

*Eighth*  
*INTERNATIONAL TAX PLANNING*  
*CONFERENCE – 2002*

*Permanent Establishment under  
Indian Tax Laws and Practices*

Pinakin Desai

## Meaning of Permanent Establishment (P.E.)

---

- The concept as explained by the Andhra Pradesh High Court in C.I.T. V/s. Visakhapatnam Port Trust (144 ITR 146 .... 162):

“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 place 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”.

Cont...

## Meaning of Permanent Establishment (P.E.)

- Extract from (66 ITD 296... 303,304)(Mum.).

“..... it seems to be evident that permanent establishment denotes some place of fixed nature with permanency, and it does not include in its ambit a moving vessel which operates near a fixed place and which does not belong to the assessee. .... Assessee’s vessel being in India only for 2½ months cannot be said to be of enduring continuity nor could it be said in this case that there was a virtual projection of the assessee into the soil of India.

- Extract from (237 ITR 798 ... 805)(AAR)

“It seems to the authority that the expression “fixed place” envisages the possibility of locating, identifying or pointing out to a definite place as the place from which a business is carried on and does not import a requirement that the place of business should be stationary and not moving”.

## Selection of Branch (P.E.) V/s. WOS

---

- Some tax considerations :
  - ➔ Tax, if any, on repatriation.
  - ➔ Impact of force of attraction rule of treaty.
  - ➔ Enjoyment of tax concessions.
  - ➔ Applicable rate of tax [impact of non-discrimination clause]
  - ➔ Double dipping of loss.
  - ➔ Exposure to capital gains tax on inter-unit transfer of assets.
  - ➔ Mark up on inter-unit intangibles.

Cont.....

## Selection of Branch (P.E.) V/s. WOS

- Examine spread of Indian treaties before selection.
- Relevant to inbound P.E.

Underlying tax credit permitted [but, no tax sparing]	No underlying tax credit – but, tax sparing	Underlying tax credit as also tax sparing
USA	E.g. Denmark, France	E.g: UK, Australia, Japan
This module makes WOS more attractive.	This module makes PE more attractive	This module offers neutrality of choice.

- Singapore & Mauritius offer underlying credit and tax sparing both ways.
- Tax sparing is a normal feature in Indian treaties.[Major exception : USA].

## Judicial thinking on Double Taxation

- For treaties which work on credit method, the view taken is that once tax is paid in source country, no liability survives in country of residence. Refer :
  - ➔ C.I.T. V/s. S.R.M. Firm [208 ITR 400] [Mad]
  - ➔ C.I.T. V/s. Lakshmi Textiles Ltd. [245 ITR 521] [Mad]
  - ➔ DCIT V/s. Jamnadas Madhavji & Co, Bombay [Unreported]

As a consequence, set off of loss cannot be claimed by HO.

- Contra view (in line with predominant international thinking) has been expressed in Bombay Burmah Trading Ltd. V/s. ACIT 82 ITD 531 (Mum)].
- Very few Indian treaties work on exemption method (E.g. Hungary)
- Treaties like Germany, Swiss work on credit method qua India while work on exemption method qua the other country.

# Types of P.E.

---

- Fixed place P.E. (or) Basic Rule PE.
- Construction P.E.
- Service P.E.
- Agency P.E.

## Typical enumeration of P.E.

- **Universal Application:**

- place of management; branch; office; factory; workshop; mine, oil or gas well, quarry or any other place of extraction of natural resources.

- **Most Indian treaties extend to:**

- Commercial warehouse; Agricultural farm, plantation etc; Sales outlet or premises for receiving or soliciting orders

- **Some Treaties cover:**

- Installation or structure for exploration of natural resources if lasting for specified duration [Providing services of well trained employees is not P.E. (46 ITD 114)(Del)].



## Exclusion List

- Most Indian treaties list out exclusion of following preparatory or auxiliary activities.
  - Use of facilities for storage or display of enterprise stock.
  - Maintenance of enterprise stock for storage or display.
  - Maintenance of enterprise stock for processing by others
  - Fixed place of business for purchases for enterprise.
  - Fixed place of business for advertising, supply of information, scientific research.
- Treaties like Germany, Sri Lanka, Korea *et al* are OECD patterned and exclude “delivery” function also. [USA, Canada, Singapore *et al* exclude “occasional delivery”].
- Some treaties expressly clarify that combination is not P.E. if combination results in auxiliary activity.

## Construction P.E.

- Indian treaties usually cover building site or construction, installation or assembly project.
- No guidance : Does the Article lay down a rule or an exception?
- Most treaties cover supervisory activities in connection therewith (Exceptions : treaties with France, Netherlands, *et al.*).
- Project duration threshold varies 3 to 12 months – predominantly, 6 months.
- Each project to be regarded as separate. (See protocol with UK). (But, treaties with USA, China *et al.* prescribe aggregation of all sites, projects, activities).
- Installation incidental to sale covered in few treaties if value >10% of sale value.

## Service P.E.

- Illustrative pattern: (for services other than supervisory services)

	<b>Service P.E. Present</b>	<b>Service P.E. Absent</b>
• FIS clause present	UK, USA, Australia	Netherlands, Finland
• FIS/FTS clause absent	Sri Lanka, Nepal	Malaysia, Mauritius

- China & Swiss: Service PE concurrent with FTS.
- Applies to services furnished within source country. Some treaties expand scope to services, facilities, equipment hire for mineral oil prospecting.
- Normal trigger Point: 90 days to 183 days during 12 month rolling period.
- Rendition to AEs may curtail threshold to one day [E.g: Australia, USA].

## Agency P.E. : Independent Agent

- Agent acting in the ordinary course of business (IA) is not P.E.
- But, under some treaties, such agent constitutes PE if he is virtually devoted to the enterprise. [E.g: China; Sri Lanka]. [USA, Canada, France *et al* relax arm's length dealings].
- Some treaties rope in agent if he is virtually devoted to the enterprise or AEs. [E.g: U.K., Singapore, Australia]. [Norway *et al.* relax arm's length dealings].

Cont....

# Agency P.E. : Independent Agent

- Judicial precedents

Advertising agent for foreign publishing company.	AL Nisr Publishing, 239 ITR 879 [AAR]
Custodian in regular activity.	XYZ/ABC, Equity Fund, 250 ITR 194 [AAR]
IA may even be WOS if independence can be proved	ABC, 223 ITR 416 [AAR]

## Agency P.E. : Dependent Agent

- Agent is Dependent Agent [DA]
  - ➔ If he has and habitually exercises authority to conclude contracts [E.g: China, Korea, S.A.] [Dependent agent not having authority to conclude contract does not give rise to agency P.E. See (237 ITR 230)(AAR)]

### Extensions:

- ➔ Though no such authority, habitually maintains and delivers stock regularly for the enterprise. [E.g : Netherlands, Mauritius].
- ➔ If orders secured wholly or almost wholly for group enterprises [E.g: Belgium, Bangladesh] [Canada, USA *et al* confined to orders for the enterprise]

## Principles of Computation : P.E. Attribution (Article : 7)

---

- Few Indian Treaties on OECD Model provide for tax on profits attributable to P.E. [E.g: France, Germany, Netherlands]. No authentic domestic guidance on coverage of “profits attributable to P.E.”.
- Treaties with U.K., Swiss, Japan, *et al* provide for taxation of profits indirectly attributable to P.E. commensurate with P.E. contribution to negotiation, conclusion, fulfillment of contracts placed on H.O. [10% of profits attributed for negotiating & concluding contract (41 ITR 781)(Mad)].
- Most treaties on UN Model prescribe Force of Attraction rule.

Cont.....

## **Principles of Computation : P.E. Attribution (Article : 7)**

- Normal rule in Indian treaties is to attribute to each contracting state profit which P.E. can make as a distinct, separate enterprise operating under comparable circumstances.
- Attribution is restricted to operations in India. [Refer domestic law Explanation (a) to Section 9; CBDT Circular No.23 dt 23.7.1969]. [Clarified also in some protocols. E.g. : France, Swiss].
- Protocol with Germany amplifies non attribution in respect of overseas supplies; also planning; research, technical services exercised outside the country.
- Refer AAR Ruling in 228 ITR 487 (AAR).

Cont...



## Principles of Computation : P.E. Attribution (Article : 7)

---

- Almost all treaties permit deduction of all expenses in accordance with domestic law (including E&GA) incurred for P.E. business. [Local law restricts E&GA deductibility : Section 44C].
- Exceptionally, there is no reference to domestic law restrictions [E.g: Thailand, Mauritius.]
- MFN or hedge caveats by certain countries on E&GA deductions.
- Most treaties expressly clarify that no mark up beyond cost reimbursement permitted on inter-unit interest (except banks), royalty, fees, commission *et al.*

Cont....

## Principles of Computation : P.E. Attribution Article : 7

---

- Fractional Apportionment approach in accord with ALP recognised in most Indian treaties. Treaties with Netherlands, USA *et al.* are silent on this.
- Domestic Indian rule [Rule : 10] also recognises this method based on turnover/receipts.

Cont...

## **Principles of Computation : P.E. Attribution (Article : 7)**

---

- Even when P.E. subsists, as per most treaties, no attribution by reason of mere purchases for Enterprise [Domestic law (Explanation (a) to Section 9 may protect even if purchase operations are for other Enterprises)].
- Most Indian treaties favour consistent attribution approach from year to year. Domestic law also upholds consistency.
- Almost all Indian treaties uphold unaffected applicability of all other specific Articles of the treaty. [But, receipts effectively connected with P.E. to be charged as P.E. profit as per domestic law].

## **Rule 10 : Determination of income in the case of Non-Residents**

- In any case in which the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India ..... cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax may be calculated:-
  - i. at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or
  - ii. on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or
  - iii. in such other manner as the Assessing Officer may deem suitable.

# Presumptive Taxation Under Domestic Law

Section	Business / Income covered	Extent of Deemed Income
44B/172	Shipping business income on account of carriages from Indian Ports or receipts in India.	7.5% of receipts
44BB	Business of providing services or facilities in connection with, equipment hire for using in prospecting and extraction of mineral oils.	10% of receipts
44BBA	Operation of aircraft on account of carriage from India or receipts in India.	5% of receipts.
44BBB	Civil construction, erection, testing, commissioning of equipments in connection with approved power projects.	10% of receipts.

## **Favourable Domestic Law Provisions [exemptions or reliefs]**

- Income reasonably attributable to operations in India is alone chargeable. [Explanation (a) to Section 9].
- Following incomes do not bear tax.
  - ➔ News Bureau transmitting news and views [Explanation (c) to Section 9].
  - ➔ Income from shooting cinematograph film in India [Explanation (d) to section 9].
- Exemption to export oriented undertakings [Section 10A, 10B].
- Exemption to specified industrial undertakings [Section 80IB].

Cont....

## **Statutory Provisions : Domestic Law**

- May need to Pay Minimum Alternative Tax (MAT) on book profit of PE. [See XYZ, (234 ITR 335)(AAR)].
- Royalty & fees for technical fees comprised in PE revenue taxable on gross basis.[Refer Section 44D]. Tax at flat rate of 20% [Section 115A][But, consideration towards execution of construction, assembly or like project is not FTS. See bracketed portion in section 9(1)(vii) Explanation]. [Refer 237 ITR 142 (AAR)].
- Depreciation w.r.t. written down value as computed on deemed allowance basis [Refer Explanation 11 to Section 43(1)].
- Beware of ramifications of attracting tax status as A.O.P.

## Domestic Law Procedures : Applicable to PE

- Needs registration under Companies Act (Section 594). Has to submit audited accounts to ROC.
- Has compliance obligations such as : Submission of tax return; Transfer Pricing justification; Tax audit of accounts; Tax withholding; Advance tax payments *et al.*
- Can procure advance ruling on implications of even a proposed transaction. Permitted to modify draft plans put to AAR for tax efficiency [XYZ, (224 ITR 473)(AAR)]. Can opt for quick determination of total income by AAR.
- Can apply for nil or lower tax withholding rate.
- Can choose method of accounting at par with residents.



*THANK YOU*