



PERMANENT ESTABLISHMENT IN PRESENT ERA: AN OVERVIEW

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• Introduction

One of the key concepts in the double tax treaty is Permanent Establishment ('PE'). As per the definition of Article 5 (1) of the Organization for Economic Cooperation and Development ('OECD')- The Model Convention with Respect to Taxes on Income and on Capital, PE is defined as a fixed 'place of business' ('POB') through which the business activity of an enterprise is wholly or partially carried on.¹

PE is used as a key instrument by all three model conventions namely, OECD, United Nations Model, US Model to establish the taxation jurisdiction though the definitions of PE by each of the conventions are different from each other. PE of the foreign entities are soft target for generating revenue. A source country cannot tax profits of a non-resident

from business activities in their state until and unless those business activities create a PE in the source country.² For such taxation, tax treaty between the source country and the resident country is required. Therefore, the main purpose of PE is to allocate the economic allegiance for foreign entities other than the registered entities.

OECD has developed a project named Base Erosion and Profit Sharing ('BEPS'). The work carried under BEPS-Action 7 provides changes to the definition of PE in the OECD Model Tax Convention to address strategies used to avoid having a taxable presence in a jurisdiction under tax treaties. New Article 7 may not be widely adopted by OECD countries and non-OECD countries which reflects differences within the OECD between Working Party No. 1, which is responsible for tax treaty issues, and Working Party No. 6, which is responsible for the taxation of multinational enterprises. The new Article 7 are based on the arm's length principle. Under the arm's length principle, a PE of an international enterprise is treated as

¹ Article 5, OECD, Available at <https://www.oecd.org/tax/treaties/1914467.pdf>, last visited on November 18, 2021.

² Article 7, OECD, Available at <https://www.oecd.org/tax/treaties/1914467.pdf>, last visited on November 18, 2021.



a separate entity for the purposes of determining the profits that are attributable to the PE.³ The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the Multilateral instrument ('MLI'). The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles which implement the changes of PE.⁴

- **Types of Permanent Establishment**

As per Article 5 (2) , there is an inclusive list which states that PE includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. However, Article 5 (4) lists out certain exceptions, which does not constitute PE like facilities meant only for storage, display or delivery of goods or merchandise belonging to the enterprise, etc.

In general, there are five categories in which PE is classified namely Place of Effective management (commonly referred to as

'POEM'); Fixed Place PE like branch office, workshop, etc.; Construction PE like building site; Agency PE; and Service PE. Other than these, there is one more category which holds the utmost importance in today's epoch is Digital PE.

Articles 5 (1) and 5 (2) of the OECD model tax treaty convention deals with actual PE and deemed PE respectively. Actual PE can be located whereas for deemed PE the creation of actual connection of such establishment is not required. In deemed PE, there has already been a presumption of PE. Here, nature of business must not be casual in nature. Article 5 (3) deals with the construction PE which states that when a building site or construction or installation project continues for more than a period of 12 months, it constitutes a PE. Agency PE is dealt under Article 5 (5) which states that dependent agent who neither have any functional nor financial independence in a contracting state, such dependent agent of an enterprise will be determined as PE in that

³ MICHAEL KOBETSKY, INTERNATIONAL TAXATION OF PERMANENT ESTABLISHMENTS, PRINCIPLES AND POLICY, CAMBRIDGE TAX LAW SERIES (2011).

⁴ Available at <https://www.oecd.org/tax/beps/beps-actions/action7/> last visited on November 20, 2021.



state whereas Article 5 (6) stipulates that the enterprise carrying out business through a broker, a general commission agent or any other independent agent, is not considered to be a PE for that contracting state where the enterprise is carrying out such business, if they are acting in the ordinary course of their business. Service deemed PE is the extension of the deemed PE. Since few years, service PE are becoming very important because of the advent of technology. Digital PE is not yet covered under any of the Articles of OECD tax treaty convention albeit various discussions held in order to amend the definition of PE. A final report by the OECD on the same is yet to be published.

• Tests to Determine Fixed Place Permanent Establishment

There are 3 general tests which is required to be satisfied to determine the 'fixed place' PE.

These are as follows:

- a. There must be POB;
- b. POB must be fixed;
- c. Business must be carrying from that fixed place.

For constituting PE of an enterprise, fixed POB must not be temporarily at the enterprise's disposal. Neither it should be disposal for any

third party for their purpose. The use of the fixed place must last for a certain period of time. However, the duration for constituting PE is not mentioned anywhere. It is also pertinent to note that mere existence of business connection does not constitute PE. There must be accrual of the income from business activities. Geographical location also constitutes PE like a diving offshore vessel functioning within a certain area. In fixed POB, there is a concept called '*equipment PE*'. Equipment attached to the land also constitutes fixed POB like ship. Movable POB with a temporary fixed location can also constitutes PE. Thus, there should be some regularity, continuity and repetitiveness. To ascertain PE, certain factors are also important to look into like the nature of business, whether the activity is recurring or not, whose business is carried out at PE, etc. Generally, it is assessee who is running the business of PE but if there will be no exclusive business of assessee, in that case one has to look into the core business of the assessee to ascertain whether there is PE or not.

• Recent Trend

After digitalisation, the risk of PE has been increased. Digital PE being global in nature,



emerged as a new concept which possess several challenges. Since various business models keep changing, the question arises whether the traditional concept of PE holds any importance in the present epoch or not. In this virtual world, it is very difficult to ascertain the economic presence of a multinational companies in a source country where they are relying more and more on digital medium rather than focusing on expansion of their physical presence in a source country. In certain cases, it is seen that the companies are running their business merely through the online medium in order to avoid the tax. Therefore, there is need to have a rigid law regulating the digital PE. In case of Spanish Dell⁵ in 2012, the concept of virtual PE came into light wherein the Court held that the website cannot be deemed as PE whereas a server constitutes PE since it is an equipment and has physical location. The same view has been taken by the OECD Commentary⁶ wherein it has been specifically mentioned that the server on

which the website is stored is said to be the PE since it has the fixed POB whereas the website being the intangible property cannot be constituted as the PE. Action 1 of BEPS is very relevant which addressed the tax challenges of the digital economy. It states that people are using internet as a place to situate their different types of business models. G20 also endorsed BEPS. In November, 2019 OECD issued a secretariat proposal for a 'unified approach' under Pillar One to combat the tax challenges which has increased tremendously by the digitalisation of the economy.⁷ Here, a 'new nexus' rule has been initiated through a standalone rule as an important characteristic of the solution provided under the said proposal wherein there is no dependency on the physical presence of a company.

- **India's Perspective**

World is witnessing the expeditious expansion in the arena of digital PE and India is one of them being the consumer centric

⁵ Case number 182/2012. Date of Decision: 15.03.2012.

⁶ ¶ 42, Available at <http://www.oecd.org/berlin/publikationen/43324465.pdf>. last visited on November 18, 2021.

⁷ <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf>, last visited on November 19, 2021.



nation. To avoid any kind of tax evasion and double taxation, India introduced the equalisation levy in 2016. A new concept of 'significant economic presence' (SEP) was also introduced in Budget, 2018 while keeping in mind the digital PE. The concept of SEP and PE is very similar in nature with an exception of fixed POB in SEP. PE is defined under clause (iiia) of section 92F of the Income Tax Act. It is pertinent to note that India is not a party of OECD albeit it is focusing on the OECD commentaries while deciding the cases. Judges have the flexibility to interpret where they can pick the examples from the commentaries. India has adopted the unilateral approach while dealing with the digital PE. One of the important tests which India applies to ascertain the PE is the 'disposal test'. This test is not comprehensive and is subjective in nature. It applies differently to different situations. Another important aspect while interpreting PE is the attribution of profits which has been recently taken care by judiciary in a number of cases. It has been observed that India is quite aggressive while interpreting PE. India has

inclusive framework on BEPS membership. MLI is also activated. It is reviewing the 'preventing treaty abuse' in 2019.

- **Judicial Precedents**

Formula One World Championship Case⁸

It is the benchmark case where fixed POB discussed extensively. The 'disposal test' is the main test in order to ascertain whether there is PE or not i.e., whether the enterprise has the right to use the said premises and has control thereupon. It is immaterial whether the premises are owned or rented by the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice. The three main characteristics of PE which is required for locating the fixed POB in India are stability, productivity and dependence. It was also held that business income of non-resident will be only that part of the income of non-resident which is attributable to the said PE.

The decision of the Formula One was heavily relied in other subsequent judgments like in

⁸ Formula One World Championship Ltd. v. CIT, International Taxation-3, Delhi and Ors. (2017) 15 SCC 602



E-Funds case⁹, ULO Systems LLC vs. DCIT IT¹⁰, In re MasterCard Asia Pacific Pte. Ltd.¹¹, Noida vs. DCIT International Taxation, Dehradun¹². Supreme Court in e-funds case held that where the services are not rendered within the source country by the subsidiary company it cannot constitute service PE. In ULO systems, it was held that “as long as presence is in a physically defined geographical area, permanence in such fixed place could be relative having regard to the nature of business.”

Toronto Blue Jays Baseball Club, et al. vs. Minister of Finance¹³

In this case, the applicants own and operate three professional teams. It was held that to constitute PE, the premises must be used by the person and that person has the control over them.

American Income Life Insurance Co. vs. Her Majesty the Queen¹⁴

In this case, Canadian-resident individuals was soliciting sales of the U.S. resident’s insurance products in Canada. It was held that no PE was constituted as it has neither a fixed POB through which it carries on its business, nor does it operate through agents who habitually exercise in Canada and have an authority to conclude contracts in its name. A list of factors has been given which is to be considered in determining whether the parent’s business was being carried on from the fixed POB.¹⁵

Another important case is **DIT (IT), Mumbai and Ors. vs. Morgan Stanley and Co. Inc. and Ors¹⁶** where Hon’ble Supreme Court made a reference to ‘software PE’. Other important cases dealing with PE are **Universal Furniture Ind. AB vs. Government of Norway Stavanger Court,¹⁷ Adobe Systems Incorporated vs. Assistant Director of Income Tax and**

⁹ Assistant Director of Income Tax v. E-Funds IT Solution Inc (2018)13 SCC 294

¹⁰ (2019) 176 ITD 805

¹¹ [2018] 94 taxmann.com 195 (Del)

¹² MANU/ID/0806/2019, Date of decision: 29.03.2019

¹³ (OCA) 2005/02/15

¹⁴ 2008 TCC 306

¹⁵ ¶ 47, Available at <https://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/28677/index.do>, last visited on November 20, 2021

¹⁶ MANU/SC/2750/2007

¹⁷ Case No. 99-00421, Dated 19-12-1999



Ors¹⁸, ITO vs. Right Florists Limited¹⁹.

One of the recent cases is **LG Electronics Inc. Korea vs. DCIT (International Taxation)²⁰** where the concept of fixed POB was discussed. In another recent case of **Rolls-Royce PLC. vs. DDIT²¹** the Delhi HC upheld the Tribunal's view that there is PE since activities are carried out by a 100% subsidiary of an assessee. It also discussed the issue of profit attribution. In **Right Florist Case**, 'digital PE' discussed wherein it was observed that website *per se* cannot be considered as PE. The said observation was in line with the OECD Commentary.²²

- **Conclusion**

PE is one of the most important concepts in the area of global tax policies. There is a need to reevaluate the definition of PE under Article 5 of the OECD to cover 'digital PE'. A consistent and reasonable approach is required on the part of the entities while dealing with their tax regime. With an introduction of SEP in India, tax treaties need to be addressed and re-negotiated so that the provisions regarding the same can be duly

adhered to meet the required ends. The 'new nexus' rule should be incorporated in the double taxation avoidance agreement and tax treaties. Tax authorities of various jurisdiction should bring explicit and flexible rules to combat the challenges posed by the virtual development. It is the need of an hour to have a consensus based multilateral solution to address the tax challenges caused by the digitalisation. An effective framework is required to remove all the grey areas.

¹⁸ (2017) 292 CTR (Del) 407

¹⁹ ITA No. 1336/Kol/2011

²⁰ MANU/ID/1096/2019

²¹ 2019 SCC Online Del 11696

²² *Supra* note 7