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TAXMANN

Course Material

M.A. (INTERNATIONAL TAXATION)

1.2.5. PERMANENT ESTABLISHMENT

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PERMANENT ESTABLISHMENT

Module I

1. Introduction

If a company is incorporated in India, its earnings are subject to Indian taxation. India has the authority to tax a company's global income on the basis of the "residential base" of taxation. India also has the power to tax the foreign company's income to the extent that the source of income is in India. According to the Indian Income Tax Act, 1961, if a foreign company's income is received or deemed to be received in India, or is accrued/ arisen or deemed to have accrued/ arisen in India, the source of such income is said to be in India, then India has the right to tax such income under the principle of "source base" taxation. If a foreign company has a long-term presence in India for the purpose of conducting business, the revenue received by such company, to the extent that it is due to their presence in India, becomes taxable in India. The concept of Permanent Establishment (PE) is derived from this rationale.

The most important issue in the treaty based international fiscal law is the concept of Permanent Establishment (PE).All the three model conventions namely, UN (United Nations) Model, OECD (Organisation for Economic Co-operation and Development) Model and US (United States of America) Model use PE as the main instrument to establish taxing jurisdiction over a foreigner's business activities.

2. General Definition (Article 5, Paragraph 1)

Under the Income-tax Act, 1961, the taxability of business profits is determined by existence of business connection in India under section 9(1)(i). Under the DTAA, taxability of business profits is determined by existence of a Permanent Establishment (PE) in India. It may be noted that the scope of business connection under section 9(1)(i) is wider than that of a PE.

Article 5(1) of the DTAA usually provides that for the purpose of this convention, the term 'Permanent Establishment' means a *fixed place of business through which the business of an enterprise is wholly or partly carried on*. The term PE is also defined under section 92F(iiia) to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

3. Underlying Concepts

According to the concept of PE, the profits of an enterprise of one Contracting State are taxable in the other state, only if the enterprise maintains a PE in the later state and only to the extent that profits are attributable to the PE. Thus, as a legal concept, PE is a compromise between source state and residence state for purposes of taxation of business profits. The term must be understood so as to arrive at that degree of economic penetration, which according to treaty partners justifies a nation in treating a foreign person in the same manner as domestic persons. Profits attributable to a PE, in the State of Source are either exempted in State of Residence or the State of Residence allows credit of taxes paid by the PE on such profits. To this extent, the taxing jurisdiction by the State of Residence is said to be transferred to the State of Source, where the person needs to file his return of income and comply with domestic tax laws.

"The words 'permanent establishment' postulate the existence of a **substantial element** of an **enduring or permanent nature** of a foreign enterprise in another country which can be attributed to a **fixed placed of business** in that country. It should be such as that it would amount to a **virtual projection** of the foreign enterprise of one country into the soil of another country."

Overview of articles of OECD Model Commentary is as under:

Article No.	**Particulars**	**Type of PE**
Article 5(1)	Basic rule	Fixed base PE
Article 5(2)	Illustrative list of PE	Inclusions to fixed base PE
Article 5(3)	PE in relation to projects	Construction PE & Service PE
Article 5(4)	List of exclusions	Exclusion from fixed base PE
Article 5(5) & (6)	Dependent/ Independent agent	Agency PE
Article 5(7)	Associated enterprise	Subsidiary PE

Note: Article 5(6) in UN Model contains a special rule for agents of insurance company and is absent in OECD and US Model.

4. Three Tests

The following conditions must be fulfilled to determine the existence of a PE:

1. Place of Business Test
   a) The Place of Business Test
   b) The Location Test
2. Power of Disposition Test
   a) The Right of Use Test
   b) The Permanence Test
3. Functional Test
   a) The Business Activity Test
   b) The Business Connection Test

5. Place of Business Test

A distinguishing feature of the PE for source-taxation based on the enterprise´s trade or business is the requirement of a "fixed place of business". Article 5 (1) of the OECD model defines the term PE emphasizing its essential nature as a "fixed place of business" with a specific "situs". Although there is no definition of "fixed place of business" as such in the OECD Model Convention, the test is composed of three elements:

- the existence of a "place of business", i.e., a facility such as premises or, in certain instances, machinery or equipment;

- this place of business must be “fixed”, i.e., it must be established at a distinct place with a certain degree of permanence; and
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons (personnel) not “independent” of the enterprise conduct its business in the State in which the fixed place is situated.

5.1. ‘Fixed’ Place of Business

Place of business testhave two folds. First, there must be a “**place of business**” and second, the place of business must be “**fixed**” in terms of location of the place of business. Normally, a place of business would postulate not merely a place but a place together with physical objects, which would be required to carry on business activity. It may be noted that a place of business could exist even if no employees are employed there. Illustratively, any equipment (such as, vending machines, telephone exchange, pipeline etc.) which is installed and which can function without the presence of any employee could constitute a PE provided the other conditions for a PE that are mentioned in Article 5(1) are satisfied. The place of management, though considered a PE, requires existence of an office or similar facility in order to constitute a PE and the management activities should be conducted through such fixed place. In other words, to constitute a PE, the existence of physical presence is must.

5.2. Location Test

The place of business must be a fixed place. The residence of an employee may also be treated as a PE if the same if used as office for business.

The “**location test**” has its roots in the ‘base theory’, which requires a fairly fixed place of business in the other country. It should be linked to a specific geographical point in the Source State. Location test would exclude place of business that are mobile. At the same time, however, it would not exclude a movable place of business. Thus, a petroleum drilling rig may constitute a PE even if it is moved rather frequently from one location to another.

6. <u>Power of Disposition Test</u>

A place of business may constitute a PE of an enterprise if that place is “at the disposal of” the enterprise.

It is, therefore, generally accepted that no legal title is required to use a particular place of business. The Commentary on Article 5 of the UN Model notes, in particular that “It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise.”

The normal rule is that the place of business should be that of the non-resident enterprise and not of anyone else. The requirement is that the place of business should be at the disposal of the enterprise. As a corollary, what is material is the right to use the place and not the manner in which such right has been secured; i.e., whether the place is owned, rented or otherwise at the disposal of the enterprise.

The right to use could be legal right to use and factual right to use. The enterprise should have the premises or facilities at its disposal. This implies that the place should be available to the enterprises for carrying on its business without any hindrance.

Example: A chartered accountant or Advocate were to use the facilities of his client, it would be doubtful whether he could be considered to have the place at its disposal and consequently, it is not likely to be considered as his PE. It may be noted that mere user of a place of business would not be sufficient to constitute that place as a PE since there would not be a legal right. However, if the chartered accountant or advocate has entered into an arrangement with the client whereby the chartered accountant or advocate would handle the assignment from a particular place in the client's premises, such place may be considered to be at its disposal and consequently, it may be considered to have PE. This may be so even if the assignment being handled is of that particular client. Similarly, a person who carries on business from a room in the house or a hotel where he is staying, may also be considered to have PE notwithstanding that there may not be a specific agreement between him and the landlord or the hotel to use the house or the hotel room for business, or that such user is contractually or legally prohibited.

Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a "place of business through which the business of [that] enterprise is wholly or partly carried on" will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there.

Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise.

This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous basis during an extended period of time. This will not be the case, however, where the enterprise's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time).

Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise. It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if paragraph 4 applies to the business activities carried on at that place.

Example: Salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a place of business through which the business of that enterprise is carried on.

6.1. Permanence Test

The place of business must be for a fixed and reasonably longer period of time. The term **'carried on'** in the defination connotes that a mere passing, transient or casual activity, though carried out from a particular place, does not fall within the scope of the defination of PE. There should be a reasonable degree of **continuity and regularity**.

In order for a place of business to be "*fixed*", it is also necessary that the presence of the business is not of a temporary nature. According to the Article 5 of the OECD Model Convention, a *six-month* time limit is normally considered long enough to be considered to be "fixed". However, States and domestic courts diverge when it comes to determining the minimum period of time needed to establish a PE.

In case of permanence test, the place of business should have a certain degree of permanence. A place, which is purely of a temporary nature, would not constitute a PE. However, if the intention at the time when the place of business was set up for a fairly long time, it could constitute PE even if the activities terminated after a short period of time.

The term "permanence" should be understood as continuing for an indefinite period and not something that would continue or last forever. In other words, it is not necessary that the right to use the place of business should be perpetual.

While there is no specific time period that would bring in 'permanence', in several countries, even a period of six months may be sufficient to constitute a PE.

7. Concept and Scope Functional Test

The mere existence of a fixed place of business or the ownership of assets (say, office and equipment) by itself would not be sufficient to constitute a PE. The place of business should actually carry on business activities.

The activity performed through the place of business should be the business of the enterprise. This requires four separate tests to be satisfied.

1. The activity conducted by the enterprise must be business under the domestic law of the State where the activity is performed. It should be distinguished from other income generating activities or investments.
2. Even if the activity is classified under the domestic law of business activities, it should be treated as business activity under the Article dealing with business profits (Article 7 in case of UN Model Convention).
3. The activity should not be of a preparatory or auxiliary character which is referred to in Article 5(4) of the Model.
4. The business activity must have a certain connection to the place of business.

An enterprise performing a "business activity" and maintaining a fixed place of business in another country may still not have a PE in such country. The PE definition establishes that the business activities must be carried on "through" a fixed place of business.

8. Positive Examples of PEs

Paragraph 2 to Article 5 sets out a list of places, which prima facie will constitute a PE. In no way can this list be said to be exhaustive as it is mainly indicative. An important point to be borne in mind here is that the OECD observes that it is assumed the list of examples will be interpreted by treaty states in accordance with the principles of paragraph 1.

The list of places are:

- Place of management
- Branch
- Office
- Factory
- Workshop
- Mine, oil or gas, quarry or any other place of extraction of natural resources

The list of places mentioned is more by way of illustration. Hence, even an establishment which is not mentioned therein could well constitute a PE.

It may be noted that merely because an establishment is of the nature mentioned in Article 5(2), it need not be treated as PE. For such an establishment to be treated as PE, it should first have the indicia of a PE that are set out in Article 5(1).

Place of management: Management means the possession of actual decision making power. The place where the person actually makes these decisions is crucial, irrespective of the title that he or she bears. Further, it must be noted that management does not mean ownership.

Place of management exists where **'control and management'** of an enterprise reside.

Branch: 'Branch' is one of the most common terms appearing in treaty specifications of PE; but the same has not been defined. Generally, we understand a branch to mean an office or other establishment of a corporation incorporated under the laws of a country other than the one on which the branch is located.

When a non-resident enterprise has a branch in India, then it is usually regarded as a PE of the non-resident enterprise.

Office: The term 'office' is used in almost all tax conventions entered into between countries. A single desk or even an office at home can be treated as an office leading to the constitution of a PE.

It generally means a fixed place, room, and building from where the business is carried on.

Factory: The term factory has been defined as a building in which goods are manufactured. Farms and shipyards are not regarded as factories.

Workshop: Workshop refers to the place where industrial process is carried on. It generally means any place in which collective manual labour, under an employer is done by way of trade, making, repairing etc.

In addition to the above, **Mines, Oil and Gas well, Quarry, Oil exploration,** etc. are also treated as existence of a PE in India.

9. Construction and Service PEs (Article 5,Paragraph 3)

Article 5(3) specifically includes two kinds of activities, which together with an establishment would constitute PE. These activities constitute what are commonly referred to as 'construction' and 'service' and the rules which determine the existence of the PE are referred to as 'construction rule' and 'service rule'. Under these rules, a PE comes into existence if the enterprise is carrying on the activities mentioned in the respective rules for certain period.

A Construction PE exists when the construction site or an installation project is carried out for a period more than the prescribed period under the respective Tax Treaty with that country.

Different kinds of Construction PE are formed under following activities:

- **Project**: A project is a larger or major undertaking involving considerable money, machine and manpower. A project may be a single project or multiple projects. In some of the treaties, the number of days spent on each of the projects need to be aggregated to compute the number of days spent on projects in India while in others, such aggregation is not required. The connectivity of various projects can be established based on various factors such as geographical connections, technical connections, same client, unity of contractual obligations or unity of execution etc.
- **Building site or construction project**: 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 clause related to Supervisory activities is included only in some of the tax treaties as far as India is concerned.

It is seen in most of the treaties that if any of the above activities are carried out in India for a period of more than 6 months or if the charge payable for the project or supervisory activity exceed 10% of the sale price of machinery and equipment, the same is regarded as Construction PE. The duration of the project and percentage of payment towards supervisory activity will vary from Treaty to Treaty with various countries.

Many Indian Treaties provide for existence of Service PE if the foreign enterprise renders services (Other than Fees for Technical Services) in India through employees or other personnel, if the duration of such services in India exceeds a threshold limit. Generally, the Indian treaties provide for a threshold limit of 90 to 120 days if the services are rendered to unrelated enterprises and 1 to 30 days if such services are rendered to associated enterprise.

10. Exclusions (Article 5, Paragraph 4)

Most of the Indian Treaties provide for activities that are specifically excluded from the purview of PE. In such cases, they are **not regarded as PE** even if any of those activities are carried out through a fixed place of business. These activities are:

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; or
(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Whether an activity in India can be considered as preparative or auxiliary will depend up on the facts and circumstances of each case. Generally, if an activity of the fixed place of business forms an **integral and significant part of the activity** of the foreign enterprise as a whole or is identical with the main purpose and object of the parent enterprise, such activities will not be regarded as preparative or auxiliary in character. Even if a part of the activities performed in India **directly contributes to the earning of revenue**, the activities cannot be treated as preparatory or auxiliary in nature. Activities of **Liaison Office** in India which generally acts as a communication link between the foreign Company and vendors or customers in India is that of preparatory and auxiliary and therefore a Liaison Office, in normal case, is not considered to be a PE in India.

11. Dependent Agents (Article 5, Paragraph 5)

Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 6 applies is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts *in the name of the enterprise*, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

For paragraph 5 to apply, all the following conditions must be met:

- a person acts in a Contracting State on behalf of an enterprise;
- in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
- these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

12. Agent of an Independent Status (Article 5, Paragraph 6)

An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as independent agents.

However, an agent will not constitute dependent agents of its principal if he is an "agent of an Independent status". Following factors will determine the independency of such agent:

(a) Legally as well as economically, he is independent of the foreign enterprise on whose behalf he acts,
(b) When acting on behalf of the foreign enterprise, he acts in the ordinary course of business,
(c) Whether the agent represents multiple principals,
(d) Extent to which the agent bears "entrepreneurial risk",
(e) Extent to which the agent is subject to control and direction from the foreign enterprise.

Determination of independence is a factual exercise and all the facts and circumstances must be taken into account before concluding whether he is an agent of independent agent.

12.1. Legal and Economic Independence of the Agent

Legal Independence:

- 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.
- Agents must not be subject to detailed instructions and control with respect to the conduct of their business.
- Principals should not be in a position to exert a decisive influence on the business of their agents.
- Agents must be able to conduct their business according to their own viewpoints, competence and methodologies.

Economic Independence:

- Agents should be able to conduct their businesses independently and not be dependent on their principals for their economic viability.
- They should bear the risk of loss arising from their activities.
- They should not be wholly and exclusively dependent on their principals. The number of principals represented by an agent determines its economic independence.

12.2. Agent Acting in the Ordinary Course of its Business

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.

The key principles:

- Conduct of an agent vis-à-vis that of the principal;
- Comparison of an agent's activities with those of other agents undertaking similar agency functions; and
- Whether activities engaged in by agents are customary to their trade as brokers, commission agents, etc.

Agents should not undertake activities that form an economic component of the range of activities engaged in by their principals.

13. The Subsidiary-PE Clause (Article 5, Paragraph 7)

A permanent establishment is, however, not always easy to identify. This is particularly true where a permanent establishment is hidden behind a dependent operating company, i.e., if an operating company in addition to its own business also carries on another company's business as a permanent establishment of the latter. In this regard, the 2010 OECD Model Tax Convention (the 'OECD Model') states in Article 5(7) that:

'The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other'.

This follows from the principle that, for the purpose of taxation, such a subsidiary constitutes an independent legal entity. Accordingly, both companies are subject to unlimited tax liability in the State in which they are resident or where their place of management is located.

However, by using the wording 'not of itself', the provision clarifies that a parent company (parent) can have an (agent) permanent establishment in its subsidiary's State of residence if the general requirements for a permanent establishment set out in Article 5(1) to (5) of the OECD Model are met. Accordingly, any space or premises belonging to the subsidiary that is at the disposal of the parent (the 'right-to-use test') and that constitutes a fixed place of business (the 'location test' and the 'duration test') through which the parent carries on its own business (the 'business activity test'), gives rise to a permanent establishment of the parent under Article 5(1), subject to Article 5(3) and (4), of the OECD Model. In addition, under Article 5(5) of the OECD Model, a subsidiary constitutes an agency permanent establishment of its parent if the subsidiary has the authority to conclude contracts in the name of its parent and habitually exercises this authority, unless these activities are limited to those referred to in Article 5(4) or unless the subsidiary does not act in the ordinary course of its business as an independent agent within the meaning of Article 5(6).

14. Comparative Analysis of PEs in Different DTAAs

There are different models developed over a period based on which treaties are drafted and negotiated between two nations. These models assist in maintaining uniformity in the format of tax treaties. They also serve as checklist for ensuring exhaustiveness or provisions to the two negotiating countries.

OECD Model, UN Model and the US Model are are the most prominent and often used models.

Differences b/w the UN and Organisation for Economic Development and Co-operation (OECD) Model Tax Conventions are:

i. There is a six-month test for a building or construction site constituting a permanent establishment, rather than the twelve-month test under the OECD Model Convention, and it expressly extends to assembly projects, as well as supervisory activities in connection with building sites and construction, assembly or installation projects (paragraph 3 (a));
ii. the furnishing of services by an enterprise through employees or other personnel results in a permanent establishment where such activities continue for a total of more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned (paragraph 3 (b));
iii. Article 14 (Independent personal services) has been retained, whereas in the OECD Model Convention, Article 14 has been deleted, and Article 5 addresses cases that were previously considered under the "fixed base" test of that Article. As noted below, while the United Nations Model Convention has retained Article 14, the present Commentary provides guidance for those countries not wishing to have such an article in their bilateral tax agreements;
iv. in the list of what is deemed not to constitute a permanent establishment in paragraph 4 (often referred to as the list of "preparatory and auxiliary activities") "delivery" is not mentioned in the United Nations Model Convention but is mentioned in the OECD Model Convention. Therefore, a delivery activity might result in a permanent establishment under the United Nations Model Convention, without doing so under the OECD Model Convention;
v. the actions of a "dependent agent" may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (paragraph 5 (b));
vi. there is a special provision specifying when a permanent establishment is created in the case of insurance business; consequently, a permanent establishment is more likely to exist under the United Nations Model Convention approach (paragraph 6).

15. <u>BEPS Action Plan 7</u>

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.

The particular focus of Action 7 is the artificial avoidance of the permanent establishment status by tax-motivated constructions.

This report includes changes to the definition of permanent establishment (PE) in the OECD Model Tax Convention that will address strategies used to avoid having a taxable presence in a country under tax treaties.

These changes will ensure that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.

Thus, the following steps have been advocated:

- **Reworking exceptions to PE definition** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are 'preparatory or auxiliary'.
- **Analyzing arrangements entered through contractual agreements** –A Commissionaire arrangement may be broadly defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Commissionaire arrangements have been a major cause of concern for tax administrations in many countries.

The 2017 update to OECD and UN MC on Article 5 paragraphs 5 and 7 addresses the artificial avoidance of PE status through commissionaire arrangements and similar strategies.

Article 5(5) of the OECD/UN/US Model refers to what is popularly known as "Agency PE". It contains a deemed inclusion clause and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in Source State even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in State of Source within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold of six or twelve months, as the case may be).

As per the 2017 update to OECD and UN MC, for paragraph 5 to apply, all the following conditions must be met:

(i) a person acts in a Contracting State on behalf of an enterprise;

(ii) in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and

(iii) these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

Additional Guidance on attribution of profits to PEs under BEPS Action Plan 7

The March 2018 report contains additional guidance on the attribution of profits to permanent establishments resulting from the changes in the Report on BEPS Action Plan 7 to Article 5 of the OECD Model Tax Convention. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1).

Progress in implementation of BEPS Action Plan 7

The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the MLI (Articles 12 to 15). The Multilateral Instrument (MLI) is a flexible instrument that allows jurisdictions to adopt BEPS treaty-related measures to counter BEPS and strengthen their treaty network. The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes.

Indian Taxation Regime

The OECD, under BEPS Action Plan 7, reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities. In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended modifications to Article 5(5) to provide that an agent would include not only a person who habitually concludes contracts on behalf of the nonresident, but also a person who habitually plays a principal role leading to the conclusion of contracts. Similarly Action Plan 7 also recommends the introduction of an anti-fragmentation rule as per paragraph 4.1 of Article 5 of OECD Model tax conventions, 2017 so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise a whole activity in order to avail the benefit of exemption under paragraph 4 of Article 5 of DTAAs.

Further, with a view to preventing base erosion and profit shifting, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to implement Tax Treaty Related Measures (MLI), to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where treaty partner has also opted for Article 12. As a result, the DAPE provisions in Article 5(5) of India's tax treaties, as modified by MLI, became wider in scope than the erstwhile provisions in Explanation 2 to section 9(1)(i). Similarly, the anti-fragmentation rule introduced as per paragraph 4.1 of Article 5 of the OECD Model Tax Conventions, 2017 has narrowed the scope of the exception under Article 5(4), thereby expanding the scope of PE in DTAA vis-a-vis domestic provisions contained in Explanation 2 to section 9(1)(i). In effect, the relevant provisions in the DTAAs became wider in scope than the domestic law.

However, section 90(2) of the Income-tax Act, 1961 provides that the provisions of the domestic law would prevail over corresponding provisions in the DTAAs, to the extent they are beneficial. Since, in the instant situations, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAAs, as modified by MLI, such wider provisions in the DTAAs would become ineffective, unless the provisions of domestic law are appropriately amended.

In view of the above, section 9(1)(i) was amended to align the same with the provisions in the DTAA as modified by MLI so as to make the provisions in the treaty effective. Accordingly, section 9(1) (it was amended by the Finance Act, 2018) to provide that "business connection" shall also include any business activity carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. Such contracts should be-

(i) in the name of the non-resident; or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or
(iii) for the provision of services by that non-resident.

16. <u>Dependent and Independent Personnel</u>

16.1. Independent Personnel

Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

The term “professional services” includes especially independent scientific, literary artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.”

16.2. Dependent Personnel

Remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

SIGNIFICANT SELECTED CASES

<table>
<tr><th>S. No.</th><th colspan="2">Case Law</th></tr>
<tr><td rowspan="3">1.</td><td colspan="2">DIT (International Taxation) Vs. Morgan Stanley and Co. Inc. [(2007) 292-ITR-416 (SC)]</td></tr>
<tr><td>Issue</td><td>Decision</td></tr>
<tr><td>When does an assessee constitute a fixed place PE/ agency PE/ service PE in India? Does stewardship activity result in a service PE? Can a non-resident be taxed in India if it remunerates its associated enterprise which constitutes its permanent establishment in India on an arm’s length basis?</td><td>Supreme Court held that “A general definition of P.E. in the first part of Article 5(1) postulates the existence of a fixed place of business where the second part of Article 5(1) postulates that the business of the MNE is carried out in India through such fixed place.”

The second requirement of Article 5(1) of DTAA is not satisfied as regards back office functions. SC have examined the terms of the Agreement along with the advance ruling application made by MSCo inviting the AAR to give its ruling. It is clear from reading of the above agreement/application that MSAS in India would be engaged in supporting the front office functions of MSCo in fixed income and equity research and in providing IT enabled services such as data processing support centre and technical service as also reconciliation of accounts. In order to decide whether a P.E. stood constituted one has to undertake what is called as a functional and factual analysis of each of the activities to be undertaken by an establishment. It is from that point of view, SC are in agreement with the ruling of the AAR that in present case Article 5(1) is not applicable as the said MSAS would be performing in India only back office operations. Therefore to the extent of the above back office functions the second part of Article 5(1) is not attracted.”</td></tr>
</table>

		"As regards attribution of further profits to the PE of MSCo where the transaction between the two are held to be at arm's length, SC hold that ruling is correct in principle provided that an associated enterprise (that also contribute a PE) is remunerated on arm's length basis taking into account all the risk taking functions of the multinational enterprise. In such a case, nothing further would be left to attribute to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, therewould be need to attribute profits to the PE for those functions/risks that have not been considered."
2.	**Motorola Inc Vs. Deputy Commissioner of Income Tax [(2005) 95-ITD-269(SB)]**	
	Issue	**Issue**
	Whether the activities of the non-residents result into a business connection/ Permanent Establishment ('PE') in India, merely because the non-residents had wholly owned subsidiary in India?	No income is deemed to accrue in India to a non-resident from the sale of hardware and software if such sale is effected outside India to an Indian purchaser even tough the non-resident supplier, along with other group companies, has entered into a turnkey contract for supply and installation of equipment in India and the non-resident supplier assumes overall responsibility for the proper execution of said turnkey contract. In such a situation, as the sale of the equipment is affected outside India and the title and the risk therein passes to the Indian purchaser outside India, there is no business connection in terms of domestic tax law between the Non-resident supplier and the Indian purchaser. A PE i.e., a fixed place of business of a non-resident would exist in India if one is able to point to a physical location at the

		disposal of the non-resident through which its business is carried on in India. Employees of the non-resident supplier having use of its Indian subsidiary's office as a matter of right would constitute a PE of the non-resident supplier in India. The existence of a liaison office in India, of a non-resident does not, in itself, constitute its PE in India. A wholly owned subsidiary of a non-resident in India would constitute its PE in India if, their mutual relationship leads to the distinction between these two corporate entities becoming blurred and a reasonable inference can be drawn that the subsidiary was a virtual projection of the supplier in India. In case of Motorola, the facts of the case showed that the employees of the Motorola was using the premises of the subsidiary not only for the work of Motorola but were also working for Motorola's Indian subsidiary. While Motorola paid salaries to these employees, its Indian subsidiary provided them perquisites, which Motorola reimbursed to the subsidiary with a mark up. The special bench held without discussion that this led to a perception of the subsidiary being a projection of the activities of Motorola in India and hence a PE of Motorola could be said to be constituted in India. On facts it was however established that the activities carried on by the employees (the PE) were preparatory and auxiliary in character and because, as per Article 5(3) (e) of the DTAA between India and USA, there was a specific exclusion from the constitution of a PE by the carrying on of such activities, the Special Bench held

		that no PE of Motorola was constituted in India.
3.	**Formula One World Championship Ltd. V. CIT [2017] 80 (SC)**	
	Issue	**Decision**
	Whether the international circuit for formula one race constitutes a fixed place of business under the India-U.K. tax treaty? Whether such international circuit was under the control and at the disposal of the taxpayer?	Article 5(1), 5(2), 5(3), when read combinedly, it provides that only certain forms of establishments would not form a Permanent Establishment which are excluded in Article 5(3). Where, Article 5(2) provides the word 'includes' which means that the list of inclusions is not exhaustive and it might include the places that are not specified as PE. For any establishment to be a PE, the requirements laid down in Article 5(1) of the treaty shall be specified which includes: A) Existence of a fixed place of business B) An enterprise is wholly or party carried out through that place of business. In the given case, it could not be denied that the Buddh International Circuit is a fixed place since from the said circuit, different races including the Grand Prix is conducted, which is a business activity. There is no possibility of conducting a race without the competing teams, a paddock and a circuit, which were controlled by the taxpayer and its affiliates. An event by conduct of race has physically taken place in India and entire income is generated from the conduct of that event. Hence, commercial rights are with the taxpayer along with the physical control of the circuit. Thereby,

		omnipresence of the taxpayer and its stamp over the event stands loud, clear and firm. A PE must possess three qualities viz. stability, productivity and dependence. These all characteristics are present in the given case. Hence, there is no doubt that a taxable event has taken place in India and a non-resident taxpayer is liable to pay tax in India on income earned.
4.	**DIT v. E funds Corporation (2014) 226 Taxman 44 (Del)**	
	Issue	**Decision**
	Whether the various back-office services that are outsourced by a foreign enterprise to its Indian subsidiary constitute a Permanent Establishment of the foreign enterprise in India?	*Ruling of High Court in the given case:* **Fixed Place PE** The taxpayers did not have a) A fixed place of business in India through which the business of enterprise was wholly or partly carried on and; b) Right to use any of the premises belonging to E-fund India. Hence, Article 5(1) of the treaty cannot be invoked to constitute a PE in India. No PE would be created by itself, even if the foreign entities have saved and reduced their expenditure by transferring back-office operations to the Indian subsidiary. Moreover, the taxpayer did not have any branch office or factory or workshop in India and just because they have a subsidiary in India would not create a fixed place of business in India. If an enterprise enters into a contract, assigns or sub-contract works or render services to a third party on behalf of the principal, it would not lead to a subsidiary becoming a PE unless the

		requirements of Article 5 are satisfied. **PE due to place of management** In the given case, President of E fund India had provided management support services in UK and Australia while certain employees of South East Asia have provided marketing support services to E-fund India as well as E-fund group entities overseas. Accordingly, employees of the said entities reported to the president who in turn were reporting to E-fund Corporation. Above situation indicates that the said activities may have resulted in PE under Article 5(2)(a) under the head “Place of Management” but the said provision has not been invoked. The HC held that extent and timing of applicability of “Place of Management” principle in such cases, require findings of facts and cannot be made matters to be decided in first time of appeal before HC under section 260A of the Act. **Service PE** Employees of E-fund India were employees of the Indian entity and not the employees of the taxpayer. The words ‘employees and other personnel’ under the Article 5 of the tax treaty have to be read with the words ‘through’ and furnishing of services by the foreign enterprise within India. Hence, the employees and other personnel must be of non-resident to create a service PE.

		Agency PE A subsidiary, by itself, cannot be considered to be a dependent agent PE of the principal. However, a subsidiary can become a dependent or an independent PE agent provided the tests as specified under Article 5(4) and (5) are fulfilled. In the given case the conditions of Article 5(4) and (5) were not satisfied since E-fund India was authorised and habitually exercised authority to conclude contract or was maintaining stock or merchandise from which it delivered goods or merchandise on behalf of taxpayer or secured orders on behalf of taxpayer. The fact that E-fund India had provided necessary inputs to E-fund Corp. or E-fund Inc. so as to enable them to enter into contracts which were assigned to E-fund India, will not make E-fund India, a PE of the taxpayer. According to Article 5(5), an agent is not considered to be an independent agent, if its activities are wholly or mostly wholly on behalf of foreign enterprise and the transactions between the two are not made under arm's length price. Both these conditions have to be satisfied to deny an agent, the character of an independent agent. In the given case, the transactions between the taxpayer and e-fund India were at arm's length principle and hence, requirements of Article 5(5) are not satisfied and resultantly, there was no

<table>
<tr><td></td><td></td><td>Agency PE of the taxpayer in India.

Attribution of Profits

The activities that were not undertaken by E-fund India and the assets of the taxpayer outside India, cannot be taken into account or attributed for income of the taxpayers.

The activities of the taxpayer broadly divided into four categories were interconnected and not independent. There shall be a fair, rational and logical method of apportionment.

The anomaly while computing the proportion of net income attributable to the PE was that the net income of the group less income of E-fund India was attributed to the group assets including the assets of E-fund India. The tribunal rectified the anomaly. Income declared and taxed in the hands of E-fund India, nothing remains to be attributed or taxed in the hands of taxpayers.

The case has been affirmed by the SC in the case of ADIT vs. E-funds IT Solutions Inc. (2017) 251 Taxman 280 (SC).</td></tr>
<tr><td rowspan="3">5.</td><td colspan="2">Samsung Heavy Industries Co. Ltd. v. DIT (2014) 221 Taxman 315 (Utt)</td></tr>
<tr><td>Facts</td><td>Ruling</td></tr>
<tr><td>The taxpayer being a foreign company having its project office in India entered into a contract with ONGC and L&T as consortium partners. Under the said contract, the taxpayer received revenue generated in respect of activities undertaken in India and also outside India. With</td><td>Ruling of High Court in the given case:

There were no findings recorded by the tax authorities that the revenue earned by the taxpayer were received on account of activities which were undertaken within India. According to the treaty, if an enterprise does not have a Permanent Establishment in India, the enterprise is</td></tr>
</table>

	respect to activities undertaken in India, the taxpayer incurred certain expenses and after deducting such expenses from the revenue generated, derived a loss of income and thus, filed loss return of income. **The AO refused to accept the deduction and also held that 25 percent of the revenues claimed by the taxpayer have been earned outside India and shall be brought to tax in India. The Tribunal confirmed the order of AO.**	not obligated to submit a return in India or pay tax to India. No evidence was recorded by the tax authorities to justify that the PO of the taxpayer is a PE in India through which it carried on the business and 25 percent of the gross receipts are attributable to the said business. The High Court held that the tax liability could not be proved without establishing that the same is attributable to the PE of the enterprise situated in India. The SLP has been granted in DIT v. Samsung Heavy Industries Co. Ltd. (2017) 245 Taxman 47 (SC).

Test Your Knowledge

QUESTIONS	
1.	The concept of Permanent Establishment is one of the most important concepts in determining the tax implications of cross border transactions. Examine the significance thereof, when such transactions are governed by Double Taxation Avoidance Agreements (DTAA).
2.	How will you determine the fixed place of business?
3.	List out the activities that are carried out through a fixed place of business but are not considered as PE.
4.	State the list of places which prima facie will constitute a PE.

SOLUTIONS	
1.	Double Taxation Avoidance Agreements (DTAAs) generally contain an Article providing that business income is taxable in the country of residence, unless the enterprise has a permanent establishment in the country of source, and such income can be attributed to the permanent establishment. As per section 92F(iiia), the term "Permanent Establishment" includes a fixed place of business through which the business of an enterprise is wholly or partly carried on. As per this definition, to constitute a permanent establishment, there must be a place of business which is fixed and the business of the enterprise must be carried out wholly or partly through this place. Section 9(1)(i) requires existence of business connection for deeming business income to accrue or arise in India. DTAAs, however, provide that business income is taxable only if there is a permanent establishment in India. As per section 90(2), the provisions of the Income-tax Act, 1961 or the DTAA, whichever is beneficial, shall apply. The PE concept is narrower than the business connection concept. Therefore, in a case where the Indian Government has entered into DTAA with a country, unless and until the PE test is satisfied, the business income would not be taxable in the source country. However, in cases not covered by DTAAs, business income attributable to business connection is taxable.
2.	Place of business test have two folds. First, there must be a "**place of business**" and second, the place of business must be "**fixed**" in terms of location of the place of business. Normally, a place of business would postulate not merely a place but a place together with physical objects, which would be required to carry on business activity. It may be noted that a place of business could exist even if no employees are employed there. Illustratively, any equipment (such as, vending machines, telephone exchange, pipeline etc.) which is installed and which can function without the presence of any employee could constitute a PE provided the other conditions for a PE that are mentioned in Article 5(1) are satisfied. The place of management, though considered a PE, requires existence of an office or similar facility in order to constitute a PE and the management activities should be conducted through such fixed place. In other words, to constitute a PE, the existence of physical presence is must.
3.	The cases when activities are not regarded as PE even if any of those activities are carried out through a fixed place of businessare: ***(a)*** The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; ***(b)*** The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; ***(c)*** The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

	(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; *(e)* The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; or *(f)* The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
4.	The list of places which prima facie will constitute a PE is as follows: • Place of management • Branch • Office • Factory • Workshop • Mine, oil or gas, quarry or any other place of extraction of natural resources The list of places mentioned ismore by way of illustration. Hence, even an establishment which is not mentioned therein could well constitute a PE. It may be noted that merely because an establishment is of the nature mentioned in Article 5(2), it need not be treated as PE. For such an establishment to be treated as PE, it should first have the indicia of a PE that are set out in Article 5(1). **Place of management**: Management means the possession of actual decision making power. The place where the person actually makes these decisions is crucial, irrespective of the title that he or she bears. Further, it must be noted that management does not mean ownership. Place of management exists where 'control and management' of an enterprise reside. **Branch**: 'Branch' is one of the most common terms appearing in treaty specifications of PE; but has not been defined. Generally, we understand a branch to mean an office or other establishment of a corporation incorporated under the laws of a country other than the one on which the branch is located. When a non-resident enterprise has a branch in India, then it is usually regarded as a PE of the non-resident enterprise. **Office**: The term 'office' is used in almost all tax conventions entered into between countries. A single desk or even an office at home can be treated as an office leading to the constitution of a PE. It generally means a fixed place, room, and building from where the business is carried on. **Factory**: The term factory has been defined as a building in which goods are manufactured. Farms and shipyards are not regarded as factories. **Workshop**: Workshop refers to the place where industrial process is carried on. It

	generally means any place in which collective manual labour, under an employer is done by way of trade, making, repairing etc. In addition to the above, **Mines, Oil and Gas well, Quarry, Oil exploration,** etc. are also treated as existence of a PE in India.

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	2.1.	Agents having Independent Status - Not included in Business Connection
	2.2.	Significant Economic Presence
	2.3.	Not a Business Connection in India - Non-resident
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4.	Profit Attribution to Permanent Establishment	
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1. <u>Introduction</u>

'Business connection' has for long been recognized as a mode of determining the tax liability of non-residents.

Foreign enterprises for the purpose of Indian Income Tax Act, 1961 are the enterprises that are incorporated outside India or that do not have their place of effective management in India. Section 5(2) read with section 4 of the Income Tax Act provides that the total taxable income of foreign enterprises will include all incomes (including business profits as per section 2(24) of the Income Tax Act) that are received in India or accrue or arise in India or are deemed to be received or deemed to accrue or arise in India.

Under Section 9(1)(i) of the Income Tax Act, income accruing or arising (whether directly or indirectly) "through or from any business connection in India" shall be deemed to accrue or arise in India and shall be taxable in India. Explanation 2 of section 9 of Income Tax Act defines "business connection" to include business activities carried out through dependent agents (that is, those who habitually conclude contracts in the name of the foreign enterprise) but does not include activities carried out through a broker, general commission agent, or any other agent having an independent status.

The business profits of a foreign enterprise may be taxed in India if the business profits either accrue or arise in India, they are received in India, or where they are linked to a business connection in India.

2. <u>What is Business Connection? [Explanation 2 to section 9(1)(i)]</u>

'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident.

For a business connection to be established, the person acting on behalf of the non-resident –

(a) must have an authority, which is habitually exercised in India, to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and such contracts are
   - in the name of the non-resident; or
   - for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
   - for the provision of services by that non-resident, or

   Note - This amendment in the definition of "business connection" is for the purpose of alignment with the provisions of the Double Taxation Avoidance Agreement (DTAA) as modified by Multilateral Instrument (MLI) so as to make the provisions in the treaty effective.

(b) in a case, where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or

(c) habitually secures orders in India, mainly or wholly for the non-resident.

Further, there may be situations when the person acting on behalf of the non-resident secures order for other non-residents. In such situation, business connection for other non-residents is established if,

i. such other non-resident controls the non-resident or
ii. such other non-resident is controlled by the non-resident or
iii. such other non-resident is subject to same control as that of non-resident.

In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.

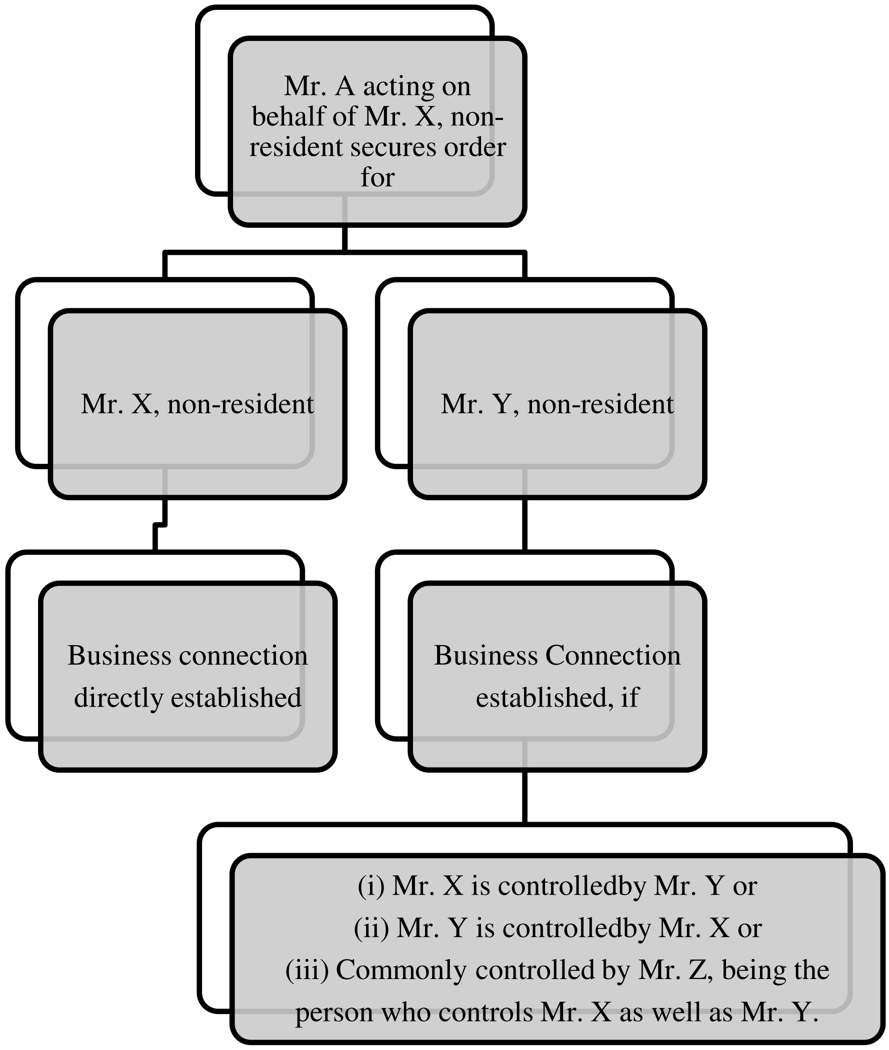

Fig. When Business Connection for other Non-residents is Established

2.1. Agents having Independent Status - Not included in Business Connection [Explanation 3 to Section 9(1)(i)]

Business connection, however, shall not be established, where the non-resident carries on business through a broker, general commission agent or any other agent having an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident.

He will, however, not be considered to have an independent status in the three situations explained above, where he is employed by such a non-resident.

Where a business is carried on in India through a person referred to in (a), (b) or (c) of (i) above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

2.2. Significant Economic Presence [Explanation 2A to section 9(1)(i)]

Significant economic presence of a non-resident in India shall also constitute business connection in India.

Significant economic presence means-

	Nature of transaction	Condition
(a)	in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India	Aggregate of payments arising from such transaction or transactions during the previous year should exceed Rs. 2 crores.
(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India	The number of users should be atleast 3 lakhs.

Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;
(ii) the non-resident has a residence or place of business in India; or
(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

2.3. Not a Business Connection in India - Non-resident

In the case of a Non-resident, the following shall not, however, be treated as Business Connection in India [Explanation 1 to section 9(1)(i)]:

(a) **In the case of a business, in respect of which all the operations are not carried out in India [Explanation 1(a) to section 9(1)(i)]:** In the case of a business, other than the business having business connection in India on account of significant economic presence, of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.

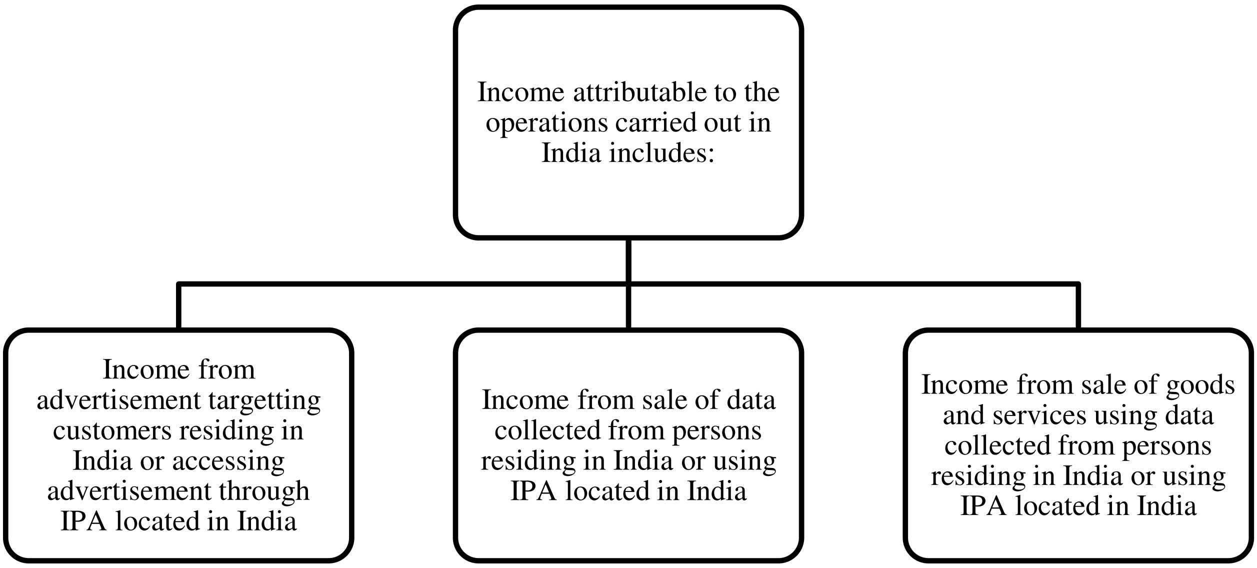

Fig. Income Attributable to the Operations Carried out in India

Note: IPA – Internet Protocol Address

The above provisions would also apply to the income attributable to the transactions or activities referred to in Explanation 2A to section 9(1)(i).

(b) **Purchase of goods in India for export [Explanation 1(b) to section 9(1)(i)]:** In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

(c) **Collection of news and views in India for transmission out of India [Explanation 1(c) to section 9(1)(i)]:** In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

(d) Shooting of cinematograph films in India [Explanation 1(d) to section 9(1)(i)]: In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, If such non-resident is:

- an individual, who is not a citizen of India or
- a firm which does not have any partner who is a citizen of India or who is resident in India; or
- a company which does not have any shareholder who is a citizen of India or who is resident in India.

(e) Activities confined to display of rough diamonds in SNZs [Explanation 1(e) to section9(1)(i)]: In case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any special zone notified by the Central Government in the Official Gazette in this behalf.

3. <u>Exclusions from Business Connection [Section 9A]</u>

Certain activities not to constitute business connection in India —

Notwithstanding anything contained in sub-section (1) of section 9 and subject to the provisions of this section, in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund.

Notwithstanding anything contained in section 6, an eligible investment fund shall not be said to be resident in India for the purpose of that section merely because the eligible fund manager, undertaking fund management activities on its behalf, is situated in India.

The eligible investment fund referred to in sub-section (1), means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfils the following conditions, namely:—

(a) the fund is not a person resident in India;
(b) the fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A has been entered into;
(c) the aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five per cent. of the corpus of the fund;
(d) the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;
(e) the fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten per cent.;
(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent.;
(h) the fund shall not invest more than twenty per cent. of its corpus in any entity;
(i) the fund shall not make any investment in its associate entity;
(j) the monthly average of the corpus of the fund shall not be less than one hundred crore rupees:

Provided that if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than one hundred crore rupees at the end of such previous year;
(k) the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India;
(l) the fund is neither engaged in any activity which constitutes a business connection in India nor has any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf;
(m) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the arm's length price of the said activity:

Provided that the conditions specified in clauses (e), (f) and (g) shall not apply in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund, or such other fund as the Central Government may subject to conditions, if any, by notification in the Official Gazette, specify in this behalf.

The eligible fund manager, in respect of an eligible investment fund, means any person who is engaged in the activity of fund management and fulfils the following conditions, namely:—

(a) the person is not an employee of the eligible investment fund or a connected person of the fund;
(b) the person is registered as a fund manager or an investment advisor in accordance with the specified regulations;
(c) the person is acting in the ordinary course of his business as a fund manager;
(d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager.

Every eligible investment fund shall, in respect of its activities in a financial year, furnish within ninety days from the end of the financial year, a statement in the prescribed form, to the prescribed income-tax authority containing information relating to the fulfilment of the conditions specified in this section and also provide such other relevant information or documents as may be prescribed.

Nothing contained in this section shall apply to exclude any income from the total income of the eligible investment fund, which would have been so included irrespective of whether the activity of the eligible fund manager constituted the business connection in India of such fund or not.

Nothing contained in this section shall have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

The provisions of this section shall be applied in accordance with such guidelines and in such manner as the Board may prescribe in this behalf.

For the purposes of this section,—

(a) "**associate**" means an entity in which a director or a trustee or a partner or a member or a fund manager of the investment fund or a director or a trustee or a partner or a member of the fund manager of such fund, holds, either individually or collectively, share or interest, being more than fifteen per cent. of its share capital or interest, as the case may be;
(b) "**connected person**" shall have the meaning assigned to it in clause (4) of section 102;
(c) "**corpus**" means the total amount of funds raised for the purpose of investment by the eligible investment fund as on a particular date;
(d) "**entity**" means any entity in which an eligible investment fund makes an investment;
(e) "**specified regulations**" means the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or the Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, or such other regulations made under the Securities and Exchange Board of India Act, 1992, which may be notified by the Central Government under this clause.

4. **<u>Profit Attribution to Permanent Establishment</u>**

Attribution of an appropriate amount of profit to the PE has always been a contentious issue which has often resulted into disputes between the tax administration and the taxpayers. The CBDT came up with a draft report dated 18^{th} April'19 on approach for attribution of profits to PE in order to bring more clarity.

The Board was of the opinion that demand is the key factor for generating business profits which has been ignored by the OECD model convention post 2010 amendment. The OECD approach provides that the profits shall be attributed to a PE keeping in mind its functional, asset and risk profile also known as FAR analysis. However, the Board has taken a different stand and has provided that the said approach lays more emphasis on supply side and overlooks the demand factor.

The proposed approach for attribution of profit by CBDT has considered three factors i.e. sale, wages and asset with equal weight for allocating profit to PE where, the wages and asset represents supply side and sale represents the demand side.

Taxability of Profits:

Where an enterprise has;

a) a business connection in India; and
b) the whole of its business is not exclusively carried out in India,

In such cases, only part of those profits that are deemed to accrue or arise in India that is attributable to the business activities carried out in India. Under the Income Tax Act, the income under the head "profits and gains of business or profession" is to be determined as per applicable provisions, and the taxpayers are required to maintain books of account and financial statements for the said purposes.

In cases where books are not maintained or determination of actual profits becomes difficult, the AO can resort to options provided under Rule 10 of the Act, which are as under:

If the AO is of the opinion that the amount of the income accruing or arising to any non-resident whether directly or indirectly, from or through any of the modes such as business connection in India or any property in India or any asset or source of income in India or money lent at interest or brought into India in cash or in kind, cannot be ascertained, the amount for the purposes of tax can be calculated as-

a) such percentage of the turnover as the AO may deem fit;
b) any amount which bears the same proportion to the total profits and gains of the business of such person, as the receipts so accruing or arising bear to the total receipts of business;
c) in any such manner as the AO may deem fit.

In a nutshell, if the enterprise satisfies the threshold nexus of business connection as well as the taxable threshold nexus of PE under the relevant tax treaty, the profits become taxable in India. Such profits shall be taxable only to the extent they are attributable under the relevant provisions of the Act and the treaty. In the model tax convention and the treaties, Article 7 provides for the applicable rules whereas rule 10 provides for the same in domestic law.

SIGNIFICANT SELECTED CASES

<table>
<tr><th>S. No.</th><th colspan="2">Case Laws</th></tr>
<tr><td rowspan="3">1.</td><td colspan="2">C.I.T. v R.D. Aggarwal& Co.</td></tr>
<tr><td>Issue</td><td>Decision</td></tr>
<tr><td>What are the Judicial interpretations of the term “Business Connection”?</td><td>In the case of CIT v. R.D. Aggarwal& Co., the contracts for the sale of goods took place outside the taxable territories, price was received by the non-residents outside the taxable territories, and delivery was also given outside the taxable territories. Therefore in the view of the court case, such a relation w.r.t expression "business connection" must be real and intimate through or from which income must accrue or arise whether directly or indirectly to the non-resident. The Supreme Court in the same case further observed that a business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. Business connection may take several forms: it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in the taxable territories, which facilitates or assists the carrying on of that business. In each case, the question whether there is a business connection from or through which income, profits or gains arise or accrue to a non-resident must be determined upon the facts and circumstances of the case.

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		Act as any trade, commerce, manufacture or any adventure or concern in the nature of trade, commerce or manufacture, but the Act contains no definition of the expression "business connection" and its precise connotation is vague and indefinite.
2.	**CIT v. Fried Krupp Industries**	
	Issue	**Decision**
	Whether the mere purchase of goods in abroad and use in India is considered as 'continuing business' or not?	In CIT v. Fried Krupp Industries, it was held that an isolated transaction between a non-resident and a resident in India without any course of dealings such as might fairly be described as business connection does not attract section 9. There is no question of continuing business relating when a person purchases machinery or other goods abroad or uses them in India and earns profit. But where there is connection, a continuity in business relationship between the person in India who helps to make the profits and the person outside India who receives and realizes the profit, such relationship constitutes a business connection. In each of such case, whether there is a business connection from or through which income arises or accrues must be determined upon the facts or circumstances of that case.

Test Your Knowledge

QUESTIONS	
1.	Examine with reasons whether the following transactions attract income-tax in India, in the hands of recipients under section 9 of Income-tax Act, 1961: A firm of solicitors in Delhi engaged a barrister in UK for arguing a case before Supreme Court of India. A payment of 5000 pounds was made as per terms of professional engagement.
2.	State with reasons whether the following transactions are subject to tax as deemed income: Mr.Arman, a foreign citizen and a diamond merchant from US, has earned income of Rs. 10 crores from display of uncut and unassorted diamonds in the Bharat Diamond Bourse, a notified special zone in Surat.
3.	Examine in the context of provisions contained under the Income-tax Act, 1961, each of the following independent cases and state in brief whether there exists business connection in each of the cases in India so as to bring the income earned, if any, to tax net in India :- (i) Sun Ltd., a company resident in Dubai, had set-up a liaison office at Mumbai to receive trade inquiries from customers in India. The work of the liaison office is not only restricted to forwarding of the trade inquiries to Sun Ltd. but the liaison office also negotiates and enters into the contracts on behalf of Sun Ltd. with the customers in India. (ii) Rose Inc. a resident of USA, has set up a branch at Hyderabad for the purpose of purchase of raw materials for manufacturing its products. The branch office is also engaged in selling the products manufactured by Rose Inc. and in providing sales related services to customers in India on behalf of Rose Inc. (iii) Mr. Raman, a resident in India and based at Delhi, is appointed as an agent by Pearl Inc. a company incorporated in UK for tracking the Indian markets. He was canvassing the orders and then communicating to Pearl Inc. in UK. He had no authority to accept the orders. All the orders were directly received, accepted and after receipt of the price/value, the delivery of goods was given by Pearl Inc. outside India. No purchase of raw material or manufacturing of finished goods took place in India. The agent was entitled to receive the commission on the sales so concluded by Pearl Inc.

SOLUTIONS	
1.	As per section 9(1)(i), all income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. In this case, there was a professional connection between the firm of solicitors in Delhi and the barrister in UK. The expression "business" includes not only trade and manufacture; it includes, within its scope, "profession" as well. Therefore, the existence of professional connection amounts to existence of "business connection" under section 9(1)(i). It was so held by the Supreme Court in Barendra Prasad Roy v. ITO (1981) 129 ITR 295. Hence, the amount of 5,000 pounds paid to the barrister in UK as per the terms of the professional engagement constitutes income which is deemed to accrue or arise in India under section 9(1)(i). Hence, it is taxable in India.
2.	As per section 9(1)(i)(e), in the case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any notified special zone. Since this benefit is available only in case of a foreign company engaged in the business of mining of diamonds, Mr.Arman, a foreign citizen and a diamond merchant from US, cannot avail of such benefit. The income of Rs. 10 crores from display of uncut and unassorted diamonds would, accordingly, be deemed to accrue or arise in the hands of Mr.Arman by virtue of business connection in India.
3.	(i) If a Liaison Office is maintained solely for the purpose of carrying out activities which are preparatory or auxiliary in character, and such activities are approved by the Reserve Bank of India, then, no business connection is established. In this case, had the liaison office's activities been restricted to forwarding of trade inquiries to Sun Ltd., a Dubai based company, its activities would not have constituted business connection. However, the activities of the liaison office extends to also negotiating and entering into contracts on behalf of Sun Ltd. with the customers in India, on account of which business connection is established. (ii) As per the opening sentence in Explanation 2, to section 9(1)(i) "business connection" shall include any business activity carried out through a person in India acting on behalf of the non-resident. Accordingly, in this case, since the branch office is carrying out a business activity by purchasing raw materials in India for Rose Inc. and selling finished product manufactured by Rose Inc. to customers in India and providing sales related services to them on behalf of Rose Inc., business connection is established. It may be noted that as per clause (a) of Explanation 2, in the case of a non-resident, no business connection would be established if the activities of the person acting on behalf of the non-resident were limited to the purchase of goods or merchandise for the non-

	resident. In the present case, however, business connection would be established, since the branch set up at Hyderabad by Rose Inc. is not solely engaged in purchase of raw materials for Rose Inc. for manufacturing its products but is also engaged in selling such manufactured products to customers in India and providing sales related services to them on behalf of Rose Inc. (iii) ‘Business connection’ shall include any business activity carried out through a person acting on behalf of the non-resident. For a business connection to be established, the person acting on behalf of the non-resident – a. must have an authority which is habitually exercised in India to conclude contracts on behalf of the non-resident or; b. in a case where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or c. habitually secures orders in India, mainly or wholly for the non-resident. In the present case, business connection would not be established, since Mr. Raman does not have the authority to accept or conclude orders in India on behalf of Pearl Inc. Moreover, all the orders were directly received, accepted and after receipt of the price/value, the delivery of goods was also given by Pearl Inc. outside India. Hence, no business connection is established in this case.

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1.	Introduction	
2.	What is Business Connection?	
	2.1.	Agents having Independent Status - Not included in Business Connection
	2.2.	Significant Economic Presence
	2.3.	Not a Business Connection in India - Non-resident
3.	Exclusions from Business Connection	
4.	Profit Attribution to Permanent Establishment	
	Significant Selected Cases	
	Test Your Knowledge	

1. Introduction

'Business connection' has for long been recognized as a mode of determining the tax liability of non-residents.

Foreign enterprises for the purpose of Indian Income Tax Act, 1961 are the enterprises that are incorporated outside India or that do not have their place of effective management in India. Section 5(2) read with section 4 of the Income Tax Act provides that the total taxable income of foreign enterprises will include all incomes (including business profits as per section 2(24) of the Income Tax Act) that are received in India or accrue or arise in India or are deemed to be received or deemed to accrue or arise in India.

Under Section 9(1)(i) of the Income Tax Act, income accruing or arising (whether directly or indirectly) "through or from any business connection in India" shall be deemed to accrue or arise in India and shall be taxable in India. Explanation 2 of section 9 of Income Tax Act defines "business connection" to include business activities carried out through dependent agents (that is, those who habitually conclude contracts in the name of the foreign enterprise) but does not include activities carried out through a broker, general commission agent, or any other agent having an independent status.

The business profits of a foreign enterprise may be taxed in India if the business profits either accrue or arise in India, they are received in India, or where they are linked to a business connection in India.

2. What is Business Connection? [Explanation 2 to section 9(1)(i)]

'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident.

For a business connection to be established, the person acting on behalf of the non-resident –

(d) must have an authority, which is habitually exercised in India, to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and such contracts are
   - in the name of the non-resident; or
   - for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
   - for the provision of services by that non-resident, or

   Note - This amendment in the definition of "business connection" is for the purpose of alignment with the provisions of the Double Taxation Avoidance Agreement (DTAA) as modified by Multilateral Instrument (MLI) so as to make the provisions in the treaty effective.

(e) in a case, where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or
(f) habitually secures orders in India, mainly or wholly for the non-resident.

Further, there may be situations when the person acting on behalf of the non-resident secures order for other non-residents. In such situation, business connection for other non-residents is established if,

iv. such other non-resident controls the non-resident or
v. such other non-resident is controlled by the non-resident or
vi. such other non-resident is subject to same control as that of non-resident.

In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.

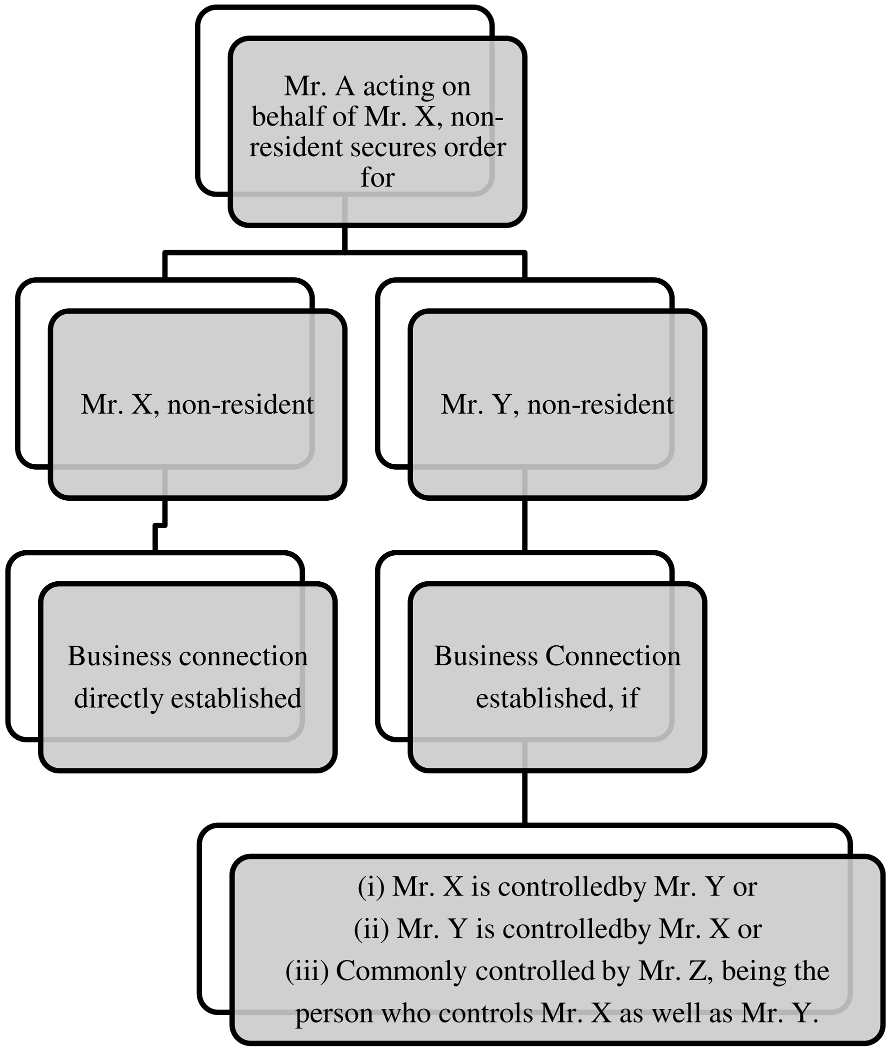

Fig. When Business Connection for other Non-residents is Established

2.1. Agents having Independent Status - Not included in Business Connection [Explanation 3 to Section 9(1)(i)]

Business connection, however, shall not be established, where the non-resident carries on business through a broker, general commission agent or any other agent having an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident.

He will, however, not be considered to have an independent status in the three situations explained above, where he is employed by such a non-resident.

Where a business is carried on in India through a person referred to in (a), (b) or (c) of (i) above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

2.2. Significant Economic Presence [Explanation 2A to section 9(1)(i)]

Significant economic presence of a non-resident in India shall also constitute business connection in India.

Significant economic presence means-

	Nature of transaction	**Condition**
(a)	in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India	Aggregate of payments arising from such transaction or transactions during the previous year should exceed Rs. 2 crores.
(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India	The number of users should be atleast 3 lakhs.

Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(iv) the agreement for such transactions or activities is entered in India;
(v) the non-resident has a residence or place of business in India; or
(vi) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

2.3. Not a Business Connection in India - Non-resident

In the case of a Non-resident, the following shall not, however, be treated as Business Connection in India [Explanation 1 to section 9(1)(i)]:

(f) In the case of a business, in respect of which all the operations are not carried out in India [Explanation 1(a) to section 9(1)(i)]: In the case of a business, other than the business having business connection in India on account of significant economic presence, of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.

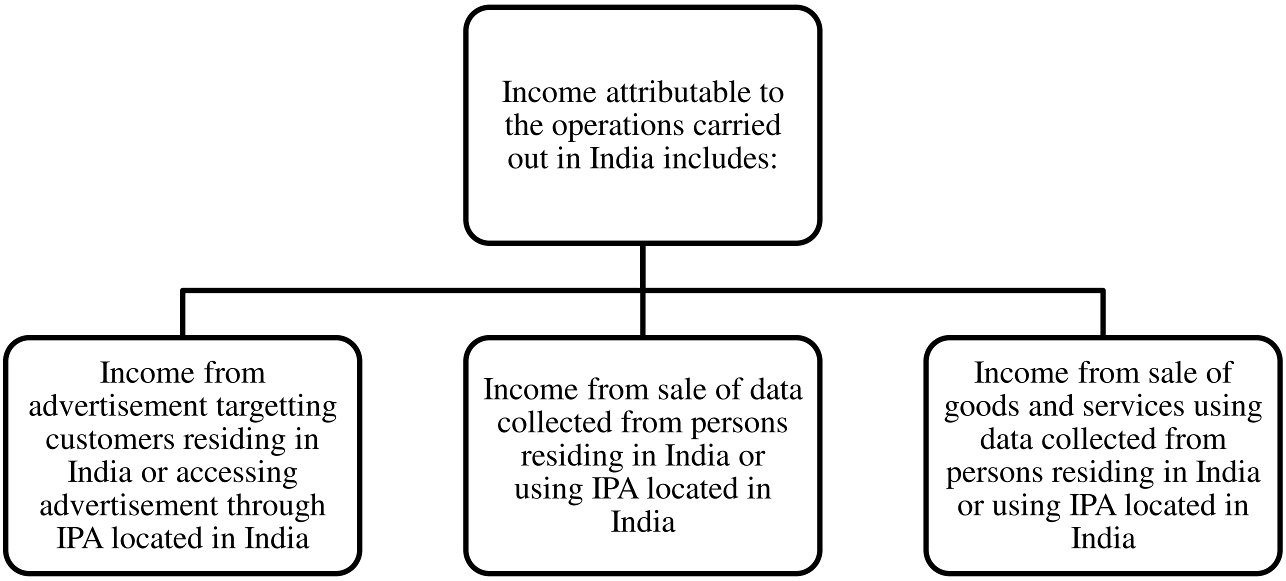

Fig. Income Attributable to the Operations Carried out in India

Note: IPA – Internet Protocol Address

The above provisions would also apply to the income attributable to the transactions or activities referred to in Explanation 2A to section 9(1)(i).

(g) Purchase of goods in India for export [Explanation 1(b) to section 9(1)(i)]: In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

(h) Collection of news and views in India for transmission out of India [Explanation 1(c) to section 9(1)(i)]: In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

(i) **Shooting of cinematograph films in India [Explanation 1(d) to section 9(1)(i)]:** In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, If such non-resident is:

- an individual, who is not a citizen of India or
- a firm which does not have any partner who is a citizen of India or who is resident in India; or
- a company which does not have any shareholder who is a citizen of India or who is resident in India.

(j) **Activities confined to display of rough diamonds in SNZs [Explanation 1(e) to section9(1)(i)]:** In case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any special zone notified by the Central Government in the Official Gazette in this behalf.

3. Exclusions from Business Connection [Section 9A]

Certain activities not to constitute business connection in India —

Notwithstanding anything contained in sub-section (1) of section 9 and subject to the provisions of this section, in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund.

Notwithstanding anything contained in section 6, an eligible investment fund shall not be said to be resident in India for the purpose of that section merely because the eligible fund manager, undertaking fund management activities on its behalf, is situated in India.

The eligible investment fund referred to in sub-section (1), means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfils the following conditions, namely:—

(a) the fund is not a person resident in India;
(b) the fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A has been entered into;
(c) the aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five per cent. of the corpus of the fund;
(d) the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;
(e) the fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten per cent.;
(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent.;
(h) the fund shall not invest more than twenty per cent. of its corpus in any entity;
(i) the fund shall not make any investment in its associate entity;
(j) the monthly average of the corpus of the fund shall not be less than one hundred crore rupees:

    Provided that if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than one hundred crore rupees at the end of such previous year;
(k) the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India;
(l) the fund is neither engaged in any activity which constitutes a business connection in India nor has any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf;
(m) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the arm's length price of the said activity:

Provided that the conditions specified in clauses (e), (f) and (g) shall not apply in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund, or such other fund as the Central Government may subject to conditions, if any, by notification in the Official Gazette, specify in this behalf.

The eligible fund manager, in respect of an eligible investment fund, means any person who is engaged in the activity of fund management and fulfils the following conditions, namely:—

(e) the person is not an employee of the eligible investment fund or a connected person of the fund;
(f) the person is registered as a fund manager or an investment advisor in accordance with the specified regulations;
(g) the person is acting in the ordinary course of his business as a fund manager;
(h) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager.

Every eligible investment fund shall, in respect of its activities in a financial year, furnish within ninety days from the end of the financial year, a statement in the prescribed form, to the prescribed income-tax authority containing information relating to the fulfilment of the conditions specified in this section and also provide such other relevant information or documents as may be prescribed.

Nothing contained in this section shall apply to exclude any income from the total income of the eligible investment fund, which would have been so included irrespective of whether the activity of the eligible fund manager constituted the business connection in India of such fund or not.

Nothing contained in this section shall have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

The provisions of this section shall be applied in accordance with such guidelines and in such manner as the Board may prescribe in this behalf.

For the purposes of this section,—

(f) "**associate**" means an entity in which a director or a trustee or a partner or a member or a fund manager of the investment fund or a director or a trustee or a partner or a member of the fund manager of such fund, holds, either individually or collectively, share or interest, being more than fifteen per cent. of its share capital or interest, as the case may be;

(g) "**connected person**" shall have the meaning assigned to it in clause (4) of section 102;

(h) "**corpus**" means the total amount of funds raised for the purpose of investment by the eligible investment fund as on a particular date;

(i) "**entity**" means any entity in which an eligible investment fund makes an investment;

(j) "**specified regulations**" means the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or the Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, or such other regulations made under the Securities and Exchange Board of India Act, 1992, which may be notified by the Central Government under this clause.

4. **<u>Profit Attribution to Permanent Establishment</u>**

Attribution of an appropriate amount of profit to the PE has always been a contentious issue which has often resulted into disputes between the tax administration and the taxpayers. The CBDT came up with a draft report dated 18th April'19 on approach for attribution of profits to PE in order to bring more clarity.

The Board was of the opinion that demand is the key factor for generating business profits which has been ignored by the OECD model convention post 2010 amendment. The OECD approach provides that the profits shall be attributed to a PE keeping in mind its functional, asset and risk profile also known as FAR analysis. However, the Board has taken a different stand and has provided that the said approach lays more emphasis on supply side and overlooks the demand factor.

The proposed approach for attribution of profit by CBDT has considered three factors i.e. sale, wages and asset with equal weight for allocating profit to PE where, the wages and asset represents supply side and sale represents the demand side.

Taxability of Profits:
Where an enterprise has;

c) a business connection in India; and
d) the whole of its business is not exclusively carried out in India,

In such cases, only part of those profits that are deemed to accrue or arise in India that is attributable to the business activities carried out in India. Under the Income Tax Act, the income under the head "profits and gains of business or profession" is to be determined as per applicable provisions, and the taxpayers are required to maintain books of account and financial statements for the said purposes.

In cases where books are not maintained or determination of actual profits becomes difficult, the AO can resort to options provided under Rule 10 of the Act, which are as under:

If the AO is of the opinion that the amount of the income accruing or arising to any non-resident whether directly or indirectly, from or through any of the modes such as business connection in India or any property in India or any asset or source of income in India or money lent at interest or brought into India in cash or in kind, cannot be ascertained, the amount for the purposes of tax can be calculated as-

d) such percentage of the turnover as the AO may deem fit;
e) any amount which bears the same proportion to the total profits and gains of the business of such person, as the receipts so accruing or arising bear to the total receipts of business;
f) in any such manner as the AO may deem fit.

In a nutshell, if the enterprise satisfies the threshold nexus of business connection as well as the taxable threshold nexus of PE under the relevant tax treaty, the profits become taxable in India. Such profits shall be taxable only to the extent they are attributable under the relevant provisions of the Act and the treaty. In the model tax convention and the treaties, Article 7 provides for the applicable rules whereas rule 10 provides for the same in domestic law.

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	What are the Judicial interpretations of the term "Business Connection"?	In the case of CIT v. R.D. Aggarwal& Co., the contracts for the sale of goods took place outside the taxable territories, price was received by the non-residents outside the taxable territories, and delivery was also given outside the taxable territories. Therefore in the view of the court case, such a relation w.r.t expression "business connection" must be real and intimate through or from which income must accrue or arise whether directly or indirectly to the non-resident. The Supreme Court in the same case further observed that a business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. Business connection may take several forms: it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in the taxable territories, which facilitates or assists the carrying on of that business. In each case, the question whether there is a business connection from or through which income, profits or gains arise or accrue to a non-resident must be determined upon the facts and circumstances of the case. The expression "business" is defined in the

		Act as any trade, commerce, manufacture or any adventure or concern in the nature of trade, commerce or manufacture, but the Act contains no definition of the expression "business connection" and its precise connotation is vague and indefinite.
2.	**CIT v. Fried Krupp Industries**	
	Issue	**Decision**
	Whether the mere purchase of goods in abroad and use in India is considered as 'continuing business' or not?	In CIT v. Fried Krupp Industries, it was held that an isolated transaction between a non-resident and a resident in India without any course of dealings such as might fairly be described as business connection does not attract section 9. There is no question of continuing business relating when a person purchases machinery or other goods abroad or uses them in India and earns profit. But where there is connection, a continuity in business relationship between the person in India who helps to make the profits and the person outside India who receives and realizes the profit, such relationship constitutes a business connection. In each of such case, whether there is a business connection from or through which income arises or accrues must be determined upon the facts or circumstances of that case.

Test Your Knowledge

QUESTIONS	
1.	Examine with reasons whether the following transactions attract income-tax in India, in the hands of recipients under section 9 of Income-tax Act, 1961: A firm of solicitors in Delhi engaged a barrister in UK for arguing a case before Supreme Court of India. A payment of 5000 pounds was made as per terms of professional engagement.
2.	State with reasons whether the following transactions are subject to tax as deemed income: Mr.Arman, a foreign citizen and a diamond merchant from US, has earned income of Rs. 10 crores from display of uncut and unassorted diamonds in the Bharat Diamond Bourse, a notified special zone in Surat.
3.	Examine in the context of provisions contained under the Income-tax Act, 1961, each of the following independent cases and state in brief whether there exists business connection in each of the cases in India so as to bring the income earned, if any, to tax net in India :- (i) Sun Ltd., a company resident in Dubai, had set-up a liaison office at Mumbai to receive trade inquiries from customers in India. The work of the liaison office is not only restricted to forwarding of the trade inquiries to Sun Ltd. but the liaison office also negotiates and enters into the contracts on behalf of Sun Ltd. with the customers in India. (ii) Rose Inc. a resident of USA, has set up a branch at Hyderabad for the purpose of purchase of raw materials for manufacturing its products. The branch office is also engaged in selling the products manufactured by Rose Inc. and in providing sales related services to customers in India on behalf of Rose Inc. (iii) Mr. Raman, a resident in India and based at Delhi, is appointed as an agent by Pearl Inc. a company incorporated in UK for tracking the Indian markets. He was canvassing the orders and then communicating to Pearl Inc. in UK. He had no authority to accept the orders. All the orders were directly received, accepted and after receipt of the price/value, the delivery of goods was given by Pearl Inc. outside India. No purchase of raw material or manufacturing of finished goods took place in India. The agent was entitled to receive the commission on the sales so concluded by Pearl Inc.

SOLUTIONS	
1.	As per section 9(1)(i), all income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. In this case, there was a professional connection between the firm of solicitors in Delhi and the barrister in UK. The expression "business" includes not only trade and manufacture; it includes, within its scope, "profession" as well. Therefore, the existence of professional connection amounts to existence of "business connection" under section 9(1)(i). It was so held by the Supreme Court in Barendra Prasad Roy v. ITO (1981) 129 ITR 295. Hence, the amount of 5,000 pounds paid to the barrister in UK as per the terms of the professional engagement constitutes income which is deemed to accrue or arise in India under section 9(1)(i). Hence, it is taxable in India.
2.	As per section 9(1)(i)(e), in the case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any notified special zone. Since this benefit is available only in case of a foreign company engaged in the business of mining of diamonds, Mr.Arman, a foreign citizen and a diamond merchant from US, cannot avail of such benefit. The income of Rs. 10 crores from display of uncut and unassorted diamonds would, accordingly, be deemed to accrue or arise in the hands of Mr.Arman by virtue of business connection in India.
3.	(i) If a Liaison Office is maintained solely for the purpose of carrying out activities which are preparatory or auxiliary in character, and such activities are approved by the Reserve Bank of India, then, no business connection is established. In this case, had the liaison office's activities been restricted to forwarding of trade inquiries to Sun Ltd., a Dubai based company, its activities would not have constituted business connection. However, the activities of the liaison office extends to also negotiating and entering into contracts on behalf of Sun Ltd. with the customers in India, on account of which business connection is established. (ii) As per the opening sentence in Explanation 2, to section 9(1)(i) "business connection" shall include any business activity carried out through a person in India acting on behalf of the non-resident. Accordingly, in this case, since the branch office is carrying out a business activity by purchasing raw materials in India for Rose Inc. and selling finished product manufactured by Rose Inc. to customers in India and providing sales related services to them on behalf of Rose Inc., business connection is established. It may be noted that as per clause (a) of Explanation 2, in the case of a non-resident, no business connection would be established if the activities of the person acting on behalf of the non-resident were limited to the purchase of goods or merchandise for the non-

	resident. In the present case, however, business connection would be established, since the branch set up at Hyderabad by Rose Inc. is not solely engaged in purchase of raw materials for Rose Inc. for manufacturing its products but is also engaged in selling such manufactured products to customers in India and providing sales related services to them on behalf of Rose Inc. (iii) ‘Business connection’ shall include any business activity carried out through a person acting on behalf of the non-resident. For a business connection to be established, the person acting on behalf of the non-resident – a. must have an authority which is habitually exercised in India to conclude contracts on behalf of the non-resident or; b. in a case where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or c. habitually secures orders in India, mainly or wholly for the non-resident. In the present case, business connection would not be established, since Mr. Raman does not have the authority to accept or conclude orders in India on behalf of Pearl Inc. Moreover, all the orders were directly received, accepted and after receipt of the price/value, the delivery of goods was also given by Pearl Inc. outside India. Hence, no business connection is established in this case.