



**Concept of Permanent Establishment (PE),
Business Connection (BC) and
Significant Economic Presence (SEP)**

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**Chargeability of Non
– Residents**

Introduction

- If a Company is incorporated in India, its income is taxable in India. India has right to tax global income of this Company based on the principal of "**Residential base**" of taxation. India also has a right to tax the income of the foreign company or non-resident to the extent to which the source of income is situated in India.
- As per the Indian Income Tax Act (The Act), if any income of a foreign company is received or deemed to be received in India OR is accrued/arised or deemed to have accrued/arised in India, the source of such income is said to be in India and by virtue of principal of "**source base**" of taxation, India has right to tax such income.
- There are only certain categories of income like Royalties, Fees for technical services, interest, dividend etc. that are covered by this section. Such taxation is generally at a reduced rate of tax and on gross receipt of the foreign company/non-residents.
- However, if the foreign Company or non-resident enterprise has **extended period of presence in India** for carrying out their business activity in India, the income derived by such foreign Company to the extent it is attributable to their presence in India will become taxable in India.
- From this logic, the concept of Permanent Establishment (PE) is derived.
- Article 5 on Double Tax Avoidance Agreements (DTAA) that India has signed with various countries thus defines the term PE as "*A Fixed place of business through which the business of an enterprise is wholly or partly carried on.*"
- At this juncture it is important to understand that the provisions of Indian Income-tax laws which govern the taxation of the non-resident in India.

Applicability of Provisions of the Act

- Section 5 and section 9 of the Indian Income Tax Act, 1961 ('the Act') embody the 'source rule' of taxation in India
- Significant from the perspective of taxation of Non – residents ['NR'] in India
- Sec9(1) of the Act encapsulates the cases where income is deemed to accrue or arise in India
 - Creates a legal fiction
 - **“Business Connection”** is discussed in section 9(1)(i) of the Act
 - The concept of business connection is generally applied where non-resident's country does not have DTAA with India



- NRs are taxed in India in respect of:
 - income received or deemed to be received in India ;
 - Income that is accrued or arising or deemed to be accrued or arising in India
- No exhaustive definition of business connection under the Act - much wider in connotation
 - used effectively by the Tax authorities to tax income of NR in India
 - However, the concept of business connection is overridden by the Article 5 of the DTAA's to provide for taxation only if there exists a PE.



**Business Connection
- A broad overview**

Business Connection – A bird's eye view

Income deemed to accrue or arise in India includes all income accruing or arising, whether **directly or indirectly, through or from** any business connection in India

No income shall be deemed to have accrued in India for NR from certain activities:

Proportionate attribution - Income attributable to the operations carried out in India would be liable to tax, if all activities are not carried out in India

- purchase of goods in India for export;
- news publishing agency collecting news/ views in India for transmission out of India
- Shooting of a cinematographic film in India (if entity is not owned by Indian citizens);
- Foreign company engaged in mining of diamonds, display of uncut and unassorted diamond in CG approved special zone

Business Connection - Agency

Business connection includes business carried out through an agent who is acting on behalf of a NR, when such agent:

- has and habitually exercises authority to conclude contract on behalf of NR, ~~unless activities are limited to purchase of goods / merchandize for the NR;~~ or
 - habitually concludes contracts; or
 - habitually plays the principal role leading to conclusion of contracts by that NR
-
- Only if contract is
 - in the name of the NR; or
 - for the transfer of the ownership/ granting right to use, property owned/ sub-let by NR; or
 - for the provision of services by the NR;

- habitually maintains in India a stock of goods from which he regularly delivers goods or merchandise on behalf of the NR
- habitually secures orders in India, mainly or wholly for the NR and / or its affiliates

- Business connection does not include any business activity carried out through a broker, general commission agent, etc. having an independent status who is acting in the ordinary course of his business
- If such broker, etc. works mainly or wholly on behalf of a NR and / or its affiliates, he shall not be deemed to be an agent of an independent status

- SEP defined to mean:
 - transaction in respect of any goods, services or property carried out by a non-resident in India, **including** provision of download of data or software in India, provided the payments therefrom exceeds monetary threshold as may be prescribed; or
 - systematic and continuous soliciting of business activities or engaging in interaction with users in India through digital means provided the number of users in India exceeding the number as may be prescribed
- Transactions to constitute SEP in India irrespective of **whether or not**,
 - The agreement for such transaction is entered in India;
 - NR has place of business or residence in India;
 - NR renders services in India
- Only so much of income as is attributable to the specified transactions or activities to be deemed to accrue or arise in India

Threshold of 'revenue' and 'users' to be decided after consultation with stakeholders

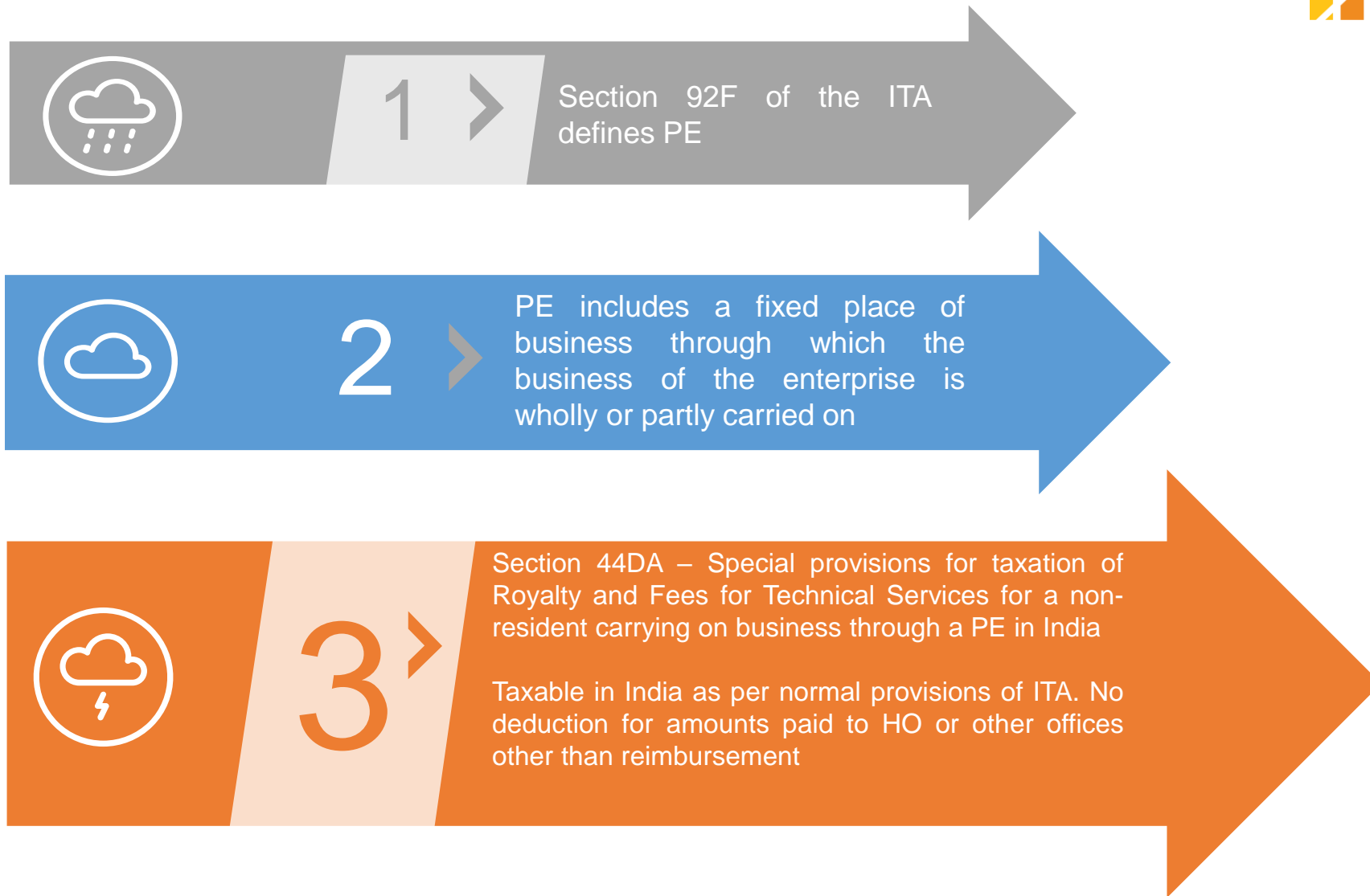
India to re-negotiate existing DTAA's for inclusion of the new nexus rule

Cross border business profits to continue to be taxed as per existing treaty rules till the DTAA's are modified

Non-treaty jurisdictions impacted by the amendment



**Permanent
Establishment
- A broad overview**



The Concept of PE is defined by Article 5 of the tax treaties

OECD : The PE concept marks the dividing line for businesses between merely trading with a country and trading in that country

PE is a term defined in tax conventions to determine when a non-resident is taxable in a source country

Under Article 7, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a PE situated therein

When the enterprise operates through a PE, the profits attributable to it, may be taxed by the country where the PE is located, leaving the country of residence to give relief from double taxation

Where a PE is in existence, the country where it is located may also tax its capital gains, dividends, interest and royalties that are effectively connected to such PE

PE –Types of PE under most treaties



Fixed Base PE

Place of Business and Virtual Projection
(Disposal Test)



Fixed place
(Permanence Test)



Business conducted through a fixed place
(Activity Test)



Agency PE

Principal – Agent contract



Dependent Agent (**control and detailed instructions**)



Habitually **concludes contracts**/ plays a principal role in concluding contracts/ secures orders/ habitually maintains stock for regular delivery on behalf of principal



Service PE

Provision of services



Through employees or other personnel



Presence of employees and/or gross revenue linked to such activities



Equipment PE

If article relating to PE includes use of equipment PE



Applicable only when not regarded as royalties



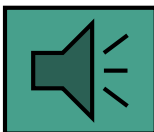
Construction PE

Relevant for construction, erection, commissioning, installation contracts



Generally, PE constituted when project duration more than 6 months or 9 months (depending on tax treaty)

Under the DTAAs, PE is not constituted where only preparatory and auxiliary activities are performed



- Provisions of bilateral tax treaty with respect to **agency PE** are proposed to be amended through Multilateral Convention to Implement Tax Treaty Related Measures [“MLI”].
- India and Japan are also signatory to MLI.



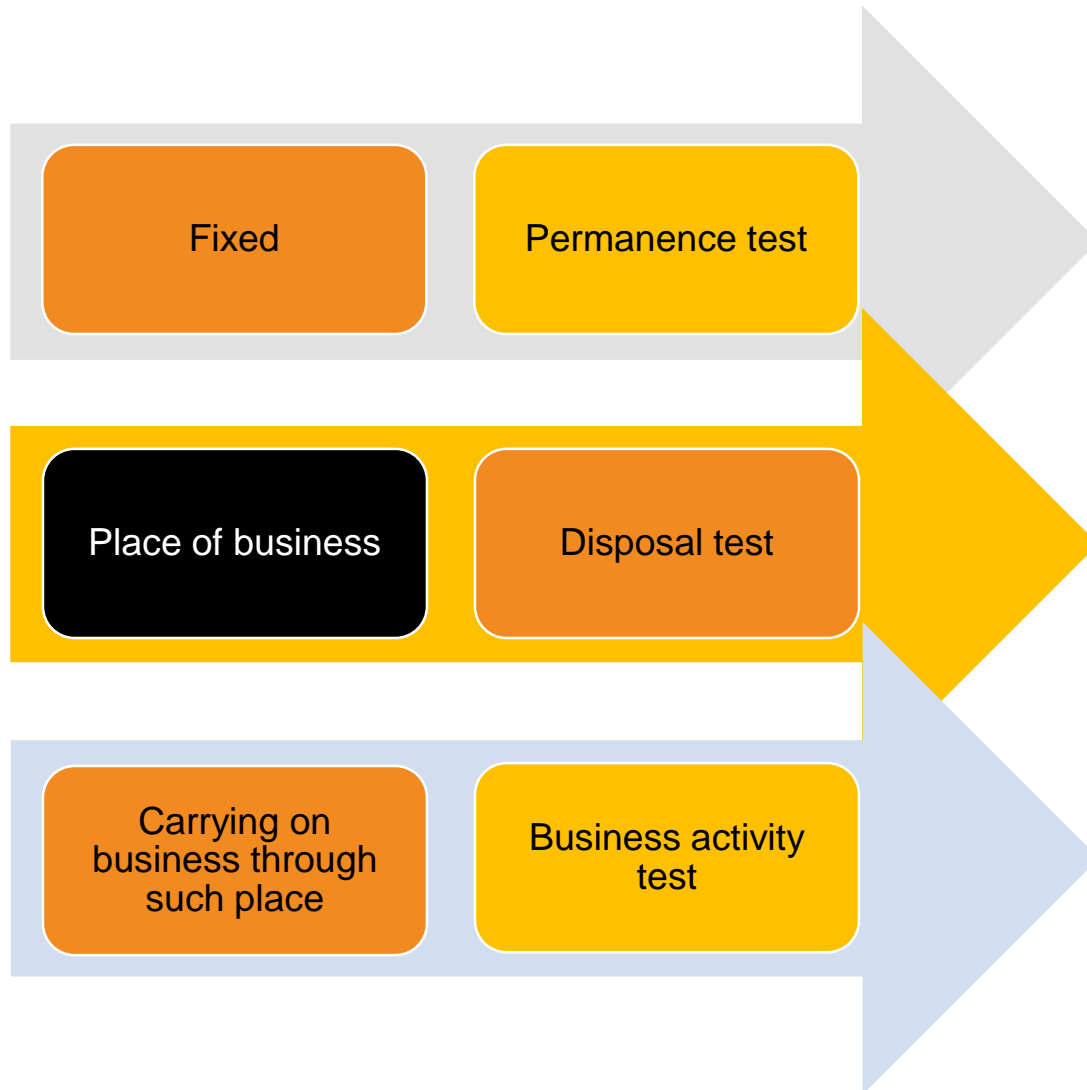
BC Vs PE

BC	PE
Domestic law concept	International tax concept
No exhaustive definition	Defined exhaustively as well as illustratively
No classification	Classified as fixed place, agency, construction & service PE on the basis of activities performed
Wider concept	Narrower concept



Fixed Place PE

Permanent establishment means a **fixed place of business** through which the **business of an enterprise is wholly or partly carried on**



Fixed Place PE: A fixed place PE of a foreign enterprise exists in the India (source country) when the following tests are satisfied:

- **Physical place:** There must be a physical place of business. It does not matter whether this place of business is owned or leased.
- **Location:** The place of business must be a fixed place. The residence of an employee may also be treated as a PE if the same is used as office for business.
- **Permanence:** The place of business must be for a fixed and reasonably longer period of time. The term '**carried on**' in the definition connotes that a mere passing, transient or casual activity, though carried out from a particular place, does not fall within the scope of the definition of PE. There should be a reasonable degree of **continuity and regularity**.
- **At Disposal:** The place must be at the disposal of the foreign enterprise. If the place of business is situated in the business premises of another enterprise and the foreign enterprise has certain part thereof **at its constant disposal**, that premises may be considered as having a PE in India.
- **Business activity:** Proper business activity must be carried out from such fixed place.

Location test / duration test

- Location test requires that place of business to be located at a single place
- It does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site
- OECD – **Both geographical and commercial coherence** are necessary, the fact that activities may be carried on within a limited geographical area should not result in that area being considered as a single place of business
- An isolated activity cannot lead to establishment of fixed place of PE as the ingredients of regularity, continuity and repetitiveness are essentially missing

Illustrative list of PE

- The term PE includes especially:
 - ✓ a place of management;
 - ✓ a branch;
 - ✓ an office;
 - ✓ a factory;
 - ✓ a workshop, and
 - ✓ a mine, an oil or gas well, a quarry or any other place of **extraction** of natural resources
 - ✓ a warehouse in relation to a person providing storage facilities for others;
 - ✓ a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
 - ✓ an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 183 days.

- OECD considers the satisfaction of the conditions prescribed in Art. 5(1) as a prerequisite for the above list to constitute PE. **India does not agree with this position**



Construction / Installation PE

- A building site or construction, installation or assembly project but only if such site, project or activities last more than 183 days.
- For the sole purpose of determining whether the 183 day period referred to as above has been exceeded,
- (i) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction, installation or assembly project and these activities are carried on during one or more periods of time that in the aggregate do not exceed 183 days, and
- (ii) connected activities are carried on at the same building site or construction, installation or assembly project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

Where a office / workshop is used for a number of construction projects, then even if none of the projects continues for more than 6 months, it will be considered as PE under Art 5(2) if it satisfies the condition of Art 5(1)

A building site or construction project includes:

- Construction of roads, bridges or canals etc;
- Laying of pipelines, excavation or dredging projects;
- Major renovation work that is more substantive than mere maintenance;
- On-site planning and supervision or erection of building, project etc.

Assembly or Installation project: It includes installation of new equipment, plant & machinery or even installation of computer network or an ERP package if the activity of the installation exceeds the prescribed time period.

Supervisory activities

- The pre-requisite for supervisory activity constituting a PE is that such activity should be carried out only in connection with a building site, a construction, assembly or installation project and not otherwise
- A PE is constituted if the supervisory activities exceed the time limit
 - It is immaterial whether the individual building site, a construction, assembly or installation project (in respect of which the supervisory services are rendered) meets the time test
 - Minimum threshold in case of supervisory activities covered under a separate and independent contract must be considered from the date when such activities start and not from the date of commencement of the entire project – [Krupp UDHE GmbH (28 SOT 254) (Mum)]
- There is no condition that the person performing supervisory activities should also be providing installation service

Measurement of time period

- A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established (Ex.: a planning office is installed)
- A site should not be regarded as ceasing to exist when work is temporarily discontinued – for example, due to bad weather, shortage of material, labor difficulties. Seasonal and temporary interruptions should be included in determining the life of a site
- In some projects, due to its nature, contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. For example – this would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid
- **Time spent previously on other sites or project (which are unconnected) should not be counted**
- **If a foreign enterprise sub contracts part of its work in Source State in relation to such site or project or activities to a sub-contractor, the time spent by the sub contractor must be considered as time spent by the main contractor in source state.**



Agency PE

What is 'habitual exercise'?

- 'Habitually' refers to a systematic course of conduct on the part of the agent and would mean repeatedly and not in isolated cases
- Depends of the nature of the contract and business of the principal

Authority to conclude contracts

- He has sufficient authority to bind the foreign enterprise and has powers to decide the final terms of the contract
- While concluding contracts, he can act on his own, freely, and without control from the principal
- He is authorized to negotiate all elements and details of a contract which are binding on the enterprise

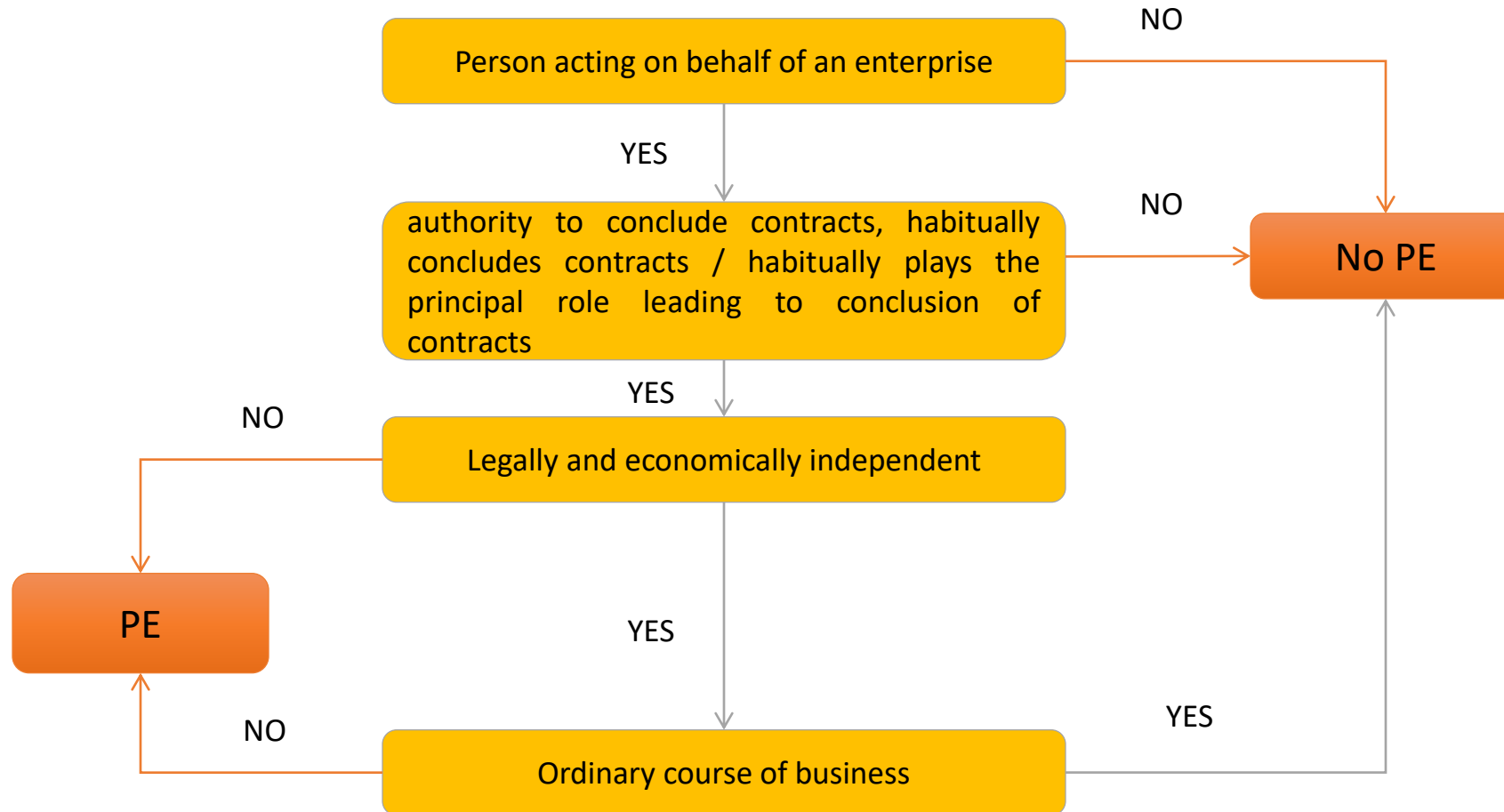
Ordinary course of business

- **Indian Evidence Act** – the current routine of business usually followed by a person or in which he was ordinarily or habitually engaged
- An agent cannot be acting in 'ordinary course' of his own business if he performs activities which economically belong to the sphere of the foreign enterprise rather than to that of his own business operations

- An agent predominantly acting for one enterprise would be economically dependent on the latter and hence, it would be a dependent agent, even though it may not be legally dependent

Wholly or mainly on behalf of NR

- OECD - What is relevant is that the agents activities are for a single principal and not that the principal's activities are carried on by a sole agent
- An agent acting wholly or almost wholly on behalf of a single entity or its group entity indicates a certain degree of dependence as such an entity may play a significant role in the business of the agent; accordingly such an agent would not fall within the scope of an independent agent
- **OECD model commentary states that a person is independent only if he is so, legally and economically and acts in the ordinary course of business when acting on behalf of the enterprise**
- OECD - Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise
- The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence
- Dependency is also determined by having regard to the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of its authority





Service PE

- Service PE could be constituted in India where any enterprise:
 - ✓ renders services in India (**other than fees for technical services**)
 - ✓ to third party / associated enterprise
 - ✓ through employees or other personnel
 - ✓ for a specified period (183 days or more) within any 12-month period commencing or ending in the fiscal year concerned
- Service PE – How to compute no. of days?

Solar days vs. Man days

- Electrical material Center Co. Ltd., vs. DDIT [ITA(TP) No. 1104 (Bang) 2013]
- Clifford Chance vs. DCIT as reported in 76 TTJ 0725/82 ITD 0106 (Bombay ITAT)

Finding of ITAT

“Multiple counting of the common days is to be avoided so that the days when two or more partners were present in India, together, are to be counted only once. Multiple counting would lead to absurd results. For example, if 20 partners were present in India together for 20 days in one fiscal year, multiple counting would result in 400 days. There cannot be more than 365 days in a year.”

Checklist for determining existence of Service PE

Criteria	Check
Furnishing services other than Royalty / FTS	√
Services through employees or other personnel within state	√
No. of days the employees or other personnel furnishing services in India	√
Test of employment whether of the foreign company or Indian company	√
Service PE vis-à-vis activities falling within negative List of PE [i.e. preparatory and auxiliary activities – Article 5(4) or combination thereof, except 5(4.1)]	√
Majority of DTAA's signed by India which have a service PE clause specifically exclude income covered under Article 12/13 (Royalties and Fees for Technical Services)	

Judicial precedents

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

- The Apex Court had held that where the activities of the foreign company entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service P.E. can emerge
- In the above decision, the Court laid two tests, viz. **(i) responsibility for the work of assigned employee; and (ii) control over the assigned employee**, however, it did not bring out the facts / process which substantiates satisfaction of this two tests in the given case (except that it mentioned that having employee's lien over the original employment was assumed as the foreign company retaining control over the terms and employment)

DDIT v. JC Bamford Excavators Ltd. 43 taxmann.com 343 (Delhi ITAT)

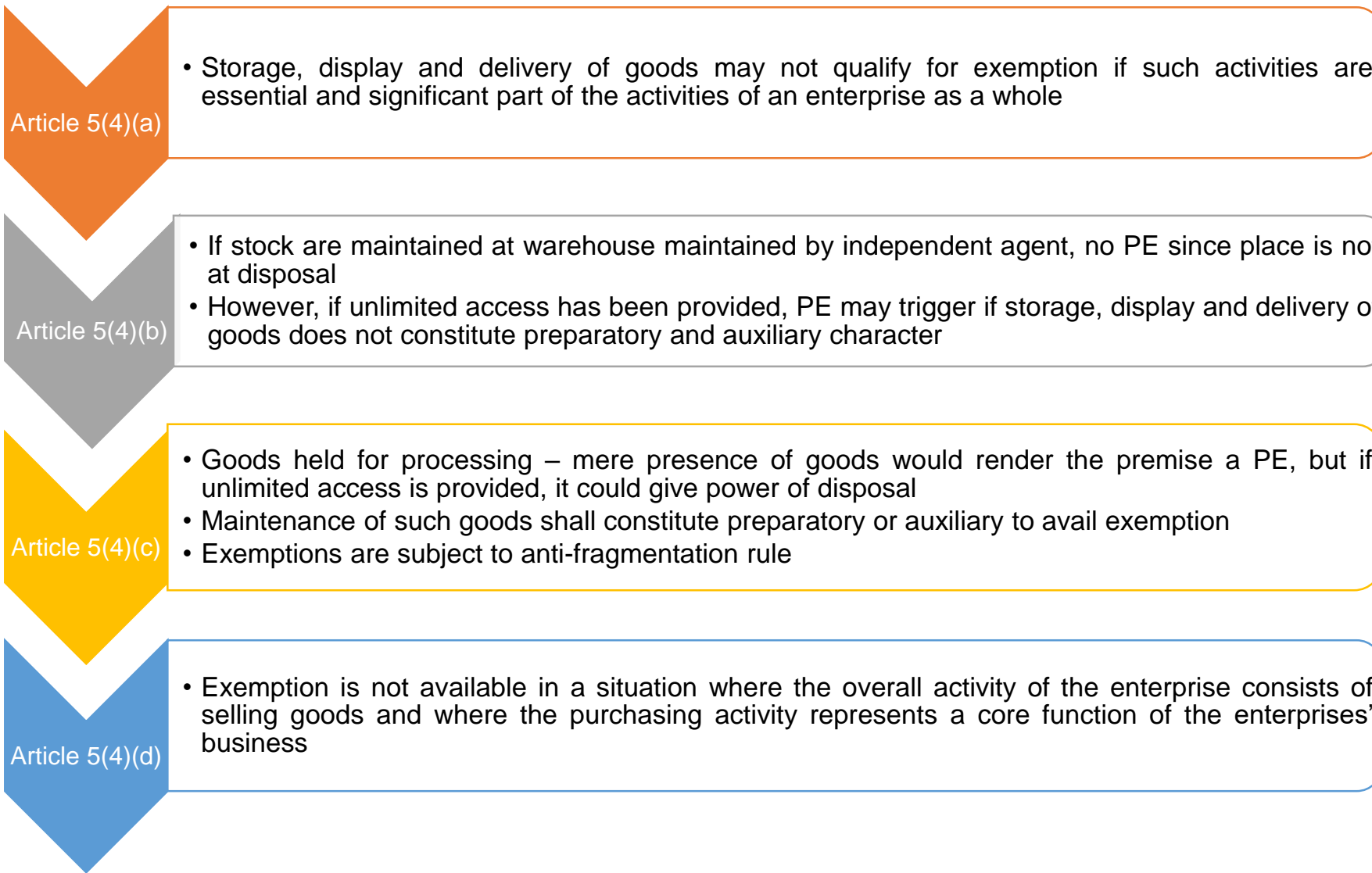
- The Delhi Tribunal held that the deputed employees which were sent on secondment to India continued to be on the payroll of the tax payer and maintained their lien on their employment. Salary for these employees was sole responsibility of the tax payer. There was no material to indicate that the tax payer terminated their services and they were employed by the Indian Entity



Exclusions from PE

Exclusions from PE

BEPS Action 7 Preventing the Artificial Avoidance of PE - proposed changes



BEPS Action 7 Preventing the Artificial Avoidance of PE – anti-fragmentation rule

- New Para 4.1:
 - To prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity
 - Under paragraph 4.1, the exceptions provided in paragraph 4 do not apply
 - Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State; and
 - ✓ that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article; or
 - ✓ the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,
 - Provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation

Requires detailed analysis of activities undertaken by an organization to identify complementary functions that are part of a cohesive business operation



Implications of PE in India

Following are the possible implications if a PE is said to be triggered in India

Business Income and profit attribution

- Business income shall be taxable for the PE in India.
- Foreign enterprise is required to ascertain the profits that are attributable to the activities carried out in India in a manner prescribed under the provisions of the Act and taxed it at the rate of 40% *[excluding surcharge and education cess]*.

Return of Income

Return of income to be filed in India by declaring the business income earned on account of a PE in India.

Other compliances

Tax audit requirements (conditional), withholding of tax or any other compliances under the provisions of the Act.

Registration under FEMA

- FEMA regulates establishment of a foreign enterprise in India for carrying on any activity relating to branch, office or other place of business.
- The concept of PE arises under the deeming fiction of the income tax law or tax treaty
- This raises a grey area on whether a foreign enterprise is required to obtain registration in India for the activities which creates virtual PE in India.



Curative Measures

In our view, following are some of the curative measures that may be adopted where there is risk of PE:

1

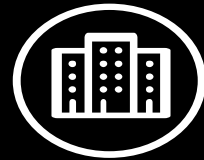
CHANGING THE PROCESS



Non-residents may choose to change the process flow to avoid the PE triggering points along with business rationale (*discussed later*)

2

SUO MOTO DISCLOSURE OF PE



Where there is high exposure, Non-residents should *suo moto* disclose that it has a PE in India

- Pay taxes at the rate of 40% on the profits attributable to the PE in India; and
- File return of income considering the said profits. (*refer the slide on PE implication*)

3

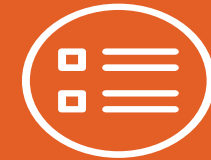
ALIGNING COMPENSATION MODEL



Aligning the compensation model to represent better ALP as per the FAR thereby subsuming the compensation for PE exposure

4

ADVANCE PRICING AGREEMENT



To cover all the existing and proposed transactions by filing an APA



Risk Mitigation Strategies

To mitigate the potential PE exposure for any non-resident in India, in respect of the services provided, Companies can evaluate the following options:

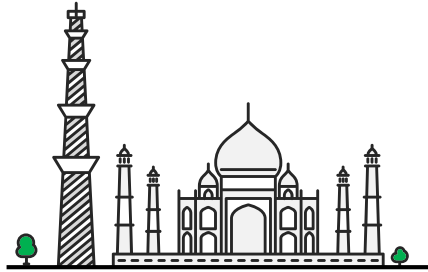
- Introductory meeting with consultants to raise awareness and present an overview of the changing landscape alongside current and future regulatory challenges.
- Carry out audit of the current setup
- Operational practice of documented policies and procedures
- Sufficient coverage through a rules-based review of the procedures and policies applied to each business line and territory
- Improvements to the internal control framework and identification of opportunities for tax efficiencies
- Reducing the risk of unexpected tax payments by minimizing the risk of errors including interest charges and penalties
- The ability to make relevant disclosures to tax authorities showing appropriate measures have been taken to manage PE issues

Contact us



HYDERABAD

Suite 5, Level 3, Reliance Cyber Ville,, Madhapur, Hitech City, Hyderabad – 500081



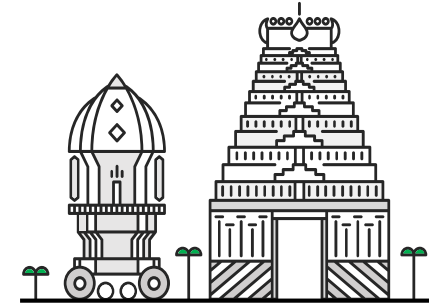
DELHI

C- 699A, 1st Floor, Sector-7, Palam Extn., Dwarka, New Delhi, Delhi 110075



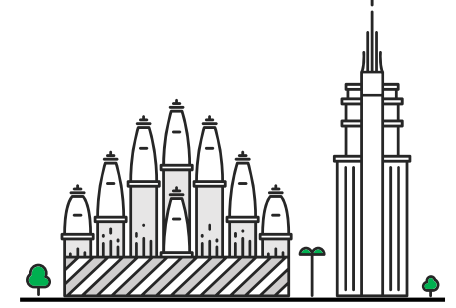
MUMBAI

Flat no.3, Plot no.226/227, Sion East, Mumbai - 400022



CHENNAI

Old no 19, New no 13B, New Bangaru colony first Street, KK Nagar West, Chennai 600078



BANGALORE

90/1, 3rd Floor, Pasha South Square, Rathavilas Road, Basavangudi, Bangalore - 560004

Vizag: Level 3, Kupilli Arcade, Akkayyapalem, Visakhapatnam 530016, Andhra Pradesh

Vijayawada: # 56-11-3, Sri Devi Complex, Y.V.R Street, MG Road, Patamata, Vijayawada, Andhra Pradesh

Tirupati: H. No: 6-154/1, Syamala Nilayam, Near Water Tank, Akkarampalli, Tirupathi, Andhra Pradesh

Kurnool: #21, Top Floor, Skandanshi Vyapaar, New Bus Stand Road, Kurnool 518 003, Andhra Pradesh



UAE Address: 2103, Bayswater Tower, Business Bay, Dubai, UAE



USA Address: SBC LLC, 8 The Green, Suite A in the City of Dover, Delaware - 19901

Thank You



www.steadfastconsultants.in