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# *The Past, Present and Future of Permanent Establishment*

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# Foreword

Today, we function in a world where businesses are rapidly transforming their operations by adopting new technologies and solutions to enter new markets and expand their global business presence. The concept of Permanent Establishment (PE) is also evolving to keep pace with this changing business environment – to facilitate reasonable and transparent taxation of cross-border transactions in this dynamic business landscape.

In November 2015, the Organisation of Economic Cooperation and Development (OECD) issued its Action Plans (APs) on Base Erosion and Profit Shifting (BEPS). BEPS APs have been developed by the OECD and G20 countries with the main aim of curbing tax-planning strategies that exploit gaps in tax rules to artificially shift profits to low or no tax jurisdictions.

BEPS AP 7 – “Preventing the Artificial Avoidance of Permanent Establishment Status” seeks to curb tax strategies companies use to circumvent existing PE provisions in international tax treaties. The OECD has also issued a public discussion draft on how profits should be attributed to a PE under BEPS AP 7 proposals. BEPS AP 1 – “Addressing the Tax Challenges of the Digital Economy” endorses some of the guidelines of BEPS AP 7, as and when these are applicable in the digital economy.

BEPS AP 15 – “Developing a Multilateral Instrument to Modify Bilateral Tax Treaties” recommends the development of a multilateral instrument to enable countries to seamlessly amend their bilateral tax treaties in order to implement measures recommended in the BEPS APs. In cognisance with this AP, the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting” (MLI) was signed in Paris, France, on 7 June 2017. India was one of the signatories and was represented by our Prime Minister, Mr. Narendra Modi.

In this report, we attempt to track the evolution of taxation of PEs in India – the how, when and why, and the consequences of establishing the PEs of foreign companies in the country. To do this, we first analyse the concept of PE in Indian tax legislations and India’s bilateral tax treaties, and then examine international tax commentaries and landmark Indian judicial precedents, including some recent ones, to gain a clear perspective of how Indian jurisprudence has progressed over the years. We also assess the potential impact of BEPS AP 7 and the MLI on India’s bilateral tax treaties and how this may affect companies doing and wanting to do business in the country.

# The concept and significance of PE

## The concept of PE and its significance



In the modern era, the advent of globalisation has facilitated great technological advancement, which has led to easy access to and real-time communication between various countries, irrespective of the physical distance. Today, the world has shrunk to a 'global village', where no destination is inaccessible. Consequently, corporates around the world have become global in their operations and have been expanding their businesses beyond the boundaries of their countries into new markets in their quest to achieve growth and economies of scale.

Over time, two types of cross-border transactions have emerged – (a) doing business with a country, and (b) doing business in a country. The former involves foreign companies being engaged in business transactions with the residents of a country, wherein these companies conduct their business activities without setting up a business presence in this country, for instance, selling products to its residents, but transferring the titles, risks and rewards outside the country. In such a situation, the taxation mechanisms of foreign companies are usually straightforward. Such foreign companies are not taxable in the country in which purchasers of their products are located, since they neither have an official presence in it nor do they undertake any business activities in it.

The latter situation envisages the presence of a company in a country that is not its country of residence. In this case, the company undertakes business activities in the foreign country by establishing its formal presence in it. The activities of such a company may be conducted by its employees or an agent, or from a fixed base through which it operates in the country. The taxation-related implications of these cross-border transactions are complex. The main questions that arise are two-fold: (a) Which country has the right to tax the business profits earned by the foreign company through its formal presence in a country? (b) If the country in which a foreign company has a formal presence has the right to tax the business profits earned by it by utilising the country's resources, how can the proportion of profits to be taxed be determined?

This is where the international tax concepts of PE and profit attribution come into play. These determine the right of a country to tax the profits of a company that is the resident of another country. They lay down the principles and factors to be considered for the constitution of a PE, and the consequent profit attribution methods and the taxation mechanisms it should use to avoid double taxation. The PE concept is recognised by most countries and has been incorporated by them in their domestic tax provisions and international tax treaties.



The relevance of the existing international concept of PE has been recently reviewed by the OECD, subsequent to which, BEPS AP 7 was issued in November 2015. This AP aims to restrict the practice of companies trying to artificially avoid constituting PEs in the countries in

which they conduct their businesses. The suggestions proposed in BEPS AP 7 were incorporated in the MLI recently signed by several countries in Paris, France, in July 2017. Subsequently, the OECD issued a public discussion draft on how profits should be attributed to a PE under AP 7 proposals.

## Profit attribution – the concept and its significance



With a clear understanding and application of the concept of PE, there arose the need for a definite methodology for attribution of profits to a PE. This led to the formulation of a model for attribution of profits to a PE. This was based on the fundamental principle of appropriating the profits of such a PE to a separate legal entity on an arm's length basis. However, there was lack of clear understanding of the application of this fundamental principle, which often resulted in double taxation in certain countries and non-taxation in others.

Various reports were published by the OECD, which provided guidelines on attribution of profits in the case of PEs. However, the practices followed by both OECD and non-OECD countries, and these countries' interpretation of Article 7 of the OECD's 'Model Tax Convention on Income and Capital' (MTC) varied significantly. In order to eliminate this uncertainty, the OECD provided for the 'Authorised OECD Approach' (AOA) in the following reports:

- The report Attribution of Profits to Permanent Establishments in 2008 (Attribution report 2008). In this report, the AOA formulated the most preferred approach to attribution of profits to a PE under the existing Article 7 of the MTC.
- The report Attribution of Profits to Permanent Establishments in 2010 (Attribution report 2010) focused on the interpretation and application of the revised and updated Article 7 in the MTC and was an amended and revised version of the Attribution report in 2008.

In both the reports, the AOA was based on the 'separate entity approach', under which a PE is recognised as hypothetically being a separate and independent entity from its Head Office (HO), which performs the same or similar functions as that of an independent enterprise under same or similar conditions. The AOA also provides that attribution of the profits of a PE should be ascertained on the basis of the functions performed by it, the assets it uses and the risks it assumes. Accordingly, the AOA determines the amount of attributable profit, based on the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines) by analogy (using the Arm's Length Principle).

The AOA recommends a two-step approach for determination of profits attributable to a PE:

- **Step 1:** A functional and factual analysis of the PE, aligned with a Functions, Assets and Risks Analysis (FAR Analysis), as recommended in TP guidelines
- **Step 2:** A comparability analysis to determine the appropriate arm's length return for the PE's transactions, on the basis of the FAR analysis

## PE in India



India recognises and acknowledges the PE concept in its international tax treaties under 'Article 5 – Permanent Establishment'. Domestic tax laws<sup>1</sup> provide for the concept of a 'business connection' in Section 9 of the Act and PE in Section 92F of the Act. India is also one of the

signatories to the MLI signed recently. According to the provisional list of India's reservations on the MLI, it appears that it has accepted the MLI's recommendations on PE.

<sup>1</sup> Indian 'Income-tax Act, 1961' ('the Act' or 'Indian tax laws' or 'domestic tax laws' or 'domestic tax provisions')

# ‘Business Connection’ concept under Indian tax laws

A foreign company needs to pay taxes in India on income received or deemed to have been received in India, or on income that accrues or is deemed to accrue or arise through a ‘business connection’ in India<sup>2</sup>. Indian tax laws<sup>3</sup> provide for an inclusive definition of ‘business connection’ and include any business activity carried out by a person on behalf of a foreign company, where the person:



Indian tax laws also provide that when the activities mentioned above are undertaken by an independent agent of a foreign company in India, in the ordinary course of its business, the agent may not be its PE in the country. Certain other exclusions have been made, e.g., for sourcing activities, where the operations of the foreign company are restricted to purchase of goods in India for the purpose of export<sup>4</sup>, its activities including collection of news and views in India for transmission out of the country, and so on.

In its landmark decision in the case of **R.D. Aggarwal** in 1964, India’s **Supreme Court** laid down the following principles for constitution of a ‘business connection’ of a foreign company in India:

**Continuity of business:** Isolated events should not constitute a business connection and the foreign company should be able to demonstrate continuity of its business activities in India.

**Business activities:** There should be a real and intimate connection between the business activities of the foreign company and its activities in India, including business activities such as back office operations and support services, which do not constitute a PE in the country.

The Indian judiciary has also observed that where no business operations are undertaken in India, business connection is not established in the country.<sup>5</sup>

Furthermore, Indian tax laws provide that royalty or fees for technical services (FTS), effectively connected with a PE or a fixed place of business in India, will be taxable in the country on a net basis.

While establishment of the business connection of a foreign company in India is a fact-specific exercise and may vary from case to case, the principles given above, laid down by the Indian judiciary, act as guidance for taxpayers in the country.

<sup>2</sup> Section 5 of the Act

<sup>3</sup> Section 9 of the Act

<sup>4</sup> *Mondial Orient Ltd (Karnataka HC) (2014)*

<sup>5</sup> *Asia Satellite Telecommunications Co. Ltd (Del HC) (2011)*

## *PE in Indian tax laws*

The concept of PE was introduced in domestic tax laws as a part of statutory Transfer Pricing (TP) provisions, wherein an inclusive definition has been provided, which covers various types of PEs.

Furthermore, in relation to countries with which India has tax treaties, the provisions of the applicable treaties

or the Act, whichever are more beneficial for the foreign company, will apply.<sup>6</sup> Consequently, in view of the inclusive definition of PE and the concept of a 'business connection' under the Act, in most cases, the provisions of the tax treaties are beneficial and therefore applicable for eligible foreign companies.



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6 Section 90 of the Act

# Attribution of profit under Indian tax laws

Under Indian tax laws, if a non-resident has a business connection in India, profit attribution is only permissible on the part of its income that is ‘reasonably attributable’ to its operations in the country. Furthermore, if its business is carried out through a dependent agent (explained in subsequent sections of the paper), profit attribution to the dependent agent is only permissible on the income attributable to the operations it carries out in India.<sup>7</sup> In order to determine the appropriate level of profits to be attributed to the PE, a methodology for attribution of profit has been provided in the Income-tax Rules.<sup>8</sup> This is similar to the Global Formulary Apportionment (GFA) approach, which recommends allocation of the global profits earned by taxpayers to various countries, based on financial parameters including the turnover and asset bases of taxpayers, compared to transaction pricing-based allocation. However, the OECD has discarded the GFA in favour

of the Arm’s Length Price (ALP), which is based on global TP principles. Various Indian courts and Tribunals have repeatedly supported application of ALP for attribution of profits to PEs.<sup>9</sup>

Indian TP provisions are applicable for international transactions between two more associated enterprises (AEs). The definition of an ‘enterprise’ under Indian tax laws denotes and includes a PE. Therefore, it can be reasonably argued that international transactions between a PE and its HO need to follow the Arm’s Length principles. However, there is some uncertainty about whether dealings between an HO and a PE are subject to TP provisions, since there is a school of thought which believes that India’s current TP provisions can only apply to dealings between separate legal entities (i.e., separate taxpayers) and not between two separate enterprises (HOs and their PEs) of the same taxpayer.<sup>10</sup>



7 Section 9 of the Act

8 Rule 10 of the Rules

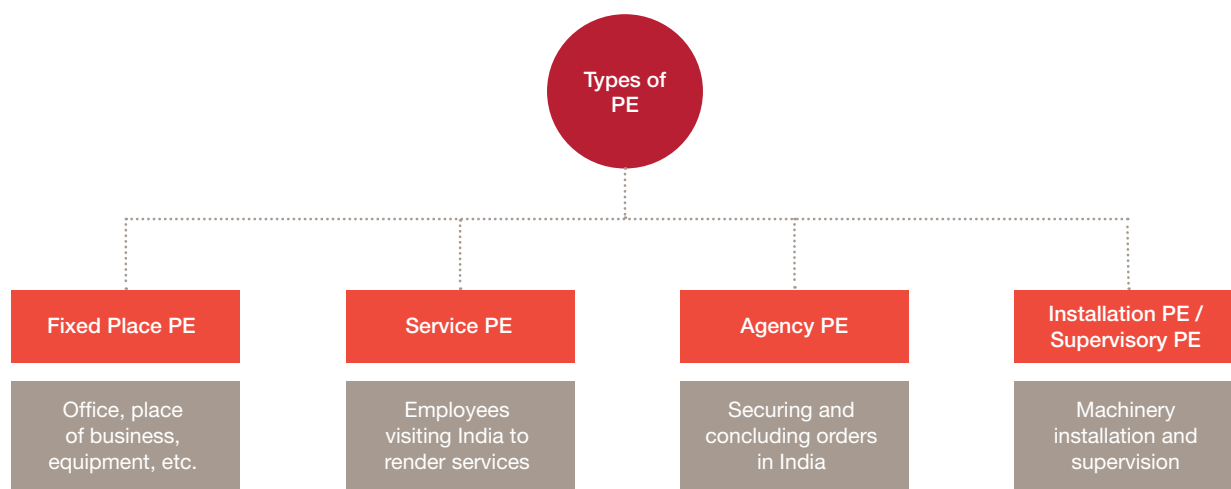
9 Morgan Stanley & Co. (SC) (2007)

10 Aithent Technologies Pvt. Ltd (Delhi ITAT) (2015); Sumitomo Mitsui (Mumbai ITAT)(2012)

# PE in India's bilateral tax treaties

India's bilateral tax treaties are mainly based on the United Nations' (UN's) Model Tax Conventions (MTCs) and include certain aspects of the OECD's MTCs. Article 5 of such tax treaties usually includes the framework for constitution of the PE of a foreign company in India. And while India's tax treaties with every country are separately negotiated, these generally have provisions relating to the following types of PEs:

Tax treaties exclude certain transactions from the ambit of PEs. They mandate that a PE cannot be constituted if a foreign company is engaged in specified activities that are preparatory and auxiliary in nature.



## Attribution principles



### Introduction

As mentioned earlier in this report, the basic principles for attribution of profits to a PE were set forth in the OECD's Attribution reports in 2008 and 2010.

The version of the report in 2008 formed the base for the OECD. In this report, the AOA for attribution of profits, which was more refined and rational than earlier approaches, was introduced. Subsequently, in 2010, the OECD amended its commentary on Article 7 of the MTC, to incorporate its guidelines of the 2008 version of the report. Thereafter, it decided to revise the MTC as well as the Commentary in an update in 2010 to enable incorporation of its principles in their entirety. The second phase of the report mentioned above was introduced with this update. These amendments made application of TP principles on attribution of profit to PEs explicit and indicated that transactions between PEs and foreign taxpayers were to be undertaken at ALP.



## Principles

The AOA entails two steps that are detailed below:

### Step 1: Hypothesising a PE as a separate and independent enterprise

Functional and factual analysis	Attribution of assets	Attribution of risks	Attribution of free capital	Recognition of dealings
<ul style="list-style-type: none"> <li>• Identification of all activities, responsibilities and the extent to which these are undertaken by the PE</li> <li>• Identification of all other functions performed by the PE with other unrelated or related parties</li> <li>• Identification of Significant People Function (SPF)</li> </ul>	<ul style="list-style-type: none"> <li>• Determination of assets that are 'economically owned' and/or used by the PE and in what capacity</li> <li>• Tangible assets attributed to part of enterprise usually using these</li> <li>• Intangible asset attribution, usually based on SPF</li> </ul>	<ul style="list-style-type: none"> <li>• Assumption of risks attributable to the SPF performed by the PE</li> <li>• Initial assumption of risk not a determinant as part of the enterprise, based on the assumption that the initial risk may be transferred to another part of the enterprise, and vice versa</li> </ul>	<p>Need for a PE to have adequate capital to be self-sufficient and support its FAR</p> <ul style="list-style-type: none"> <li>• Step 1: Measurement of risk and value of the assets attributed to a PE, identified previously</li> <li>• Step 2: Determination of the 'free' capital needed to fund the PE's assets and support its risks</li> </ul>	<p>Checkpoints for use of 'Threshold Test' before recognising internal dealing as a transaction between two independent entities:</p> <ul style="list-style-type: none"> <li>• Existence of a real and identifiable event</li> <li>• Determination of dealing of economic significance</li> <li>• Maintenance of a record of the dealing</li> </ul>

### Step 2: Determination of the profits of a hypothesised separate and independent enterprise, based on a comparability analysis

The AOA recommends that dealings between a PE and its HO should be compared with transactions between independent enterprises, based on the comparability factors detailed in the TP Guidelines. On the basis of this analysis, an appropriate TP method can be selected and applied to determine the arm's length remuneration for the PE's dealings.

### India's approach

Generally, most of India's bilateral tax treaties cover taxation of a PE in Article 7 in line with updating of the OECD's MTC in 2008 (although India has reserved rights on certain clauses of this updated version). It is interesting to note that India was the only country that reserved its right to use the updated version of Article 7 of the MTC in 2010 (and the Commentary, as well as any subsequent changes made to it) because it did not agree with the approach to attribution of profits to PEs. At the same time, there is no specific guidance from the Revenue on how India's preferred approach to attribution of profit is different from that of the OECD AOA and what additional steps need to be taken to bridge this gap.

However, despite India's reservations on the OECD's AOA, it is reassuring that there are a plethora of Indian judgments that follow application of the arm's length principles recommended by the OECD.

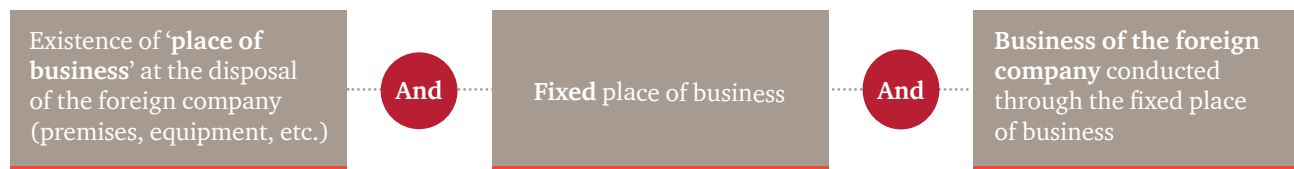


# Fixed place PE



The term PE generally means a fixed place of business through which the business of an enterprise is wholly

or partly carried on.<sup>11</sup> The following are the essential characteristics of a fixed place PE:



## Place of business test

A 'place of business' is any premise, facility, machinery, etc., used by a foreign company to conduct its business in India. It is essential that the foreign company has the 'right to use' such a place of business, i.e., it should be at the disposal of the foreign company to constitute a fixed place PE in India.

According to the UN's 'Commentaries on the Articles of the United Nations Model Double Taxation Convention

between Developed and Developing Countries' (UN's Commentary) and the OECD's 'Commentaries on the Model Tax Convention, 2010' (OECD's Commentary), it is considered that a PE has been constituted in a country, even without the formal presence of the foreign company in it. However, the company should have some space at its disposal. The following are some illustrations cited in these commentaries to aid understanding of whether a space is at the disposal of a foreign company:

Sr no	Facts of the illustration	Whether the Disposal Test is satisfied
1.	A salesman regularly visits a major customer to take orders and meets the purchase director in his office.	No, since the customer's premises are not at the disposal of the enterprise. <sup>12</sup>
2.	An employee of a company is allowed to use an office in the headquarters of another company for a prolonged period of time to ensure that the latter complies with its obligations under contracts concluded with the former.	Yes, since the employee is carrying on activities related to the business of the former company from the office of the latter.
3.	A road transportation company uses the delivery dock at a customer's warehouse every day for a number of years to deliver goods purchased by the latter.	No, since the company's use of the delivery dock is limited to delivery of goods to customers and it cannot use the delivery dock for any other purpose.
4.	A painter has been spending three days a week in the large office building of its main client for two years.	Yes, since he is undertaking the main functions of his business from the office building.

In sync with international tax commentaries, the Indian judiciary has stated that for a place of business to be at the disposal of a foreign company in India, it is essential for such a company to have a certain degree of control over the premise or space in the country, so that it has unrestricted access to it and can use it, based on its requirements, to undertake its business activities in India.<sup>13</sup> In 2014, in the case of the **E-Funds IT Solution**, the **Delhi High Court**

held that a subsidiary cannot be deemed to be a PE of a foreign company if the Disposal Test is not satisfied. Furthermore, the Delhi Income Tax Appellate Tribunal (ITAT or Tax Tribunal) held that where a foreign company has unrestricted access to the premises of a Liaison Office (LO) and its business activities are undertaken through such an LO, it constitutes the Fixed Place PE of the foreign company in India.<sup>14</sup>

<sup>11</sup> Article 5(1) of India's tax treaties

<sup>12</sup> Agency PE not examined in this illustration

<sup>13</sup> Formula One World Championship Ltd. (SC) (2017); E-Funds IT Solution (Del HC) (2014); Adobe Systems Incorporated (Del HC) (2016); Airlines Rotables Ltd (Mum ITAT) (2011); Motorola Inc. (Del ITAT)(SB) (2005); Rolls Royce Plc (Delhi ITAT) (2009); GE Energy Parts Inc.(Del ITAT) (2017)

<sup>14</sup> Rolls Royce Plc (Delhi ITAT) (2009); GE Energy Parts Inc. (Del ITAT) (2017)

## Permanence Test – fixed place of business

It is essential that there is a certain degree of permanence in relation to the business activities of a foreign company in India, i.e., a fixed place PE in India should not be temporary or transitory in nature.

India's bilateral tax treaties do not generally have any threshold relating to the presence of a foreign company in the country (whether it is permanent, temporary or transitory) for it to constitute a fixed place PE. According to the OECD's commentary, if a foreign company maintains a place of business in another country for a period of more than six months, this is likely to constitute its fixed place PE. This is also the UN's view in its Commentary. However, there are certain exceptions, which are elaborated on below:

**Recurring activities:** The OECD's Commentary indicates that in such a situation, the number of times its place of business is used by a foreign company should be aggregated to determine existence of a fixed place PE.

**Limited duration:** A foreign company can constitute a fixed place PE if it is engaged in limited duration activities in a specific country, since all its economic activities are undertaken in this country.

Historically, the Indian judiciary, having recognised that there is no threshold time period provided in India's tax treaties for constitution of a fixed place PE in India, has been of the opinion that based on the business activities of foreign companies in India, their presence in the country should be for a reasonable period of time for them to constitute a fixed place PE in India<sup>15</sup>.

However, in its decision in the case of **Formula One World Championship Ltd.** in 2017, the **Supreme Court** held that a foreign company can constitute a PE even if its activities (in this case, a race) in India are undertaken only for three days. This decision was based on its reasoning that if a business is conducted in India by a foreign company for a limited number of days, during which it has complete control over and access to it, this is sufficient for it to constitute a PE in India.

Therefore, whether a foreign company's presence in India satisfies the Permanence Test is a fact-specific exercise, based on the nature of business activities conducted by a foreign company in the country.

## Business activity test

For a foreign company to constitute a PE, its business activities should be undertaken at a fixed place of business. However, even if a place of business is at the disposal of the company and the Permanence Test is satisfied, its PE cannot be constituted in India unless it engages in its business activities at this place.

In its decision in the case of **Morgan Stanley and Co.**, the **Supreme Court** held that when a local subsidiary engages in back office work in India for its overseas parent, it does not qualify to constitute a PE in the country, since no business activities of the foreign company are undertaken in India.

Similarly, in the case of **Airlines Rotables Ltd.**, the Mumbai Tax Tribunal held that since none of its business activities, which led to its growth in India, were undertaken at the warehouse of the Indian company, the warehouse did not constitute a fixed place PE in India.

In relation to automated equipment in India, in the case of **Galileo International Inc. (Del ITAT) (2008)**, the Delhi Tax Tribunal observed that automatic machines or equipment that do not require human intervention may constitute a fixed place PE of a foreign company in India if the company operates and maintains this equipment for its business activities in the country. This decision was approved by the Delhi High Court.<sup>16</sup>

However, as observed by the Pune Tax Tribunal in the case of **Epcos AG (ITAT Pune) (2009)**, if an Indian subsidiary conducts its own business with the help and guidance of a foreign company or parent company in India, it cannot be a PE of the foreign company in the country.

## Fixed place PE: profit attribution of profit Process

In the case of a Fixed Place PE, the AOA is carried out as follows:

**Step 1:** A functional and factual analysis is conducted to hypothesise the PE as a separate and distinct entity. This analysis is undertaken to identify the part of the foreign enterprise that manages specific risks and owns particular assets. It requires identification of the SPF, recognition and determination of the nature of dealings between the PE and the other constituents of the enterprise, and ensures adequate capital attribution to the PE, based on its risks and assets.

**Step 2:** The arm's length remuneration is ascertained by determination of the 'comparability' between the dealings of the PE and its HO, as well as uncontrolled transactions and selection and application of the most appropriate TP method (aligned with its dealings).

<sup>15</sup> *Visakhapatnam Port Trust (AP HC) (1985); Subsea Offshore Ltd. (Mum ITAT) (1998); Fugro Engineers BV (Delhi ITAT) (2008);*

<sup>16</sup> *Galileo International Inc. (Del HC) (2009)*

## Results

On the basis of the two-step approach recommended by the OECD, there may be two scenarios:

- a. If the results of Step 1 determine that a PE is engaged in routine dealings with its HO and it does not undertake any SPF, it is entitled to routine remuneration for its services, since all its SPF-related decisions are taken by the HO and it neither assumes any significant risk nor owns any assets of note. On the basis of Step 2, the cost and arm's length mark-up adequate is determined for such a PE.
- b. A fixed place PE is entitled to a higher proportion of the remuneration if it is identified at Step 1 that it is undertaking certain SPF, owns assets and assumes risks. A detailed comparability analysis in the form of Step 2 is required to determine the arms' length consideration of such dealings. Attribution, based on the Profit Split Method, Revenue Split, etc., may also be applied, depending on the facts and circumstances of the case.
- c. It is important to note that the profit attribution approach does not deal with the issue of whether certain expenses are deductible when computing profits attributable to a PE, since such matters are subject to domestic law.

## Way forward

Over the years, Indian tax authorities and judiciary have kept pace with the evolving business environment in India and have matured, to assess on a case-to-case basis whether a foreign company can constitute a fixed place PE in the country, based on international tax principles.

A recent example is the decision of the Delhi High Court in the case of **E-Funds IT Solution**, wherein it held that since the Disposal Test was not satisfied, a PE of the company could not be constituted in India. Similarly, in the case of **Formula One World Championship Ltd.**, the Supreme Court of India held that based on the combined reading of the factual matter presented before it, a PE could be constituted, although the company's business activity (in this case a race) in India was only for a duration of three days.

The concept of a fixed place PE is of vital importance today, with India fast becoming an attractive destination for foreign companies for their investments, given its large consumer base, growing markets, availability of skilled resources and opportunities for economies of scale.



# PE exclusions – preparatory and auxiliary activities



India's tax treaties exclude certain activities from the ambit of PE because these are preparatory and auxiliary in nature. The following are the specified activities:

Storage of goods and merchandise	Purchasing activities	Other activities	Combination of these activities
<ul style="list-style-type: none"> <li>• Consignment stock</li> <li>• Storage for processing abroad</li> <li>• Storage for delivery</li> <li>• Storage for display</li> </ul>	<ul style="list-style-type: none"> <li>• Activities related to purchase</li> <li>• Purchase of goods for processing</li> </ul>	<ul style="list-style-type: none"> <li>• Collection of information</li> <li>• Research &amp; Development (R&amp;D)</li> </ul>	Combination of one or more of these activities

## Storage of goods and merchandise

Storage of goods and merchandise is an important business function. However, this activity in itself does not lead to constitution of a PE of a foreign company

in India. India's tax treaties have specific exclusions in relation to storage of goods and merchandise, which are enumerated below:

Consignment stock	Storage for processing abroad	Storage for delivery	Storage for display
<p>The stock of goods of a foreign company is at the disposal of and under the control and supervision of an Indian company.</p> <p>In the case of <b>Airlines Rotables</b>, the Delhi Tax Tribunal observed that since its warehouse and stock of goods were not under the control of the foreign company (so that it could expand its business), it could not constitute a PE in India.</p>	<p>The stock of goods of a foreign company is maintained in India for an interim period for the purpose of 'processing' these outside the country.</p> <p>The term 'processing' refers to the process by which some or all the essential characteristics of a product are altered.</p>	<p>The stock of goods of a foreign company is maintained in India, only for the purpose of delivery in the country; its sale-related activities are undertaken by the foreign company outside India.</p> <p>While this exclusion forms a part of the OECD's MTC, the UN's MTC excludes this from its list of PE exclusions, i.e., under the UN's MTC, a company maintaining a stock of goods in a country for the purpose of delivery may constitute a PE in the country if all other conditions are satisfied.</p> <p>Since India follows a hybrid of the OECD's MTC and the UN's MTC, some of its tax treaties include this exclusion, while it is absent in others.</p>	<p>The stock of goods of a foreign company is maintained in India, only for the purpose of display in the country. This envisages a situation wherein all its other activities such as sale and delivery are undertaken outside India.</p>

According to the Indian judiciary, the benefit of exclusions is only available if a foreign company undertakes storage of goods and merchandise for itself. Where such storage of goods is undertaken for and on

behalf of any third party in India, it can be construed that the foreign company is undertaking business activities in the country, and therefore, may constitute a PE in it.<sup>17</sup>

17 XYZ/ABC Equity Fund (AAR) (2001)

## Purchase-related activity

India's tax treaties exclude activities undertaken in India by a foreign company exclusively for the purpose of making purchases.

Before taking purchase-related decisions, foreign companies generally conduct market research and vendor verification activities in order to ensure the efficiency of their purchase functions. Such activities include collection of information on purchase of goods in India and quality checks.

The Indian judiciary has varied opinions on whether purchase-related activities can result in constitution of a PE in India. While the Mumbai Tax Tribunal<sup>18</sup> held that such activities form a part of PE exclusions, according to the AAR,<sup>19</sup> functions undertaken by an LO, such as selection of vendors and quality control, do not qualify for PE exclusions, since these are in addition to the purchase function.

In the case of **Nike Inc. (Karnataka HC)(2013)**, an LO had been set up in India for the purpose of identifying manufacturers and ensuring that goods were manufactured in India according to requirements. The taxpayer contended that its activities were ancillary and auxiliary to the activities of its HO and other group companies. According to the Karnataka High Court, the object of the transaction was to purchase goods in India for the purpose of export, and therefore, its income would not be deemed to accrue or arise in the country.

Similarly, in the case of **Mondial Orient Ltd (Karnataka HC)(2014)**, the Karnataka High Court was of the opinion that the object of the company's Branch Office (BO) was to undertake activities such as product design and development, sourcing, merchandising, follow up, quality control, factory evaluation and shipping co-ordination to ensure purchase of goods in India for the purpose of export, and therefore, no income was deemed to accrue to or arise for it in the country.

## Other activities

India's tax treaties have a residuary PE exclusionary clause, according to which if a foreign company undertakes any other activity (not mentioned in the PE exclusions list), which is preparatory or auxiliary in nature, at a fixed place of business in India, this does not constitute its PE in the country.

The term 'preparatory and auxiliary' has not been defined in the OECD's MTC or UN's MTC or its commentaries. When this came up for adjudication before the Indian judiciary in the case of **UAE Exchange Centre Ltd. (Del HC) (2009)**, the Delhi High Court held that the term 'auxiliary' denotes aid or support. A similar view was taken by the Delhi Tax Tribunal in the case of **BKI/Ham VOF (Del ITAT) (2001)**, wherein it was of the opinion that the term 'auxiliary' meant 'subsidiary or ancillary'.

The Indian judiciary has held that collection of information in India for the purpose of relaying it to the HO of a foreign company or its group companies outside India constitute preparatory and auxiliary activities, and therefore, should not lead to constitution of its PE in India<sup>20</sup>, provided collection of information is not its core business activity. Similarly, it held that where an LO is engaged in identifying customers, studying products available in India and arranging negotiations between a foreign company in India (without participating in it), such activities can be construed as preparatory and auxiliary in nature, and therefore the company cannot constitute a PE in India.<sup>21</sup>

Furthermore, training of agents in India in relation to the required standard of services and administrative procedures have been held to be preparatory and auxiliary in nature.<sup>22</sup>

## Combination of activities

Typically, when a foreign company undertakes a combination of preparatory and auxiliary activities at its fixed base in India, this does not make it eligible to constitute a PE in the country. However, if it combines a preparatory and auxiliary activity with its core business activity, i.e., it undertakes business activities such as sale of goods in India, and this is combined with a supporting activity, for instance, maintenance of stock for delivery of goods, this would lead to its being eligible to constitute a PE in the country.

## No requirement of attribution of profits

Since preparatory and auxiliary activities do not create a PE exposure, the need for attribution of profits does not arise. This can be explained from the perspective of an economic nexus, since such activities are far removed from profit-generating activities in terms of the functions, assets and risks of a foreign company. Therefore, attribution of an economic return is not possible or may not have a significant tax-related impact for the source country.



18 *M Fabrikant & Sons Ltd (Mum ITAT) (2011)*

19 *Columbia Sportswear Company (AAR) (2011)*

20 *Sojitz Corporation (Kol ITAT) (2008); Sumitomo Corporation (Del ITAT) (2008)*

21 *Mitsui & Co Ltd. (Del ITAT SB) (1991)*

22 *Western Union Financial Services Inc (Del ITAT) (2007)*

## Way forward

### BEPS AP 7

BEPS AP 7 focuses on the relevance of PE exclusion rules in today's technologically advanced world. It recognises that in view of the dynamic business environment, an activity cannot be earmarked as being 'preparatory and auxiliary' in nature, i.e., determination of whether an activity is preparatory and auxiliary in nature is a fact-specific exercise and can vary, depending on the nature of the business activities of a foreign company.

AP 7 suggests that the issues involved are two-fold:

Issue	BEPS AP 7 propositions
Whether an activity undertaken by a foreign company in another country is preparatory and auxiliary in nature, based on the nature of its business, e.g., whether storage and delivery of goods constitute the preparatory and auxiliary activity conducted by a foreign eCommerce business with warehouses, personnel and functions in India	BEPS AP 7 suggests that all exclusions in the definition of PE in MTC should be made subject to a 'preparatory and auxiliary' condition, i.e., exclusion will only be available if such activities are preparatory or auxiliary in nature, as against earmarked activities defined in existing tax treaties.
Whether fragmentation of activities between different places of business or entities constitute preparatory and auxiliary activities	Anti-fragmentation rules have been proposed under BEPS AP 7 to address this issue, which restricts a foreign company and its group companies from fragmenting a cohesive business operation into several small operations in order to demonstrate that each of these is only engaged in a preparatory or auxiliary activity.

### MLI – Articles 13 to 15

Article 13 of MLI provides options for amending the 'preparatory and auxiliary' clause in bilateral tax treaties. One of the options comprises the BEPS AP 7 mandates mentioned above.

Anti-fragmentation rules have also been included in the MLI, wherein exemption for specific activities will not be available if a business operation is fragmented into different functions, which are undertaken by the same company or group of companies, and the overall activity arising from the combination of these activities is not preparatory or auxiliary in nature.

Moreover, specific exemption from activities will not be available if a company or its group companies undertake business activities in India (so that its activities make it eligible to constitute PE in the country) along with activities that are preparatory and auxiliary in nature.





## Expected changes in India's tax treaties

According to India's provisional list, with expected reservations on the MLI, it seems the country has chosen the option suggested in the MLI, which includes AP 7's recommendations in relation to exemption of specific activities, i.e., the need for every activity that is preparatory or auxiliary in nature to be covered under PE exclusions. Various other countries such as Australia, Italy, Japan, the Netherlands, Spain and Russia have also opted for this option.

India appears to have accepted the MLI's recommendations on anti-fragmentation, since there is no mention of it in its provisional list of reservations. Countries such as the UK, Japan, the Netherlands, Spain and Italy have also accepted MLI's recommendations.

Once countries, including India, ratify and confirm the provisions of the MLI they are willing to adopt, the countries that finally adopt similar provisions as India in relation to PE exclusions and fragmentation of activities will need to be identified, since India's bilateral tax treaties with these countries will be affected.

## Impact on India

### Existing provisions in India's tax treaties

In most of India's existing tax treaties, 'storage of goods and merchandise' and 'purchase activity' are not subject to the condition of being 'preparatory and auxiliary' in nature, in order to be covered under PE exclusions.

No anti-fragmentation rules are included in India's tax treaties.

### Proposed position under MLI (based on its provisional list of reservations)

Exclusion will only be available if activities are preparatory and auxiliary in nature – on a stand-alone basis, as well as when undertaken as a combination of activities.

For instance, in the example mentioned above, foreign eCommerce businesses with warehouses in India, with a significant number of people and other functions they conduct in the country, may not be eligible to claim PE exclusion, since these activities may constitute the core business activity of such companies.

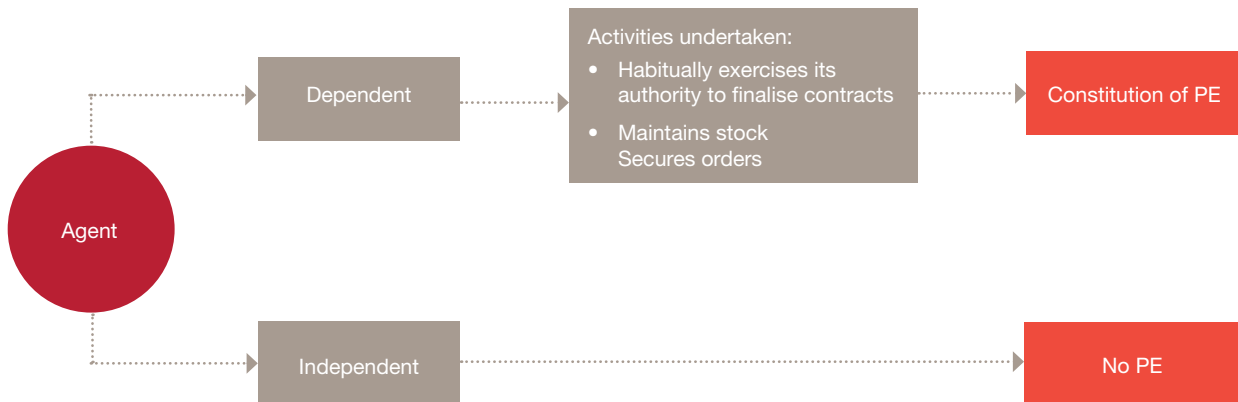
Anti-fragmentation rules need to be complied with. These rules restrict division of a business activity into smaller and similar activities conducted by its group companies.

India is yet to submit its final list of reservations and notifications in relation to MLI to the OECD.

# Agency PE



India's tax treaties provide for constitution of an Agency PE where a dependent agent undertakes certain activities in India on behalf of a foreign company.



## Principal-agent relationship

### Who is an agent?

The primary condition for constituting an Agency PE in India is the establishment of an 'agency relationship' between a foreign company (principal) and its representative in India (agent), i.e., it is necessary that the agent will act on behalf of the foreign company in India.

The Indian judiciary has observed that an agency relationship has the following characteristics:<sup>23</sup>

- An agent works in accordance with the principal's authority while dealing with third parties.
- The activities undertaken by the agent are in relation to the business activities of the principal.
- The principal has a certain amount of control over the agent's activities and can intervene in the performance of the agency function.

- Any loss incurred by the agent is indemnified by the principal.

### Dependent agent

Once it is established that an Indian player is the agent of a foreign company, it needs to be ascertained whether it is a dependent agent of the foreign company.

According to the OECD, the following principles are of importance while determining whether an agent is a dependent agent:

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

The following are the characteristics of an independent agent:

Legal independence	Economic independence	Ordinary course of business
<ul style="list-style-type: none"> <li>• The degree of control exerted by principals on the conduct of the businesses of agents determines whether or not the agents are legally independent. This control should not be of a degree as that in an employer-employee relationship.</li> <li>• Agents must not be subject to detailed instructions and control with respect to the conduct of their business.</li> <li>• Principals should not be in a position to exert a decisive influence on the business of their agents.</li> <li>• Agents must be able to conduct their business according to their own viewpoints, competence and methodologies.</li> </ul>	<ul style="list-style-type: none"> <li>• Agents should be able to conduct their businesses independently and not be dependent on their principals for their economic viability.</li> <li>• They should bear the risk of loss arising from their activities.</li> <li>• They should not be wholly and exclusively dependent on their principals. The number of principals represented by an agent determines its economic independence.</li> </ul>	<p>Where an agent undertakes to conduct the activities of the principal in its normal course of business, this should not constitute a PE of the agent (foreign company) in India.</p> <p>The key principles:</p> <ul style="list-style-type: none"> <li>• Conduct of an agent vis-à-vis that of the principal</li> <li>• Comparison of an agent's activities with those of other agents undertaking similar agency functions</li> <li>• Whether activities engaged in by agents are customary to their trade as brokers, commission agents, etc.</li> </ul> <p>Agents should not undertake activities that form an economic component of the range of activities engaged in by their principals.</p>

23 Bhopal Sugar Industries Ltd. (SC) (1977)

Another point for consideration is whether agents need to be independent of their principals only as regards their agency functions or their entire businesses. The Indian judiciary has a varied opinion on this.

In its decision on **Western Union Financial Services Inc.**, the Delhi Tax Tribunal observed that while determining the independence of agents, their entire business should be considered and not be determined activity-wise. A similar observation was made by the **Mumbai High Court** in the case of **B4U International Holdings Ltd. (Mum HC) (2015)**.

On the other hand, in its decision on **Galileo International Inc.**, the Delhi Tax Tribunal observed that only those business activities, in respect of which services are provided to foreign companies, need to be considered while determining the independence status of agents.<sup>24</sup>

### Specified activities

According to India's tax treaties, if a dependent agent undertakes any of the following activities in the country on behalf of its foreign principal, a PE can be constituted in India.<sup>25</sup>



Conclusion of contracts	Maintenance of stock of goods	Securement of orders
<p>A dependent agent has the authority to conclude contracts on behalf of a foreign company if:</p> <ul style="list-style-type: none"> <li>such a contract is binding for the foreign company and the agent decides the final terms of the contract.</li> <li>an agent can act independently and finalise contracts on behalf of a foreign company.</li> <li>the agent is authorised to negotiate<sup>26</sup> the terms of the contract, which are binding on the foreign company.</li> </ul> <p>Furthermore, the Indian judiciary has observed that if a Limited Risk Distributor (LRD) does not have any authority to negotiate or conclude contracts on behalf of a foreign company in India, it does not constitute its Agency PE in the country.<sup>27</sup></p>	<p>An agency PE can be constituted in India if a dependent agent habitually maintains a stock of goods in India and delivers this on behalf of the foreign company.</p>	<p>The Protocol to the India-US Tax Treaty specifies that the following conditions need to be fulfilled:</p> <ul style="list-style-type: none"> <li>Agents frequently accept orders on behalf of foreign companies.</li> <li>A substantial portion of their activities constitute those they undertake for foreign companies.</li> <li>Acceptance of an order by an agent is binding on the foreign company.</li> <li>Customers have a reasonable basis to believe that agents have the authority to enter and finalise contracts, which are binding on the foreign companies.</li> </ul> <p>In the case of <b>Rolls Royce Plc</b>, the Indian judiciary observed that an Agency PE can be constituted if a dependent agent secures orders for the foreign company in India, and all orders are routed through the agent.</p>



<sup>24</sup> The decision of the Delhi ITAT was confirmed by the Delhi High Court, though no observations were made by the Delhi High Court as regards independence of an agent.

<sup>25</sup> *Morgan Stanley & Co (SC) (2007); E Funds IT Solution (Del HC)(2014); eBay International AG (Mum ITAT) (2012)*

<sup>26</sup> *Galileo International Inc (Del ITAT)(2008); Amadeus Global Travel Distribution SA (Del ITAT) (2011)*

<sup>27</sup> *Varian India (P) Ltd (Mum ITAT) (2014)*

## Profit attribution

### Agency PE

#### Process

Unlike in the case of a Fixed Place PE, where the source country has taxing rights over a single taxable unit (in the form of the PE created), in the case of an Agency PE, the source country has taxing rights over two different legal entities — the dependent agent enterprise (or the intermediary) and the dependent agent PE. Principally, the profit attributable to the PE is different from the arm's length return for the intermediary, and can be either greater or less than the latter.

Accordingly, the AOA will be conducted as follows:

**Step 1:** A functional and factual analysis will be required to evaluate the functional and risk profile of the intermediary and determine the additional functions or risks that are to be attributed to the PE. This analysis would need to clearly differentiate between the FAR profile of the Agency PE and that of the intermediary, although the FAR profile of a Dependent Agency PE (DAPE) generally subsumes the functional profile of the intermediary that creates the PE.

**Step 2:** A DAPE's arm's length remuneration will need to be ascertained by a comparison of the dealings of the entities and transactions between associated enterprises, and selection and application of the most appropriate method to examine of these dealings. It is important to note that the profit attributable to a DAPE is not equivalent to the arm's length return for an intermediary, but it is the arm's length return for the FAR of the DAPE in respect to the agency-related activity performed by a dependent agent on behalf of the foreign taxpayer.

#### Results

The two-step approach followed by the OECD:

- A. No further profits need to be attributed if the results of Step 1 highlight that the dependent agent (intermediary) has been suitably rewarded at arm's length for performing its functions and the profit attributable to the DAPE is not greater than the profit already earned by the intermediary.
- B. However, if the profit attributable to the DAPE is greater than the arm's length profits of the intermediary, the difference will be taxed in the hands of the former.
- C. An approach that is often debated is whether the same results can be achieved by increasing the arm's length profits of the intermediary to account for the DAPE's incremental profits. However, this approach may not be accepted by the Revenue, since an intermediary and a DAPE are separate taxable entities. And even if the results are the same from an economic perspective, the differences in the tax rates and tax computation methodologies of an Indian and a foreign taxpayer will not allow the profit attributed to the DAPE to be reflected in the intermediary's

books. This is in spite of the fact that from the perspective of tax collection, the intermediary may be considered a representative assessee of the DAPE, to ease the former's tax proceedings.

### Way forward

#### BEPS AP 7

According to BEPS AP 7, the 'in substance' functions of an agent in a country on behalf of a foreign company need to be analysed in order to determine whether an Agency PE has been constituted, against the condition of formal conclusion of a contract mandated in the current OECD MC. The following amendments have been proposed:

- The clause "authority to conclude contracts" to create a PE should be deleted. Instead, a clause should be included that an Agency PE should be constituted if an agent "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise".
- An Agency PE is constituted when the activities of a dependent agent (given above) relate to transfer of ownership and rights relating to property owned by a foreign company or provision of services by it.



- The definition of an independent agent should be restricted. An agent should not be considered an independent agent if it acts exclusively on behalf of one or more foreign companies with which it is closely associated.

### Article 12 of the MLI

Article 12 of the MLI suggests adoption of the recommendations of BEPS AP 7. These are not minimum standard provisions and therefore do not mandatorily apply to India's tax treaties.

### Changes in India's tax treaties

On going through India's provisional list of expected reservations on the MLI, it appears that it has agreed to implement the MLI's suggestions (given above). Other countries such as Japan, the Netherlands, New Zealand, Russia and Spain have also agreed to incorporate the MLI's recommendations on deletion of the need for authority to conclude contracts to constitute PEs. This is similar to the MLI's provisions proposed to be adopted by India. Furthermore, countries such as Japan, the Netherlands, Spain and Russia have agreed to incorporate the MLI's recommendations on restrictions on the definition of an independent agent—very like the MLI's proposals to be adopted by India.

Once countries, including India, ratify and confirm that they are willing to comply with the provisions of the MLI, countries that comply with similar provisions in relation to Agency PEs will need to be identified, since India's tax treaties with these countries will be affected.

### Impact on India

Most of India's tax treaties include the clause "authority to conclude contracts" as a condition for a dependent agent to constitute the Agency PE of a foreign company in India. If the MLI's recommendations are adopted in India and other countries, companies will need to evaluate their Agency PEs' exposure in a situation wherein an Indian company will play a major role in conclusion of contracts on behalf of a foreign company, and such contracts will be finalised without any significant changes in them.

Therefore, foreign companies that engage Indian group companies to identify and communicate with potential customers in India may have to revisit their existing business models to analyse the potential tax impact of changes proposed under the MLI. Furthermore, in view of India's restricted definition of independent agent, such companies will need to re-analyse the independence of agents in the country.





India's tax treaties provide that the Service PEs of foreign companies can be constituted in India if these enterprises provide services in the country through their employees or other personnel working under their control and

supervision for a period exceeding the threshold delineated in specific tax treaties.

Some key concepts to be considered:

Stewardship-related activity	Secondment of employees to India	Fees for technical services	Services provided by other personnel	Duration test – employee days vs solar days
Services provided by parent company	Employees of foreign company seconded to Indian company to undertake activities for the latter	Specific exclusion from Service PE in some of India's tax treaties	Services provided by employees under the control of the foreign company in India	Mechanism for calculating number of days of a foreign company's presence in India

## Stewardship-related activity

Stewardship-related functions refer to the activities of a foreign company that are undertaken with the primary objective of protecting its interests.<sup>28</sup> These can include a wide range of activities, depending on the requirements of the Indian group company, for example:

- Monitoring the activities of the Indian group company in order to ensure its compliance with the group's policies
- Conducting checks on quality of goods and services and reviewing business activities to ensure that the output meets the requisite requirements
- Guiding the Indian group company on conduct of its business activities

As observed by the Indian judiciary, the stewardship-related activities of a foreign company in India should not constitute its Service PE.

## Secondment of employees

Due to globalisation, companies set up offices and facilities in foreign countries. Secondment or deputation of employees to these countries by such companies is a popular method used to ensure that the businesses of their group companies in these countries are on par with their organisations' global policies.

Secondment means deputation of employees by a foreign company to its Indian group company, based on the latter's requirements. Some of the key features of a secondment arrangement:

- Seconded employees are released from a foreign company for the period of the secondment and such a company can neither allocate work to the employees nor impose any lien or restrictions on them during this period.
- Seconded employees work solely under the direction, control and supervision of the Indian company, and they only undertake activities for it.

- The Indian company is responsible for work undertaken by a seconded employee, including for the risks and rewards.
- The Indian company is also responsible for appraisals as well as payment of salary, social security contributions, bonuses, etc., to the seconded employees. If such payments are made by the foreign company, the Indian company has to reimburse the amount on a cost-to-cost basis.
- The Indian company has to indemnify any loss that may arise to it due to the activities of a seconded employee.
- Seconded employees are governed by the same disciplinary policies that are applicable for the Indian company's own employees.
- The Indian company is responsible for withholding tax on salary payments to seconded employees.

Typically, under a secondment arrangement, an Indian company is the 'economic employer', while the foreign one continues to be such employees' 'legal employer'.

Alternatively, seconded employees can be transferred to the payroll of Indian companies. In this situation, the Indian company becomes these employees' economic and legal employers.

The Indian judiciary observed in the case of **Centrica India Offshore (P) Ltd. (Del HC) (2014)** that seconded employees were entitled to participate in foreign companies' retirement and social security plans as well as other benefits according to the applicable policies of these organisations, and their salaries should be paid by the foreign companies, which would claim this money from the assessee. The Court also observed that reimbursement of salaries to a foreign company was not a decisive factor. Subsequently, the Delhi High Court observed that such seconded employees render services to Indian companies on behalf of foreign companies,

<sup>28</sup> Morgan Stanley & Co. (SC)(2007)

and therefore, their presence in India can lead to the constitution of a Service PE in the country. The Special Leave Petition filed by Centrica in relation to the decision of the Delhi HC was dismissed by the Supreme Court.

Similarly, in the case of **Morgan Stanley**, the Supreme Court observed that the Service PE of a foreign company can be constituted in India as the agent retains lien over it. A similar observation was made in the case of **JC Bamford Investments**.<sup>29</sup>

However, in the case of **Tekmark Global Solutions LLC (Mumbai ITAT) (2010)**, the foreign company deputed certain personnel to the Indian company. These employees worked under the control and supervision of the Indian company. The Mumbai Tribunal held that for all practical purposes the deputed personnel are to be considered the employees of the Indian company, and therefore, should not constitute a PE of the foreign company. The Mumbai Tribunal also held that reimbursement of expatriate costs (on an actual cost basis without any mark-up) should not be taxable in the hands of the foreign company.

### **Services in the nature of ‘fees for technical services’**

Some of India’s tax treaties mandate that a Service PE cannot be constituted in India when services provided by foreign companies and the consideration received qualify as FTS or Fees for Included Services (FIS), as defined in applicable tax treaties. This is a measure to ensure minimal levy of tax on such transactions in order to attract technical experts to India from abroad.

However, where the tenure of such employees in India is for a long duration, a fixed place PE may be constituted in the country, depending on the nature of activities undertaken in it.

### **Other personnel**

According to India’s tax treaties, a Service PE can be constituted if services are provided by “other personnel” who are not a company’s employees, but are under the control and supervision of a foreign company. The term “other personnel” has not been defined in the UN’s MTC or the OECD’s MTC. It generally refers to people who work under the directions of a foreign company.

In the case of **e-Funds IT Solutions**, the Delhi High Court interpreted the term “other personnel” to mean persons (other than employees) engaged or appointed by a foreign company. Similarly, in the case of **Lucent Technologies International Inc (Del ITAT) (2009)**, it observed that the term “other personnel” refers to persons over whom the foreign company has a certain degree of control.

Therefore, services provided by such personnel in India on behalf of a foreign company can constitute a PE of the company in India, depending on the nature of services they provide.

### **Calculation of number of days**

To determine whether a Service PE of a foreign company can be constituted in India, it is essential to compute the number of days its employees have been present in the country, in order to determine whether the threshold mandated in the tax treaties has been complied with. There are two mechanisms for calculating this – workforce days and solar days.

Workforce days refers to the calculation of the presence of a foreign company in India, based on its number of employees in the country as well as the duration of their presence (in days) in it, e.g., if 20 of its employees have been in India for 7 days, their presence in the country will be considered as 140 workforce days.



29 JC Bamford Investments Rochester (ITAT Del) (2014)

According to the concept of solar days, only the number of days the employees of a foreign company have been present in India is considered, irrespective of its number of employees in the country. According to this method, part of a day, the day of arrival, the day of departure and all other days spent by an employee in India (including Saturdays and Sundays national holidays; holidays before, during and after the activity and short breaks) are taken into consideration in this calculation. In the example mentioned above, seven solar days are considered in a week.

Usually, the solar days concept is used to compute the presence of a foreign company's employees in India to determine whether their presence in the country makes it eligible to constitute a Service PE.

In its recent decision, the Bangalore Tax Tribunal<sup>30</sup> observed that a Service PE can be constituted even if a foreign company provides services from another country to an Indian enterprise. However, in this case, its employees' presence in India should not breach the threshold mandated in the relevant tax treaty. In this decision, the Bangalore Tax Tribunal has deviated from the basic requirement for constitution of a PE in India – the presence of employees and a fixed base in the country.

### **PE attribution – Service PE**

#### **Process**

The concept of profit attribution in the case of a Service PE is somewhat similar to that of a Fixed Place PE (if seconded employees are providing services to an Indian company under the control and supervision of a foreign enterprise) or a DAPE (if services are provided by an intermediary constituting 'other personnel').

## **Results**

The following has been observed in the two-step approach followed by the OECD:

- a. Depending on the significance of the functions performed by the employees constituting the PE, either cost plus-based, revenue, profit split or profit-based attribution may be adopted.
- b. Where 'other personnel' are rendering services on the directions of or on behalf of a foreign enterprise, the FAR profile of the intermediary and that of the Service PE need to be differentiated. Accordingly, there may be attribution of additional profits beyond the amount the intermediary earns as arm's length remuneration, depending on whether 'other personnel' (constituting a Service PE) perform an SPF for assumption of risks and ownership of assets.
- c. The principles of profit attribution not only focus on the functions performed by a PE, but also on the intangible assets it owns or uses, which typically emanate from the service contract under which such activities are being carried out.

## **Way forward**

Activities such as secondment of employees and stewardship activities are becoming increasingly popular, since this is an efficient way of helping Indian group companies in various ways, such as helping them set up their operations or functions in India and comply with the group's standards and policies.

From the tax perspective, the Indian judiciary focuses on the nature of activities undertaken by a foreign company in India. Typically, it scrutinises related documentation to ascertain the relevant details. The Indian judiciary has also been known to rely on information available in the public domain, such as from LinkedIn profiles and news articles, in order to ascertain the nature of a foreign company's activities in India.



30 ABB FZ - LLC (ITAT Bangalore) (2017)

# Construction PE



India's tax treaties provide for the constitution of a 'Construction PE' if a foreign company undertakes the following activities in India for a specified duration:

Activities in relation to a building or construction site

Installation

Assembly

Supervisory services related to these services

The Construction PE clause included in India's tax treaties comprises a combination of the OECD's MTC and the UN's MTC, wherein a 'building site, or construction or installation project' pertains to the OECD's MTC and 'assembly projects and connected supervisory activities' to the UN's MTC.

## **Building, construction or installation site**

According to the OECD's Commentary, a 'building, construction or installation site' includes construction of roads, bridges or canals; renovation (involving more than just maintenance or redecoration) of buildings, roads, bridges or canals; laying of pipelines, and excavation and dredging.

It also states that the term 'installation project' is not restricted to installation of a construction project, but also of new equipment such as a complex machine in an existing building or outdoors.

## **Assembly projects**

Typically, 'assembly' means the act or process of fitting together the parts of a machine or equipment. The Indian judiciary has observed that where a series of processes and activities are involved and a combination of various components lead to the creation of an article, this is tantamount to 'manufacture' and cannot be considered as merely a simple assembly.

## **Supervisory services**

Supervisory services need to be provided for a building site and construction or installation services for the constitution of a Construction PE in India.<sup>31</sup> A 'supervisory' role involves observation and direction, i.e., when a foreign company has the power to observe and direct an Indian company in relation to its connected activities, this may lead to constitution of the former's supervisory PE in India.

Consulting services provided by a foreign company in relation to its connected activities in India are not eligible for constitution of a PE. In this context, the term 'consulting' refers to a situation, wherein a

foreign company provides expert advice to an Indian organisation. Supervisory functions may include consultancy services, since the foreign company is empowered to provide advice or its opinion to an Indian enterprise and direct it to follow this. In a consulting role, the foreign company is restricted to providing expert advice, and the decision of whether it will implement this rests with the Indian company.

## **Duration Test**

India's tax treaties provide for a duration threshold for the activities mentioned above for constitution of a Construction PE in India. This duration is usually 120 days or 183 days. This is a mandatory test. A Construction PE cannot be constituted if a foreign company undertakes such activities, but the threshold rules are not satisfied.<sup>32</sup>

According to the OECD's Commentary, the Duration Test for a Construction PE is mandatory for every site or project being implemented in India. However, if the activities performed at various sites are a part of a single project, such a project is considered for the purpose of constitution of a PE.<sup>33</sup>

The duration of a project is calculated from the date on which the first preparatory activities required for the project work commence<sup>34</sup> or when a site becomes available for the project work.<sup>35</sup>

Usually, 'solar days' are calculated and taken into consideration to determine the duration of a project. It is important to note that while determining the duration of activities, temporary interruptions such as bad weather and shortage of raw material should not be excluded.<sup>36</sup> As regards whether the time threshold needs to be looked at every financial year, in the case of **Krupp Uhde GmbH (Mum ITAT)(2009)**, the Mumbai Tax Tribunal categorically held that this time period should be kept in mind over the entire duration of a project and not just during a financial year. Furthermore, it stressed that the duration should end once the project is completed or when the contractor's responsibility comes to an end.

31 *Steel Authority of India Ltd (Del ITAT) (2007)*

32 *ITC Ltd. (Kol ITAT) (2001)*

*BKI/HAM v.o.f (Uttarakhand HC) (2011)*

*Brown & Root Inc (AAR) (1999)*

33 *Valentine Maritime (Mauritius) Ltd. (Mumbai)(2011)*

34 *Cal Dive Marine Construction (Mauritius) Ltd (AAR)(2009)*

35 *National Petroleum Construction Company (Del ITAT) (2012)*

36 *Krupp Uhde GmbH (Mum ITAT)(2009)*

## Sub-contracting of work

Many foreign companies sub-contract construction activities. In this scenario, for a Construction PE to be constituted in India, it needs to be determined whether the time spent by the sub-contractor needs to be aggregated with that spent by the foreign company.

According to the OECD's Commentary, where work is subcontracted under a comprehensive project-related work schedule, the work carried out by the sub-contractor should be aggregated with that undertaken by the main contractor, in order to determine whether this makes it eligible for constitution of a PE in India. In the case of **Pintish Bamag, In re (AAR) (2009)**, the AAR observed that the example mentioned above is applicable in a situation where conjoint efforts are made by a main contractor and a sub-contractor.

Typically, where a sub-contractor is independently responsible and liable for activities it undertakes in India under the sub-contract arrangement, the time spent by it may not be aggregated with that of the main contractor for the purpose of determining its eligibility for constitution of a PE in India. Alternatively, where the main contractor is responsible for execution of a project (including that of the sub-contractor), the time spent by the subcontractor should be included for determination of a Construction PE in India.

## PE attribution – Construction PE

### Process

Profit attribution in the case of a Construction PE is somewhat similar to that of a Fixed Place PE.

### Results

On the basis of the two-step approach followed by the OECD, there may be two scenarios:

- A. If the results of Step 1 determine that a Construction PE undertakes routine activities and not Statutory Provident Fund (SPF)-related work, with all SPF-related decisions being taken by its HO, and it neither assumes significant risk nor owns any significant assets, such a PE is entitled to routine remuneration for its services. On the basis of Step 2, cost plus-based remuneration may be sufficient for the PE.
- B. A Construction PE is entitled to a higher proportion of the remuneration if it is determined during Step 1 that it is undertaking certain SPF-related work, owns assets and assumes risks in this regard. This may require it to undertake a detailed comparability analysis (in the form of Step 2) to determine the ALP of its dealings with its HO.

Tax-related issues pertaining to Construction PEs are on the rise in relation to attribution of profits from offshore supply and splitting of consolidated contracts. Although offshore supply is not taxable in India, the Revenue may raise a question about whether offshore and onshore (PE-related) contract values have been split correctly or if the Construction PE is also indirectly assuming

any risk related to its offshore supply. Accordingly, it is critical that splitting of FAR and remuneration between a company's HO and PE is clearly documented in customers' contract terms and SPF before execution of a contract.

## Way forward

### BEPS AP 7

BEPS AP 7 recommends the Principal Purpose Test (PPT) to curb artificial splitting of contracts in order to avoid constitution of a Construction PE, as mandated in tax treaties. The PPT provides that for the purpose of determining the threshold period for constitution of a Construction PE, connected activities (exceeding 30 days) carried out by the entity or its closely related company at the project site should be aggregated and included while determining the duration of a foreign company's presence in India.

### MLI – Article 14

In line with the recommendations of BEPS AP 7, Article 14 of the MLI provides for the PPT as under:

The MLI includes 'supervisory activities' and 'consultancy services' undertaken in connection with specified activities, including construction or installation at building sites, for determination of a Construction PE. Under these provisions, if the PE undertakes specified activities in India during one or more periods of time for a duration not exceeding 30 days (without going beyond the threshold mandated in the tax treaty), its connected activities should be undertaken at the same site or project or some other specified place by closely related companies (with each of these periods exceeding 30 days), in order to determine the duration of a foreign company's presence in India. In this case, the different periods of time during which the company has carried out such activities should be aggregated and added to the period during which it has conducted specified activities.

### Changes in India's tax treaties

According to the provisional list of India's reservations, submitted on the MLI, it has agreed to implement the suggestions of the MLI in relation to Construction PEs. Countries such as Australia, the Netherlands, Ireland and Russia have also accepted the MLI's recommendations.

Once countries, including India, ratify and confirm that they are willing to adopt the MLI's mandates, other countries that put in place similar provisions as India in relation to Construction PEs will need to be identified, since India's tax treaties with these countries will be affected.

### Impact on India

Inclusion of consultancy services under Construction PE and the PPT is likely to affect the real estate, construction and EPC sectors in India adversely. Foreign companies may need to revisit their arrangements in order to ascertain the impact of these changes.

# Consequences of forming PEs in India

Article 7 of India's tax treaties provides that when a PE is constituted in India, appropriate profits (as are identifiable in relation to activities undertaken in India) should be attributed to it. It is important to consider that when a PE is created, profit attribution principles not only focus on the functions of the PE, but also on the assets it owns or uses and the risks it assumes.

Furthermore, irrespective of the type of PE, its attributable profits must be determined at arm's length. The Indian judiciary's pronouncements have confirmed the need for a TP analysis of these. Accordingly, a PE's factual and functional aspects are essential for evaluation of profit attribution, and these must be recorded in its profit attribution study to help the company defend its tax position, should the need arise.

Mandatory requirements for PEs in India:

- Maintenance of books of accounts and other documents in accordance with the provisions
- Auditing of accounts by an accountant and a duly signed and verified audit report obtained in the prescribed format before the due date of filing the return of income
- Taxation of profits attributable to a PE in India at the rate of 40% (plus applicable surcharge and cess) on a net basis, subject to domestic tax provisions
- Mandatory Permanent Account Number (PAN) , Tax Deduction and Collection Account Number (TAN) and Indirect Tax registrations
- Filing of return of income in India
- Deduction of expenses incurred, such as salary cost of employees, from income attributable to a PE, subject to its compliance with Withholding Tax provisions under domestic tax provisions
- Mandatory compliance with Withholding Tax requirements – Withholding Tax on payments made, filing of Withholding Tax returns, issue of tax withholding certificates, etc.
- Payment of Indirect Tax and compliance with its related rules
- Mandatory personal taxation of employees of foreign companies in India



# References

## Judgments referred to in this report

Sr. No.	Decision	Citation
1.	CIT vs R.D. Aggarwal & Co.	(56 ITR 20)(SC)
2.	DIT vs. Mondial Orient Ltd.	(28 taxmann.com 263) (Karnataka HC)
3.	Asia Satellite Telecommunications Co. Ltd vs. DIT	(332 ITR 340) (Del HC)
4.	DIT vs Morgan Stanley & Co.	(292 ITR 416) (SC)
5.	Aithent Technologies Pvt. Ltd vs. ITO	[54 taxmann.com 261 (Delhi ITAT)]
6.	Sumitomo Mitsui	[19 taxmann.com 364 (Mumbai ITAT)]
7.	Formula One World Championship Ltd. vs CIT	(394 ITR 80)(SC)
8.	DIT vs E-Funds IT Solution	(346 ITR 256) (Del HC)
9.	Adobe Systems Incorporated vs ADIT	(292 CTR 407)(Del HC)
10.	Airlines Rotables Ltd v. JCIT	(131 TTJ 385) (Mum ITAT)
11.	Motorola Inc. v. DCIT	(95 ITD 269)(Del ITAT)(SB)
12.	Rolls Royce PLC vs DDIT	(122 TTJ 359) (Delhi ITAT)
13.	GE Energy Parts Inc. vs ADIT	(184 TTJ 570)(Del ITAT)
14.	CIT vs Visakhapatnam Port Trust	(144 ITR 146)(AP HC)
15.	DCIT vs Subsea Offshore Ltd.	(66 ITD 296)(Mum ITAT)
16.	Fugro Engineers BV vs ACIT	(122 TTJ 655)(Delhi ITAT)
17.	Galileo International Inc vs DCIT	(19 SOT 257)(Del)
18.	DIT vs Galileo International Inc	(336 ITR 264)(Del HC)
19.	ACIT vs Epcos AG	(28 SOT 412) (ITAT Pune)
20.	XYZ/ABC Equity Fund vs CIT	(250 ITR 194)(AAR)
21.	ADIT vs M Fabrikant & Sons Ltd	(9 taxmann.com 286)(Mum ITAT)
22.	Columbia Sportswear Company, In re	(337 ITR 407)(AAR)
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Sr. No.	Decision	Citation
25.	UAE Exchange Centre Ltd. v. UOI	(313 ITR 94 )(Del HC)
26.	BKI/Ham VOF v. ACIT	(70 TTJ 480) (Del ITAT)
27.	Sojitz Corporation v. ADIT	(117 TTJ 792)(Kol ITAT)
28.	Sumitomo Corporation v. DCIT	(110 TTJ 302)(Del ITAT)
29.	IAC vs Mitsui & Co Ltd	(39 ITD 59)(Del ITAT SB)
30.	Western Union Financial Services Inc vs ADIT	(104 ITD 34)(Del ITAT)
31.	Bhopal Sugar Industries Ltd vs Sales Tax Officer	(1977 AIR 1275)(SC)
32.	of DIT vs B4U International Holdings Ltd	(374 ITR 453)(Mum HC)
33.	eBay International AG vs ADIT	(140 ITD 20 )(Mum ITAT)
34.	Amadeus Global Travel Distribution SA vs. DCIT	(113 TTJ 767)(Del ITAT)
35.	Varian India (P) Ltd v. ADIT	(67 SOT 17)(Mum ITAT)
36.	Centrica India Offshore (P) Ltd. vs CIT	(364 ITR 336)(Del HC)
37.	JC Bamford Investments Rocester vs DDIT	(164 TTJ 433) (ITAT Del)
38.	DDIT vs. Tekmark Global Solutions LLC	(131 TTJ 173)(Mumbai ITAT)
39.	Lucent Technologies International Inc	(28 SOT 98)(Del ITAT)
40.	Steel Authority of India Ltd vs ACIT	(10 SOT 351)(Del ITAT)
41.	JDIT vs Krupp Uhde GmbH	(124 TTJ 219) (Mum ITAT)
42.	Pintish Bamag, In re	(184 Taxman 122)(AAR)
43.	DCIT vs ITC Ltd	(82 ITD 239)(Kol ITAT)
44.	CIT vs. BKI/HAM v.o.f	(15 taxmann.com 1o2)(Uttarakhand HC)
45.	Brown & Root Inc, vs CIT	(103 Taxman 515)(AAR)
46.	ADIT v. Valentine Maritime (Mauritius) Ltd	(45 SOT 34) (Mumbai)
47.	Cal Dive Marine Construction (Mauritius) Ltd, In re	(AAR no. 789 of 2008)
48.	National Petroleum Construction Company	(26 taxmann.com 50)(ITAT Del)

# Notes



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