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Taxation of profits of foreign enterprises in India: three and a half myths

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Foreign enterprises for the purpose of Indian Income Tax (IT) Act are enterprises that are incorporated outside India or that do not have their place of effective management in India (as per new section 6 of IT Act, effective from April 2017). Section 5(2) read with section 4 of the IT Act provides that the total taxable income of foreign enterprises will include all income (including business profits as per section 2(24) of the IT Act) that is received in India or accrues or arises in India or is deemed to be received or is deemed to accrue or arise in India.

The question that arises is when can business profits be deemed to accrue or arise in India? Section 9(1)(i) of the IT Act provides the answer. Under that section, 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 IT 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.

To sum up, 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. This is of course subject to the existence of a permanent establishment in India. A ruling handed down by the New Delhi Income Tax Appellate Tribunal (*Geo Connect Ltd vs. Deputy Commissioner of Income Tax; 2017*) fortifies some of the most common myths associated with the taxation of profits of foreign enterprises, owing to an incorrect understanding of the meaning of business connection (under section 9 of IT Act) and permanent establishment (Article 5 of a tax treaty). This blog is a candid attempt at demystifying these myths.

Myth 1: Permanent establishment and business connection are competing concepts and must be read and applied differently

The ITAT's ruling in *Geo Connect* finds mention of the Indian Supreme Court's rather bizarre observations made in an earlier decision in *Ishikawajma Harima Heavy Industries Ltd. vs. Director of Income Tax* (2007) that "the concepts of profits of business connection and permanent establishment should not be mixed up." "The concept of permanent establishment is relevant for assessing the income of a non-resident under the tax treaty," the court added, "whereas business connection was relevant for the purpose of application of section 9." While it is correct that

business connection and permanent establishment are treated differently as they derive their import from different origins, it is also correct that taxation of income arising from both business connection and permanent establishment recognizes the source principle of taxation as they confer right on the source country to tax the income of a foreign enterprise. Business connection under section 9 of IT Act is an Indian equivalent of the treaty concept of permanent establishment and means carrying of a business activity by a foreign enterprise in India, including through a person acting on behalf of such foreign enterprise. Both the concepts rely on the source rule to tax profits arising to foreign enterprises in the source country; they both only tax foreign profits to the extent that they are attributable to the activities taken place in the source country that gave rise to the such income; they both are aimed at taxing business profits that arise from business activities including through agency activities; and they both imply that business profits of an enterprise shall otherwise only be taxed in the resident country.

Myth 2: Existence of a permanent establishment does not necessarily imply existence of a business connection

It may appear at the first instance that this Myth relies heavily on Myth 1 to make a point, but if one were to delve deeper, it would emerge that there indeed is a stark difference between both myths: Myth 1 is about the origin and meaning of the concept of business connection, whereas Myth 2 is about its application (both independently under the domestic law as well as vis-a-vis permanent establishment under the treaty). While *Geo Connect* does not examine business connection from this angle, the Supreme Court in *Ishikawajma* opined that "the existence of a permanent establishment will not constitute sufficient business connection." While the reverse may be true (that is, the existence of a business connection may or may not constitute a permanent establishment), the argument that a foreign enterprise can have a permanent establishment in India and yet have no business connection in India is misplaced. Even if we leave aside the definition of business connection in Explanation 2 of section 9 of IT Act, it is difficult to understand as to how the illustrations set out in Article 5 of a tax treaty such as a place of management or an office or a branch located in India through which the activities of the foreign enterprise are continually carried on will not constitute business connection in India. Likewise, how can foreign enterprises that have workshops or factories located in India and from where business activities that are not of auxiliary or preparatory character are being carried on contend that they do not have a business connection in India for the purposes of section 9 of IT Act.

Myth 3: The starting point to examine the taxation of profits of foreign enterprises must always be the IT Act

Some would argue (and rightly so) that a treaty does not and cannot confer taxing rights but only allocates them and therefore if a country for some reason cannot tax profits of foreign enterprises under its domestic law, it will not be able to invoke the provisions of the treaty to tax income that is otherwise not taxable under the domestic law. This piece is not aimed at evoking a discussion on the international/municipal law supremacy debate but attempts to make a very limited point which is this: it is always desirable that courts must start (unlike what happened in *Geo Connect*) with Article 5 of tax treaty to examine if profits of a foreign enterprise can or cannot be taxed in India and not with section 9 of IT Act. I say this for the following three reasons: (i) the definition of permanent establishment in a tax treaty is more illustrative and plain compared to the inclusive definition of business connection under section 9 of IT Act; (ii) if the court concludes in favour of a permanent establishment then there is no need to examine the meaning of business connection under section 9 of IT Act as the existence of permanent establishment will necessarily imply the

existence of a business connection (see Myth 2 above); and (iii) if the court concludes that there is no permanent establishment then section 9 of IT Act anyway becomes redundant as Article 5 of tax treaty will restrict taxation of business profits in the absence of a permanent establishment. It will of course be a different story where India does not have a tax treaty with a foreign country in which case section 9 of IT Act will play a significant role.

The half myth: The mandate and ratio of *CIT vs. R D Aggarwal* (1965) on the definition of business connection is conclusive

The Supreme Court in *R D Aggarwal* observed as follows: "business connection presupposes an element of continuity between the business of the non-resident and the activity in the taxable territory. A stray or isolated transaction is normally not to be regarded as business connection…Business connection must be real and intimate and through or from which income must accrue or arise whether directly or indirectly to the non-resident." It is imperative to note that these observations were made back in 1960s when the then IT Act did not contain any definition of business connection and as such the court was left with no other option but to interpret the term in the way that it did. However, the case lost its charm after the introduction (in 2004) of Explanation 2 to section 9 of IT Act which categorically defines business connection. Courts today must bear in mind and interpret the meaning of business connection within the confines of Explanation 2 to section 9 of IT Act (wide and inclusive as it may be) with an extremely careful and restricted reliance on *R D Aggarwal*. A lot has anyway changed in the way businesses function in a globalized world today since the delivery of the decision in 1965.

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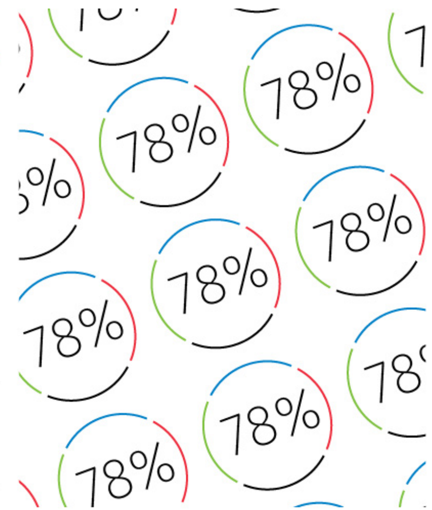

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