

Kluwer International Tax Blog

India's position on PE rule bound to increase international tax litigation

Shilpa Goel (Tax Lawyer) · Monday, May 28th, 2018

The importance of the permanent establishment (PE) principle in tax treaties cannot be undermined. Whether or not a source country has the right to tax business profits of a foreign company would depend wholly on the existence or non-existence of a PE of that company in the source country. Work undertaken by the OECD in the area of corporate tax avoidance, notably, its work on Action 1 (digital taxation) and Action 7 (artificial avoidance of PE status) of the base erosion and profit shifting (BEPS) project sought to change the way in which countries have traditionally applied the PE principle.

India has been actively participating in the BEPS project since its launch in 2013. The Government has taken several measures to prevent multinational tax avoidance, including tax transparency measures. Some of the recent tax measures such as a six percent equalization levy on advertising payments and the introduction of virtual nexus to attribute profits to a business connection in India have been widely criticized.

The Budget 2018 introduction of a new virtual tax nexus in the domestic tax law to tax profits of non-resident companies will of course not have any immediate practical impact until the Government successfully negotiates with its treaty partners the PE definition contained in tax treaties. What is of immediate concern is India's stand on the meaning and application of physical PE and service PE, as evinced from the Government's position statement on the 2017 update to OECD Model Tax Convention.

It is correct to say that companies that rely on digital models to earn revenue have been able to avoid PE status in the source country and there is an urgent need for countries to update their tax rules to catch up with changing times. The important question is how. As part of its work on BEPS Action 7, on preventing the artificial avoidance of PE status, the OECD has proposed key revisions to definition of permanent establishment stipulated in Article 5 of the OECD Model Tax Convention to target such kinds of arrangements. In particular, the OECD has revised the preparatory and auxiliary activity exceptions and has removed the requirement for dependent agents to habitually conclude contracts in the market country

India's observations on changes agreed as part of BEPS Action 7 on the agency PE principle is unfortunate. The agency PE rule was revised to cover cases where agents habitually play the principal role leading to the conclusion of contracts (including for the provision of services) that are routinely concluded without material modification by the foreign company. The change is

aimed at ensuring that foreign companies can no longer not avoid agency PE status in the source country by virtually concluding contracts and the requirement to conclude contracts “routinely” implies that there is some degree of continuity of business activities entitling the source state to tax income arising from such business activities. Therefore, India’s position that contracts do not need to be routinely concluded will create avoidable uncertainty and will open a floodgate of court cases.

In its observations to the OECD Convention, the Government stated that furnishing of services is sufficient for creation of a service PE and that India will exercise its tax rights even when services are furnished by non-residents from outside the country (that is, electronically). Likewise, the Government’s position that a website would constitute a PE in certain circumstances where it leads to significant economic presence of a foreign enterprise and depending on the facts, an enterprise can be considered to have acquired a place of business through a website on any equipment, if opening the website on that equipment includes downloading of automated software, such as cookies, which use that equipment to collect data from that equipment, process it in any manner or share it with the enterprise. This stand is contrary to the many judgments where courts have categorically ruled, and on sound reasoning, that a website cannot constitute PE.

It goes without disputing that foreign businesses who make profits out of business activities carried out in India must pay income tax in the country. But any tax collected must be in accordance with the provisions of the tax treaty. The tax authorities will naturally interpret and apply the PE principle as per the Government’s position at the OECD-level, which is not entirely in line with settled principles of international tax law and past judicial precedents. This would raise problems of double taxation (and therefore riskier investments) and will likely lead to an increase in treaty disputes.

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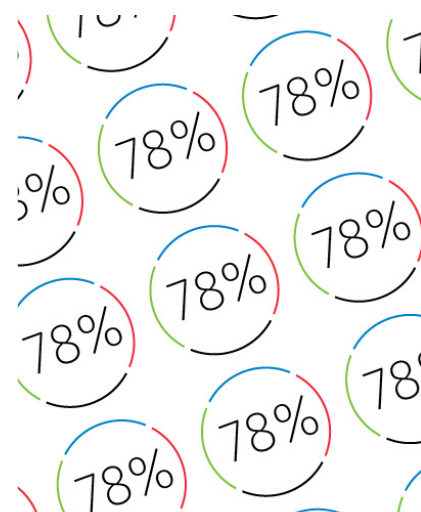
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