

Permanent Establishment : Concept, Controversies and the Road Ahead

Santosh G., Assistant Manager, Pricewaterhouse Coopers Private Limited, Bangalore and Ajay G Prasad, Associate, Pricewaterhouse Coopers Private Limited, Bangalore.

e-mail :

santosh.g@in.pwc.com.
ajay.g.prasad@in.pwc.com

The concept of business connection is essentially different from the concept of a PE and the two cannot be equated. While business connection is relevant for assessment under the Act, the concept of PE is relevant for assessing the income of a non-resident under the DTAA. The existence of a PE would not constitute sufficient business connection, and the PE would be the taxable entity.

INTRODUCTION

Growth in international commerce, triggered by growth in information technology, has resulted in the creation of enterprises that have a presence in multiple tax jurisdictions. There is a consequent interest on the part of each State to assert its tax jurisdiction on such enterprises and fill up its coffers. To avoid a scenario where more than one state asserts its tax jurisdiction, countries worldwide have entered into tax treaties, popularly known as Double Taxation Avoidance Agreements.

International taxation is essentially either source based or residence based. While a source-based approach entitles the "source" country to tax the income of non-residents that is earned within its borders, in a residence-based system, a country asserts jurisdiction to tax the worldwide income of its residents, regardless of its source.¹ Double Taxation Avoidance Agreements (DTAAs) have had an effect of assuring businesses around the world that their income will not be doubly taxed, i.e. the income taxed in the residence country will not be taxed in the source country, and hence promote foreign investment by making the country more attractive to foreign investors who have a choice among multiple locations for investment.² Indeed, it can be argued that DTAAs do not seek to actually avoid double taxation but only provides a system of credit for the non-resident tax payer.

The two most popular tax conventions are the OECD³ and the

UN Convention⁴ which have acted as templates for a number of DTAAs. The OECD Model, it is believed, tends to favour the developed nations or the capital exporting nations as it recognises residence based taxation and ousts the source country's right to tax that income. The underlying rationale for the existence of this principle is that it is the investors of the developed countries that invest in developing countries and not the other way round. On the other hand the UN Model is perceived to be more favourable to the developing or the capital importing countries as it recognises both residence and source based taxation, albeit at a smaller percentage.⁵

However, such source based taxation is subject to one important caveat, the presence of a permanent establishment (hereinafter 'PE') in the source country. The intention of this paper is to critically examine the meaning and importance of a PE and the various issues that have arisen in its interpretation, particularly in the host country of investment. This paper is divided into two parts. Part I examines the law in place dealing with PE and the various judicial pronouncements of the Indian courts. Part II of the paper seeks to throw light on certain issues that have received contrasting and often controversial interpretations, especially in the context of e-commerce. It also deals with the various clarifications provided by policy makers and the position of India on the same. It concludes by reiterating the importance of a clear and a uniform policy in relation to PE taxation.

INDIAN POSITION

It is well established that a non resident is liable to pay tax in

1. John K. Sweet, *Formulating International Tax Laws in the age of Electronic Commerce: The Possible Ascendancy of Residence Based Taxation in an era of Eroding Traditional Tax Principles*, 146 U.P.A.L.REV.1949,1953 (1998)

2. Eric Neumayer, *Do Double Taxation Treaties increase foreign direct investment to developing countries?*, Revised Version, February, 2006 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=766064 (last visited 5th October, 2008)

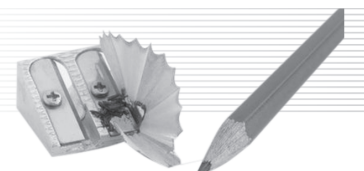
3. OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (2005) [Hereinafter 'OECD Model Convention']

4. UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (UN, ST/ESA/102, 1980) [Hereinafter 'UN Model Convention']

5. Eric Neumayer, *supra* note 2.

By the end of 1960s there were 322 treaties, which rose to 674 by the end of 1970s and to 1143 by the end of the 1980s. By the end of 2002 there were 2255 DTAAs worldwide.

Articles



Permanent Establishment : Concept, Controversies and the Road Ahead

India in respect of income that is received in India or accrued or deemed to accrue in India.⁶ He may earn such income through a business connection that he has in India.⁷ The taxation of such income derived from a business connection in India is avoided by the non-resident, if he is a non-resident in a country with which India has signed a DTAA. In such cases, income is treated as 'business profits' under the DTAA and consequently taxed only if the non-resident has a PE in India and such profits are attributable to the PE.⁸ This overriding effect of the DTAA is due to the fact that the DTAA supersedes the Act⁹ and in case of a conflict between the Act and the DTAA, the assessee shall be entitled to the beneficial provisions among the two, i.e. the DTAA and the Act.¹⁰

An important point of distinction needs to be mentioned here. The concept of business connection is essentially different from the concept of a PE and the two cannot be equated. While business connection is relevant for assessment under the Act, the concept of PE is relevant for assessing the income of a non-resident under the DTAA. The existence of a PE would not constitute sufficient business connection, and the PE would be the taxable entity.¹¹ Hence, even if global income of a resident is subject to tax, the tax liability on global income of a non-resident is conditioned by the existence of a PE in the source country.¹²

Article 7 of the various DTAA that India has entered into, including the OECD and the UN Models deal with the concept of 'business profits'. Accordingly 'business profits' is subject to tax in the source country only if such business is carried on in the source country through a PE situated in such country. The generally advocated rationale for taxing the PE in a country is the assumption that it has a significant presence in the country and the non-resident enterprise is earning its income in the source country through the carrying on of activities by the PE.

Meaning of PE

Both the OECD Model Convention and the UN Model Convention contain the definition of a PE. As already stated above, these model conventions have served as the basis for

6. THE INCOME TAX ACT, 1961, No. 43 (1961); [Hereinafter referred to as the 'Act']; Section 5(1)

7. IT Act; Section 9(1).

8. Article 7(1), OECD Model Convention and UN Model Convention, *supra* note 3, 4

9. IT Act; Section 90(2)

10. *UOI v. Azadi Bachaon Andolan* (2003) 263 ITR 706 (SC)

11. *Ishikawajma-Harima Heavy Industries Ltd. v. DIT, Mumbai*, AIR 2007 SC 929.

12. *Id.*

the various DTAA entered into by India with a number of countries. India's official policy has tended to follow the UN Model in a majority of cases, as it is considered beneficial for a capital importing country like India.

PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop and places of extraction of natural resources. It also includes a building site a construction, assembly or an installation project or any supervisory activities connected to them. It also includes furnishing of services or consulting services provided by the employees of the enterprise or any other personnel engaged for such purpose.¹³

The above seemingly broad definition is qualified by a few other principles contained in the Conventions. A mere place for the storage of goods or for its display or for purchasing goods or a place for merely carrying out auxiliary or preparatory services does not constitute a PE. Where persons act as agents of a non-resident person and exercise the power to conclude contracts on behalf of such non-resident persons, and where such agents though not concluding contracts, stock goods and merchandise and deliver the same on behalf of such non-resident person, a PE is said to be constituted. However, agents or brokers, acting independently do not fall under the definition, provided such persons are acting in the ordinary course of their business. Such agents should not be engaged substantially or wholly in such assignments alone and should not take such instructions that undermine his status as an independent agent.¹⁴

From the above definition it becomes clear that a PE can take three forms; fixed place PE, an agency PE and a service PE. To constitute a fixed place PE, there must be a fixed place of business and additionally the business of the enterprise should be carried on through this fixed place of business. It includes in its ambit a captive service provider, where the enterprise is wholly dependent on the parent enterprise for its survival.¹⁵

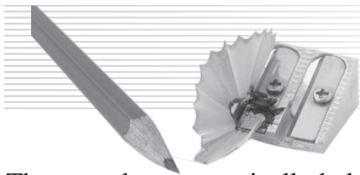
An agency PE is constituted when one has the authority to enter into or conclude contracts. By implication the conventions create two types of agents; the dependant and the independent.

13. Article 5 of the OECD Model Convention, *supra* note 3

It is interesting to note that the OECD Model Convention does not expressly deal with the concept of the creation of a service PE through employee secondment or deputation in common parlance.

14. *Id.*

15. *Vispi T. Patel and Rajesh S. Athavale, Supreme Court Ruling on Outsourcing Industry Opens Debate on Interpretation of Permanent Establishment Issues*, INTERNATIONAL TRANSFER PRICING JOURNAL, MARCH/APRIL 2008



The court has categorically held that an independent agent is one who carries on his own business and hands over the purchase price to the non-resident. He is not under the control and instructions of the non-resident enterprise in carrying on his business. He settles transactions on his own and does not wholly devote his business to the non-resident entity.¹⁶ Where a distributor in the source country acts as a dependant agent and habitually exercises the power to conclude contracts on behalf of the non-resident enterprise, it was held to be a PE.¹⁷

Service PE is the third form of PE and includes cases where an enterprise provides services through its employees or other personnel in the source country. In such cases the non-resident enterprise continues to be responsible for the work performed by the employees. Such activities are brought under the tax net as it is meant to protect the tax base of the source country in cases where a substantial contribution is made by the employees of the foreign enterprise. The profits derived from such activities would not be allowed to escape source state taxation. The Income Tax Appellate Tribunal, Delhi Bench while ruling on the Indo-UK Treaty, held that where employees of the foreign enterprise visited India frequently and used the premise of its Indian associate, such associate constitutes its PE.¹⁸

Keeping in line with the above definitions in the various DTAAs, the meaning of the term PE was captured succinctly in the case of *CIT v. Vishakapatnam Port Trust*¹⁹ where it was held that “permanent establishment postulates the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to fixed place of business in that country. It should be of such a nature that it would amount to a *virtual projection of the foreign enterprise of one country into the soil of another country.*”²⁰

Extent of liability to tax

Another important point that merits our attention is the extent to which the business profits of the non-resident is liable to taxation in the source country through the PE. The various tax conventions lay down that only arms’ length profits are to be taxable. Such arm’s length profits are those profits which the PE would have made if instead of dealing with its head office, it had been dealing with as a separate enterprise operating under normal competitive conditions. Such arm’s length profits are to be calculated as per the provisions of the Indian Income Tax. However it is provided that while

calculating the tax liability of the PE in the source country there shall be allowed as deductions, expenses which are incurred for the carrying on of the business.²¹ The expenses that are deductible are again dependent on the domestic statute. Once the PE is compensated adequately, there would be no further attribution of profits.²²

In a recent ruling, the Bombay High Court categorically held that when a foreign enterprise has a PE in India, it is not liable to pay tax in India if the foreign entity has already paid an arms’ length remuneration to the PE. It was additionally held that though there is no fixed criterion to decide the amount of profits attributable, such amount must be worked out by taking into account all the functions performed and risks borne by the enterprise.²³

Taxation of special income

Another point of contention that often arises is the case of taxation of special incomes like royalties and technical fees. Taxation of royalties and fees for technical services does not depend on the existence of PE but are dependent on how the fiscal statutes of the countries treats the subject and the rates provided in the various DTAAs. But there has been a spurt of litigation in this matter and the courts had to often pronounce upon the nature of income i.e. if the income can be classified under the head ‘royalties’ or the head ‘business profits’. This issue assumes significance in the light of the principle that ‘no PE, no tax’ on business profits.

Courts have evolved their own principles with the passage of time for achieving some sort of clarity on the subject, though with little success. One of the tests laid down to distinguish between the two heads of income is that where the transferor retains the right in the property so transferred and only transfers the right to use such property, it is considered as royalty but all cases of outright transfer fall under the head ‘business profits’²⁴ and hence become liable to tax in India if they do indeed have a PE.

ISSUES ARISING IN ITS INTERPRETATION

The issue of interpretation before the various courts of law obviously arises when corporations seek to avoid calling their business connection in the country as a PE as this will bring them under the tax net. Since the presence or absence of a PE

16. *Dun and Bradstreet Espana S.A.* 272 ITR 99

17. *Galileo International Inc. and Maruthi Info. & Tech Centre v. DCIT* 2008 19 SOT 257.

18. *Rolls Royce PLC v. DDIT 113 TTI 446.*

19. 144 ITR 146 (AP)

20. *Emphasis supplied.*

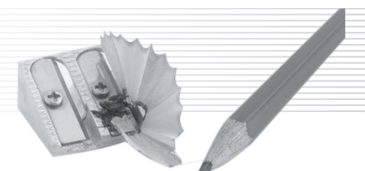
21. INCOME TAX DEPARTMENT, DEPARTMENT OF REVENUE, MINISTRY OF FINANCE, GOVERNMENT OF INDIA, Section 9: Income deemed to accrue or arise in India, available at <http://www.taxmann.com/DitTaxmann/IncomeTaxActs/2006ITAct/cirsec9.htm> (last visited 1st November, 2008)

22. *Morgan Stanley and Co. v. DIT 152 Taxman 1.*

23. *Vispi T. Patel and Rajesh S. Athavale, supra note 15*

24. *CIT v. Davy Ashmore India Ltd.* 190 ITR 626., Dy. CIT, Non Resident Circle, New Delhi v. *Metapath Software International Ltd.* [2006] 9 SOT 305(NULL)

Articles



Permanent Establishment : Concept, Controversies and the Road Ahead

in the country will decide whether the revenue can exercise its jurisdiction on the income of a non- resident, it is desirable that there is clarity on the concept. But far from it, there is considerable uncertainty about what constitutes a PE. Growth in information technology and the consequent change in the way business can be carried out have not helped matters for the revenue or the courts of law, which constantly come into the picture to interpret the actions of the revenue or the assessee.

E-commerce and PE

The conflict in interpretation needs to be looked at from the standpoint of e-commerce where traditional market spaces have disappeared and created virtual markets and the resulting ease with which operations can be shifted and given a different colour by big corporations to avoid the constitution of a PE and thereafter to avoid tax in a particular county with a relatively higher tax rate. In retaliation the revenue and the courts will seek to interpret such actions as devices to avoid tax and seek to bring such actions within the tax net.

E-commerce transactions are characterized by elements such as online sales through an enterprise' website, money being paid and received electronically, products being downloaded from the web site onto the consumer's computer etc. It also involves various parties to the transaction, like the internet service provider, the online service provider etc.²⁵ It is imperative that international and domestic tax principles and practices take into view the above to prevent revenue loss, specially since tax principles have traditionally required some sort of geographical presence or a geographical connection to levy taxes.

E-commerce has thrown up a number of issues that the traditional tax principles is finding difficult to accommodate. Apart from the generic issues listed above, another important issue is the concept of 'disintermediation'.²⁶ E-commerce has removed the need for the presence of any physical intermediary of the non-resident enterprise in the source country. This disintermediation often results in significant losses to the source country as non-resident enterprises can shift their business operation from the physical intermediaries in the source country to their e-commerce base in the residence country as there is no physical presence in the source country. The above problem gets accentuated for the policy makers these transactions could be sometimes anonymous, as neither the buyer nor the seller can be conclusively identified.²⁷ Another point for consideration could be the role of e-commerce as a dependent or an independent agent. Internet technology can

25. See Dr.Jean Philippe Chetcuti, *Taxation of E-commerce : The Challenge of e-commerce to the Definition of a Permanent Establishment: The OECD's Response*, available at <http://www.inter-lawyer.com/lex-e-scripta/articles/e-commerce-pe.htm> (last visited 1st November,2008)

26. *Id.*

27. *Id.*

be substituted for the functions performed by the dependent agents like concluding contracts etc.²⁸ This again entails the loss of revenue to the source country. Having discussed the issues that require clarity, let us proceed to look at how the policy makers have reacted to the same.

OECD Clarifications on certain Issues

The OECD Commentary has tried to help national governments establish some uniformity on a variety of these issues by issuing clarifications. There was considerable speculation regarding the question as to whether websites constitute a PE. The OECD proceeded to clarify that websites do not constitute a PE but servers may constitute a PE. The stated reason for this is that the servers have a fixed base and if it remains located at a specific location for a certain duration it can constitute a PE. Further, where the server performs core functions of the non-resident enterprise, it can be considered a PE. What constitutes core function is to be decided on a case to case basis. It has also been clarified that internet service providers will not constitute a dependent agent as they are independent agents acting in the course of their business as they host the website of a number of enterprises.²⁹ The counter argument to this clarification could be that servers can be placed anywhere in the world which can ensure profits are not taxed in the source country or taxed in a country with relatively less tax liability. Additionally, servers need not have any geographical connection to any country.³⁰

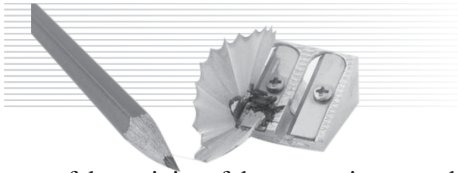
The OECD has also evolved a principle called as the 'core business activity', and in case this is performed by a place of business, then it is deemed to be a PE of the non-resident enterprise. However, such activities should not be auxiliary or preparatory in nature. The next question that arises is what the 'core business activity'. The OECD proceeds to clarify those activities forming an essential and significant part of the activity of the enterprise as a whole constitutes the 'core business activity'. Core business activities are those which increase the value of the enterprise, either as a going concern or based on the asset value and contribute to its earnings.³¹ Having answered the first question, one will naturally ask as to what constitutes 'preparatory or auxiliary' activities. Back office operations are preparatory or auxiliary in nature and therefore, would not give rise to a PE. Front-office operations, however, would form an essential and significant

28. *Id.*

29. OECD COMMITTEE ON FISCAL AFFAIRS, *CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE:CHANGES TO THE COMMENTARY ON THE MODEL TAX CONVENTION ARTICLE 5* (Dec.22,2002) available at <http://www.oecd.org/dataoecd/46/32/1923380.pdf> (last visited 1st November,2008)

30. Dr.Jean Philippe Chetcuti, *supra* note 25.

31. OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 3



part of the activity of the enterprise as a whole, which contribute to the business earnings of the enterprise and, therefore, such operations may be regarded as core business activities thereby creating a PE.³² But the counter argument could be that constitution of a PE can be totally avoided by carrying on only preparatory or auxiliary services in the source country.³³ Hence, it can be seen from the above discussion that by no means the OECD 'clarifications' has clarified all these matters.

The Road Ahead

India is not a full time member of the OECD, but since 2006 has been given the status of an 'Observer'. India has made well known the differences in approach that it has adopted over certain issues *vis a vis* the OECD interpretation. Primary among them is the issue of treating websites as a PE. Though the OECD has clarified that a website does not constitute a PE, India is of the opinion that hosting such websites on a server in India can constitute a PE, in light of the reasons given above. It is of the opinion that a PE can be constituted without the presence of a fixed place of business of the foreign enterprise in the source

country i.e. India. India also has a different take on the creation of an agency PE. It believes that the mere presence of an agent of a foreign enterprise in the negotiation of business is sufficient to conclude that he has exercised the power to conclude a contract, and hence an agency PE is created. In relation to service PE, while India firmly believes that mere provision of services constitutes a service PE, the OECD disagrees. While the OECD believes that only the profits, in case of services performed outside the source are to be taxed, India seeks to levy tax on the entire consideration received outside the source state for such transactions.³⁴

The road ahead for the taxation of PE *vis a vis* e-commerce is anything but clear. Whether the concerns of India are justified, and if at all the incorporation of such reservations actually benefits India, is a different matter and beyond the scope of this paper. What can only be highlighted through the above discussion is the significant amount of differences that exist in its interpretation and the urgent requirement of an acceptable policy that takes into its fold the various issues discussed above. □

32. *Vispi T. Patel and Rajesh S. Athavale, supra note 15*

33. *Dr. Jean Philippe Chetcuti, supra note 25*

34. *Mukesh Butani, India's Reservation on OECD Tax Convention, September 08, 2008, Business Standard.*