

Article 5 & 7 - controversies & Case study

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CONTENTS

- BUSINESS CONNECTION - INDIAN PERSPECTIVE
- ORIGINATION OF PE
- ARTICLE 5(1) - FIXED BASED PE
- ARTICLE 5(2) - ILLUSTRATIVE LIST
- ARTICLE 5(3) - CONSTRUCTION AND INSTALLATION & SERVICES PE
- ARTICLE 5(4) - EXCLUSION TO FIXED BASED PE
- ARTICLE 5(5) &(6) - AGENCY PE
- ARTICLE 5(7) - SUBSIDIARY PE
- ARTICLE 7 - ATTRIBUTION OF PROFITS TO PE



BUSINESS CONNECTION - INDIA PERSPECTIVE

- Relevance of Business Connection to Scope of Income
- As per Section 9(1)(i) of the Income Tax Act, 1961 ('the Act') all income accruing or arising **whether directly or indirectly, through or from any Business Connection ('BC')** in India or through or from any property or capital asset or source of income or transfer of capital asset situated in India is taxable in India
- Explanation 2 to Section 9
 - Inclusive definition
 - Authority to conclude contracts
 - Mere purchase - not "Business Connection"
 - No authority - but maintains stocks - regular delivery on behalf of a Non-resident
 - Habitually secures orders (even if no authority, no stocks)
 - Exclusive broker
 - Independent broker
- BC arise in which situation?
- Whether the term BC is relevant for all types of income?
- Quantum of income taxable in India?
- PE under Section 92F(iii) & Section 44DA

Term "Business Connection" is generally much wider than "PE"

BUSINESS CONNECTION - INDIA PERSPECTIVE

- Test laid down by the Hon'ble Supreme Court for existence of a business connection [**CIT v. R. D. Aggarwal & Co (56 ITR 20) (SC)** and **GVK Industries Ltd. v. ITO [1997] (228 ITR 564)**]
 - 'Business connection' admits of no precise definition
 - It undoubtedly means something more than 'business'
 - With India vs. In India
 - There should be a real and intimate relation between business carried on by Non- Resident ('NR') and some activity in India which directly or indirectly contributes to earning of profits by the NR
 - It may take several forms: it may include carrying on a part of the main business or an activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in India, which facilitates or assists the carrying on of that business
 - There should be an element of continuity between the business of NR and the activity carried in India
 - A stray transaction is normally not regarded as business connection
 - Question has to be dealt with based on the facts and circumstances of each case

ORIGINATION OF PE



HISTORY OF THE TERM 'PE'

- **History of 'PE'**
 - First included in Article 2(1) of the DTAA between Prussia & Austria-Hungary in 1899
 - Concept of PE incorporated in model conventions of 'League of nations' in 1928
 - Definition of 'PE' was part of first report of Fiscal Committee of the OEEC (now known as OECD)
 - Included in OECD's draft convention
 - Continued thereafter in every DTAA & Model Convention
- **History of 'PE' in India**
 - From F.Y.63-64 through India-Greece DTAA
 - Concept of 'PE' in Indian Income Tax Act introduced vide Section 92F(iiiia) through Finance Act 2002, w.e.f.01/04/2002

NEED OF PE IN TAX TREATIES

- Historically States have endeavored to tax income on the basis of the ‘nexus’ with the State
- Residence of the tax payer and Source of the income constituted as the basis for claiming the ‘nexus’
- The tussle resulted in double juridical taxation of the tax payer in respect of same income
- PE determines the right of a Contracting State (“CS”) to tax the profits of the enterprise of another CS
- PE Concept - literally the backbone of all modern tax treaties
- The rule is designed to ensure that business activities will not be taxed by the state unless and until they have created significant economic bonds between the enterprise and that state
- PE is narrower than BC
- Profits attributable to the PE taxed in the PE state

MEANING OF THE TERM 'PE'

- The concept as explained by Andhra Pradesh High Court in **CIT. v. 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”

- **Conceptual difference:** - The SC in the case of **Ishikwajima** observed that there is a conceptual difference between business connection and permanent establishment

“The concepts ‘profits of business connection’ and ‘permanent establishment’ should not be mixed up. Whereas business connection is relevant for the purpose of application of Section 9; the concept of permanent establishment is relevant for assessing the income of a non-resident under the DTAA”

- PE rule determines the right of a Contracting State to tax the profits of an enterprise of the other Contracting State
- With India vs In India

CONCEPT OF PE

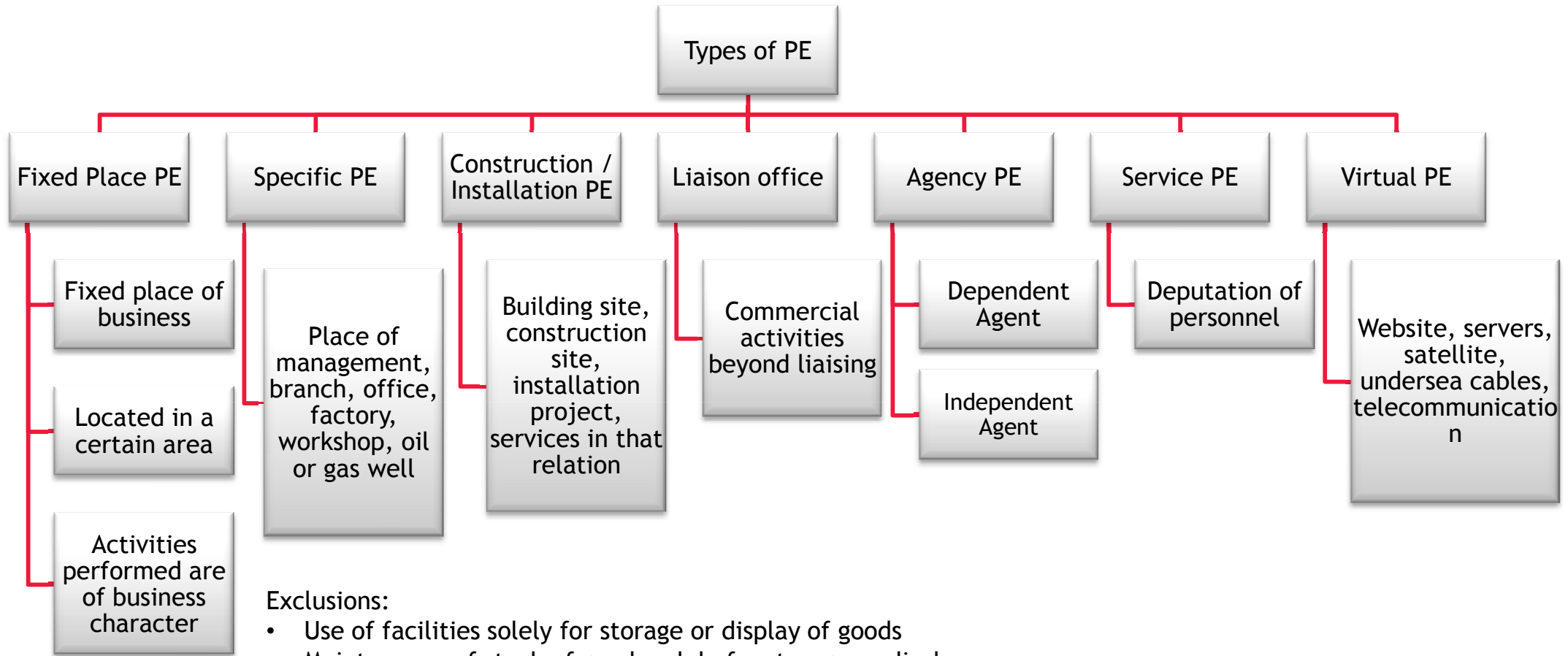
PE

Artificial entity created for taxing income of non-resident arising from business operation carried out in India

When activities conducted in India exceeds the specified number of days prescribed in the relevant DTAA

Establishment of PE in India envisage right with Indian Revenue Authorities to tax income of a non- resident, attributable to PE activities in India

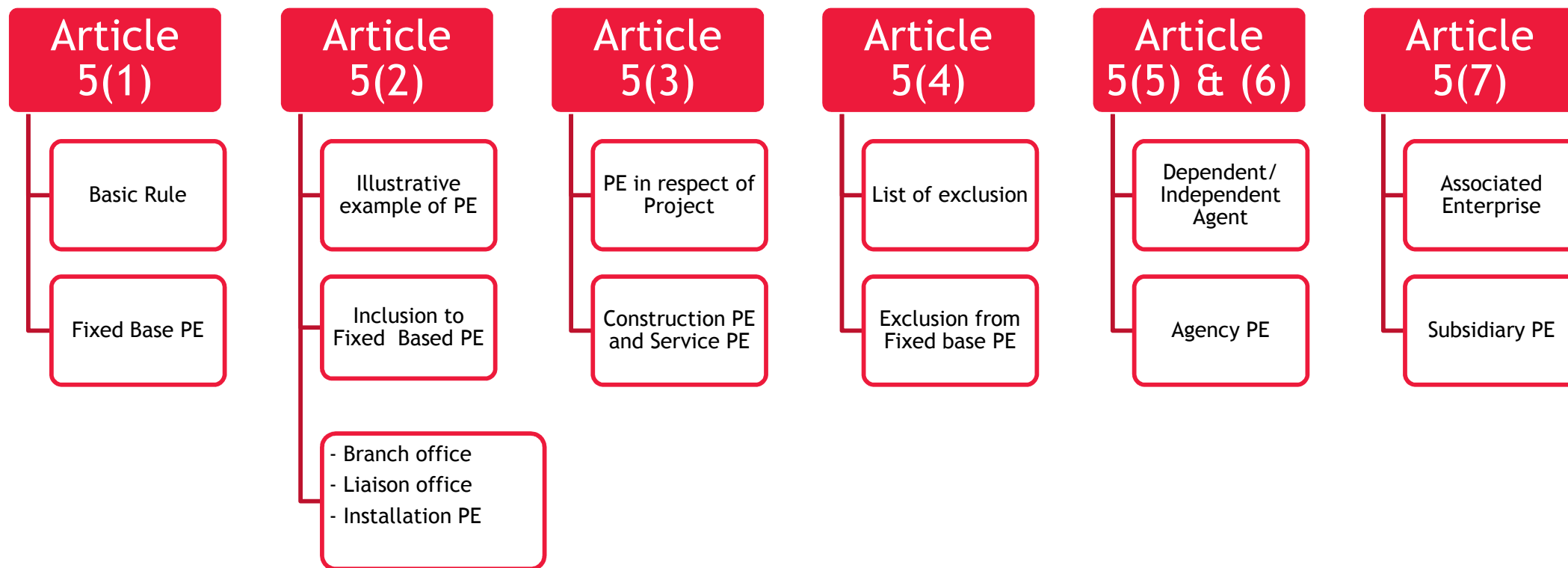
TYPES OF PE



Exclusions:

- Use of facilities solely for storage or display of goods
- Maintenance of stock of goods solely for storage or display
- Maintenance of stock of goods solely for processing by third party
- Maintenance of fixed business place solely for purchasing goods or collecting information
- Maintenance of a fixed business place solely for carrying on preparatory or auxiliary activities
- Maintenance of fixed business place solely for a combination of above activities, such that it is preparatory or auxiliary in nature

OVERVIEW OF ARTICLE 5 UNDER OECD MC



ARTICLE - 5(1) FIXED BASED PE



ARTICLE - 5(1) - FIXED BASED PE

- As per Article 5(1) of the OECD MC

“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” (Basic Rule)

Conditions:

- a. **A place of business** i.e. a facility such as premises or a in certain circumstances machinery equipments;
- b. It is a “**fixed**” i.e. it must be established at a distinct place with a certain degree of permanence;
- c. Carrying on **business through this place** of business.

All conditions of Article 5(1) needs to be cumulatively satisfied

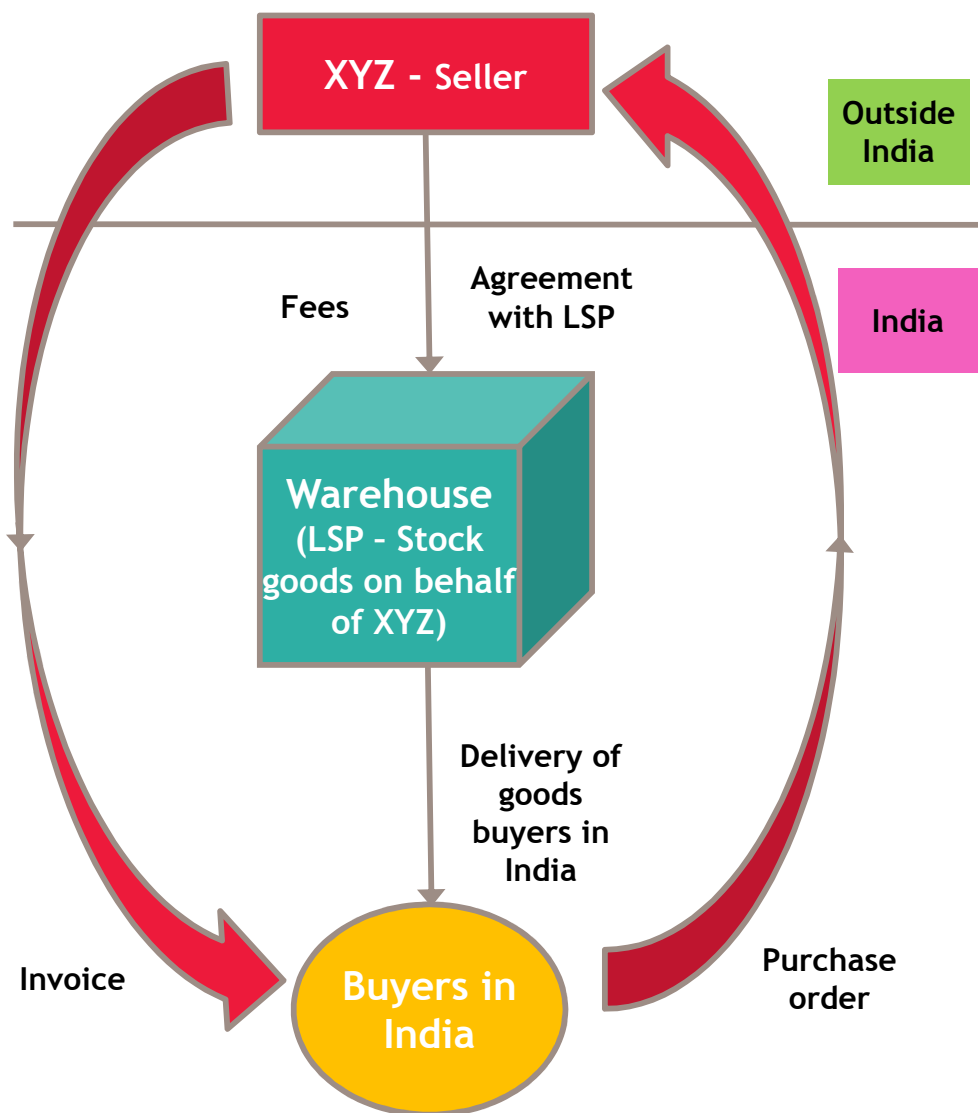
ARTICLE - 5(1) - FIXED BASED PE

- There must be fixed place of business - **situs test**
 - Presence to be 'visible' in other contracting state
 - Covers premises and tangible asset used for carrying out business
 - The residence of a country manager was held to be a fixed place of business as the same was used as an office address - **Sutron Corporation (AAR)**
 - An office space of 3 x 6 meters was held to be a fixed place of business. (**Motorola Inc & Others, 95 ITD 269 (Del)**)
- The fixed place of business must be located in a certain territorial area - **location test**
 - Movable place of business with temporary fixed location
 - Usually attached with geographical location
- The use of fixed place of business must be for certain period of time - **tempus test**
 - No minimum threshold under Indian law
 - Carrying out activities through place exclusively available to business in India - deemed to be fixed PE even if the place is used for a day
 - Interestingly AAR in case of **Golf in Dubai, LLC** held that conducting of golf tournament in India for a week time does not lead to existence of fixed based PE in India

ARTICLE - 5(1) - FIXED BASED PE

- The taxpayer must have a certain right to use over the fixed place of business - **ius test (disposal test)**
 - Place should be at disposal of foreign enterprise
 - Ability to exercise some right or control
 - Legal right to use need not be the sole determinant factor - Even illegal occupation could amount to PE
 - Place may be owned, leased or rented
- The activities performed through the fixed place of business must be of business character - **activity test**
 - Business of foreign enterprise needs to be wholly or partly carried out through fixed place
 - The use of premises by agent to carry out business of the principal may lead to held that such premises are at the disposal of the principal and hence, constitute a PE - **Galileo International Inc**
 - The office of courier company was considered as a PE of foreign company engaged in the business of courier services, as the foreign company delivered packages to local courier company for onward delivery to the addressee - **ACIT v. DHL Operations BV**

CASE STUDY - I - FIXED BASED PE



• Facts of the case

- XYZ is a Foreign resident, engaged in supply of goods to customer in India
- In order to minimize supply delays, XYZ proposes to enter into agreement with independent logistic service provider ('LSP') in India, who would stock goods on behalf of XYZ and deliver the same to buyers in India on 'Just-in-Time' basis.
- Goods are shipped to LSP based on the purchase order place by buyers in India
- During storage, ownership of goods remain with XYZ
- Upon receipt of 'pull request' from the buyers, LSP deliver the goods to the respective buyer
- XYZ raised invoice on buyers in India and pursuant to which buyers makes payment directly to XYZ
- LSP is separately remunerated by XYZ for storage and delivery services
- LSP to provide adequate warehouse space, allows inspection to XYZ and ensure goods are delivered promptly

• Issue:

Whether LSP would constitute a PE in India?

CASE STUDY - I - FIXED BASED PE... Contd.

Relevant Factors

- Distinct and separate earmarked space with a degree of permanence;
- Possession / Ownership / Operations of warehouse not conclusive to determine Fixed Place PE-Adequate ware house space at a specified location;
- Right to enter the warehouse for the purpose of physical inventory, inspection, audit, repackaging, etc.
- Mere outsourcing and not carrying operation through its own employee do not rule out application of fixed place PE - Both XYZ and LSP are responsible for timely delivery of goods
- Third condition of Fixed place PE implies place at disposal - OECD MC has contrary view (mere presence of an enterprise at a particular location would not necessarily mean that the location is at the disposal of the foreign enterprise)
- Question of attribution
- Impact to foreign company in sales and distribution supply chain
- Exclusion Article 5(4) contain exclusion of maintenance of stock of goods solely for storage or display

Seagate International Headquarters Pvt. Ltd. [AAR No. 831/2009]

Airlines Rotables Limited v. JDIT [131 TTJ 385 (Mum)] - Storage of goods on consignment basis at customer's place not at disposal of the foreign enterprise does not constitute PE in India under India-UK tax treaty. Hon'ble Mumbai Tribunal note that to constitute of fixed based PE, the physical (location), subjective (disposal) and functional (business through that place) criteria have to be satisfied

ARTICLE - 5(2) - ILLUSTRATIVE LIST OF PE



ARTICLE - 5(2) - ILLUSTRATIVE LIST - OECD MC

- Article 5(2) provides illustrative list of PE
- **The term PE includes especially:**
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop, and
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources
- Definition is identical under UN and US Model
- List is indicative and not exhaustive
- OECD considers the satisfaction of conditions prescribed in Article 5(1) as a pre-requisite conditions to constitute PE under Article 5(2)
- India does not agree with the above interpretation of OECD and holds that all the illustrations given in Article 5(2) could independently constitute PE

Article 5(1) and Article 5(2) - dependent or independent ? - Contradictory views

ARTICLE - 5(3) - CONSTRUCTION AND INSTALLATION PE



ARTICLE -5(3) - CONSTRUCTION AND INSTALLATION PE - OECD MC

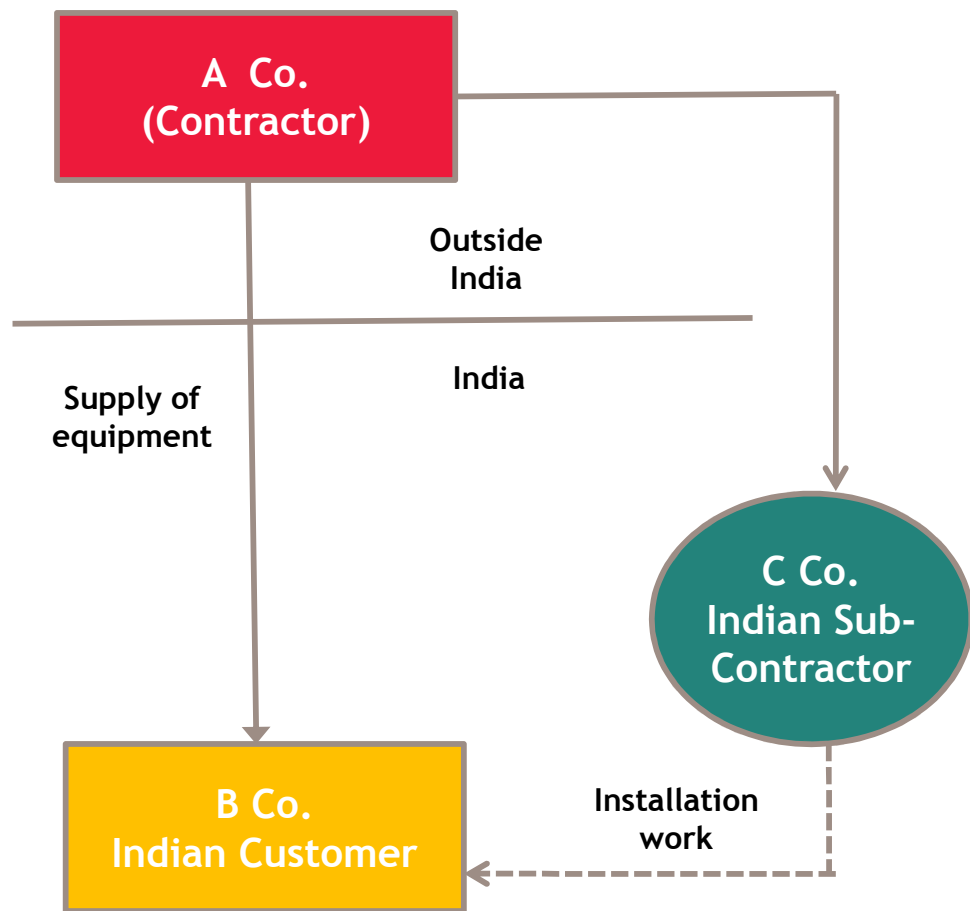
- Building site, construction, assembly or installation project or supervisory activities in connection therewith - constitute PE, if it continues for more than 6/12 months
- It includes:
 - Construction of buildings, roads, bridges or canals, excavating and dredging including substantial renovation
 - Laying of pipelines
 - Demolition and clearing operations (not necessary connected with the another construction work)
 - Installation of new equipment in place of existing one
 - Planning and supervision covered only if carried on by the building contractor itself
 - Final assembly of movable projects (eg. Airplanes)
- 5(3) - threshold limit not fulfilled although 5(1) fulfilled - Whether PE? Eg. project office
- Supervisory activity PE whether independent of installation and assembly?
- Whether supervisory and installation service provider to be same person? -Steel Authority of India (10 SOT 351 - Del)

Construction PE is placing significance on 'duration test' as against 'permanent test'

ARTICLE 5- PARA 3(a) - PE IN RELATION TO PROJECT

- “Permanent/Fixed place of business” element replaced by test of minimum length of time.
- 6/12 Months time applied to each individual site or project.
- Activities may extend over more than one calendar year or assessment year - **Paper Products Limited - 257 ITR 1 - Delhi HC**
- Time taken for unconnected projects should not be considered for 6/ 12 month period.
- Legal acts are excluded in calculating the time limit.
- Business activity is started on the spot. PE exits from day one.
- Same principles apply that govern the beginning
 - A site exists until the work is completed or permanently abandoned
 - Trial run is included in the minimum period
 - After sales services is either sufficiently connected with the building, installation or assembly work- PE
 - Auxiliary services subsequent to a fully completed assembly or installation project - No PE
 - Temporary interruptions not to be excluded on account of bad weather, lack of raw materials, labour problems ,etc. - **Krupp UDHE GmbH**

ARTICLE -5(3) - CONSTRUCTION AND INSTALLATION PE - CASE STUDY - I

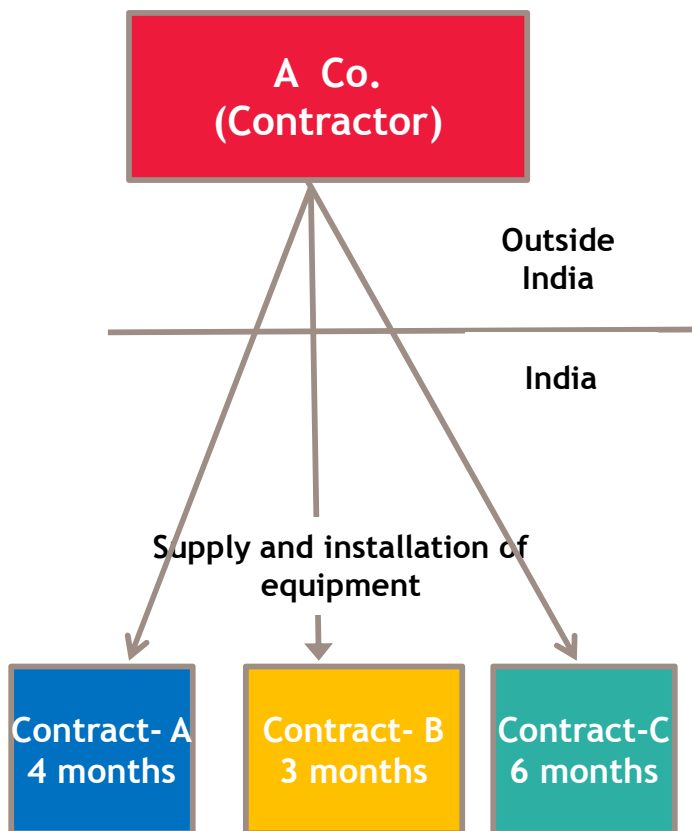


- Facts of the case
 - B Co. enter into contract with A Co. for supply and installation of equipment
 - Installation of work for long duration
 - A Co. appoint C Co. an independent company and sub-contracting responsibility of entire installation of equipment in B Co.
 - A Co. contractually liable for installation of equipment, however backed by indemnity from C Co.
 - A Co. separately make payment to C Co. for installation services
 - Employees of A Co. visit India for performing supervisory activity
- Issue involved - Whether time spent by sub-contractor viz. C Co. needs to be aggregated for determining PE of A Co?

Relevant Case

Pintsch Bimag [318 ITR 190 (AAR)]

ARTICLE -5(3) - CONSTRUCTION AND INSTALLATION PE - CASE STUDY - II



The OECD MC provides that the duration test 'applies to each individual site or project'.

- **Facts of the case**
 - A Co. secure 3 contracts in India for supply and installation of equipment
 - All the contracts are independent and there is no inter connection and independence. None of the contract is an extension of another contract

- **Issue involved**

Whether different periods of the projects are to be aggregated to reckon the threshold limit of 12 months under Article 5(3) of the tax treaty?

- **Analysis:**

The duration test for installation and assembly projects specified under Article 5(3) of the tax treaty cannot be read together for all projects since they do not pass the test of cohesiveness, interconnection and interdependence

Tiong Woon Project & Contracting Pte. Ltd. [2011-TII-24-ARA-INTL]
ADIT v. Valentine Maritime (Mauritius) Ltd [2010-TIOL-195-ITAT-MUM]
J Ray McDermott Eastern Hemisphere Ltd (130 TTJ 121) (Mum)
Krupp UDHE GmbH (28 SOT 254) (Mum)
Hyosung Corporation [2009] (314 343)(AAR)
DCIT v. Hyundai Heavy Industries (128 TTJ 4) (TDel)
Sumitomo Corporation v. DCIT [2007] (110 TTJ 302) (Del)

ARTICLE -5(3) - CONSTRUCTION AND INSTALLATION PE - Other issues

Issues related to computation of threshold limit

- Date on which physical work commences, including preparatory activities - **Cal Dive Marine Construction (Mauritius) Limited (315 ITR 314) (AAR)**
- In case contract involved various activities which are dependent on each other, the minimum period may commence from the date when first activity commenced - **Krupp UDHE GmbH**
- 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 9 months under the India Mauritius tax-treaty - **GIL Mauritius Holdings Ltd v. ADIT [2011] (48 SOT 17) (Del)**
- Where the similar services rendered among the different contracts but within the same parties, then the duration of the totality of services furnished under different contracts should be aggregated for the computing threshold limit - **Worley Parsons Services Pty Ltd (A.A.R No. 748 of 2007)**

ARTICLE - 5(3) - SERVICE PE



ARTICLE - 5(3) - SERVICE PE

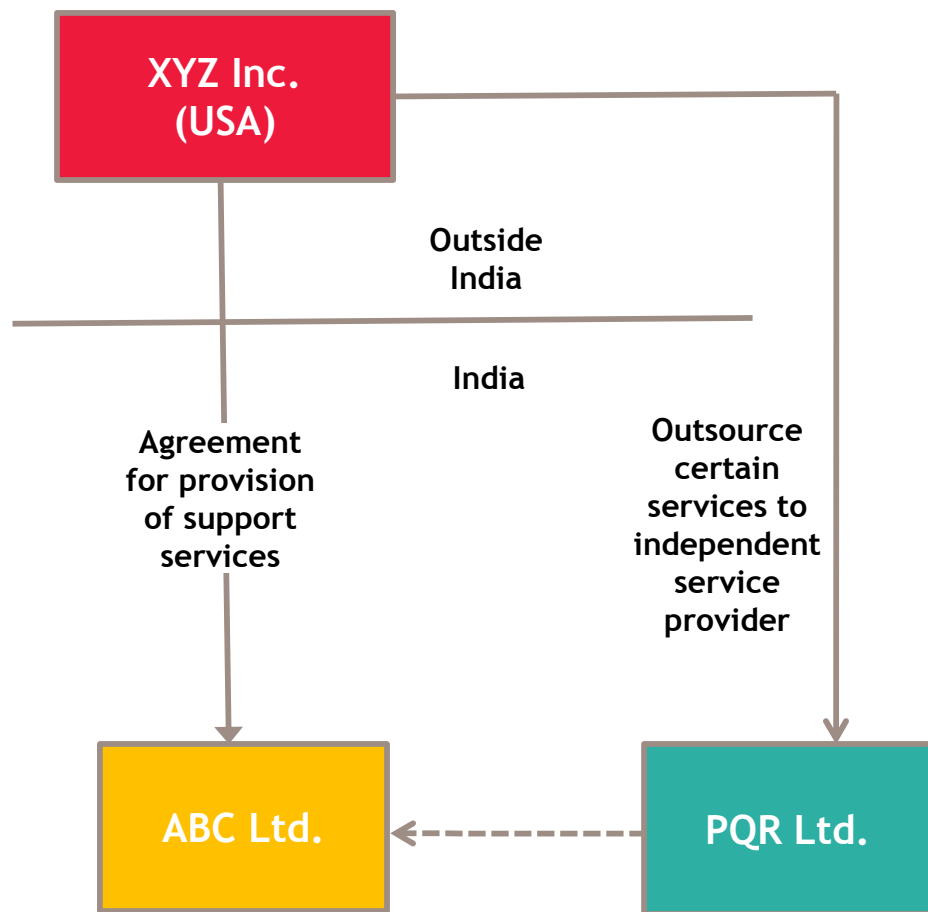
- The term PE includes especially..... the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise **through employees or other personnel**, but only if:
 - (i) **activities of that nature continue** within that State for a period or **periods aggregating more than 90 days within any twelve-month period** ; or
 - (ii) **the services are performed** within that State for a **related enterprise** [within the meaning of paragraph 1 of Article 9 (Associated Enterprises)]

[Article 5(2)(i) of the India - USA DTAA]

- It is important to evaluate the requirements of Article 12 before examining Service PE clause

'Permanent test' of PE is replaced by a 'test of minimum length of time'

ARTICLE -5(3) -SERVICE PE



• Facts of the case

- XYZ Inc., USA entered into agreement with ABC Ltd for provision of support services
- Further, XYZ Inc entered into another agreement with PQR Ltd. and outsource part of the obligation in its favour
- Employees of XYZ Inc. work under direct supervision of ABC Ltd and their stays in India does not exceed minimum threshold limit
- Pursuant to an agreement, employees of PQR Ltd rendered services to ABC Ltd.
- XYZ Inc. does/ does not have direct control over the employees of PQR Ltd.

• Issue involved

- Whether time spent by the employees of PQR Ltd. for providing services to ABC Ltd. on behalf of XYZ Inc. should be taken in to account for determining threshold limit from the perspective of XYZ Inc.?
- Assuming, period of stay of personal of XYZ Inc. in India exceeds threshold limit, will it result into constitution of Service PE in India?

Lucent Technologies International Inc. v. DCIT [2009-TIOL-161-ITAT-Del]

Morgan Stanley and Co Inc. (292 ITR 416) (SC)

Tekmark Global Solutions LLC [ITA No. 671/Mum/2007]

ARTICLE - 5(3) - SERVICE PE - SECONDMENT V. DEPUTATION

Secondment Model - Typical features

- An employee of X Co. of USA is seconded to A Ltd. in India
- Employee shift his payroll with A Ltd.
- Employee continues on the payroll of X Co for limited benefit purpose
- Employee reside and rendered services in India. He reports to A Ltd.
- Employee works under direct supervision and control of A Ltd.
- Employees receive salary from A Ltd.
- Long duration of contract

Under Secondment Model, Service PE exposure can be mitigated

Deputation Model - Typical features

- An employee of X Co. of USA is deputed to A Ltd. in India
- Employee continues on the payroll of X Co.
- Employee reside and rendered services in India. He reports to A Ltd. and X Co.
- Employee works under direct supervision and control of X Co.
- Employees continue to receive salary from X Co., who in turn reimbursed by A Ltd.
- Short duration of contract

Under Deputation Model, Service PE exposure is there

Secondment Model is not preferred since

- Employees are keen to retain lien over original employer
- Continuity of social security/ provident fund could be affected if payroll shift to another employer
- Position of the employees within the organization could be affected

ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

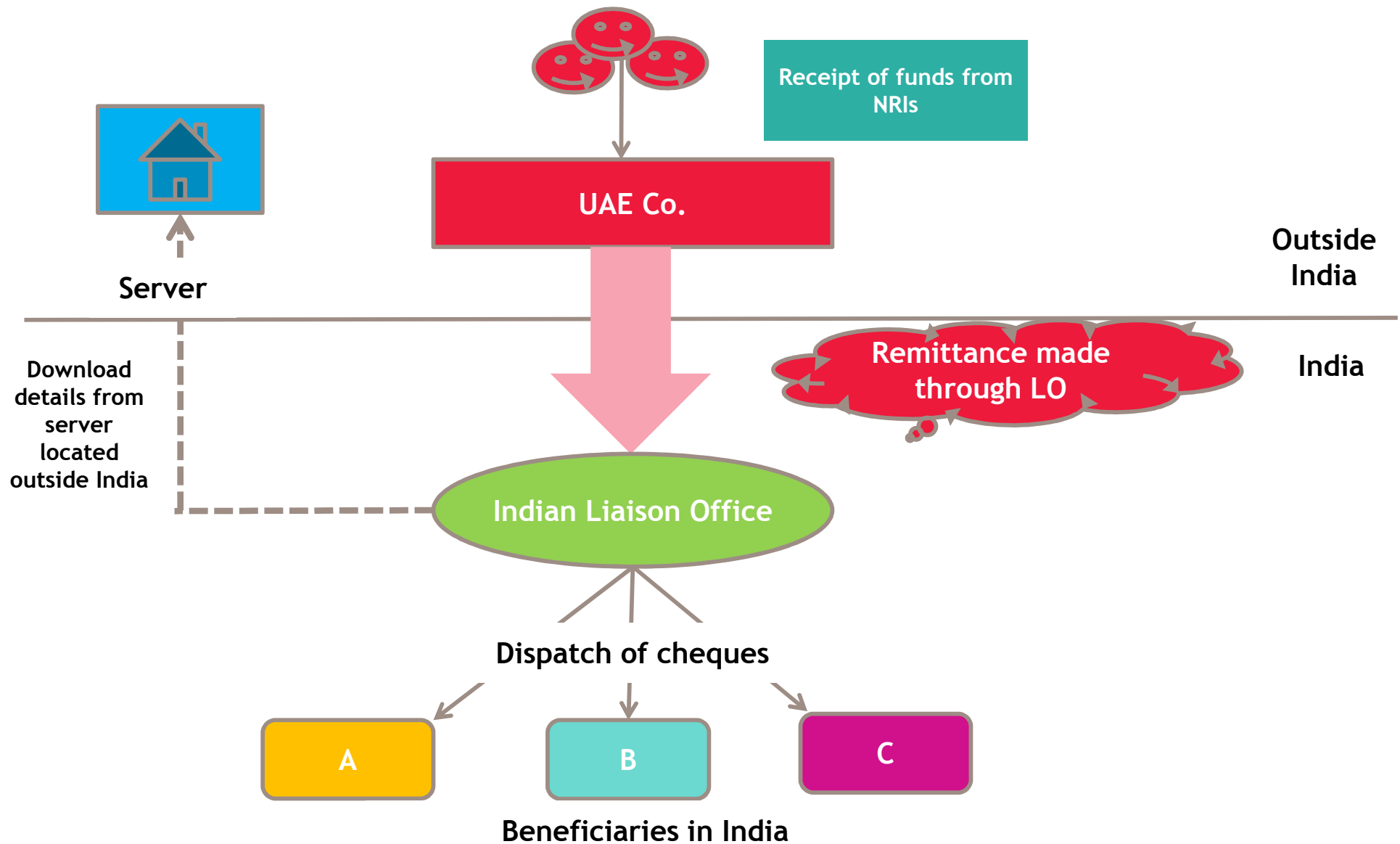


ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

- Exceptions in Article 5(4) - activities that do not result in PE
- Exclusion
 - 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
- Storage of goods on consignment basis at customers place does not create a PE in India under the India-UK tax treaty - **Airlines Rotables Limited v. JDIT [131 TTJ 385 (Mum)]**
- Liaison Office ('LO')

Under the exchange control regulations in India, a foreign company may establish an LO to represent the foreign company in India or to function as communicating channel between the Head Office and the companies in India. Further, LO is prohibited from undertaking any commercial, trading, industrial or any other income generating activities in India.

ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE



ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

- **Facts of the case:**

- ✓ UAE Co is engaged in the business of money transfer. UAE Co. has established LO in India
- ✓ UAE Co. received funds from NRIs, who wants to remit money to India
- ✓ UAE Co. is managing the accounts of NRIs
- ✓ The LO downloads the remittance information from the server located outside India, printing cheques and delivering the same to the actual beneficiaries in India
- ✓ UAE Co. compensate LO for expenses incurred by it to carryout above functions

- **Issue involved:**

Whether functions performed by the LO in India on behalf of UAE Co. would amounts to fixed based PE in India?

- **Analysis**

UAE Exchange Center Ltd [2004](268 ITR 9)(AAR)

However, the **Hon'ble Delhi High Court (313 ITR 94) reversed the AAR ruling** and held that the activities were purely in aid of the main activity of remittance of money in India.

Activities of Liaison Office - preparatory and auxiliary in nature - not a PE

ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

- Favorable judicial pronouncements:
 - So long as the activities of LO in India are in the nature of preparatory and auxiliary in an nature, there can be no inference of PE in India
 - **Metal One Corporation v. DDIT [TS-356-ITAT-2012-(DEL)]**
 - **DIT v. Nokia Networks OY (Del. HC)**
 - **DDIT v. Western Union Financial Service Inc. [ITA No.1572 to 1574/Del/2010]**
 - **K.T. Corporation v DIT (181 Taxman 94) (AAR)**
 - **IAC v. Mitsui & Co. Ltd (39 ITD 59) (Del) (SB)**
 - **Mitsui and Co Ltd v ADIT (ITA No. 4625/Del/2005)**
 - **Motorola Incorporation and others v. DCIT (95 ITD 269)(TDel)**
 - **DCIT v. M/s Tokyo Marine & Fire Insurance co. Ltd [2008-TIOL-86-ITAT-DEL]**
 - So long as the functions of LO in India are confined to purchase of goods in India for the purpose of export, no income can be brought to tax in the absence of PE in India
 - **Angel Garments Limited (287 ITR 341) (AAR)**
 - **DDIT v. Nike Inc (ITA No. 1205 to 1210/ Bang/2008)**
 - **Ikea Trading (Hong Kong) Ltd [2008-TIOL-23-ARA-IT]**
 - LO in India undertake trade equiries, promoting of products, negotiations but does not having authority to conclude the contract will not amount to PE in India - **Gutal Trading In re [2005] (278 ITR 643) AAR]**

ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

- Against judicial pronouncements

- ✓ In the case of **DDIT v. Jebon Corporation India Liaison Office [2009] (127 TTJ 98)** LO identified customers in India and secured orders for HO. The LO has decision making authority on behalf of the HO and is empowered to conclude contracts and secure purchaser order on behalf of HO. Based on these facts, the Hon'ble Tribunal held that LO will be treated as PE and will not be covered by the exclusion from the definition of PE. The views of the Tribunal further upheld by the Hon'ble Karnataka High Court - **[2012] (19 Taxmann.com (Kar.))**
- ✓ The services rendered by the LO in India other than the actual sale of goods are also integral part of the business of the HO and have a role in the profit made by the sale of branded products and hence, the activities of LO can not be constituted as preparatory in nature. - **Columbia Sportswear Company [2011-TII-21-ARA-INTL]**

Tax authorities in number of cases alleged that the activities of the LOs go beyond a preparatory or auxiliary character, thereby creating a PE to which income would need to be attributed. There is thin line of demarcation between what is preparatory and non-preparatory activities.

ARTICLE - 5(4) - EXCLUSION TO FIXED BASED PE

Illustrative examples of preparatory and non-preparatory activities

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

ARTICLE - 5(5) & (6) - AGENCY PE



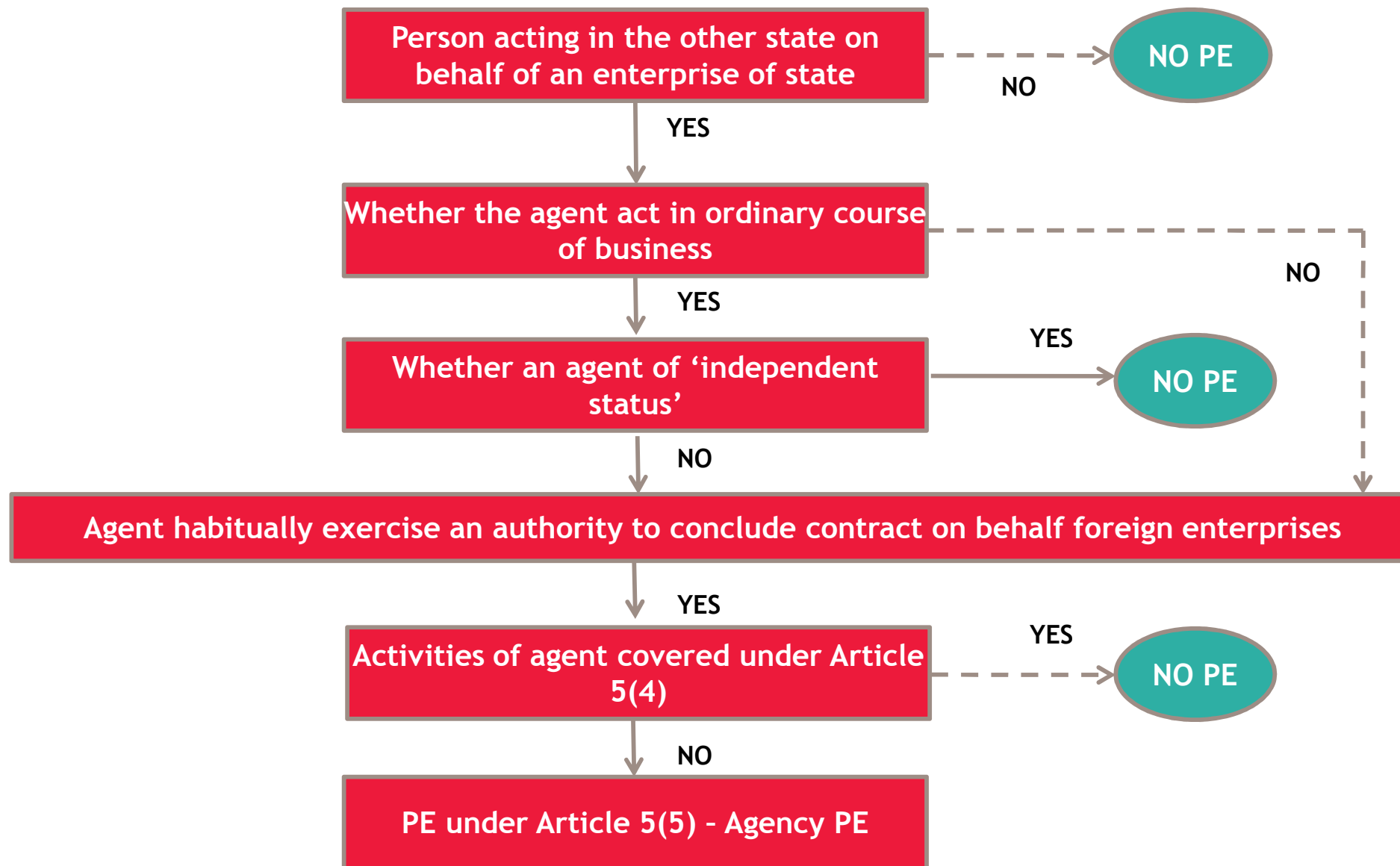
ARTICLE - 5(5) &(6) - AGENCY PE

- Article - 5(5) of the OECD MC reads as under:

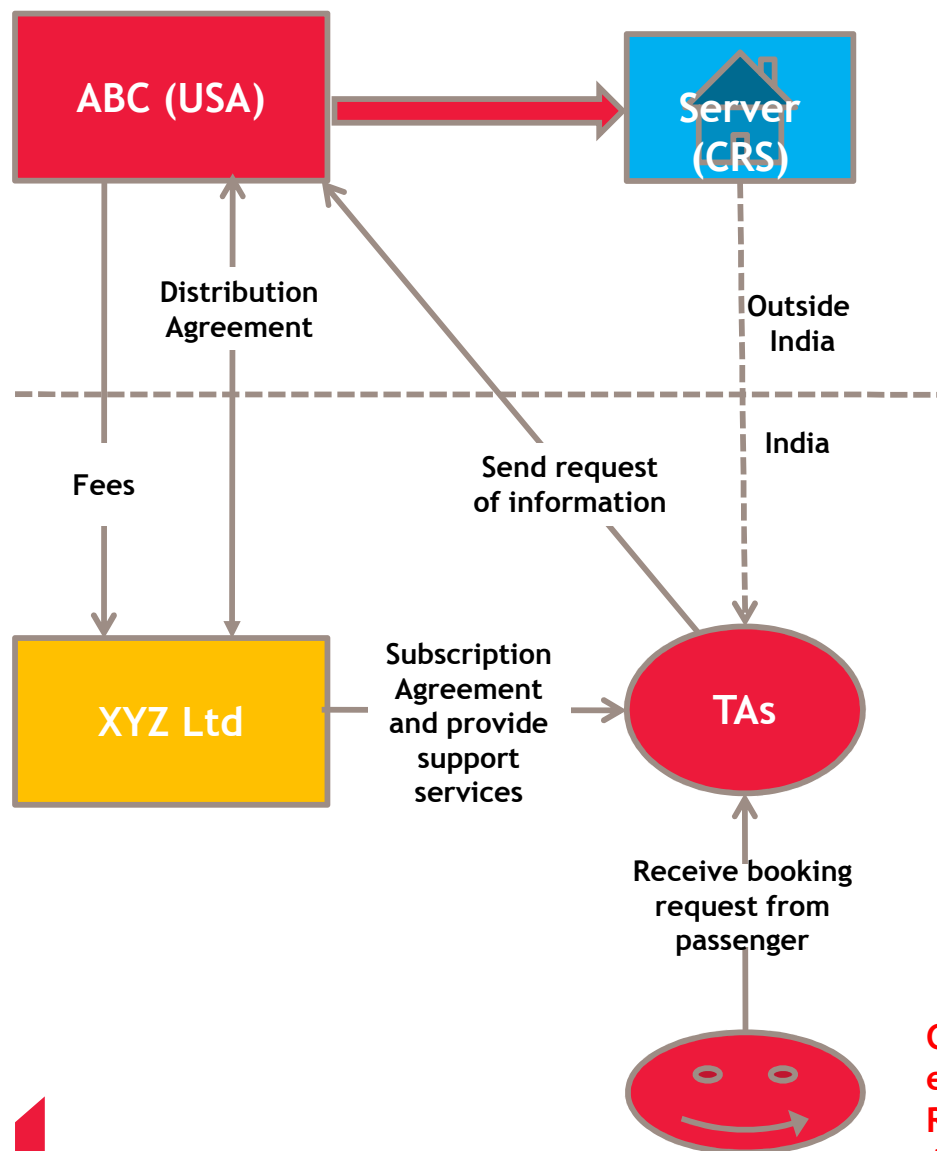
“Notwithstanding the provisions of paragraphs 1 and 2, where a person -other than an agent of an independent status to whom paragraph 6 applies -is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, 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”.

- The primary test for an agency is the legal capacity of the agent to bind the principal to third party
- Independent agent - **No PE** - since having legal and economic independence and doing business in ordinary course of business
- Dependent agent - **Yes PE** - if he
 - has right to acts on behalf of foreign enterprise (wholly and almost wholly on behalf of foreign enterprises)
 - has right to conclude contract on behalf of foreign enterprise
 - Legal and/or economic dependence
 - Habitually maintains stock of goods and regularly delivers goods for and on behalf of foreign enterprises

ARTICLE - 5(5) &(6) - AGENCY PE



ARTICLE - 5(5) & (6) - AGENCY PE - DEPENDENT AGENT



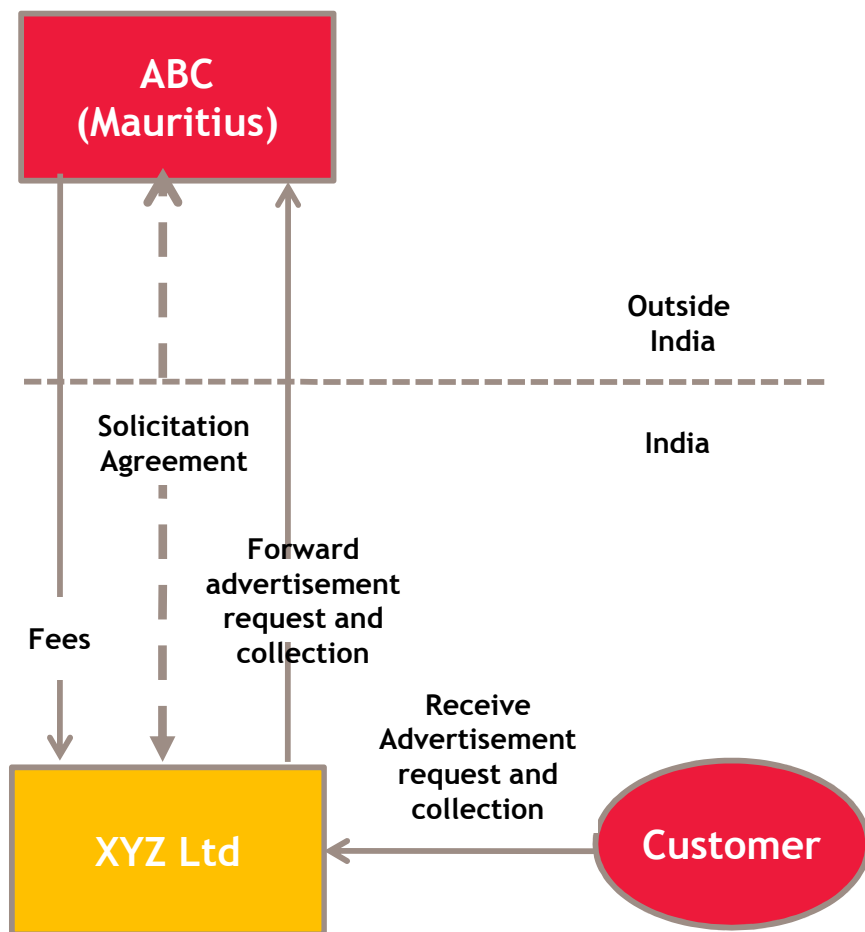
• Facts of the case:

- ABC is resident of USA and engaged in the business of business of maintaining and operating a system.
- ABC providing electronic global distribution services to airlines, hotels, tour and cab operators by connecting to travel agents(TAs)
- ABC utilized Computerized Reservation System ('CRS') to stores information/data (fare, availability) and for booking purpose.
- ABC enter into **Distribution Agreement with an unrelated party called XYZ Ltd. to exclusively market and distribute the CRS services to the TAs in India for a mutually agreed fee.**
- XYZ undertook installation of CRS system at TAs computers, provided connectivity, configured the computer to enable it to access CRS, trained the TAs etc. only for ABC.
- XYZ Ltd undertake number of activities and facilitates ABC to conclude contract between airlines and customer in India.
- TAs received booking request from customer and directly send information (booking request) to ABC. ABC in turn check the availability with CRS. If the same is available, forward the information to TAs, upon which TAs issued tickets to customers.

Galileo International Inc. v. DCIT (19 SOT 257)
eBay International AG Switzerland - (Mum ITAT)
Reuters Limited Construction House [2011] 48 SOT 246 (Mum)
Amadeus Global Travel Distribution SA (113 TTJ 767) (DEL)

ARTICLE - 5(5) & (6) - AGENCY PE - INDEPENDENT AGENT

- Facts of the case



- ABC is Mauritian resident company engaged in the business of telecasting TV Channels. The only source of revenue is from the sale advertisement slots
- ABC does not have any facility of infrastructures in Mauritius which could be used for generation or maximization of advertisement revenue
- ABC has appointed XYZ Ltd as its advertisement collecting agent in India. XYZ is also forwarding advertisement request to ABC. However, ultimate decision was taken by ABC
- Further, as per the solicitation agreement, XYZ Ltd did not have any authority to conclude contract on behalf of ABC
- XYZ Ltd is also providing similar services to various other parties
- ABC directly raise invoice on customers in India
- Revenue from ABC (commission/services income) is only counts about 5% of total income of XYZ Ltd

DDIT v. B4U International Holdings Ltd. [TS-358-ITAT-2012-MUM]
Western Union Financial Services Inc. ADIT [2007] (104 ITD 84) (Del)
DIT v. Daimler Chrysler A.G. [2010] (39 SOT 418) (Mum)
AI Nisr Publishing (239 ITR 879) (AAR)
Dassault Systems K.K. (229 ITR 105) (AAR)
Ericsson Radio Systems A.B. (95 ITD 269) (Del)(SB)
TVM Ltd v. CIT (237 ITR 230) (AAR)
Golf In Dubai, LLC (306 ITR 374)(AAR)
Rolls Royce Plc. v. ADIT [ITA No. 282/Del/2005]
Specialty Magazines P. Ltd. (274 ITR 310)

ARTICLE - 5(7) - SUBSIDIARY PE



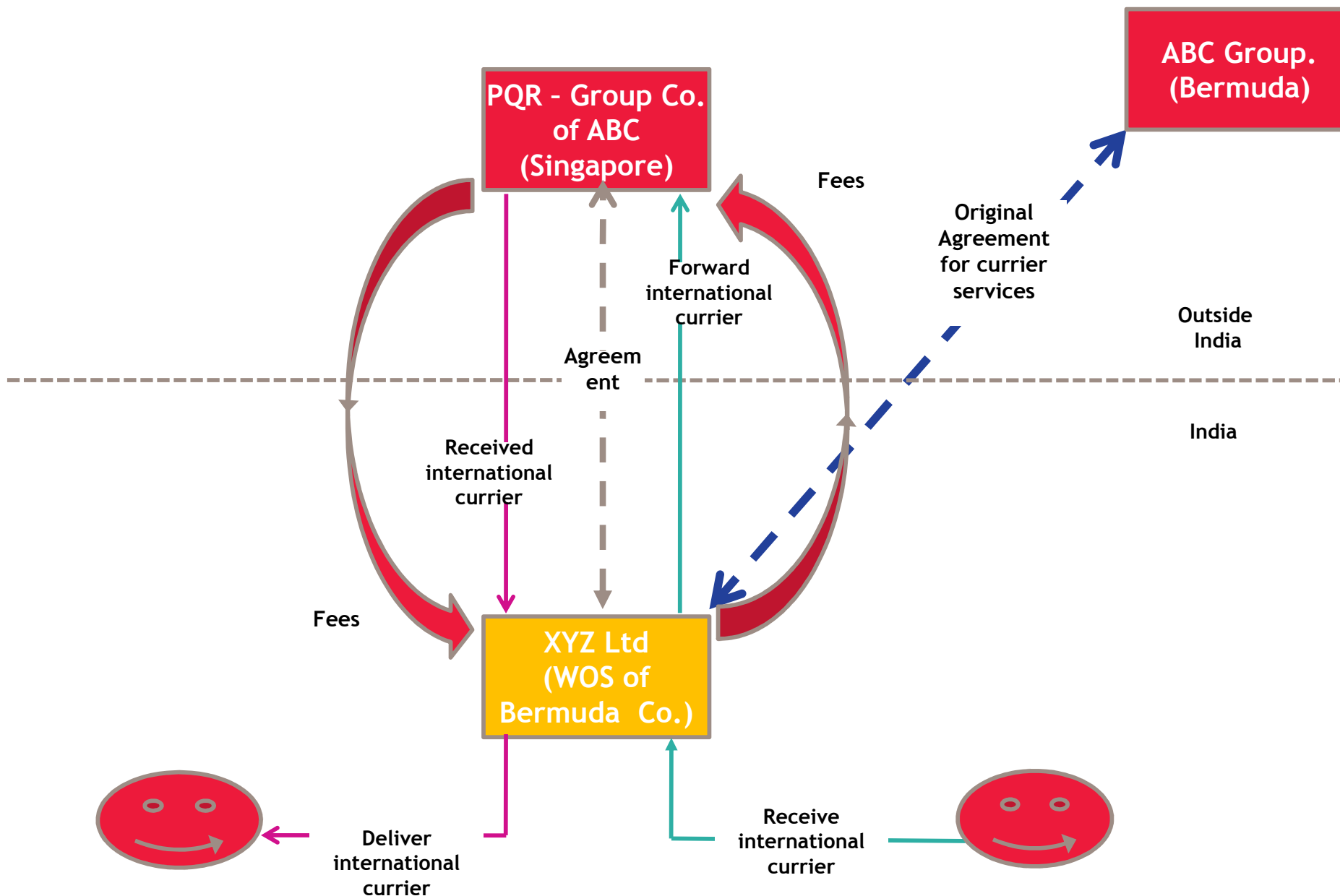
ARTICLE - 5(7) - SUBSIDIARY PE

- Article 5(7) of OECD MC reads as under

“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 PE or otherwise), shall not of itself constitute either company a PE of the other”.

- Existence of a subsidiary by itself does not constitute PE
- Subsidiary is legally independent entity
- In order to establish subsidiary as PE, the other test of fixed base PE/ Service PE/ Agency PE needs to be satisfied
- **OECD MC 2010 on treatment of Subsidiary as a PE of a foreign enterprise**
 - The control which a parent company exercises over its subsidiary in its capacity as shareholder is irrelevant
 - Business of a subsidiary company managed by a parent company does not constitute PE of the parent company
 - A subsidiary company may be a PE of the foreign enterprises under the following circumstances:
 - ❖ any space or premises belonging to the subsidiary that is at the disposal of the parent company
 - ❖ the subsidiary habitually exercises an authority to conclude contracts in the name of the parent

ARTICLE - 5(7) - SUBSIDIARY PE



ARTICLE - 5(7) - SUBSIDIARY PE

- **Facts of the case**

- ABC Group is engaged in the business of door to door express shipments by air and land and performing related services
- PQR (Group Co. of ABC) has entered in to agreement with XYZ for overlooking the movement of packaging within in India (both inbound and outbound)
- PQR had no office, equipment, employee or agent in India
- PQR is responsible for the transportation of packages through out world outside India and XYZ was responsible for transportation within in India
- The contract entered between PQR and XYZ was on principal to principal basis
- XYZ was appointed as non-exclusive service provide in India. However, XYZ was not free to engage any other service provider for rendering services outside India, except under special circumstances
- XYZ was also involved in domestic currier services where the network of ABC Group was not used. Income from agreement with PQR was about 33% of total income.
- Neither PQR nor XYZ were authorized to act on behalf of each other.
- Neither PQR nor XYZ were was liable to each other for negligence, misrepresentation or otherwise for loss of profits or revenue in business

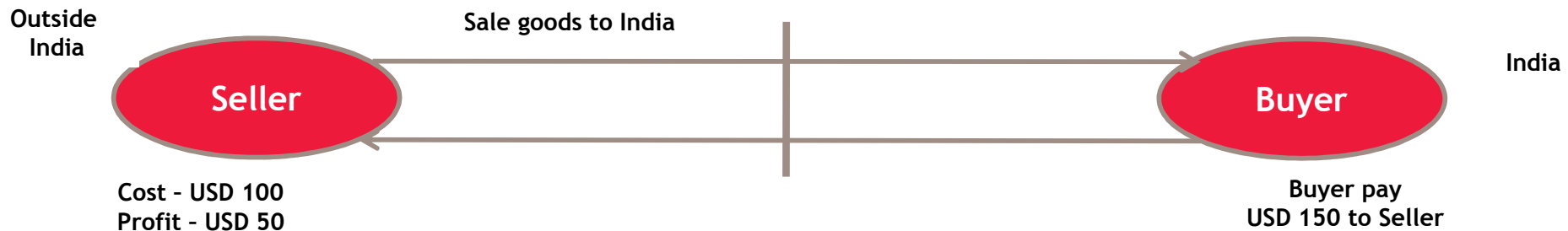
- **Issue involved**

Whether in light of the fact that PQR had no office, equipment, employee or agent in India, group subsidiary company viz. XYZ can be considered as PE in India?

ARTICLE -7 - ATTRIBUTION OF PROFITS



TAXATION OF FOREIGN ENTERPRISES



Can India tax part of Seller's profit in India?

- Taxation of business profits of foreign enterprises in India

- ✓ Business connection under the Act - Section 9(1)(i)
- ✓ PE under tax treaty - Article 7 read with Article 5

Characterization	If PE exist - taxation on net basis	If no PE
Dividend	Article 7	Article 10
Interest		Article 11
Royalty / Fees for technical services		Article 12
Business profits (other than above)		Not taxable
Other income		Article 21

METHODS PRESCRIBED UNDER RULE - 10 FOR ATTRIBUTION OF PROFITS

Rule	Method	Brief description
Rule 10(i)	Presumptive Method	Ad hoc profits are estimated as attributable to the operations in India
Rule 10(ii)	Proportionate Method	<p>Proportionate profits based on worldwide income is attributed to the operations in India</p> <p>Difficult method as worldwide income of the enterprise is to be computed under the Act before applying proportionate method</p> <p>In case of different businesses, relevant business income be considered</p>
Rule 10(iii)	Discretionary Method	Such method as is deemed fit by tax authorities - AO may devise any mechanism on facts and circumstances of the case

FORCE OF ATTRACTION - INDIA PERSPECTIVE

- Provisions of section 5(1) and 5(2) provides that income is taxable in India if it is received in India or deemed to be received in India or accrues or arises in India or is deemed to accrue or arise in India
- Section 9 covers income which is deemed to accrue or arise in India
- Explanation 1 to Section 9 reads as under:

“For the purposes of this clause

- (a) In the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;”*

ARTICLE - 7 - FRAMEWORK

Para	Brief description
Para 1	Part I - Existence of PE & attribution of Profits to business of such PE Part II - Force of Attraction Rule (UN Model)
Para 2	Principle of distinct and separate enterprise approach
Para 3	Principles of Computation of income of PE
Para 4	Source country can follow principles of apportionment, if customarily followed
Para 5	No allocation of profits for mere purchase of goods for the enterprise
Para 6	Consistent use of Attribution method
Para 7	Given priority to other article if profits include income taxable under other article like CG, FTS, Royalty etc

ARTICLE - 7(1) - FORCE OF ATTRACTION RULE

- Article 7(1) of the tax treaty reads as under (OECD Model):

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:

(a) that permanent establishment;

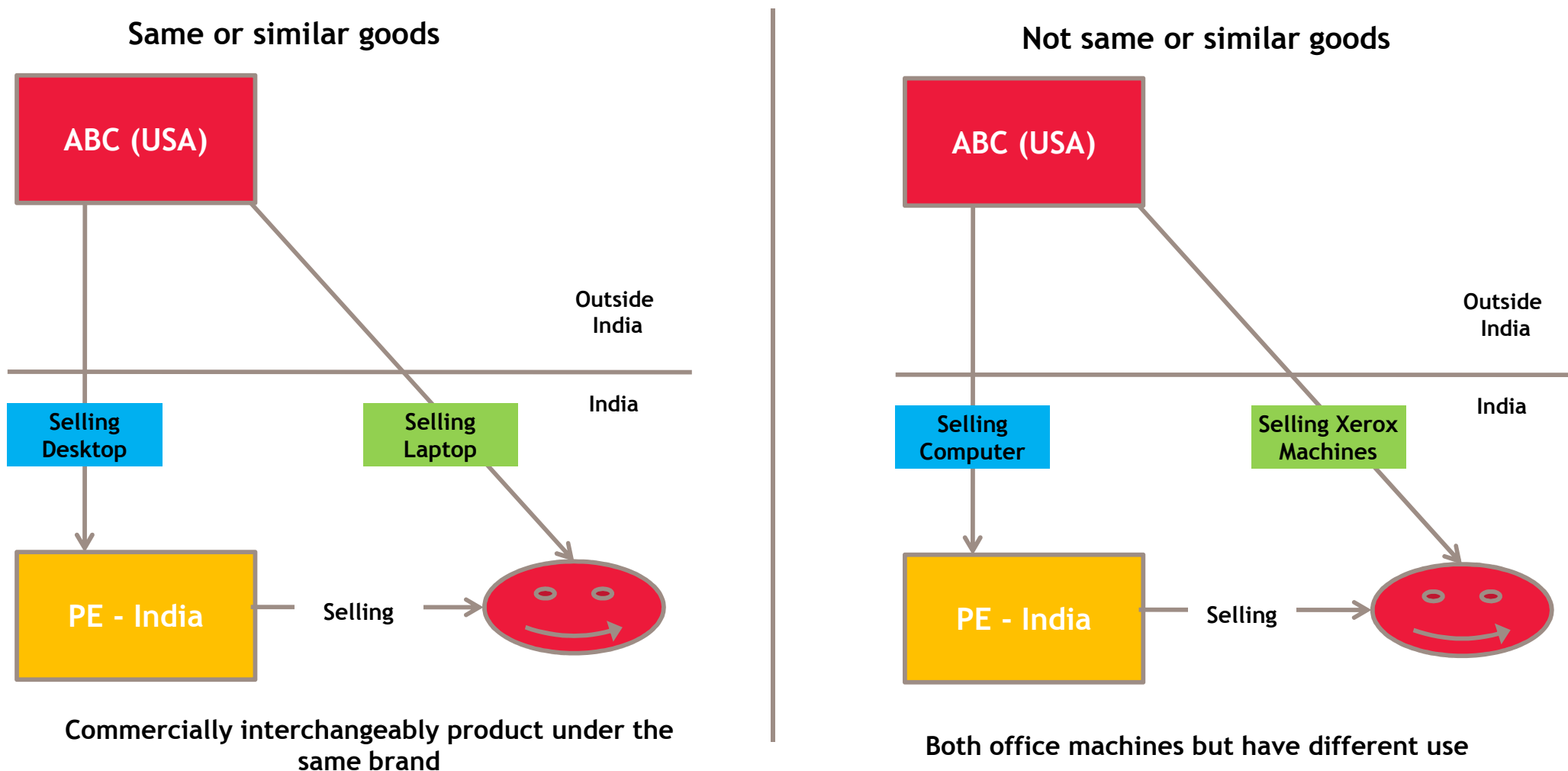
(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or

(c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment”

- Types of FOA rule

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

ARTICLE - 7(1) - FORCE OF ATTRACTION RULE



Article 7(1)(c) does not apply to sales activity as Article 7(1)(b) restricts its scope to sale of 'same' or 'similar' goods only

ARTICLE - 7(1) - FORCE OF ATTRACTION RULE

- Article 7(1) of India-UK tax treaty

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent, establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is directly or indirectly attributable to that permanent establishment.”

- In case of **Linklaters & Paines v. ITO [2012] (28 Taxmann.com 250)(Mum)**, the taxpayer is a partnership firm of Solicitors and is a resident of UK. During the year The taxpayer has carried out certain work on Indian project, majority of which was done in UK and some of the work was done in India by persons who visited for short period of time. While dealing with the issue whether entire profit in respect of Indian project is taxable in India or not, the Hon'ble Mumbai Tribunal held as under:

“In our considered view, therefore, the connotations of “profits indirectly attributable to permanent establishment” do indeed extend to incorporation of the force of attraction rule being embedded in Article 7(1). The way it needs to be implemented, on the facts of the present case, is like this. In addition to taxability of income in respect of services rendered by the PE in India, any income in respect of the services rendered to an Indian project, which is similar to the services rendered by the permanent establishment, is also to be taxed in India in the hands of the assessee - irrespective of the fact whether such services are rendered through the permanent establishment, or directly by the general enterprise. There cannot be any professional services rendered in India which are not, at least indirectly, attributable to carrying out professional work in India. This indirect attribution, in view of the specific provisions of India UK tax treaty, is enough to bring the income from such services within ambit of taxability in India. The twin conditions to be thus satisfied for taxability of related profits are (i) the services should be similar or relatable to the services rendered by the PE in India; and (ii) the services should be ‘directly or indirectly attributable to the Indian PE’ i.e. rendered to a project or client in India. In effect thus, entire profits relating to services rendered by the assessee, whether rendered in India or outside India, in respect of Indian projects is taxable in India.

ARTICLE - 7(2) - APPROACHES TO DETERMINE PROFIT

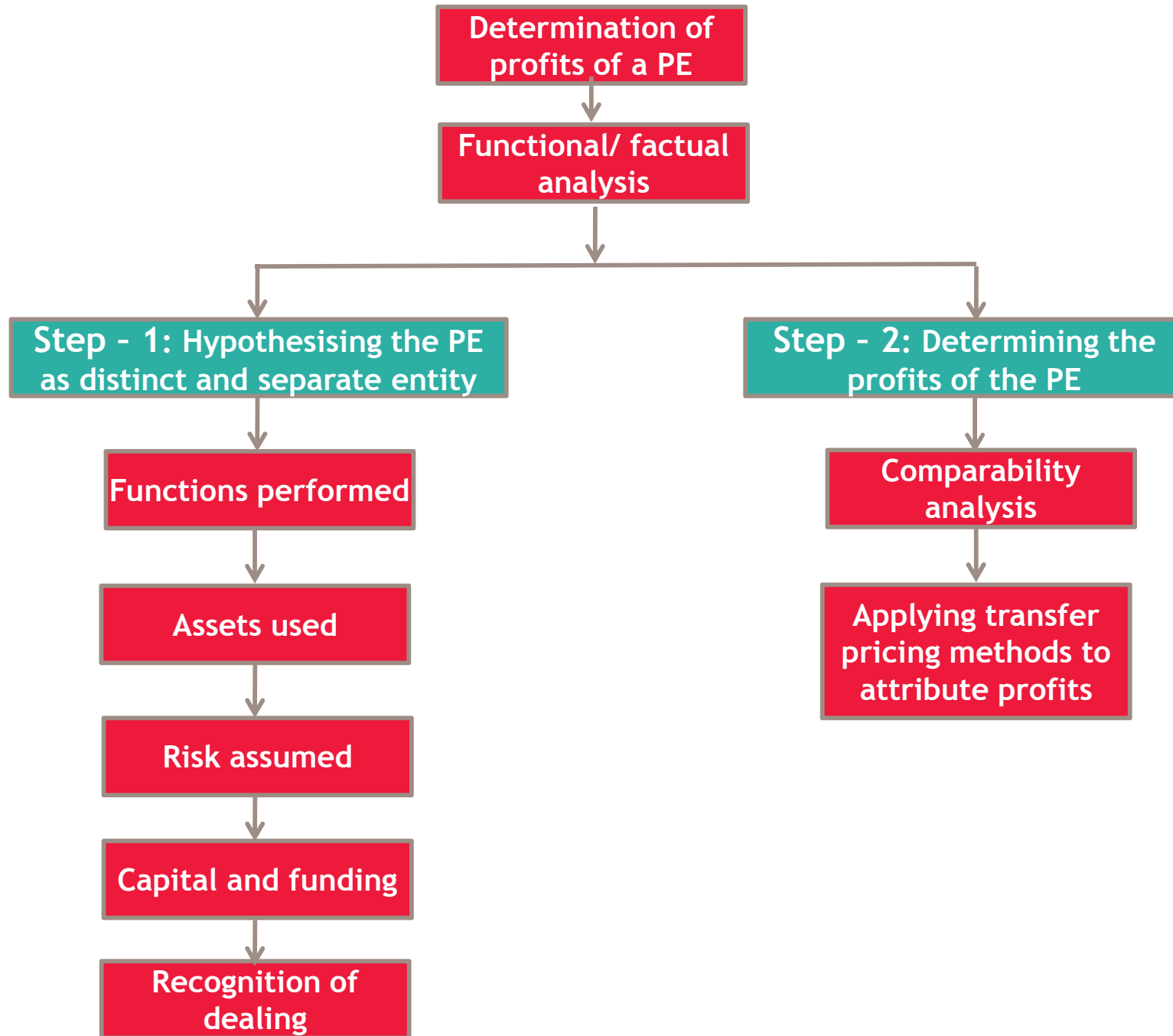
- Article - 7(2) reads as under:

“Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment”

- Approaches to determine profit (OECD Approach)
 - a. relevant business activity; or
 - b. functionally separate entity
- Recommended approach - OECD report suggest functionally separate entity approach as referable

Independent entity approach

ARTICLE - 7(2) - APPROACHES TO DETERMINE PROFIT



ATTRIBUTION OF PROFITS TO DEPENDENT AGENT

- **CBDT Circular No. 23 dated 23 July 1969**

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

The above principle is well established in various courts decision including the Hon'ble Supreme Court decision in the case of *Morgan Stanly*.

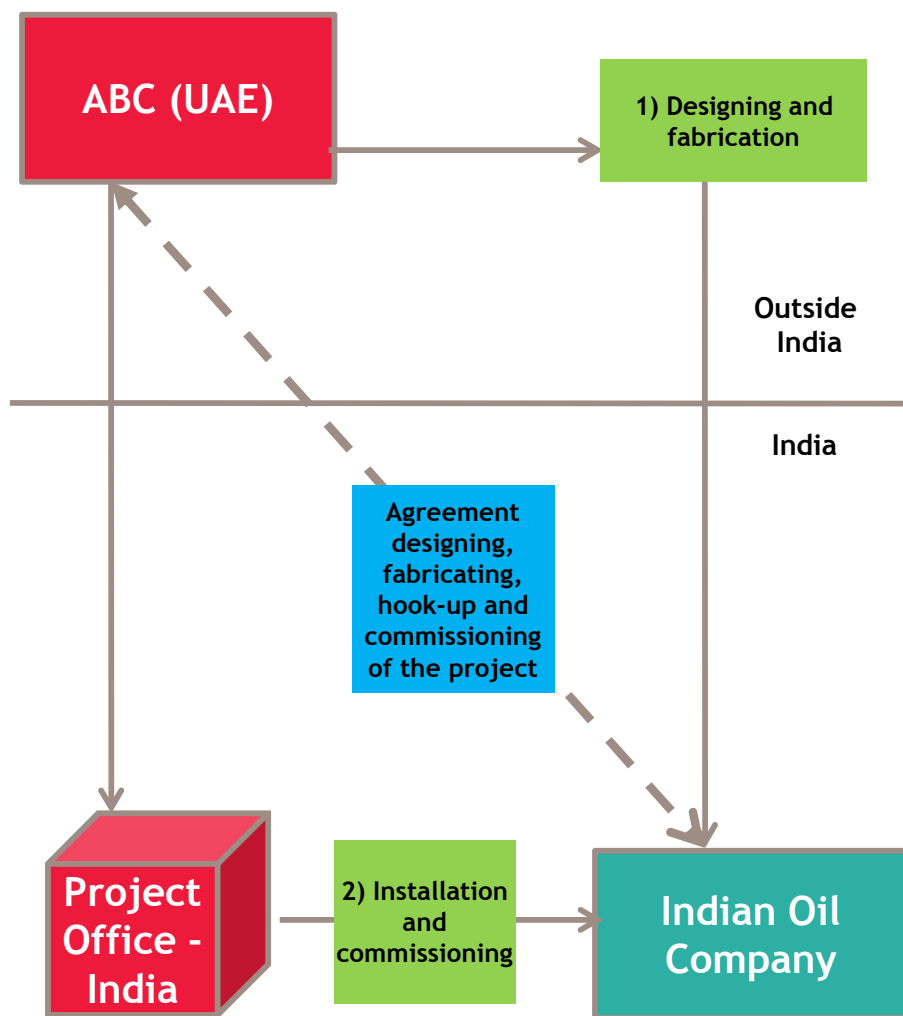
Withdrawal of CBDT Circular No. 23 of 1969 - Controversy

ATTRIBUTION OF PROFITS TO DEPENDENT AGENT

- **Favorable decisions** - If agents in India remunerated at arm's length, no further attribution of profits can be to the deemed PE
 - **Rolls Royce Singapore Pvt. Ltd. v. ADIT [2011] (202 Taxman 45)(Del)**
 - **SET Satellite (Singapore) Pte. Ltd. v. DDIT [2008](307 ITR 205)(Mum)**
 - **BBC Worldwide v. DCIT [2011](203 Taxman 554)(Del)**
 - **DIT v. Morgan Stanly [2007] (292 ITR 416)(SC)**
- **Against decisions** - Attribution of further profits over an above the arm's length remuneration

Recently in the case of **ADIT v. MTV Asia LDC [TS-52-ITAT-2012 (Mum)]**, the Mumbai Tribunal held that in addition to payment of 15% commission to Indian agent on the assessee's gross advertisement revenue, which was accepted at arms length, further attribution of 10% of profits to the Indian PE is reasonable. The attribution of profits @10% was based on the erstwhile CBDT Circular No. 742 which had provided for presumption taxation by treating 10% of the advertisement revenue from India as income of foreign telecasting companies.

ATTRIBUTION OF PROFITS - COMPOSITE CONTRACT



- **Facts of the case**
 - ABC, UAE has awarded contract by an Indian company under international competitive bidding for designing, fabricating, hook-up and commissioning of the project for oil facilities and sub-marine pipe lines in India.
 - The contract provide separate payments to ABC, on the basis of work of design, engineering, procurement and fabrication.
 - As per the agreement, ABC has carried out designing and fabrication work in UAE.
 - Installation and commissioning carried out in India but activity last for a period less than threshold limit prescribed in tax treaty between India and UAE
- **Issue involved**
 - Whether composite contract can be divisible in different parts?
 - Whether income related to offshore supply of designing is taxable in India?

ATTRIBUTION OF PROFITS - COMPOSITE CONTRACT

Analysis

- Composite contract includes offshore supply, off shore services, onshore supply, onshore services, construction and erection, etc. Entire income from composite contract cannot be attributed separately to PE. Only profits directly or indirectly attributed to PE can be taxed
- Income from services taxable in India only if services rendered in India and utilized in India
- In case of composite/turnkey contract, Onshore supply, installation, construction and erection carried out by PE is taxable in India. However, profits attributable to the activities carried outside and not related to the PE in India should not be taxable in India:
 - **National Petroleum Construction Company v. ADIT [ITA No. 5168/Del/2010, 5 Oct 2012]**
 - **DIT v. Nokia Networks OY [2012] (25 Taxmann.com 225)(Del-HC)**
 - **Ishikawajima-Harima Heavy Industries Ltd. (288 ITR 408)**
 - **Hyundai Heavy Industries Ltd. [2007] (291 ITR 482) (SC)**
 - **Roxon OY (103 TTJ 891) (Mum)**

However, in the following judicial decision it has been held that turnkey contract is composite one and cannot be divisible into outside India activity and inside India activity

- **Roxar Maximum Reservoir performance WLL [2012](207 Taxman 293)(AAR)** - followed look at approach at the transaction as whole - reliance on SC decision in the case of Vodafone International Holding BV
- **Linde A.G. [2012] (207 Taxman 299)(AAR)**
- **Alstom Transport SA [2012](208 Taxman 223)(AAR)**
- **Dongfang Electric Corporation v. DDIT [2012](52 SOT 496)(Kol)**

ARTICLE - 7(3) - PRINCIPLES OF COMPUTATION OF INCOME OF PE

- Article 7(3) reads as under:

“In the determination of the profits of a permanent establishment, there shall be allowed as deduction expenses which are incurred for the purposes of the business 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....”

ARTICLE - 7(4) - APPORTIONMENT OF PROFIT

- Article 7(4) reads as under:

“Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts nothing in paragraph (2) of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary ; the method of apportionment shall, however, be such that the result will be in accordance with the principles contained in this article”

- 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)



ARTICLE - 7(5) - MERE PURCHASER OF GOODS - NO ATTRIBUTION

- Article 7(5) reads as under:

“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
- The benefit would not be available if PE carries out other activities including purchases

ARTICLE - 7(6) - ATTRIBUTION METHOD SHOULD BE CONSISTENTLY FOLLOWED

- Article 7(6) reads as under:

“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”

- Attribution of profits should be worked out based on the consistent method followed year on year basis
- Attribution method can be changed for good and sufficient reasons



ARTICLE - 7(7) - PRIORITY OF SPECIFIC ARTICLE OVER THE GENERAL ARTICLE

- Article 7(7) reads as under:

“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.”

- In case this article includes any income which is chargeable under specific article, the same shall be dealt with that specific article

ARTICLE - 7(7) - PRIORITY OF SPECIFIC ARTICLE OVER THE GENERAL ARTICLE

- Effectively connection with PE in India

Article 12(3) of the OECD Model Convention

“The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

If the royalty income accrue or arises to non- resident through PE situated in India the said royalty income is effectively connected with such PE, then the royalty income shall be taxable under Article 7 and not under Article 12 of the tax treaty.

- In the case of **Worley Parsons Services Pty. Ltd. (313 ITR 273) (AAR)**, the Hon’ble AAR held that the terminology ‘effective connection’ denotes a real and intimate connection. Clear correlation between the services, which give rise to ‘Royalties’ income and the PE, is a key factor for the purpose of exclusion of the income from the purview of ‘Royalties’

ATTRIBUTION OF PROFITS - OTHE ISSUES

- In the case of **Rolls Royce Singapore Pvt. Ltd. v. ADIT [2011] (202 Taxman 45)(Del)**, the Hon'ble Delhi High Court while dealing with the issue of attribution of profits to PE, inter-alia held that the Transfer Pricing analysis to determine the “arms length” price has to be done by taking the “**Functions, Assets used and Risk involved**” (‘FAR’) and in case the same has not been done, the argument on “arms length” price would not be acceptable
- The AO can not simply apply Rule 10 without rejecting TP Study for the proper reason. Rule 10 can be applied in cases where the income of PE cannot be definitely ascertained and the AO has demonstrate the same. For rejecting TP Study, the AO must provide reasons and evidence - **Hyundai Rotem Company v. Asst. DIT [TS-612-ITAT-2012 (Del)]**
- Profits attributable to the PE to be determined in accordance with the domestic laws of India and all restrictions on allowance of various business expenses, as contained in the Indian IT Act, will apply - **Mashreq Bank PSC v DDIT (108 TTJ 554 (T-Mum))**

BUSINESS OPERATIONS NOT REQUIRING PROFIT ATTRIBUTION

- Courts have ruled that the profits cannot be attributed to the following activities
 - Performance of guarantee in India after sale of goods outside India (**CIT v. Hindustan Shipyard Ltd - 109 ITR 158**)
 - Buying operations (**Rahim v. CIT - 17 ITR 256**)
 - Isolated Purchases (**CIT v. Jiyajeerao Cotton Mills Ltd - 118 ITR 72**)
 - Conclusion of loan agreement in India (**C.G. Krishnaswami Naidu v. CIT - 62 ITR 686**)
 - Formation of contract in India (**CIT v. Anamallais Timber Trust Limited 18 ITR 333**)
 - Procurement of orders (without acceptance) on behalf of non-resident (**CIT v. R. D. Aggarwal - 56 ITR 20**)



Thank You

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