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Permanent Establishment and Business Profit

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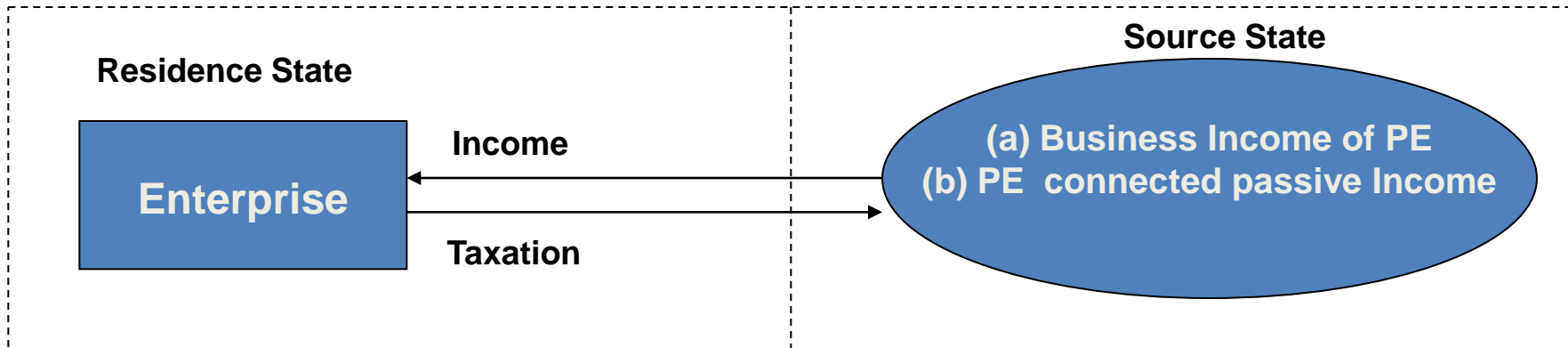
Key takeaways

Permanent Establishment



Permanent Establishment

Concept of PE



- **Source Country's right to tax Residents of Other Contracting State under Tax Treaties**
- **Visakhapatnam Port Trust [1983] 144 ITR 146 (AP)**

“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 placed of business** in that country. It should be such as that it would amount to a **virtual projection** of the foreign enterprise of one country into the soil of another country.”

Permanent Establishment under Income-tax Act

- The **concept of PE was introduced** in the Act as part of the statutory provisions of transfer pricing by the Finance Act, 2001
- Circular No. 14 of 2001 ([2001] 252 ITR (St.) 65, 107) clarified that the term PE has not been defined in the Act but its meaning may be understood with reference to the tax treaty entered into by India.
- However, vide Finance Act, 2002, **the definition of PE was inserted** in the Act under section 92F(iiiia) which states that the PE includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.
- Morgan Stanley [2007] 292 ITR 416 (SC) – Supreme Court observed that the PE
 - is an inclusive definition
 - covers service PE, agency PE, construction PE, etc.

Various types of PE

Overview of article of OECD Model Commentary is as under:

Article no.	Particulars	Type of PE
Article 5(1)	Basic rule	Fixed base PE
Article 5(2)	Illustrative list of PE	Inclusions to fixed base PE
Article 5(3)	PE in relation to projects	Construction PE & Service PE
Article 5(4)	List of exclusions	Exclusion from fixed base PE
Article 5(5) & (6)	Dependent / Independent agent	Agency PE
Article 5(7)	Associated enterprise	Subsidiary PE

Article 5(6) in UN Model contains a special rule for agents of insurance company & is absent in OECD and US model

Fixed base PE

- Article 5(1) of the OECD Model Commentary governs basic rule for Fixed base PE
“For the purpose of this Convention, the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on”
- Definition is identical under UN and US Model
- Elements of Fixed base PE
 - Existence of ‘place of business’
 - Place of business is at disposal
 - Place of business must be ‘fixed’
 - Business is carried on wholly or partly through fixed place of business

Above conditions need to be cumulatively satisfied

What is the place of business?

Reasonable degree of permanence and continuity

- Place of business maintained for less than six months – para 6 of OECD MC unless –
 - The nature of business is such or
 - Business is exclusively carried on in the source state only
- Activity of recurrent nature - aggregate period is to be considered and not each period on a stand alone basis
- Temporary interruptions (seasonal business, holidays) to be ignored while determining permanency

What is the place of business?

Geographical and Commercial Coherence

- Movement of activities between neighboring locations
 - A very large mine or an oil field
 - Office regularly rented by a consulting firm in a hotel building
 - Trader setting up regular stand in a pedestrian street or in an outdoor market/fair
- Whether PE exist in the following cases - Geographical coherence exist
 - Painter working for different clients in a building
 - Painter working on a single contract undertaken through out the building for single client

What is the place of business?

- **Whether PE exist in following cases – cases of commercial coherence**
 - A consultant working at different branches in separate locations pursuant to a single project for training the employees of a bank – each branch should be considered separately
 - A consultant moves from one office to another within the same branch location pursuant to a single project for training the employees of a Bank

Existence of both Geographical as well as Commercial Coherence is must

Reference to para 5.2, 5.3 & 5.4 of OECD MC

Place of business at disposal

- **Certain space should be available at the disposal**
- **Ownership test – immaterial**
- **Some rights / domain / control to use is required**
- **Test of place of business at disposal (reference to para 4.2 – 4.6 of OECD MC)**

Not at disposal	At disposal
Regular visits by Salesman to meet purchase director to take orders	Employee of parent, is allowed to use office of subsidiary company under a contract with parent for sufficiently long period of time
Road transporter using a delivery dock for a number of years for delivering of goods purchased by client	Painter, for two years, spending 3 days a week in large office building of client for painting purpose
Foot print area of a satellite	
Roaming arrangement where home country operator transfers call to a foreign network	

Fixed base PE

- Article 5(2) of the OECD Model Commentary provides inclusive definition of PE
- Basic rule reads as under –
 - The term ‘permanent establishment’ includes especially:
 - A place of management;
 - A branch;
 - An office;
 - A factory;
 - A workshop, and
 - A mine, an oil or gas well, a quarry or any other place of extraction of natural resources
- This list is inclusive and not exhaustive
- Definition is identical under UN and US Model

Power of Disposition - judicial precedents

- There should be some evidence to indicate that whenever any employee of the foreign enterprise came to source state, he could straightaway walk into the business premises and occupy a space or a table
 - Motorola Inc [2005] 95 ITD 269 (Del) (SB)
 - Western Union Financial Services Inc [2006] 101 TTJ 56 (Del)
- US Co engaged in providing Computer Reservation Services had a PE in India under Article 5(1) as it exercised complete control over the computers installed at the premises of the subscribers and the computers could not be shifted from one place to another within the premises of the subscriber
 - Galileo International Inc [2008] 19 SOT 257 (Del)
- The premises of a wholly owned subsidiary in India were available to all the employees of the UK company in respect of its business operations in India - The UK Co. had a place of business at its disposal and a PE in India
 - Rolls Royce Plc [2009] 122 TTJ 359 (Del)

Construction / Installation PE

Article 5(3) - Comparison

OECD Model Convention	UN Model Convention	US Model Convention
“A building site or construction or installation project constitutes a permanent establishment only if it lasts <u>more than twelve months</u> ”	“The term ‘permanent establishment’ likewise encompasses: a) A building site, a construction, <u>assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;</u>	“A building site or construction or installation project, or an <u>installation or drilling rig or ship used for the exploration or exploitation of natural resources</u> , constitutes a permanent establishment <u>only if it lasts more than twelve months</u> ”

Analyses of Construction / Installation PE

- **Analyses of Construction / Installation PE in following situations:**
 - Single Contract v. Multiple Contracts
 - Project office – if more than six months
 - Construction / Installation activities along with supervisory activities
- Once it is found that the duration in respect of each contract is less than 9 months, it will not constitute PE in terms of Article 5 of the India Mauritius tax treaty.
 - J. Ray McDermott Eastern Hemisphere Limited [2012] 54 SOT 363 (Mum)
- While computing the time limit of nine months for construction and assembly projects, preparatory activities for starting the projects have to be considered but purely preliminary activities such as visits for negotiations and taking soil samples need not be considered.
 - Cal Dive Marine Construction (Mauritius) Ltd. [2009] 315 ITR 334 (AAR)

Construction/Installation PE – Recent Judicial Pronouncements

- **Supervisory services provided by a foreign company through its technicians do not constitute a PE in India under Germany tax treaty**
 - *GFA Anlagenbau Gmbh [2014] 47 taxmann.com 313 (Hyd)*
- **Activities relating to installation of pipe lines by a marine vessel are treated as ‘construction and assembly’ and results into PE if carried on for more than nine months under the Mauritius tax treaty**
 - *GIL Mauritius Holdings Ltd [2011] 48 SOT 17 (Del)*
- **The time period of independent installation and assembly projects cannot be aggregated in order to determine the constitution of a PE under Article 5(3) of Singapore tax treaty**
 - *Tiong Woon Project & Contracting Pte Ltd [2011] 338 ITR 386 (AAR)*
- **Rectifying or supplementing installations of Pipelines can be construed as installation or assembly project**
 - *ABC [1999] 237 ITR 798 (AAR)*

Service PE

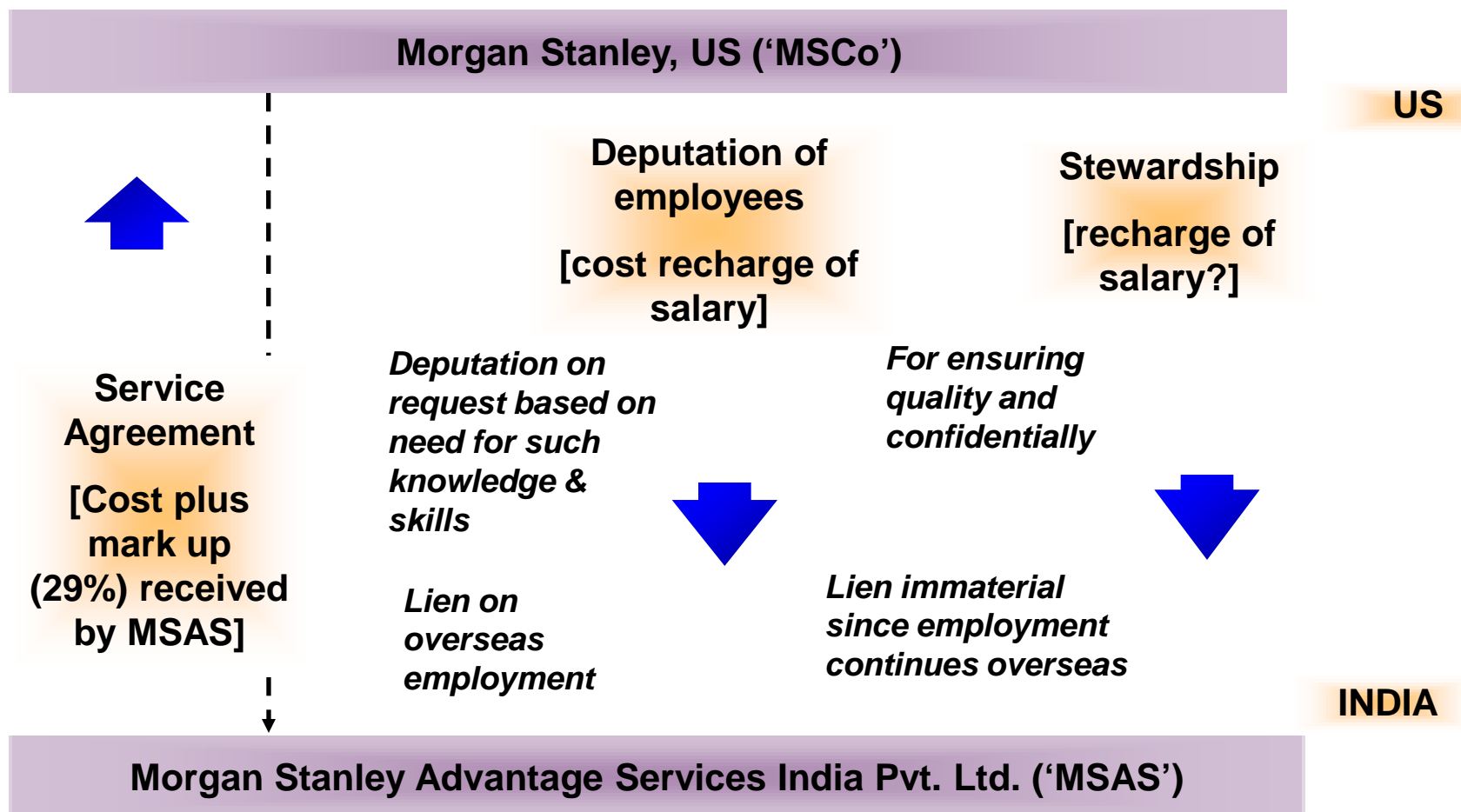
▪ Service PE - Features

- Furnishing of 'services' within India which is not FTS / FIS
- Through employees or other personnel
- Activities continue for a period exceeding 90 days (30 days or one day where services are rendered by associated enterprises)
- OECD / US Model Convention does not have an Article governing this
- No service PE clause in some Treaties – Netherlands, France, Mauritius, etc.

Relevant judicial pronouncements:

- **Deputation of personnel by the US Company to the Indian Company, without providing any further service cannot create a PE in India**
 - *Tekmark Global Solutions LLC [2010] 38 SOT 7 (Mum)*
- **Foreign company is having a service PE in India by virtue of employees of its sister concern being made available to the Indian subsidiary to carry out the project**
 - *Lucent Technologies International Inc. [2009] 28 SOT 98 (Del)*

Morgan Stanley & Co. Inc [2007] 292 ITR 416 (SC) - Facts



Morgan Stanley & Co. Inc [2007] 292 ITR 416 (SC)

- Employees of MSCo sent on stewardship (for short duration) to protect the interest of MSCo. Employees not engaged in day-to-day management of MSAS nor in any specific services to be undertaken by MSAS. Hence, no Service PE
- Service PE created on deputation of employees to MSAS, even if they work under control and supervision of MSAS. Key factors considered:
 - ✓ Lien on employment with MSCo; hence control over employee's terms of employment
 - ✓ Employees continues to be on the payroll of MSCo
 - ✓ On completion of tenure, employee is 'repatriated' to parent
 - ✓ Responsibility for risks and rewards of service with MSCo
 - ✓ Request for deputation from MSAS based on need for those skills in India

Exceptions in Article 5(4) - Exclusions of activities that do not result in PE

▪ Exclusions of activities

- Use of facilities for storage or display of goods
- Maintenance of stock of goods for storage or display
- Maintenance of stock for processing of goods
- Purchasing goods or merchandise or for collecting information for the enterprise
- Carrying on, for the enterprise, any other activity of a preparatory or auxiliary character

Preparatory /Auxilliary	Non-Preparatory/Auxilliary
Market survey / Industry analyses / economy evaluation	Managing an enterprise or its parts
Furnishing of information including product information to prospective customers	A management office for supervisory and co-ordinating functions
Ensuring technical presentation to potential users	Supervisory or control of performance of contract
Development of market opportunities	After sales services to customers
Basic operation before commencement of business activities in India	A fixed place of business for the delivery of spare parts to customers

- **Article 5(5) of the OECD Model Commentary**

“Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph”.

- **Article 5(5) of the OECD Model Commentary is identical to Article 5(5)(a) of UN Model Commentary & Article 5(5) of US Model Commentary**

Agency PE

- Person said to have authority to conclude contracts if, he/she:
 - Has sufficient authority to bind foreign enterprise and decide final terms
 - Can act independently, without control from the principal
 - Is authorized to negotiate all elements and details of a contract
 - Where approval of contract by foreign enterprise is a mere formality
- **Klaus Vogel** - “A general authority cannot be taken to exist if the authority to negotiate and conclude contract is so restricted that it allows the agent to settle for only such prices and terms and conditions as were fixed in advance by his principal, the agent having no scope for decisions of his own in this respect...”
- **Arvid Skaar** “No agency PEwhen the authority is limited to fixed prices and other fixed conditions determined by the principal, even if the contract is concluded by the agent”

Comparison – Article 5(6) of the conventions

OECD and US Model Conventions

“An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as independent agents”.

UN Model Convention

Notwithstanding the preceding provisions of this article, an enterprise of a Contracting State shall not be deemed **However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial & financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph”.**

Dependent Agent - activities

- Whether mere negotiating is sufficient to constitute PE if actual signing does not take place in the other State ~ depends on the authority of the agent
- Authority must be habitually exercised
 - Mere one-off contract or a single contract does not lead to an agency PE (Extent & frequency of the transactions)
 - Mere existence of authority to conclude contracts does not lead to PE unless the agent is actually engaged and concludes in a manner (Klaus Vogel at page 334)
 - If the principal has put the agent in a position where a bonafide third party is justified in believing that the agents action are based on an authorization and thus create an obligation for the principal

Agency PE – Relevant Judicial Pronouncements

- **Since an agent represents multiple principals and provide similar services to various principals and the agent does not act exclusively for the sole principal, such agent does not have an agency PE in India**
 - *AL NISR Publishing [1999] 239 ITR 879 (AAR)*
- **Even though the agent acts independently in the ordinary course of his business, if they devote their activities, wholly or almost wholly on behalf of the foreign enterprise, they would be considered as dependent agents**
 - *Reuters Limited Construction House [2011] 48 SOT 246 (Mum)*
- **Pre-sale activities and incidental post sale support activities for products supplied by the foreign company cannot be treated as DAPE**
 - *Varian India Pvt Ltd [2013] 33 taxmann.com 249 (Mum)*
- **Agency PE does not exist as long as it is shown that the transactions between the agent and the taxpayer are made under arm's length conditions**
 - *Delmas, France [2012] 17 taxmann.com 91 (Mum)*
- **The Applicant did not constitute a dependent agent of the UK Company as the income from the UK company was only 75% to 80% of the total revenues of the Indian Company**
 - *Specialty Magazines P. Ltd. [2005] 274 ITR 310 (AAR)*

- **Article 5(7) of the OECD Model Commentary**

“The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other”

- **Definition is identical under UN and US Model Commentaries**

- **Existence of a subsidiary by itself does not constitute PE**

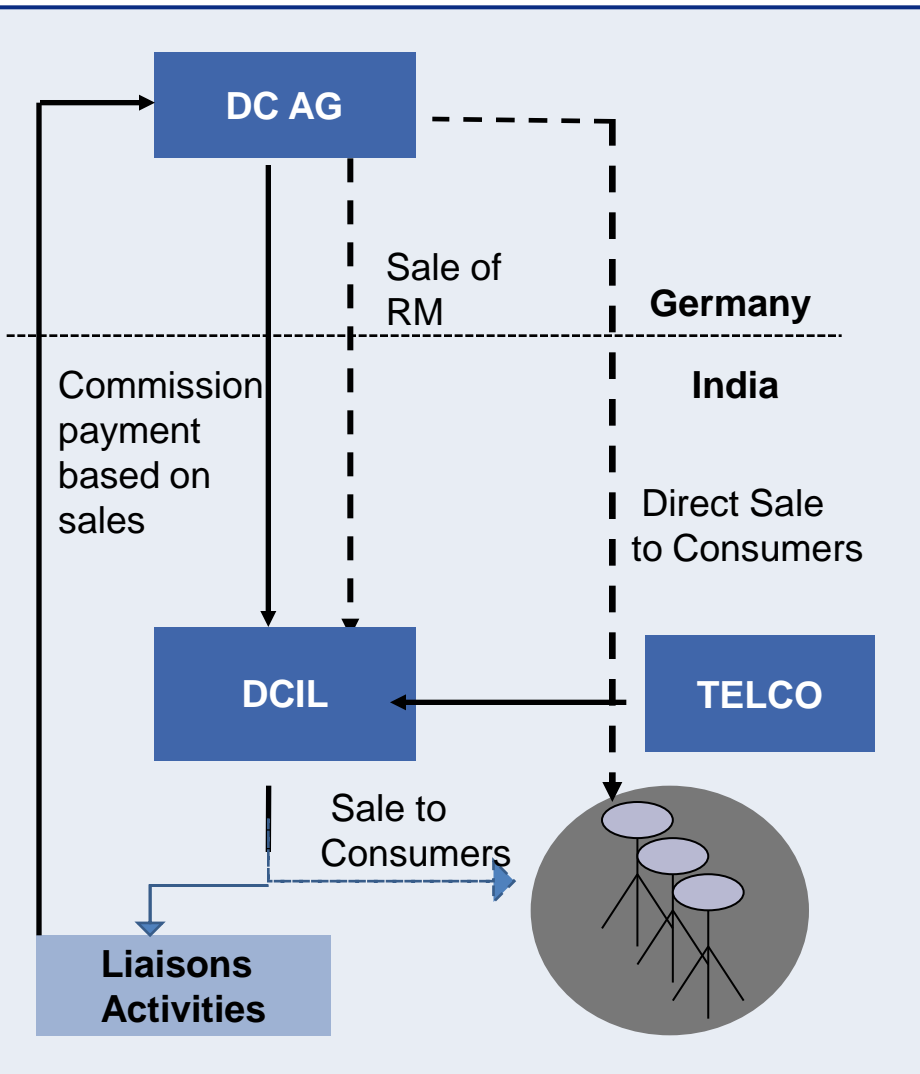
- Legal independence of the subsidiary respected

- **Test of fixed base PE / service PE / agency PE need to be satisfied**

Judicial Precedent

- Subsidiary of the taxpayer was treated as a PE in India by virtue of employees of affiliates being made available to the Indian subsidiary to carry out the project
 - Lucent Technologies International Inc. [2009] 28 SOT 98 (Del)
- Indian subsidiary created for securing orders in India wholly for the group and having a right to conclude contracts for the group is an Agency PE for the group
- The exception with respect to control over Subsidiary not constituting a PE as per Article 5(10) of the tax treaty is not applicable as the whole business in India of the multinational group is carried on within the geographical contours of India
 - Aramex International Logistics Private Limited [2012] 348 ITR 159 (AAR)

Subsidiary Company – whether PE?

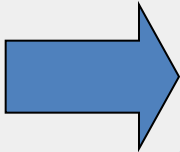


Facts

- DC AG, set up a JV with TELCO viz. DCIL in India for the manufacture / assembly and sale of cars
- DC AG sold RM, CKDs and other parts to DCIL
- DCIL Role:
 - Manufacture and sale of cars for sale to Indian consumers
 - Liaison activities in connection with Direct Sales by DCAG for a commission based on sales
- MD & ED of DCIL was deputed by DCAG

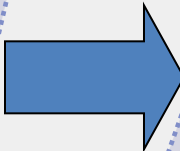
Subsidiary Company – whether PE?

Formation of PE – whether fixed place / Place of Management PE was formed due to deputation of MD and ED?



- **No Fixed place PE** : Mere existence of a subsidiary does not constitute a PE
 - Foreign Co was not given right to use Indian Co's premises
 - Sale of CKDs to Indian Co was on P2P basis; Indian Co does not constitute sales outlet / warehouse of Foreign Co
- **No Place of Management** : Foreign Co had separate board of directors in India from Indian Co
 - MD and ED were deputed as employees of Indian Co

Agency PE – Indian Co is a DAPE of Foreign Co in respect of cars sold directly to Indian consumers?



- **No Agency PE**: Indian Co was only acting as 'Post office' between Foreign Co & Indian consumers
- Indian Co does not bear any risk or carry out negotiation of price, finalizing deal etc.
- The activity was not main business of Foreign Co but just preparatory or auxiliary activities

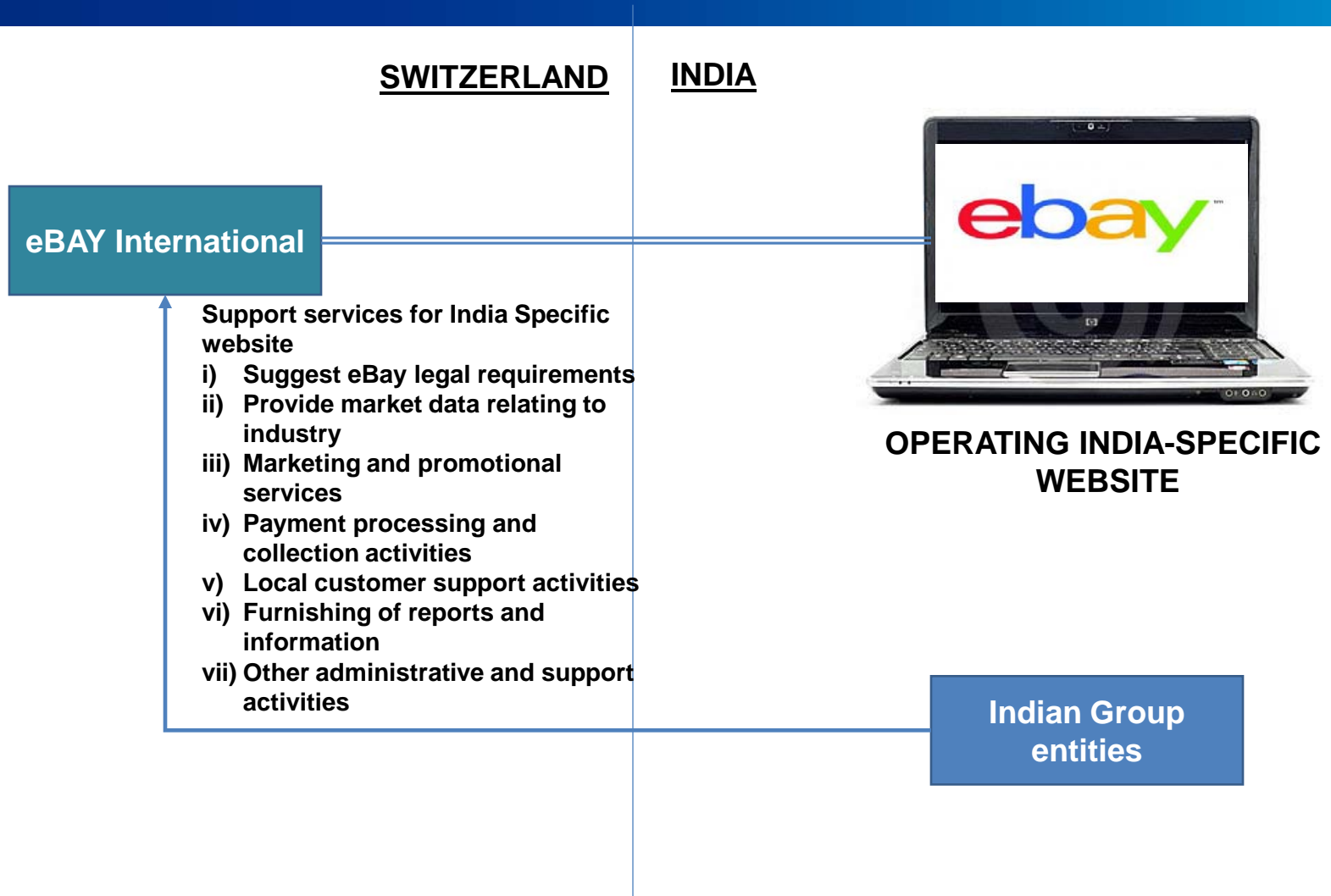
E-commerce

- Key elements in e-commerce transaction – website, server, computer of user, telecom infrastructure, etc.
- No physical presence or contact
- Lack of identification of parties to a transaction
- No physical trails or records
- New methods of payment
- Lack of active human involvement at point of service

Treaty characterisation of E-commerce transactions

E-commerce transaction	TAG (OECD view)	India position
Online shopping portals	Business profits	Business profits
Online auctions	Business profits	Business profits
Subscription to a web-site allowing the download of digitized products	Business profits	Royalty
Electronic access to professional advice	Business profits	FTS
Electronic ordering and downloading of digital products	Business profits	Royalty
Electronic ordering and downloading of digital products for purposes of copyright exploitation	Royalty	Royalty

eBay International AG [2013] 40 taxmann.com 20 (Mum)



eBay International AG [2013] 40 taxmann.com 20 (Mum)

- **Tribunal's findings on existence of DAPE**
 - *Website not controlled directly or indirectly by Indian group companies*
 - *Indian group companies have no role in introducing any specific customer to Assessee*
 - *Transaction on website is finalised through website operated from outside India*
 - **No DAPE under Article 5(5) of DTAA as:**
 - Indian group companies are dependent agents but do not constitute DAPE
 - Indian group companies have not negotiated or entered into contract for and on behalf of Assessee
 - There is no case of habitually maintaining stock of goods for or on behalf of Assessee since goods are delivered by seller to buyer directly
 - No manufacturing or processing of goods in India for Assessee

- **Tribunal's findings on existence of Place of Management PE:**
 - *Indian group companies are not taking any managerial decisions, and are simply rendering certain marketing services to the taxpayer.*
 - *They have no role in the operation of the websites*
 - *Hence, no place of management PE can be said to exist*

Right Florist (P.) Ltd. [2013] 143 ITD 445 (Kol)

Facts

- Right Florist, an Indian company, used search engines of Google/ Yahoo for advertising its business
- Payments were made to Google (Ireland) and Yahoo (US), for displaying the Right Florist's advertisement when certain key terms were used on such search engines

Issue

- Whether Google/Yahoo have a taxable presence in India

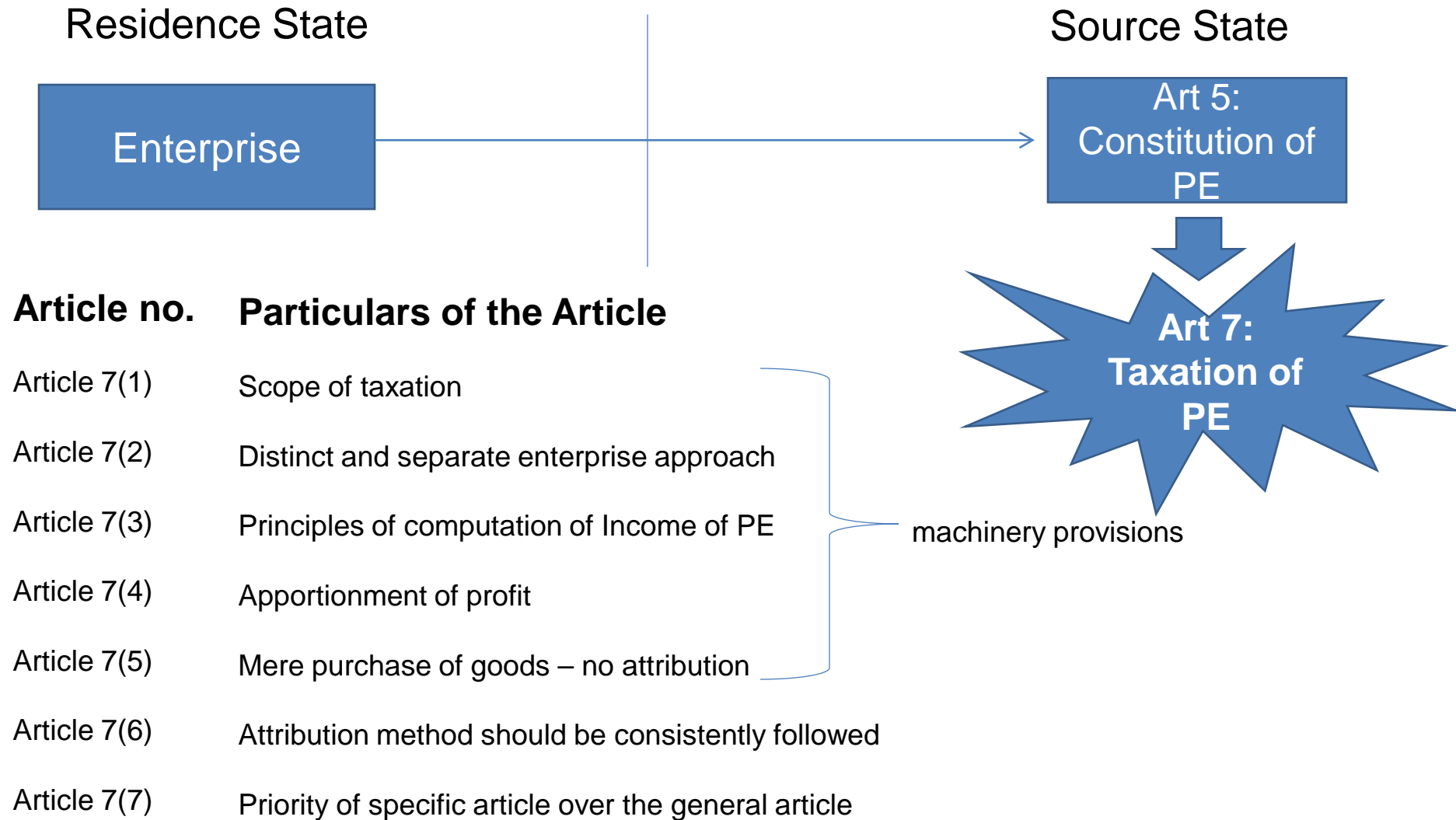
Ruling

- Reliance placed on OECD MC to conclude that a search engine, which has a presence through its website, cannot have a PE in India unless the web servers are located in India

Business Profits and attribution to PE



Framework of Article 7



Force of Attraction Rule

Article 7 Para 1 of the UN Model Convention

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the may be taxed in the other State but only so much of them as is attributable to

- (a) that permanent establishment;**
- (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or**
- (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.”**

The Article reproduces Article 7 para 1 of the OECD – Model Convention, with the addition of clauses (b) and (c)

‘Force of attraction’ rule not present in OECD Model Convention

Force of Attraction Rule – Judicial precedents

- **Profit attributable to PE also include profit from direct transactions effected by the HO, to the extent that such transactions are of the same or similar kind as those effected through the PE – Canada tax treaty - *SNC Lavalin/Acres Inc.* [2007] 15 SOT 1 (Mum)**
- **Article 7 of Finland tax treaty was based on UN Model Convention and thus had a restrictive scope of the force of attraction rule which only extends the scope of transactions which are to be taxed in the other country and not the nature of transactions - *Roxon OY* [2006] 10 SOT 454 (Mum)**
- **‘Indirectly attributable’ principle in the UK tax treaty incorporates the ‘force of attraction’ rule with the result that even profits from offshore services in respect of projects in India are taxable in India - *Linklaters LLP* [2010-TII-80-ITAT-MUM-INTL]**
- **Article 7(3) of the UK tax treaty clearly explains the scope and ambit of the profits indirectly attributable to the PE. No need to refer to the provisions of Article 7(1) of UN Model Convention. No application of force of attraction rule while applying the UK tax treaty - *Clifford Chance* [ITA Nos. 5034/Mum/2004, 5035/Mum/2004, 7095/Mum/2004, 3021/Mum/2005] (SB)**

Attribution of profit to PE – Article 7(2)

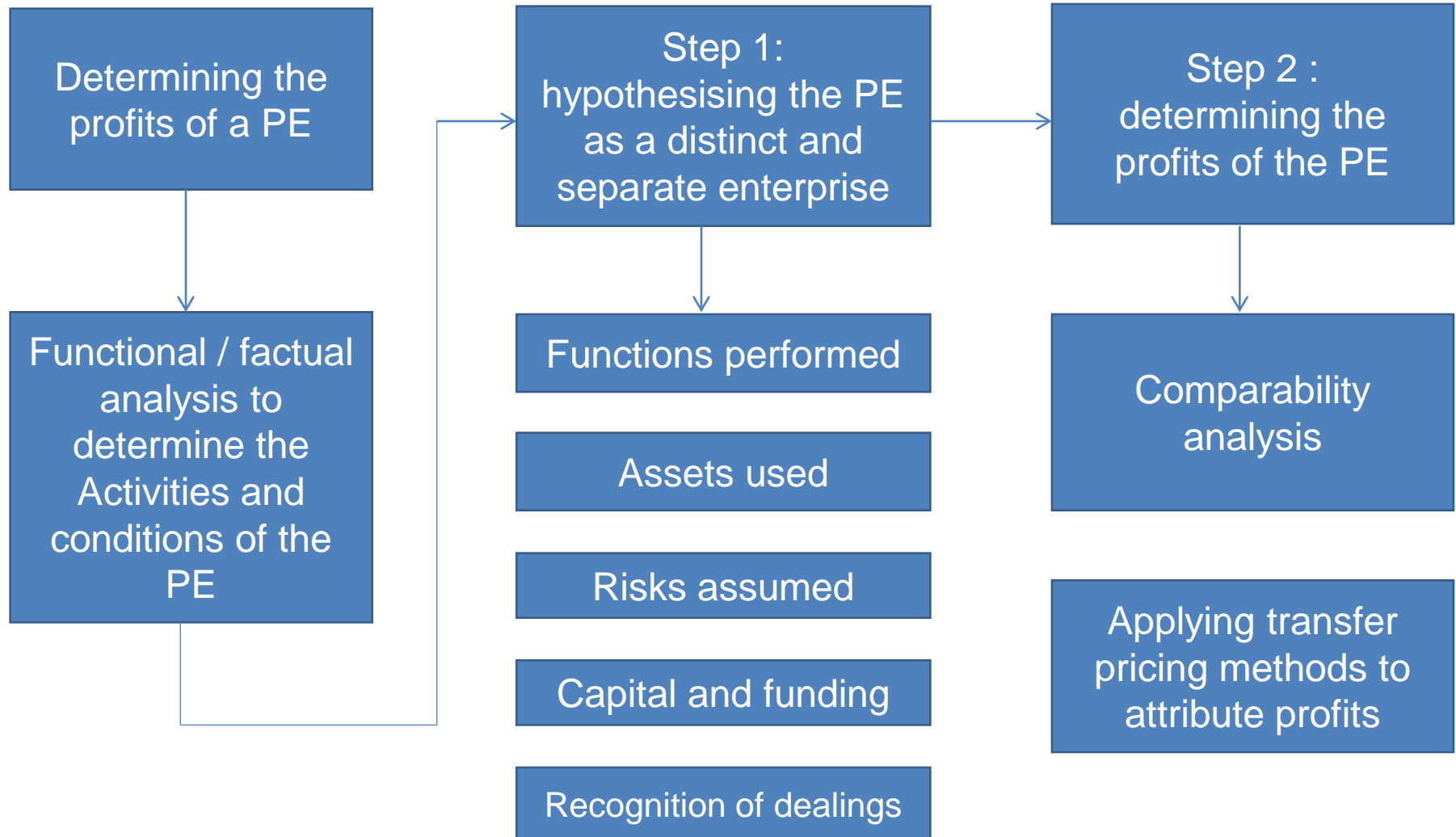
Approaches to determine profit

- Approaches to determine profit [discussed on OECD Report (2006)]:
 - relevant business activity; or
 - functionally separate entity.
- Recommended approach – OECD report suggest functionally separate entity approach as preferable
- Judicial precedents in India appears to adopt ‘relevant business activity’ approach
- Profit should be determined by applying the arm’s length principle – OECD Transfer Pricing Guidelines could be applied

OECD Report (2008)

- It determines the preferred interpretation & application of Article 7 of the OECD Model Commentary
- Special consideration for PEs of banks, enterprises carrying on global trading of financial instruments & insurance enterprises

Authorized OECD Approach: An Outline



Computation of profits attributable to PE under the Act

- Attribution of income to the extent of operations / activities carried out in trade
- Nothing attributable if activities are preparatory or auxiliary in nature e.g. purchasing of goods
- No specific mechanism provided for attribution of profits
 - Transfer pricing rules can be applied
 - Rule 10 of the Income-tax Rules can be applied

Computation of profits attributable to PE under the Act

Rule 10 – Method of Attribution under the Act:

- Determination of actual profits if it can be ascertained
- Methods prescribed in rule 10 are not accurate methods
 - These involve estimation and subjectivity
 - ✓ Hukumchand Mills Ltd. [1976] 103 ITR 548 (SC)
- Can be followed only when the AO is of the opinion that profits cannot be definitely ascertained
 - Rule 10 is last in priority list and is to be applied in exceptional situations
- Rule 10(i) - Presumptive Method
 - Adhoc profits is estimated as attributable to the PE by applying reasonable percentage

Computation of profits attributable to PE under the Act

- Rule 10(ii) - Proportionate Method
 - Proportionate profits based on world income is attributed to the PE
 - Difficult method as world income of the enterprise is to be computed under the Act before applying proportionate method
 - In case of different businesses relevant business income be considered
 - ✓ Iraqi Airways [1987] 23 ITD 115 (Del)
- Rule 10(iii) - Discretionary Method
 - Attribution in some other method - combination of above 2 methods
 - ✓ Netherlands Steam Navigation Co. Ltd. [1969] 74 ITR 72 (SC)

Revised Article 7

- **OECD Profit Attribution Report 2008 recommended:**
 - Changes in the model commentary vis-à-vis the existing Article 7
 - Introduction of a revised Article 7 to conform to the recommendations of the report
- **New Article 7 substituted in the OECD 2010 Update**
 - Seeks to provide detailed instructions on profit attribution without restraining itself to the original intention or context of Article 7
 - Commentary thereon applicable only to tax treaties which adopt the new Article 7
 - Number of paras of the old Article 7 removed, viz. paras relating to general & administrative expenses, global formulary apportionment method, etc.

Revised Article 7

Article 7(2) in the Revised Article reads as under:

“For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”

Does the scope of attribution extend beyond Expl. 1(a) to Section 9(1)(i)?
“Income accrue or arise in India shall be only such part of income as is reasonably attributed to the operations carried out in India”

Article 7(3) - Provisions

Old Article 7(3)

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere

New Article 7(3)

Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment, the competent authorities of the Contracting states shall if necessary consult each other

Article 7(3) - Principles of computation of Income of PE

- In determining profits of a PE
 - Deduction shall be allowed for expenses (including executive & general administrative)
 - Incurred for the PE
 - Incurred in or outside the source country
 - In accordance with and subject to limitations of domestic law
- No deduction – amount paid by PE to the HO or to any other offices of the enterprise, except reimbursement of actual expenses
 - For use of patents or other rights in the form of royalties, fees or other similar payments
 - For specific services performed or for management in the form of commission
 - For money lent in the form of interest (exception for banking enterprises as explained by CBDT Circular 740)

Similarly, income received by PE from HO for aforesaid purposes shall be ignored

Article 7(4) - Apportionment of profit

- Source Country has been given right to apply apportionment method
 - If it is customary in the source country
 - Profits are apportioned to various parts of the enterprise to ascertain profits attributable to the PE
- Result of such apportionment method shall be in line with article 7(2) and 7(3)
- OECD Commentary recognises following 3 methods of Apportionment
 - Receipts of the enterprise
 - Expenses of the enterprise
 - Capital structure of the enterprise

Article 7(5) - Provisions

Old Article 7(5)

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise

- No profits shall be attributed to PE for mere purchase of goods for the enterprise
 - Goods shall include services
- The benefit would not be available if PE carries out other activities including purchases

Article 7(6) - Provisions

Old Article 7(6)

For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary

Article 7(6)

- Attribution to be worked out based on consistent method
 - Method can be changed for good and sufficient reasons

Article 7(7) – Provisions

New Article 7(7)

Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

- **Priority of specific article over the general article**
 - In case profits include any income which is chargeable under any specific article, the same shall be dealt with by that specific article

- **Business Income Vs Other Income**
 - Article 21(1) of the OECD Model Convention:

“Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.”

Selected Circulars under the Act

CBDT Circular No. 23 dated 23 July 1969 – *Now withdrawn*

Non-Resident selling goods from outside India to Indian customers on principal-to-principal basis through Agents in India

- If the agent's commission fully represents the value of the profit attributable to his service; it should prima facie extinguish the assessment.
- This principle is now well established including by Supreme Court in the case of Morgan Stanley

CBDT Circular No. 5 dated 28 September 2004 (Taxation of BPO Units in India)

- Indian Company rendering BPO services may constitute PE of the Foreign Company
- Only profits attributable to business activities in India of PE taxable under Article 7 of the tax treaty
- Separate entity approach, deductibility of expenses and arm's-length principle emphasized

Relevant judicial pronouncement

- **High Court upheld the Tribunal's order where it was held that 15% of revenue attributable to operations in India but since it is lower than Dependant Agent's compensation, it extinguishes the assessment of the PE and no further income is taxable in India**
 - *Galileo International Inc. [2008] 19 SOT 257 (Del)*
- **Payment of arm's length remuneration to BBC India extinguishes tax liability of BBC UK**
 - *BBC Worldwide Ltd. [2011] 203 Taxman 554 (Del)*
- **For ascertaining ALP, Functions & risks of the multinational enterprise to be considered and not that of the agent. In the absence of Transfer Pricing analysis, it cannot be said that commission is at arm's length**
 - *Rolls Royce Singapore (P) Ltd. [2011] 13 Taxman.com 81 (Del)*
- **Once the arm's length remuneration has been paid to agent in India, no further attribution of income can be made to foreign principal**
 - *Set Satellite (Singapore) Pte. Ltd [2008] 307 ITR 205 (Bom)*

Recent decisions



Centrica India Offshore Pvt. Ltd. [2014] 364 ITR 336 (Del)

Facts:

- Foreign companies are in the business of supplying gas and electricity to consumers across the UK and Canada.
- The overseas entities outsourced their back office support functions to Indian company
- Indian company is charging full costs plus a mark-up of 15 percent to overseas entities
- To seek support during initial year of its operation, the taxpayer sought some employees on 'secondment' from the overseas entities and therefore, it entered into a 'secondment agreement' with the overseas entities
- The taxpayer reimbursed salary cost to overseas employers on cost to cost basis. The taxpayer offers salaries paid to every seconded employee for taxation purpose and withheld their taxes in India.
- AAR held that overseas entities constitute Service PE on account of employees deputed by overseas entities under the terms of secondment agreement.

High Court Ruling

- There was no purported employment relationship between the taxpayer and the secondees. None of the documents, including the attachment to the secondment agreements, reveals that the secondment arrangement can be terminated.

Centrica India Offshore Pvt. Ltd. [2014] 364 ITR 336 (Del)

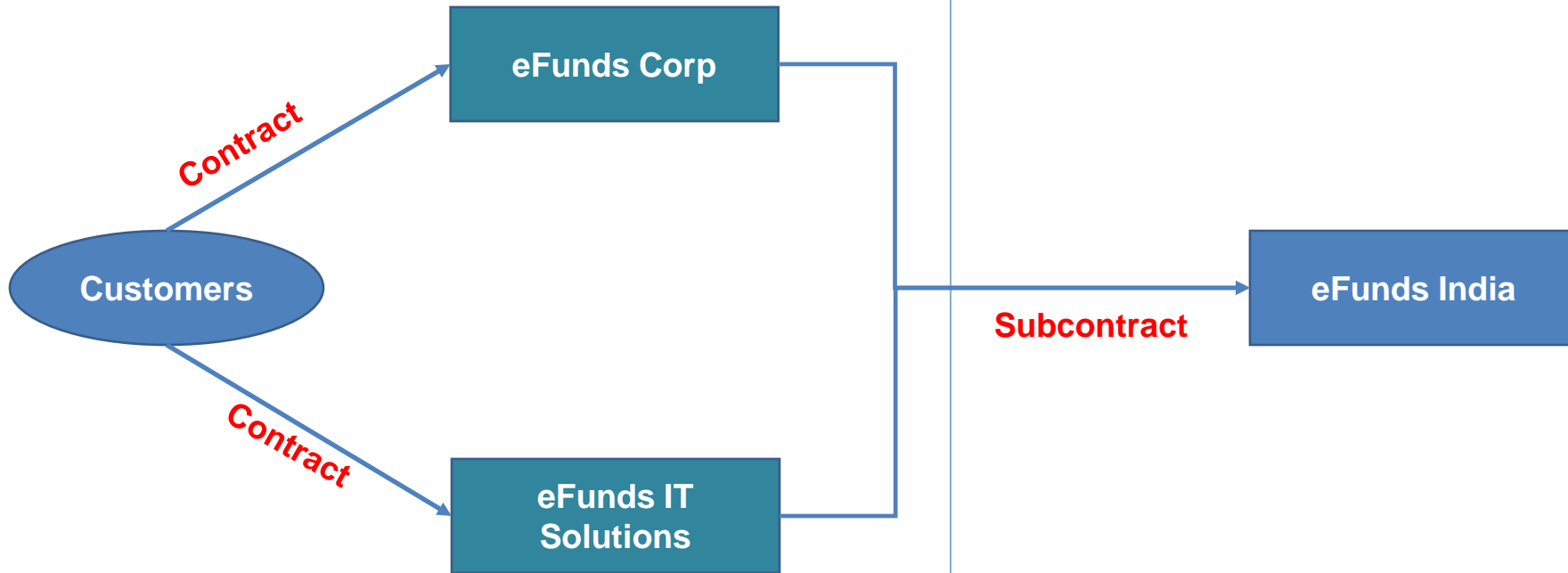
- All direct costs of such seconded employees and other costs were ultimately paid by the overseas entity
- Employees have only been seconded or transferred for a limited period of time to Indian Co, in order to utilise their technical expertise in the latter
- The employment relationship between the secondees and the overseas organisation was at no point terminated, nor was the taxpayer given any authority to even modify that relationship. The salary was paid through the overseas entity, which was not a mere conduit
- OECD Commentary - Foreign company may not constitute a service PE if the seconded employees work exclusively for the Indian enterprise and they were released by the foreign enterprise which was not the case in this decision.
- The HC discussed the concept of economic employer v. legal employer
- Accordingly, **overseas entities constituted Service PE in India**

SLP filed by Centrica India has been dismissed by the Supreme Court

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

USA

INDIA



E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- **Case deals with key issue of PE Implications to foreign companies sub-contracting services to Indian subsidiaries**
- **Significant impact to IT/ITeS sectors and other sectors where delivery centers are located in India**
- **Tribunal held that eFunds Corp and eFunds IT Solutions (both US companies) were having PE in India on account of them sub-contracting work under their customer contracts to the group's Indian subsidiary**
- **High Court reversed Tribunal's decision and held as under:**
 - ***Existence of business connection in India:*** Since the Indian entity was providing information/details to the US entities for the purpose of entering into contracts with third parties and subsequently the said contracts were performed fully or partly by e-Funds India as an assignee or sub-contractee, a business connection was established
 - ***Subsidiary as PE:*** Subsidiary constitutes an independent legal entity for the purpose of taxation. Holding or a subsidiary company by themselves would not become PE unless other requirements of the PE definition are satisfied.

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- **Fixed Place PE:** Nothing to show that the US Cos had a fixed place of business in India or had any right to use premises of eFunds India.
- **Place of Management PE:** International division headed by President managed operations of eFunds entities in UK and Australia and provided marketing support to various overseas entities. **Prima facie Place of Management PE could be constituted - but this provision was not invoked. Issue requires factual investigations and cannot be made matters to be decided for the first time in an appeal before the HC under section 260A of the Act**
- **Articles 5(3) v. 5(1) and 5(2):** Not falling within the exclusions in Art. 5(3) does not automatically result in the formation of a PE. The requirements of Art. 5(1) or 5(2) must be satisfied
- **Service PE:** Employees of the eFunds India were its employees and not of the US entities. Hence, a Service PE could not be constituted.
 - Two employees of efunds US deputed to efunds India were working under control and supervision of efunds India, therefore does not constitute service PE in India

E-Funds IT Solutions (ITA No. 736/2011 & 737/2011) (Del)

- **Agency PE:**
 - Subsidiary company by itself would not become dependent agent of Hold Co.
 - Requirement of Article 5(4) and 5(5) were not satisfied in present case
 - Under India-USA treaty, no agency PE if transactions between agents and principal are at arm's length, even if agent is devoted wholly or almost wholly for the principal
- **MAP agreement** relevant but cannot be primary basis to decide whether Foreign companies have PE in India
- **Attribution of Profits to the PE** – in view of the income declared and taxed in the hands of eFunds India, nothing remains to be attributed or taxed in the hands of eFunds USA

Nortel Networks India International Inc. [2014] 49 taxmann.com 147 (Del)

Facts

- Taxpayer was a leading supplier of hardware and software products for GSM cellular radio telephones system
- Indian subsidiary of the taxpayer, entered into a contract with Reliance Infocom for supply of hardware equipment
- AO held that the taxpayer does not have any manufacturing or trading infrastructure
- It does not have any financial or technological capability of its own. The taxpayer was only a paper company incorporated for the sole purpose of evading taxes in India
- Indian Subsidiary was a fixed place of business and DAPE of the taxpayer as well as it had a business connection in India

Permanent Establishment

- Indian Co had undertaken the responsibility for negotiating and securing the contracts. The contract for installation and commissioning was also undertaken by Indian Co.
- The taxpayer was merely a shadow company of Nortel group
- Since the hardware supplied by the taxpayer was installed by Nortel India and the contracts were pre-negotiated by the same, it was constituted a fixed place of business and DAPE of the taxpayer in India

Nortel Networks India International Inc. [2014] 49 taxmann.com 147 (Del)

- Liaison office of Nortel Canada was rendering all kinds of services to all the group companies including the taxpayer – Fixed place PE
- The subsidiary acted as a service provider and at the same time acted as a sale outlet co-operating with after sale service
- The activities carried out by the PE are the core activities of the taxpayer resulting in generation of income and they cannot be considered to be preparatory and auxiliary

Attribution of income

- The accounts of the taxpayer furnished in the assessment proceedings have no sanctity and the same were not audited.
- AO's reference to the global accounts of the Nortel and gross profit margin percentage as 42.6 per cent was accepted.
- The tax authorities were justified in resorting to Rule 10. However, when profits are computed under Rule 10 after applying the profit rate, the expenses pertaining to the PE have to be allowed as deduction
- Based on the facts attribution of 50 per cent of the profits to the activities of PE in India would be a reasonable attribution

Convergys Customer Management Group Inc. [2013] 58 SOT 69 (Del)

Facts

- US Co provides IT enabled customer management services by utilising its advanced information system capabilities, human resource management skills and industry experience
- US Co had a subsidiary in India by the name of CIS
- CIS provides IT enabled call centre/back office support services to the taxpayer

Ruling

Permanent Establishment

- The employees of US Co frequently visited the premises of CIS to provide supervision, direction and control over the operations of CIS and such employees had a fixed place of business at their disposal - there exist a fixed place PE
- CIS was the projection of 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
- No DAPE as relevant conditions under tax treaty not satisfied

Attribution of profit

- Overall attribution of profits to the PE was a TP issue and no further profits can be attributed to a PE once an arm's length price has been determined for the Indian associated enterprise, which subsumes the FAR of the alleged US Co (PE) had a subsidiary in India by the name of CIS
- The risk was outside India with the taxpayer as the CIS was remunerated at Cost+14 percent irrespective of failure of service delivery
- Even otherwise, no attributions can be made on account of risks in terms of Article 7(5) of the tax treaty
- AO/CIT(A) was not correct in invoking the provisions of Section 44C of the Act in attributing the income of the taxpayer without allowing the cost incurred to earn the revenue outside India thereby attributing the entire receipts
- The revenue of the taxpayer cannot be considered as the revenue of the PE by any stretch of imagination
- The taxpayer had submitted that it does not prepare India specific accounts, therefore the attribution of profits on the basis as disclosed in the TP study for assets and software cannot be accepted

Tribunal provided approach to arrive at the profit attributable to PE

- Compute global operating income percentage of the customer care business as per annual report
- This percentage should be applied to the end-customer revenue with regard to contracts/projects where services were procured from CIS. The amount arrived at is the operating income from Indian operations
- The operating income from India operations is to be reduced by the profit before tax of CIS. This residual is now attributable between USA and India
- The profit attributable to the PE should be estimated on aforesaid residual.

Attribution of Indian PE income should be made at 15 percent of profit retained by taxpayer in the USA

Key Takeaways



Key takeaways

- **PE – a dynamic concept - especially with emergence of economic and technological advancements**
- **Computation / Attribution of profits to PE – very contentious in practice**
- **PE assertions among the top cross-border tax issues faced by multinational groups in India**
- **Issues also impact Indian group entities / customers on account of withholding tax obligations**
- **Mitigation / caution points:**
 - Structuring of sub-contracting agreements to mitigate PE risks (Fixed place, virtual projection, agency etc.)
 - Need to balance oversight requirements with potential PE risks
 - Presence of executives with management / oversight roles over group entities abroad
 - Reciprocal arrangements could be considered as mirror image leading to PE exposure
 - Documenting functional analysis – key defense
 - Attribution vis-à-vis arm's length payments



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