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Tax alert: PE is independent economic center, profit attribution to PE cannot be restricted due to global income or loss

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The full bench of the Delhi High Court (HC) has rendered its decision, while overruling an earlier HC ruling, that a permanent establishment (PE) of a foreign company, is an independent taxable entity and Article 7 could not possibly be viewed as restricting the right of the source State to allocate or attribute income to the PE, based on any global income or loss that may have been earned or incurred.

In a nutshell

For the purposes of taxation, PE is viewed as a separate and distinct center. The imperatives of viewing the PE as a separate and independent center for the purposes of fiscal treatment and taxation is necessitated for reasons of attribution and recognition of income generated by it independently.

The existence and identity of the PE is separate and distinct and subject to tax to the extent of activities it may undertake in a State, distinct from that of its principal.

As per Article 7, while the profits of an enterprise of a Contracting State are ordained to be taxed only in that State, if that enterprise were to carry on business in the other Contracting State through a PE, the profits earned from activities undertaken by such an establishment would become subject to tax in the other State, coupled with the rider of the same being confined to the extent to which those profits are attributable to such an establishment.

Even though a PE may be merely a part of the larger entity, the profits generated from its activities undertaken in the other State, becomes subject to taxation, the HC observed. Article 7(1) further requires to undertake an exercise of identifying the extent of profits as are attributable to the PE. It is to that extent alone that the profits of the enterprise ultimately come to be taxed.

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Background:

- The taxpayer's[1] case is on account of a full bench of the Delhi High Court (HC), constituted as a consequence to the views of the Division Bench of the HC, expressed in an earlier ruling[2], wherein it was held that profit attribution to a Permanent Establishment (PE) would be warranted only if the enterprise as a whole, and the PE constituting merely a component thereof, had earned profits.
- The aforesaid earlier HC ruling was considering an appeal against the decision of the Income-tax Appellate Tribunal (ITAT) which had held [on the basis of an earlier ruling[3] of the Special Bench of the ITAT] that global profit or loss would constitute a relevant factor for attributing income to a PE.
- The HC before referring the matter for further consideration to full/larger bench had observed as follows:

  "The profits attributable to the taxpayer's PE in India are required to be determined on the footing that the PE is an independent taxable entity. It is, thus, possible that a taxpayer makes a net loss at an entity level on account of losses suffered in other jurisdictions, which is partly offset by profits arising from India. In these circumstances, if it is held that the taxpayer had a PE in India, prima facie the taxpayer would be liable to pay tax on the income attributable to its PE in India notwithstanding the losses suffered in other jurisdictions. This aspect was not deliberated in the case of Nokia Solutions and Networks OY[4].
- The taxpayer's contention before the HC was that even if it is assumed that the taxpayer had a PE in India, there was no question of attributing any amount as income chargeable to tax under the Income-tax Act, 1961 (ITA) to its PE, as it has incurred a loss on an entity level (global basis). Hence, income chargeable to tax under the ITA could be attributed to its PE in India only if the taxpayer had made profit on an entity level, by relying on aforesaid earlier HC ruling.

Relevant provisions in brief:

Relevant extracts of Article 5 and 7 of the India-UAE tax treaty:

ARTICLE 5 - PERMANENT ESTABLISHMENT

"1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially :

(a) a place of management ;

(b) a branch ;

(c) an office ;

(d) a factory ;

(e) a workshop ;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;…"

"ARTICLE 7 - BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the

[1] Hyatt International Southwest Asia Ltd vs. ADIT [2024] ITA No 216/2020 and others (Delhi- HC)

[2] Commissioner of Income-tax (international taxation) vs. Nokia Solutions and Networks OY (2022) SCC OnLine Del 5088

[3] Motorola Inc. Vs. Deputy Commissioner of Income Tax, Non-Resident Circle New Delhi (2005) SCC OnLine ITAT 1

[4] Commissioner of Income-tax (international taxation) vs. Nokia Solutions and Networks OY (2022) SCC OnLine Del 5088

enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment…"

Decision of the HC:

The HC framed the following question as to whether Article 7 of the India -United Arab Emirates (UAE) tax treaty would be applicable in case losses had been suffered at an entity level:

"Is Article 7(1) of the India-UAE tax treaty at all applicable to the taxpayer, having regard to the fact that it has incurred losses in the relevant financial years (FYs)?"

In this regard, the HC noted / observed as follows:

Concept of PE

- Article 5 while defining the expression 'PE' brings within its ambit a varied nature of establishments and which need not necessarily be those which have a separate legal persona. The nature of establishments which are included within the meaning of the phrase 'PE', range from a place of management to a mine or a building site and thus not being confined to a juridical entity as is ordinarily understood in law.
- In an earlier ruling[5] the HC had noticed that the PE for the purposes of taxation, is viewed as a separate and distinct center. The separate treatment which is liable to be accorded to the functioning of a PE emerged from the observations rendered in an earlier Supreme Court (SC) ruling[6].
- The imperatives of viewing the PE as a separate and independent center for the purposes of fiscal treatment and taxation is necessitated for reasons of attribution and recognition of income generated by it independently[7].

Independent status of a PE

- The concept of a PE is based upon the undertaking of economic activity in a particular State[8] irrespective of the residence of an enterprise and the same being understood to be in the nature of a conglomerate or an entity which may have many arms or independent functional units situated in various fiscal jurisdictions.
- Any entrepreneurial activity which gives rise to income or profit thus becomes liable to be taxed at source irrespective of the ultimate recipient or owner of that income. 'Source' would mean the location which gives rise to the accrual of profits or income or which is the location where the same arises. The PE principle thus enables the assignment of tax to the State which constitutes the source.
- The PE concept thus creates a functional relationship and connect between the principal entity and the place of business whose activities give rise to the income or profit. It is this fictional creation of an independent economic center in a Contracting State which informs the allocation of taxing rights.

[5] International Management Group (UK) Limited vs CIT-2 [2024] SCC Online Del 4558

[6] DIT (International Taxation), Mumbai vs. Morgan Stanley & Co. Inc (2007) 7 SCC 1

[7] Paragraph 24 of the Organisation for Economic Co-operation and Development Commentary on Article 7

[8] State or Contracting state as referred hereafter would infer as the 'source' country.

- Once the tax treaty confers an independent identity upon the PE, it would be wholly erroneous to answer the question of taxability based on either the activities or profitability of the parent or the entity which seeds and sustains the PE.
- The Contracting State in which this imagined entity is domiciled and undertakes business, thus becomes identified as an independent profit or revenue earning center which is liable to be taxed. Once such an entity is found to exist in one of the Contracting State, it is viewed as a unit which contributes to the economic life of that State and thus be liable to tax.
- The identity which attaches to a PE for the purposes of ascertainment of a taxing liability could not possibly be doubted basis an earlier SC ruling[9], wherein the SC acknowledged the distinction to be drawn between a PE with respect to income earned in the Contracting State where it was domiciled or deemed to exist and the global enterprise of which it may be a part.
- The right of the source State to tax did not extend to profits which are not allocable to the PE.
- The existence and identity of the PE is separate and distinct and subject to tax to the extent of activities that it may undertake in a State distinct from that of its principal.

Provisions of Article 7 of a tax treaty (on business profits)

- **A cross-border entity may structure its operations in a manner where it operates in more than one taxing jurisdiction. If it be open for such an entity to assert that its global profits and income are not liable to be taxed on the basis of the source principle, it would be wholly impermissible for it to contend that the income which accrues or arises in the Contracting State is also exempt from tax.**
- **The usage of the phrase *'…so much of them as is attributable to the permanent establishment.'* was a clear indicator of the tax treaty warranting the PE being liable to be viewed as an independent center of revenue.**
- The identifiable parts of Article 7 not only restrict the right of one of the Contracting States to tax, it also provisions for the extent to which a tax may be imposed by that State. It frees a trans-border entity from the specter of a tax liability if it does not have a PE in the introductory part of that covenant, then proceeds to restrict the impost by adopting the principle of attribution.
- Hence, it constructs an objective criterion for identification of a PE and when a foreign enterprise with sufficient economic presence would become subject to tax.
- On a jurisprudential plane, the sovereignty concept is based on a State's power over a territory and a set of subjects which accept its authority. It was these aspects which governed and regulated the right of a State to levy a tax. However, as trade and commerce transcended boundaries and borders, nations were confronted with profits and incomes being shifted and claimed as exempt.
- It is the aforenoted factors which appear to have moved the League of Nations in the early 1920s to constitute a group of economists to study the issue of double taxation. That group is stated to have identified the fundamental factors worthy of consideration to be (a) the origin of wealth or income, (b) the situs of income, (c) enforcement of rights connected with the above and (d) domicile of the person vested with the power to use or dispose of that income or wealth.

Source based taxation under Article 7

- As per Article 7, while the profits of an enterprise of a Contracting State are ordained to be taxed only in that State, if that enterprise were to carry on business in the other Contracting State through a PE, the profits earned from activities undertaken by such an establishment would become subject to tax in the other State

[9] DIT (International Taxation), Mumbai vs. Morgan Stanley & Co. Inc

coupled with the rider of the same being confined to the extent to which those profits are attributable to such an establishment.

- Paragraph 7(1) clearly envisages the profits of a PE being liable to be independently taxed notwithstanding that PE being a constituent of a larger enterprise which may be domiciled in the other Contracting State. The exemption from taxation which stands accorded to an enterprise of a contracting State would cease to be applicable by virtue of the use of the word *'unless'* which precedes the Article taking into consideration the existence of a PE of that enterprise in the other Contracting State.
- Article 7(2) stipulates that where an enterprise carries on business through a PE in the other Contracting State, profits would be liable to be attributed to that PE as if it were a distinct and separate enterprise engaged in similar activities and independent of the enterprise of which it may be a part.
- Article 7(2) employs the phrase *'dealing wholly independently with the enterprise of which it is a permanent establishment'*. Article 7(2) thus view the PE as a distinct and separate entity engaged in undertaking business activity in its own right in a Contracting State.
- It would consequently be **incorrect** to fuse the incomes generated by an enterprise as a whole with the income that may be earned by a PE in one of the Contracting States. It would also be **incorrect** to interpret Article 7 as to ignore the income that may be generated pursuant to activities undertaken by a PE in one of the Contracting States and making the exercise of attribution dependent upon the profits or the income that the enterprise may otherwise earn at an entity level.
- **Consequently, even though a PE may be merely a part of the larger entity, the profits generated from its activities undertaken in the other State becomes subject to taxation. Article 7(1) further requires to undertake an exercise of identifying the extent of profits as are attributable to the PE. It is to that extent alone that the profits of the enterprise ultimately come to be taxed.**

Source based and residence-based taxation for resident and non-resident taxpayers

- Global income, as a fundamental precept, has always been invoked in respect of residents of a Contracting State. Most nations have ultimately reverted to the source rule for purposes of taxation.
- The distinction which needs to be borne in mind with regard to the income of a non-resident as opposed to an entity domiciled and stationed in one of the Contracting States stands duly acknowledged in section 5 of the ITA and which subjects the global income of a resident alone to taxation. For non-residents, it is the principles of income accruing or arising which are decreed to govern. It is accepted and well recognised principles which imbue the tax treaties also.
- The profits of an enterprise do not become subject to taxation unless it be found that it functions in the other Contracting State through a PE. Article 7 further postulates that it is only such income which is attributable to the PE which would be subjected to tax in the source State.
- **The source State is ultimately concerned with the income or profit which arises or accrues within its territorial boundaries and the activities undertaken therein. As per earlier rulings[10], the profits attributable to a PE are not liable to be ignored on the basis of the performance of the entity as a whole.**
- If the taxpayer's contentions were accepted, the Revenue would be recognised to have the power to tax even in a situation where although the entity be profitable, the PE may have incurred a loss. In a converse situation, the Contracting State would be countenanced to have the right to tax only if the taxpayer at a global level were found to have earned profit. That was clearly not the import of Article 7 of the tax treaty.

[10] DIT (International Taxation), Mumbai vs. Morgan Stanley & Co. Inc (2007) 7 SCC 1 and Ishikawajma-Harima Heavy Industries Ltd. vs. Director of Income Tax, Mumbai (2007) 3 SCC 481

- While protecting the right of an enterprise to be subject to tax in the State where it be resident, Article 7 placed a negative stipulation in respect of cases where a PE was found to exist coupled with an attribution exercise being undertaken in respect of the domestic enterprise.
- Article 7 does not expand its gaze or reach to the overall operations or profitability of a transnational enterprise. It is concerned solely with the profits or income attributable to the PE. The taxability of income earned by a PE existing in a Contracting State was not even remotely linked or coupled to the overall operations of the enterprise of which it may be a part.

Conclusion

- The activities of a PE are liable to be independently evaluated and ascertained as per plain language under Article 7 of a tax treaty. A 'PE' is conceived to be an independent taxable entity and cannot possibly be doubted or questioned.
- Based on the rule of source which applies and informs the underlying theory of taxation, the source State being deprived of its right to tax a PE or that right being dependent upon the overall and global financials of an entity, could not be accepted.
- The Division Bench in the said appeals rightly doubted the correctness of taxation being dependent upon profits or income being earned at the *'entity level'*.
- Article 7 could not possibly be viewed as restricting the right of the source State to allocate or attribute income to the PE based on the global income or loss that may have been earned or incurred by a cross border entity.

In view of the above, the HC held that the tentative view expressed by the Division Bench of the HC as well as the doubt expressed with respect to the findings rendered in earlier HC ruling[11] was well founded and correct.

Comments:

A non-resident entity may conduct business through a PE in the source country. In such cases, a question arises whether any profits could be attributed to the said PE when the non-resident entity on an overall basis has incurred a loss.

The full bench of the HC as constituted to express its view on the aforesaid question, while specifically dealing with taxability of income earned by PE notwithstanding the income or loss at global level, has while holding that Article 7 could not possibly be viewed as restricting the right of the source State to allocate or attribute income to the PE based on the global income or loss that may have been earned or incurred by a cross border entity, has reiterated *inter-alia*, the following principles:

- PE for the purposes of taxation is viewed as a separate and distinct center. The imperatives of viewing the PE as a separate and independent center for the purposes of fiscal treatment and taxation is necessitated for reasons of attribution and recognition of income generated by it independently.
- The existence and identity of the PE is separate and distinct and subject to tax to the extent of activities that it may undertake in a State distinct from that of its principal. Once such an entity is found to exist in one of the Contracting State, it is viewed as a unit which contributes to the economic life of that State and thus be liable to tax.
- Any entrepreneurial activity which gives rise to income or profit thus becomes liable to be taxed at source irrespective of the ultimate recipient or owner of that income. 'Source' would mean the location which gives rise to the accrual of profits or income or which is the location where the same arises. The PE principle thus enables the assignment of tax to the State which constitutes the source.

[11] Commissioner of Income-tax (international taxation) vs. Nokia Solutions and Networks OY (2022) SCC OnLine Del 5088

- As per Article 7, while the profits of an enterprise of a Contracting State are ordained to be taxed only in that State, if that enterprise were to carry on business in the other Contracting State through a PE, the profits earned from activities undertaken by such an establishment would become subject to tax in the other State coupled with the rider of the same being confined to the extent to which those profits are attributable to such an establishment.
- Even though a PE may be merely a part of the larger entity, the profits generated from its activities undertaken in the other State becomes subject to taxation. Article 7(1) further requires to undertake an exercise of identifying the extent of profits as are attributable to the PE. It is to that extent alone that the profits of the enterprise ultimately come to be taxed.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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