to the Indian entity constituted a Service PE for the US parent company. The SC in this case devised the two pronged test of **(a)** lien of employment and **(b)** nature of activity to determine the existence of PE. There was no Service PE in this case because the nature of activity performed by the deputed personnel was merely of supervisory nature and did not contribute to the business of the PE. Therefore, no profits could be attributable to the Indian subsidiary.

Conclusion

It is pertinent to follow the "substance over form" principle for characterization of a PE. Although law regarding PE is clear, it has been observed that income tax authorities unnecessarily trouble the non-resident entities by either erring on the determination of a PE or attributing profits to a PE. Therefore, it is advisable for the non-resident entities to take a preliminary ruling concerning their transactions from the Authority of Advance Rulings. Also, great caution has to be undertaken by the income tax authorities in order to differentiate between income attributable to a PE due to activities performed by it through a non-resident entity and income generated by a PE through its activities in India.

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[10] [2007] 7 SCC 1