

**PERMANENT ESTABLISHMENT
&
BUSINESS PROFITS**

ARTICLE 5

PERMANENT ESTABLISHMENT

- The term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- The term "permanent establishment" includes especially :
 - ❖ a place of management;
 - ❖ a branch;
 - ❖ an office;
 - ❖ a factory;
 - ❖ a workshop;
 - ❖ premises used as a sales outlet or for receiving or soliciting orders; (Not there in SA TREATY)
 - ❖ a warehouse in relation to a person providing store facilities for others;
 - ❖ a mine, an oil or gas well, quarry or other place of extraction of natural resources;
 - ❖ an installation or structure used for the exploration or exploitation of natural resources;
 - ❖ a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than six months, or where such project or supervisory activity, being incidental to the sale or machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory activity exceed 10 per cent of the sale price of the machinery and equipment;

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- ❖ a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on ; (US TREATY)
- ❖ an installation or structure used for the exploration or exploitation of natural resources, **but only if so used for a period of more than 120 days in any twelve-month period ; [US TREATY]**
- ❖ 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:
 - activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period ; or
 - the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of Article 9 (Associated Enterprises)]. [US treaty] **and continue for a period or periods aggregating more than 30 days within any twelve-month period . ([UK Treaty]**
 - **Provided** that for the purposes of this paragraph an enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it provides services or facilities in connection with, or supplies plant and machinery on hire used or to be used in, the prospecting for, or extraction or production of, mineral oils in that State. [UK TREATY]

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- ❖ The term "permanent establishment" shall be deemed not to include any one or more of the following :
 - ✓ the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise ;
 - ✓ the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery ;
 - ✓ the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;
 - ✓ the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise ;
 - ✓ the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise. **However, this provision shall not be applicable where the enterprise maintains any other fixed place of business in the other Contracting State for any purpose or purposes other than the purposes specified in this paragraph (UK)**

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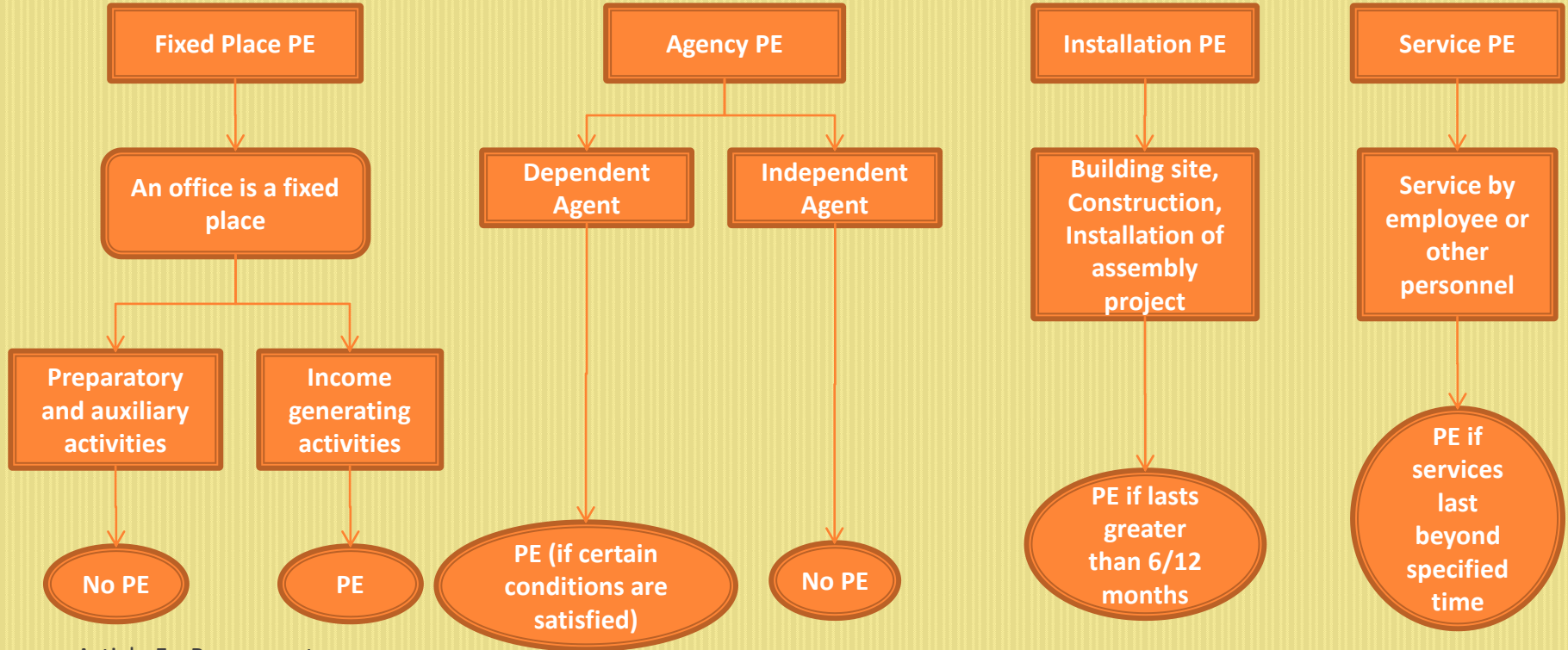
- ❖ the maintenance of a fixed place of businesses solely for any combination of activities mentioned in paragraphs previous page, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. (UK & SA)
- ❖ A person acting in a Contracting State for or on behalf of an enterprise of the other contracting State - other than an agent of an independent status, shall be deemed to be a permanent establishment of that enterprise in the first mentioned State if:
 - ✓ he has, and habitually exercises in that State, an authority to negotiate and enter into contracts for or on behalf of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise; or
 - ✓ he habitually maintains in the first-mentioned Contracting State a stock of goods or merchandise from which he regularly delivers goods or merchandise for or on behalf of the enterprise; or
 - ✓ he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise itself or for the enterprise and the enterprises controlling, controlled by, or subject to the same common control, as that enterprise.

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- ❖ *An enterprise of a Contracting State* shall not be deemed to have a permanent establishment in *the other Contracting State* merely because it carries on business *in that other State* through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, if the activities of such an agent are carried out wholly or almost wholly for the enterprise (or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it or are subject to same common control) he shall not be considered to be an agent of an independent status for the purposes of this paragraph.
- ❖ The fact that a company which is a resident *of a Contracting State* controls or is controlled by a company *which is a resident of the other Contracting State*, or which carries on business *in that other State* (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.
- ❖ For the purposes of this Article the term "control", in relation to a company, means the ability to exercise control over the company's affairs by means of the direct or indirect holding of the greater part of the issued share capital or voting power in the company.

Types of PE



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- ❖ Reasonable degree of permanence and continuity. Certain space should be available at the disposal. Ownership is immaterial. Some rights / domain / control to use is required.
- ❖ Even illegal occupation could constitute a PE.
- ❖ It may also include machinery or equipment. For e.g.
 - Ships used as museum, restaurant etc. and located at a certain place
 - Oil rigs firmly anchored to the sea bed and repeatedly used for a certain work or for the same principle
 - An automatic vending machine, gaming machine at a fixed place and operated and maintained by enterprise or its dependent agent
- ❖ PE comes into existence, as soon as the foreign enterprise commences business activities through a fixed place. The time spent to establish the fixed place of business should be excluded.
- ❖ In some projects, activity needs to be relocated from time to time. In such cases if the activities performed at each particular spot are part of a single project, then that project must be regarded as a permanent establishment if, as a whole, it lasts more than prescribed period of time.
- ❖ Temporary discontinuance of the work cannot be regarded as cessation of the site. Seasonal and temporary interruptions should be included in determining the life of a site.

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- Sub-contractor in site to be included.
- Mere fact that the subsidiary company is managed by its parent or that the parent exercise control over activities of its subsidiary and desires stringent financial reporting, does not constitute the subsidiary a PE of the parent. However, if the activities of the subsidiary on behalf of the parent are within other provisions of Article 5 then the subsidiary may become a PE of the parent.
- Klaus Vogel - "A general authority cannot be taken to exist if the authority to negotiate and conclude contract is so restricted that it allows the agent to settle for only such prices and terms and conditions as were fixed in advance by his principal, the agent having no scope for decisions of his own in this respect..."
- It is extremely important to be careful about absence or inclusion of a word or phrase in DTAA.
- Some Indian DTAA's do not have a reference of "installation" in Article 5(3)(a) like DTAA with Bangladesh , Israel , Kenya , Libyan Arab Jamahiriya , Malta , Mauritius , Mongolia, Morocco ,Nepal , Oman ,Philippines ,Qatar, Tanzania ,Thailand ,Trinidad and Tobago ,UAE ,Uganda , Vietnam, Zambia etc.
- Some Indian DTAA's do not have a reference of "supervisory activities" in Article 5(3)(a) like DTAA with Bangladesh , Brazil, France, Greece, Libya, Malaysia Nepal, Netherlands, Qatar, Sri Lanka, Slovenia etc.

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- ❖ US Co engaged in providing Computer Reservation Services had a PE in India under Article 5(1) as it exercised complete control over the computers installed at the premises of the subscribers and the computers could not be shifted from one place to another within the premises of the subscriber
• Galileo International Inc [2008] 19 SOT 257 (Del).
- ❖ The premises of a wholly owned subsidiary in India were available to all the employees of the UK company in respect of its business operations in India - The UK Co. had a place of business at its disposal and a PE in India
• Rolls Royce Plc [2009] 122 TTJ 359 (Del).
- ❖ Foreign company is having a service PE in India by virtue of employees of its sister concern being made available to the Indian subsidiary to carry out the project
• Lucent Technologies International Inc. [2009] 28 SOT 98 (Del).
- ❖ A moving vessel performing repairs of submarine pipelines in India was held as not constituting a PE. [Subsea Offshore Ltd.. 66 ITD 296 (Mum)]. It was held that 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 2 1/2 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

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- ❖ Andhra Pradesh High Court had held in the case of CIT v. Visakhapatnam Port Trust (144ITR146) that the words '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 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.
- ❖ Hon'ble Supreme Court in case of *DIT (International Taxation) v. Morgan Stanley & Co. Inc.* [2007] 292 ITR 416/162 Taxman 165 (SC), held that once that permanent establishment has been remunerated on an arm's length basis, taking into account all the functions, assets and risks, no further allocation of profit is required.
- ❖ Hon'ble Supreme Court in case of Director of Income-tax, Circle- 3 (2) International Taxation, New Delhi v. Corning SAS-[2018] 100 taxmann.com 385 (Delhi - Trib.) a branch office performing sales representation services in India and earned commission at rate of 3 per cent which was accepted in course of assessment. However, branch was constituted to be PE of Corning France in India, attributing 50 per cent of profits of foreign company from direct sales made in India to branch. It was held that once a transfer pricing analysis was undertaken, there was no further need to attribute profits to a PE.

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- Hon'ble Delhi High Court in case of Formula One World Championship Ltd. v. *CIT* [2016] 76 taxmann.com 6 (Delhi) had held that assessee, a UK company, granted to Jaypee Sports, right to host and promote Formula F1 Race at motor racing circuit owned by Jaypee and assessee had full access to circuit and it could dictate as to who was authorized to access circuit and organising any other event on circuit was not permitted, said circuit constituted PE of assessee in India.
- Hon'ble Supreme Court in case of Director of Income-tax, International Taxation, New Delhi v. Mitsui & Co- [2019] 111 taxmann.com 215 (SC) has held that where liaison office did not finalise and transact a business deal on its own or in name of head office (assessee-company), LO, could not be regarded as permanent establishment of assessee in India and income directly or indirectly attributable to these branches/officers was not taxable in India.
- Hon'ble Supreme Court in case of Ishikawajima-Harima Heavy Industries Ltd. v. Director of Income-tax - [2007] 158 Taxman 259 (SC) held that income arising out of turnkey project executed in India would not be assessable in India, only because a non-resident has a permanent establishment. It was Held that there has to be some activity through permanent establishment and, if income arises without any activity of permanent establishment, taxation liability in respect of overseas services would not arise in India.

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- Hon'ble Mumbai Tribunal in case of Audi AG v. Additional Director of Income Tax, Range-1(1), Mumbai - [2019] 111 taxmann.com 213 (Mumbai - Trib.) held that where assessee, a German based company and one of world leading car manufactures, appointed VW Group Sales as a sole distributor of Audi brand cars in India, in view of fact that cars were sold to VW Group sales on Principal to Principal basis and, VW Group not acting on behalf of assessee, Assessing Officer was not justified in invoking section 9 and article 5 of Indo-Germany Tax Treaty for taking a view that assessee had PE in India in form of VW Group Sales.
- In order to determine as to whether assessee, a German company, rendering services in field of exploration, mining and extraction to Indian companies, had PE in India, it was continuous period of stay of its employees in India which had to be taken into consideration and not entire contract period [Rheinbraun Engineering Und Wasser GmbH - [2016] 68 taxmann.com 34 (Mumbai - Trib.)]
- Hon'ble Supreme Court in case of Funds IT Solution Inc - Assistant Director of Income-tax-1, New Delhi - [2017] 86 taxmann.com 240 (SC) held that if Indian subsidiary company only rendered support services which enabled American companies in turn to render services to their clients abroad, this outsourcing work to India would not give rise to a fixed place PE. Business income of companies incorporated in US will be taxable to extent attributable to PEs would be taxable in India.

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- Hon'ble Delhi Tribunal in case of *JC Bamford Investments Rocester v. Deputy Director of Income-tax, Circle -3(1), International Taxation, New Delhi - [2014] 47 taxmann.com 283 (Delhi - Trib.)* held that where in terms of licence agreement entered into between assessee, a UK based company, and its Indian group concern, certain employees were seconded to Indian company to render services relating to manufacturing of Excavator loader in India, in view of fact that seconded employees furnished services including managerial services for a period of more than 90 days during relevant assessment years, service PE of assessee was established in India in terms of article 5(2)(k) of India.
- Hon'ble Mumbai Tribunal in case of *Assistant Commissioner of Income-tax (International Taxation)-2(2), Mumbai v. Valentine Maritime (Gulf) LLC* held that actual period of two projects unconnected undertaken by a foreign company could not be combined to determine its PE in India.
- Hon'ble Delhi Tribunal in case of *Shanghai Electric Group Co. Ltd. v. Deputy Commissioner of Income-tax, Circle-3(1)(2), International Taxation, New Delhi - [2017] 84 taxmann.com 44 (Delhi - Trib.)* held that Where assessee, a China based company, was engaged in business of supply of Boiler, Turbine and Generator (BTG) equipments to various companies for setting up of power plants in India, since it had supervisory PE in India from which it was supervising erection, installation and commissioning activities of equipments, a part of profits earned from offshore supply of said equipments relatable to operations carried out in India, was liable to tax in India.

ARTICLE 7

BUSINESS PROFITS

- ❖ 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. (*paragraph 1*)
- ❖ Where *an enterprise of a Contracting State* carries on business *in the other Contracting State* through a permanent establishment situated therein, the profits which that permanent establishment 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* shall be treated for the purposes of paragraph 1 of this Article as being the profits directly attributable to that permanent establishment. [FOA]
- ❖ Where a permanent establishment takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of profits of the enterprise arising out of those contracts which the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole shall be treated for the purpose of paragraph 1 of this Article as being the profits indirectly attributable to that permanent establishment.

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- ❖ Insofar as it has been customary in a Contracting State according to its law 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 paragraphs 1 and 2 of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this Article.
- ❖ Subject to paragraphs 6 and 7 of this Article, 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, which are allowed under the provisions of and subject to the limitations of the domestic law of the Contracting State in which the permanent establishment is situated. **(paragraph 5)**

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- ❖ Where the law of the Contracting State in which the permanent establishment is situated imposes a restriction on the amount of the executive and general administrative expenses which may be allowed, and the restriction is relaxed or overridden by any Convention between that Contracting State and a third State which is a member of the Organisation for Economic Cooperation and Development or a State in a comparable stage of development, and that Convention enters into force, after the date of entry into force of this Convention, the competent authority of that Contracting State shall notify the competent authority of the other Contracting State of the terms of the relevant paragraph in the Convention with that third state immediately after the entry into force of that Convention and, if the competent authority of the other Contracting State so requests, the provisions of this Convention shall be amended by protocol to reflect such terms. **(paragraph 6)**

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- ❖ Paragraph 5 of this Article shall not apply to amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, to by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on monies lent to the permanent establishment; nor shall account be taken in the determination of the profits of a permanent establishment of amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment of the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or any way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on monies lent to be head office of the enterprise or any of its other offices. **(paragraph 7)**
- ❖ No profits shall be attributed to permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
- ❖ Where profits include items of income which are dealt with separately in other Articles of this convention, then the provisions of those Articles shall not be affected by the provisions of this Article. Priority of specific article over the general article. In case profits include any income which is chargeable under any specific article, the same shall be dealt with by that specific article.

Force of Attraction

- ❖ When an enterprise has a PE in the source country it expenses itself to the entire gamut of income from same or similar activity.
- ❖ IBFD International tax Glossary
“Principle under which a country may tax a foreign enterprise in respect of income it derives in the other country if the enterprise maintains a permanent establishment in the other country irrespective of whether that income is derived through or otherwise economically connection with the permanent establishment...”
- ❖ Prevents tax avoidance/ evasion through artificial contracts and business contracts.

Force of Attraction



Force of Attraction

❑ India's DTAA's having FOA Rule

Following are the DTAA's which follow the UN model and do contain FOA rules (Means FOA can be invoked in these DTAA's):

DTAA with Australia, Belgium, Canada, Cyprus, Denmark, Finland, Italy, Kenya, Romania, Spain, Thailand, USA etc.

❑ India's DTAA's having no FOA

Following are the DTAA's which are based on the OECD model and do not contain FOA rules (Means FOA can not be invoked in these DTAA's):

DTAA with Armenia, Austria, Bangladesh, Botswana, Brazil, Bulgaria, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Japan, Jordan, Korea, Malaysia, Mauritius, Nepal, Netherlands, Russia, Singapore, South Africa, Sweden, Swiss Confederation, Syria, UAE, UK etc.

Force of Attraction Rule – Judicial precedents

- ❖ Profit attributable to PE also include profit from direct transactions effected by the HO, to the extent that such transactions are of the same or similar kind as those effected through the PE –Canada tax treaty - SNC Lavalin/Acres Inc. [2007] 15 SOT 1 (Mum)
- ❖ 'Indirectly attributable' principle in the UK tax treaty incorporates the 'force of attraction' rule with the result that even profits from offshore services in respect of projects in India are taxable in India - Linklaters LLP [2010-TII-80-ITATMUM-INTL].
- ❖ Article 7 of Finland tax treaty was based on UN Model Convention and thus had a restrictive scope of the force of attraction rule which only extends the scope of transactions which are to be taxed in the other country and not the nature of transactions - Roxon OY [2006] 10 SOT 454 (Mum).

Force of Attraction Rule – Judicial precedents

- ❖ In case of foreign enterprise, an income which accrues or arises to a foreign enterprise in India can be only such portion of income accruing or arising to such a foreign enterprise as is attributable to its business carried out in India. Since there is no specific provision under Act to compute profits accruing in India in hands of foreign entities, profits attributable to Indian PE of foreign enterprise are required to be computed under normal accounting principles and in terms of general provisions of Act and, therefore, ascertainment of a foreign enterprise's taxable business profits in India involves an artificial division between profits earned in India and profits earned outside India. Computation of profits in each PE decides quantum of income on which source country can levy tax, and, therefore, it is necessary that profits of PE are computed as independent units. Assessee, a Korean company, entered into an agreement with ONGC for designing, fabrication, hook-up and commissioning of a platform in Bombay High in India. Contract was in two parts; one was for fabrication of platform in Korea and other was installation and commissioning of said platform in Bombay High. Since installation PE in India came into existence only on conclusion of transaction giving rise to supplies of fabricated platforms; it emerged only after contract with ONGC stood concluded; and fabricated platform was delivered in Korea to agents of ONGC, profits that accrued to assessee for Korean operations were not taxable in India. Hyundai Heavy Industries Co. Ltd. - 291 ITR 482 - SC

Computation of profits attributable to PE under the Act

- ❑ Rule 10 – Method of Attribution under the Act:
 - ❖ Determination of actual profits if it can be ascertained. Can be followed only when the AO is of the opinion that profits cannot be definitely ascertained.
 - ❖ Methods prescribed in rule 10 are not accurate methods. These involve estimation and subjectivity - *Hukumchand Mills Ltd. [1976] 103 ITR 548 (SC)* -
 - ❖ Rule 10(i) - Presumptive Method. Adhoc profits is estimated as attributable to the PE by applying reasonable percentage.
 - ❖ Rule 10(ii) - Proportionate Method. Proportionate profits based on world income is attributed to the PE.
 - ❖ In case of different businesses relevant business income be considered - *Iraqi Airways [1987] 23 ITD 115 (Del)*.
 - ❖ Rule 10(iii) - Discretionary Method. Attribution in some other method. combination of above 2 methods.
 - ❖ *Netherlands Steam Navigation Co. Ltd. [1969] 74 ITR 72 (SC)*

Section 44C

- Section 44C was inserted to obviate the hardship faced by the Assessing Officers in verifying the veracity of the proportionate common head office expenditure as claimed by the non-resident-assessee in respect of its income of the branch/P.E. in India.
- Section provides for limit for claiming head office expenditure which could not be directly attributed to the Indian Branch.
- The expenditure which was exclusively incurred or could be directly attributed to the Indian Branch would fall for consideration under section 37 of the Act .
- Thus, it is only the common expenditure which could not be, on the basis of material available on the record, said to have been incurred exclusively either for the Indian branch or for other branches other than Indian branch. Where an expenditure was identifiable with non-Indian branch, it would be taken out of consideration for curtailment.
- The expenditure which would fall under section 44C would be the expenditure on executive and general administration expenditure.