



A study imposition of tax on permanent establishment and judicial approach: A case analysis

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Abstract

A Permanent Establishment (PE) is a fundamental concept in international tax law that establishes the tax obligations of a non-resident entity within a host country. It refers to a fixed place of business through which the business activities of an enterprise are wholly or partially carried out. Understanding PE is crucial for attributing profits to foreign enterprises and enabling the host country to levy taxes appropriately. The OECD Model Tax Convention on Income and Capital, which serves as a foundation for bilateral tax treaties, defines Permanent Establishment (PE) similarly in Article 5. While the core concepts of Permanent Establishment (PE) such as Fixed Place PE, Agency PE, and Construction PE have been elaborated, several other important facets and nuances shape the understanding and application of PE in international taxation. Additional aspects, including emerging issues related to the digital economy, specific industry considerations, and anti-fragmentation rules are elucidated.

Keywords: Permanent Establishment, International Tax, Place of Business, Foreign Countries Taxes, OECD Model Tax Convention, Bilateral Tax Treaties.

Introduction

A Permanent Establishment (PE) is a fundamental concept in international tax law that establishes the tax obligations of a non-resident entity within a host country. It refers to a fixed place of business through which the business activities of an enterprise are wholly or partially carried out. Understanding PE is crucial for attributing profits to foreign enterprises and enabling the host country to levy taxes appropriately.

Provisions under the Income Tax Act, of 1961:

In the Indian Income Tax Act, 1961, the concept of PE is detailed in several sections, with significant emphasis under Section 92F(iii) and in the Double Taxation Avoidance Agreements (DTAAs) India has established with various nations. According to the Act, a PE encompasses several forms:

- **Fixed Place PE:** This refers to a fixed location where the business of the enterprise is wholly or partially conducted. Examples include branches, offices, factories, workshops, warehouses, and other installations.
- **Agency PE:** This type of PE is established through an agent, excluding independent agents, who habitually hold the authority to conclude contracts on behalf of the enterprise.
- **Construction PE:** This is defined as a building site, or a construction, assembly, or installation project, including supervisory activities connected with such projects, that lasts for more than 12 months.

OECD Model

The OECD Model Tax Convention on Income and Capital, which serves as a foundation for bilateral tax treaties, defines Permanent Establishment (PE) similarly in Article 5. The key elements are:

- **Fixed Place PE:** A fixed location where the business of an enterprise is conducted. This includes places such as a place of management, branch, office, factory, workshop, and sites like mines, oil or gas wells, quarries, or any other location for the extraction of natural resources.
- **Agency PE:** An agent, other than an independent agent, who habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts on behalf of the enterprise.
- **Construction PE:** A building site, construction, or installation project that continues for more than 12 months.

Detailed Analysis

- **Fixed Place PE:** This is the most common type of Permanent Establishment (PE). For a location to qualify as a Fixed Place PE, it must meet specific criteria.
- **Physical Location:** There must be a physical site available to the enterprise, which can be owned, rented, or otherwise occupied.
- **Permanence:** The business location must exhibit a degree of permanence, meaning it is not merely temporary. Generally, permanence is presumed if the site is used for more than six months, although shorter periods might be sufficient depending on the context.
- **Business Activities:** Business activities must be carried out through this fixed location. These activities can range from core business functions to auxiliary and preparatory tasks.
- **Agency PE:** An Agency PE is established when a person acts on behalf of a non-resident enterprise in the host country. The key conditions include:

- **Authority to Conclude Contracts:** The agent habitually concludes contracts on behalf of the enterprise or habitually plays the primary role in the conclusion of contracts without significant modification by the enterprise.
- **Dependent Agent:** The agent must not be independent both legally and economically. Independent agents acting in the normal course of their business do not create a PE.
- **Construction PE:** This type of PE applies specifically to construction, assembly, or installation projects. The main aspects include.
- **Duration:** The project must continue for more than 12 months. The duration is calculated from the commencement of the work to its completion, including any related supervisory activities.
- **Site:** The entire site or project is treated as a single PE. Even if various parts of the project are geographically dispersed, they are considered one PE if they are interconnected.

Facets of Permanent Establishment

While the core concepts of Permanent Establishment (PE) such as Fixed Place PE, Agency PE, and Construction PE have been elaborated, some several other important facets and nuances shape the understanding and application of PE in international taxation. The additional aspects, including emerging issues related to the digital economy, specific industry considerations, and anti-fragmentation rules are elucidated as under. They are:

Digital Economy and PE

The growth of the digital economy introduces unique challenges in defining and identifying a Permanent Establishment (PE). Traditional PE concepts rely on physical presence, but digital businesses often operate without a physical presence in many of the markets they serve. This has prompted discussions and proposals for new frameworks:

1. Significant Economic Presence (SEP)

Some jurisdictions are adopting or proposing rules to tax digital businesses based on a "significant economic presence" within the market jurisdiction. This concept considers factors such as ongoing interactions with customers or users, digital transactions, and the revenue generated from a particular market.

2. User Participation

Another approach emphasizes user participation, where businesses that derive substantial value from user data and engagement in a jurisdiction could be considered to have a PE there, even without a physical presence.

3. Digital Services Taxes (DST)

Some countries have introduced DSTs, which tax the revenues generated from digital services provided within their jurisdiction. Although DSTs are not PE in themselves, they address the taxation challenges posed by the digital economy.

Specific Industry Considerations

Different industries have specific considerations regarding the establishment of a Permanent Establishment (PE) due to the nature of their activities and operations.

1. Financial Services

In the banking and financial services sector, a PE may arise from various activities such as maintaining branches or offices, conducting trading activities through dependent agents, or managing significant portfolios. Special rules may apply to define what constitutes a PE in this highly regulated industry.

2. Shipping and Air Transport

International treaties often provide specific exemptions for shipping and air transport activities. These industries are typically taxed based on the location of the enterprise's effective management rather than the presence of a PE in a particular jurisdiction.

3. Oil and Gas

The extractive industry involves complex PE considerations due to the long-term and capital-intensive nature of exploration and extraction projects. PE can be established through drilling rigs, exploration sites, and service arrangements for technical assistance and supervision.

Anti-Fragmentation Rules

Anti-fragmentation rules aim to prevent enterprises from artificially splitting their activities to avoid establishing a Permanent Establishment (PE). These rules ensure that interconnected activities, when considered together, constitute a PE even if they might not be individually.

1. Artificial Avoidance

Enterprises may divide their activities among related entities or different parts of the same entity to remain below PE thresholds. Anti-fragmentation provisions aggregate these activities to determine the existence of a PE.

2. BEPS Action Plan

The OECD's Base Erosion and Profit Shifting (BEPS) Action Plan, particularly Action 7, targets strategies aimed at avoiding PE status artificially. This involves modifying the PE definition to ensure that activities fragmented across multiple sites or entities are treated collectively.

Attribution of Profits and Transfer Pricing

While the fundamental principles of attributing profits to a PE were previously discussed, it's important to delve deeper into the methodologies and challenges associated with this process:

Authorized OECD Approach (AOA): The AOA provides a framework for attributing profits to a PE based on functions performed, assets used, and risks assumed (FAR analysis). It treats the PE as if it were a separate and independent enterprise.

1. Transfer Pricing Methods

traditional transfer pricing methods like the Comparable Uncontrolled Price (CUP) method, Resale Price Method (RPM), and Transactional Net Margin Method (TNMM) are employed to determine the arm's length remuneration of intra-company transactions involving the PE.

2. Functional and Risk Analysis:

A comprehensive functional and risk analysis is crucial for identifying the economic activities of the PE. This analysis serves as the basis for profit allocation, ensuring that the PE is adequately compensated for the value it adds.

PE and Indirect Taxes

Permanent Establishment considerations extend beyond direct taxes to impact indirect taxes such as Value Added Tax (VAT) or Goods and Services Tax (GST). The implications include: VAT/GST Registration: A PE may trigger the requirement for VAT/GST registration in the host country, necessitating compliance with local indirect tax laws and the collection and remittance of taxes on taxable supplies.

1. Supply Chains

The presence of a PE influences supply chain structuring, as transactions involving a PE may be subject to different VAT/GST treatments compared to cross-border transactions without a PE.

Compliance and Documentation

Ensuring compliance for a Permanent Establishment (PE) involves significant documentation and procedural obligations:

1. Documentation Requirements

Enterprises must maintain thorough documentation to support the nature and extent of activities conducted through the PE. This includes contracts, financial records, and correspondence evidencing business conducted via the PE.

2. Tax Filings

PEs are subject to local tax filing obligations, encompassing annual tax returns, transfer pricing documentation, and potentially country-by-country reporting (CbCR) as part of the Base Erosion and Profit Shifting (BEPS) framework.

3. Audit and Assessments

Tax authorities may scrutinize PE activities through audits and assessments. Enterprises need to be prepared for such inquiries and ensure that their documentation and compliance practices are robust.

Emerging Trends and Future Developments

The concept of PE is evolving in response to changing business dynamics and global economic trends:

1. Unified Approach

The OECD has proposed a unified approach under Pillar One of its Inclusive Framework on BEPS, aiming to allocate more taxing rights to market jurisdictions where consumers are situated. This initiative may redefine PE concepts.

2. Digital Economy and Global Consensus

Ongoing efforts seek a global consensus on taxing the digital economy, potentially leading to new definitions and rules for PE that better align with modern business practices.

3. Impact of Technology

Technological advancements and the rise of e-commerce and digital services are likely to continue challenging

traditional PE notions, prompting further adaptations in international tax regulations.

Exceptions to Permanent Establishment

Both the Indian Income Tax Act and the OECD Model acknowledge exceptions where the presence of a fixed place or an agent does not establish a Permanent Establishment (PE):

Preparatory or Auxiliary Activities: Activities that are preparatory or auxiliary in nature, such as storage, display, or delivery of goods, collection of information, or advertising, do not constitute a PE.

1. Independent Agents

Activities conducted by an independent agent, as part of their regular business operations, do not create a PE for the enterprise.

2. Specific Activities

Certain specific activities, like maintaining a stock of goods for storage, display, or delivery, or for processing by another enterprise, are also excluded from PE determination.

Attribution of Profits

After establishing a PE, the next step is to attribute profits to it. The profits attributable to the PE are those that the PE would have earned if it were a distinct and independent enterprise conducting similar activities under similar conditions. This process involves:

1. Separate Entity Approach

Treating the PE as a separate and independent entity transacting at arm's length with the enterprise of which it is a part.

2. Functional Analysis

Conducting a detailed functional analysis to identify the functions performed, assets used, and risks assumed by the PE.

3. Transfer Pricing Principles

Applying transfer pricing principles to allocate profits between the head office and the PE.

Anti-Avoidance Measures

Both Indian Tax Law and the OECD have implemented measures to prevent the avoidance of PE status:

1. Commissionaire Arrangements

Counteracting arrangements where an agent sells products in their own name but on behalf of a foreign enterprise, creating an economic presence without a PE.

2. Artificial Fragmentation

Preventing the splitting of contracts or activities to evade the PE threshold, such as dividing a construction project into smaller parts, each lasting less than 12 months.

3. BEPS Action Plan

The OECD's BEPS Action Plan recommends measures to combat the artificial avoidance of PE status, including modifications to the PE definition in the Model Tax Convention.

Judicial Approach – Case Analysis

Case Name: Director of Income Tax (International Taxation) v. Morgan Stanley & Co. Inc (2007) 292 ITR 416 (SC)

Facts: Morgan Stanley & Co. International Limited (MSCo), a global financial services firm headquartered in the United States, sought to enhance operational efficiency by outsourcing certain back-office functions to its Indian subsidiary, Morgan Stanley Advantage Services Pvt. Ltd. (MSAS). MSAS, incorporated in India, provided various support services including equity research, account reconciliation, IT-enabled services, and financial analysis.

1. Operational Details

Service Agreement: MSAS and MSCo entered into a Service Agreement outlining the nature of services, compensation mechanisms, and operational details. MSAS was remunerated on a cost-plus basis, where MSCo reimbursed MSAS for its costs along with an additional profit mark-up.

Employee Secondment: MSCo assigned some employees to work at MSAS's premises in India. These employees, though physically located at MSAS, were considered MSCo's employees and were responsible for overseeing the quality of work at MSAS.

2. Functional Activities

Equity Research: MSAS provided research reports and analytical support for MSCo's equity trading operations.

3. Account Reconciliation

MSAS conducted reconciliation of financial accounts and other related bookkeeping tasks.

4. IT-enabled Services

This included data processing, database management, and other technical support services essential for MSCo's operations.

The Indian tax authorities, particularly the Director of Income Tax (DIT), contended that the activities performed by MSAS constituted a Permanent Establishment (PE) of MSCo in India under Article 5 of the India-USA Double Taxation Avoidance Agreement (DTAA). The Revenue argued that the services provided by MSAS were integral to MSCo's business, thereby establishing a Service PE in India.

5. Fixed Place PE

The premises of MSAS were argued to be at the disposal of MSCo, thereby constituting a Fixed Place PE.

6. Dependent Agent PE

The Revenue contended that MSAS functioned as a dependent agent of MSCo, exercising authority to conclude contracts on behalf of MSCo or performing principal roles leading to the conclusion of contracts.

7. Contentions of the Revenue

The Revenue contended that MSCo had a Service PE in India through MSAS, asserting that MSAS conducted core functions of MSCo, thereby making the income attributable to these functions taxable in India. Additionally, they argued that MSCo had a Fixed Place PE in India, as MSAS's premises were available to MSCo, and MSAS acted as a dependent agent of MSCo, habitually exercising authority to conclude contracts or playing a principal role in contract conclusion.

8. Contentions of the Assessee

The Assessee argued against having a PE in India. They maintained that MSAS was an independent entity providing back-office support services, which did not constitute a PE under the India-USA DTAA. The Assessee asserted that MSAS operated as an independent agent, conducting business on its account, thus not creating a PE for the Assessee in India. Even if a PE existed, the Assessee argued that profits attributable to the PE should be determined based on arm's length principles, as MSAS was compensated at arm's length, covering functions performed, assets used, and risks assumed.

- **Existence of a PE:** Whether the Assessee had a PE in India under Article 5 of the India-USA DTAA through MSAS.

- **Attribution of Profits:** If a PE existed, how should profits attributable to the PE be computed, particularly considering the arm's length remuneration already paid to the Assessee.

Judgment

The Hon'ble Supreme Court of India ruled in favor of Morgan Stanley, concluding:

- MSAS's services, being back-office functions and support services, did not constitute a Service PE under Article 5(2)(1) of the DTAA.
- MSAS did not qualify as a Fixed Place PE for MSCo as its premises were not at the disposal of MSCo for carrying out its business.
- MSAS did not habitually exercise authority to conclude contracts on behalf of MSCo; its services were supportive and did not entail binding MSCo in contracts.
- Since MSAS was remunerated on an arm's length basis, covering functions performed, assets used, and risks assumed, no further profits could be attributed to the alleged PE.

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