Chapter-9: Tax implications in case of Permanent Establishment and No Permanent establishment

9.1 Introduction

9.1.1 With the advent of globalization, there has been an increase in diverse business models and business's are no longer restricted to geographical boundaries. Consequently, corporates are expanding there operations globally. Eventually, two types of cross-border transactions have arisen-

a) Doing business with a country: This situation envisages a foreign company is doing business with India from its home country or from any place outside India without setting up business presence in India. For example: Offshore supply of goods and services

b) Doing business in a country: This situation envisages a foreign company is doing business in India by setting up of business presence. The activities of the foreign company may be conducted by its employees/ agent, or from a fixed base through which it operates in India

9.1.2 Thus, cross border transactions entails different tax implications and then comes the role of Permanent Establishment ('PE') which plays a vital role in distributing taxing rights among source state and the residence state. However, the concept of PE is relevant for determining the taxability of a 'non-resident' for income accruing from any PE in India if India has tax treaty with the country of Non Resident ('NR').

9.1.3 PE is an extension of the foreign enterprise in another country for the purpose of carrying out business activity therein. For determining whether PE of NR exists or not, a fact based analysis needs to be undertaken. Based on this, the source country gets a right to tax income generated from the business activities carried on therein.

9.1.4 The main questions that arises are two-fold:

a) Which country has the right to tax the business profits earned by the foreign company through its business presence in a country in India?
b) If India has the right to tax the business profits earned by the foreign company by utilising the India's resources, how can the proportion of profits to be taxed is determined?

9.1.5 India recognises and acknowledges the PE concept in its international tax treaties under 'Article 5 – Permanent Establishment'. Income tax Act, 1961 ('Act') provides for the concept of a 'business connection' in Section 9 of the Act and PE in Section 92F of the Act.

9.1.6 A NR would not attract tax merely because it has a business connection in India. A Non Resident dealing with a resident of India may be liable to tax in India if he has a PE in India. Thus, it is relevant to understand the term PE in detail for:

a) Determining whether the NR has PE in India so that the taxable income can be determined
b) Tax deductible at source ('TDS') for payment to NR by resident

9.2 Taxability under the 'Act'

9.2.1 As per Section 5(2) of the Act, a NR is taxable in India only on income which is received or is deemed to be received in India, or on income which accrues or is deemed to accrue to him in India during the relevant year. Thus, a NR is not taxable in India on income which accrues to him outside India unless it is received in India or it is deemed to accrue to him in India.
As per Section 9 of the Act, certain types of income are deemed to accrue in India even though such income actually accrues outside India. For example, Section 9(1)(i) deems income accruing, whether directly or indirectly, through or from any business connection in India to accrue in India.

9.2.2 The term business connection was initially not defined in the Act. However, Explanation 2 to Section 9(1)(i), was introduced with effect from April 1, 2003. The said Explanation defines the term 'business connection' in an inclusive manner. The Explanation

defines the term 'business connection' as a situation where a NR carries on any business activity through an agent in India.

9.2.3 Hence, overtime, meaning of the term is interpreted from the several jurisprudence. Hon'ble Supreme Court in case of R. D. Aggarwal and Co. (56 ITR 20) held that Business connection involves a relation between a business carried on by a non-resident which yields profits or gains, and some activity in India which contributes directly or indirectly to the earning of those profits or gains. It predicates an element of continuity between the business of the non-resident and the activity in India after a change in the way the business activities are carried on.

9.3 Taxability under the tax-treaty

9.3.1 Article 5 of the tax treaties defines a PE to mean 'a fixed place of business through which the business of enterprise is wholly or partly carried on'. Thus, for constitution of the fixed place PE, following conditions satisfied cumulatively:

a) There is a place of business ('place of business test')
b) Such place of business is fixed ('permanence test')
c) The business of the enterprise is carried on wholly or partly through such fixed place of business ('business activity test')
d) Such place of business is at the disposal of enterprise ('disposal test')

9.3.2 As per Andhra Pradesh High Court in Vishakhapatnam Port Trust (144 ITR 146) –
Permanent Establishment postulate existence of a substantial element of an enduring or permanent nature of the 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 virtual projection of the foreign enterprise of one country into the soil of another country.

9.3.3 Further, an illustrative list of PE's in most treaties includes place on management, branch, office, factory, workshop. Tax treaties typically exclude from the definition of a PE, activities related to a physical presence within a source country that are merely

preparatory or auxiliary in nature, such as the maintenance of a warehouse to store goods etc.

9.3.4 Certain other categories of PE generally found in the tax treaties are discussed below

A) Construction PE:

Construction PE in a source country exists only when the construction site or an installation project is carried out for more than the prescribed threshold period as specified in the tax treaties between the two countries.

B) Service PE:

Service PE is attracted by the foreign enterprise in India, if the of foreign enterprise furnish or perform services in India, other than services covered under Royalties or Fees for Technical Services, for a specified period of time through employees or other personnel. Thus, Service PE would be formed if the following conditions are satisfied:

(i) The services are furnished within the source state;
(ii) The service are furnished by the foreign enterprise through employees or other personnel;
(iii) The period of furnishing of services exceeds the specified threshold period.

C) Agency PE:

Agency PE is constituted where a dependent agent undertakes certain activities in India on behalf of a foreign company. Following principles are important while determining whether an agent is a dependent agent:

(i) It is legally and economically dependent on its principal.
(ii) Its activities are conducted in the ordinary course of its business.

D) Subsidiary PE:

Mere existence of a subsidiary does not by itself make the subsidiary company a PE of the parent company. To constitute subsidiary as a PE, the business of the parent/ holding company should be carried on through the subsidiary. Thus, a subsidiary company, per se, does not constitute a PE.

9.4 What happens when there is a PE is constituted?

9.4.1 Once a PE of the NR is created in India, profits of NR which are reasonably attributable to the operations of PE would be taxable in India. Further, some tax treaties also contain 'force of attraction' clause whereby profits derived from sale of goods or merchandise of the kind similar to those sold through the PE or from other similar business activities as those effected through that PE, may be considered attributable to the PE.

9.4.2 For the purpose of 'attribution of profits', the PE would be considered as an entity separate from the parent entity, earning arm's length income from its dealings with the parent company. However, there are several jurisprudence where courts have held that as long as the PE is remunerated by the parent company on an arm's length basis, nothing further would be left to be attributed to the PE and to be taxed in the hands of NR.

9.4.3 From the perspective of India tax laws, if profits cannot be definitely ascertained, the tax authorities typically calculate the taxable income either

(i) As a reasonable percentage of global turnover; or
(ii) Total profits in the ratio of Indian receipts to total receipts; or
(iii) Such other manner as they may deem suitable

9.4.4 The applicable tax rate for taxation of PE in India is 40% of net amount (plus applicable surcharge and cess).

9.4.5 Further, section 44DA of the Act provides that in case the foreign company has PE in India and income is by way of royalty and fees for technical services which is effectively connected to PE the applicable tax rates will be 40% of net amount (plus applicable surcharge and cess) i.e after deduction of expenses incurred in relation to earning such income shall be allowed.

9.5 What happens when there is no PE is constituted?

9.5.1 In case NR does not have PE in India and income is effectively connected to the business carried out by it, then the NR will not be taxed in India and hence no question of withholding tax arises.

9.5.2 In case NR doesnot have PE in India and it wan't to avail treaty benefit (for ex: no withholding tax should apply in absence of PE), NR deductee has to submit Self-declaration relating to No Permanent Establishment in India to the deductor along with other documents (like Tax residency certificate, Form 10F).

9.6 Certain other points that needs consideration:

9.6.1 It is pertinent to mention that the tax treatment of income generated by a PE would depend upon the nature of the income, i.e. whether it is business income or capital gain, income from shipping and air transport, dividend, royalty, fees for technical services etc. Also, it is essential to determine whether or not there are special provisions applicable to NR for certain income under the Act and also to determine applicable rates of taxes accordingly.

9.6.2 If India does not have a tax treaty with the country of the NR then for determining the tax liability of the NR in respect of a transaction with a resident, it is necessary to determine the tax liability only under the Act.