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Business Connection and Permanent Establishment

30th Residential Refresher Course
Chartered Accountants Association, Ahmedabad

Ms. Shefali Goradia*
September 19 -21, 2003

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Nishith Desai Associates (NDA), is based in Mumbai, Bangalore and Silicon Valley, and specializes in globalisation of Indian corporates, International Tax & Transfer Pricing, Offshore Funds, Corporate and Securities laws, ADRs, M&A, Information, Communication & Entertainment (ICE) laws, e-commerce laws, and Media & Entertainment laws & Biotechnology. The firm has structured and acted for the largest number of private equity funds for India. NDA acted as underwriter’s counsel in Infosys Technologies and Satyam Infoway’s American Depository Receipt (ADR) offerings in the USA. It also represented Rediff.com, Silverline Technologies and Wipro in the ADR listings. NDA was involved in the first cross-border stock swap merger out of India, that is, BFL’s acquisition of MphasiS, and was also involved in Silverline’s acquisition of Seranova.

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BUSINESS CONNECTION AND PERMANENT ESTABLISHMENT

-This paper must be read in conjunction with the Responsibility Statement.

CONTENTS

INTRODUCTION

The concept of permanent establishment ("**PE**") has gained considerable importance with the growing trend of globalization. The concept of a PE is important for several Articles of the Convention[1]; and the concept or its cognate, also appears in the domestic laws of some countries. For example, in India we have the concept of 'business connection' ("**BC**"), which we shall discuss later on in this paper. The PE concept marks the dividing line for businesses between merely trading with a country and trading in that country; if an enterprise has a PE, its presence in a country is sufficiently substantial than when it is trading in a country[2]. As the Indian judiciary[3] puts it; the words 'permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

The primary use of the PE concept is to determine the right of a country[4] to tax the profits of an enterprise of another country. In short, PE is a term defined in tax conventions to determine when a non-resident is taxable in a source country. It defines the requisite level of nexus in a country to support taxation of income at source. Under Article 7, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a PE situated therein.

Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.*e*, Article 14. The provisions of that Article were similar to those applicable to business profits. Article 14 uses the concept of fixed base rather than that of permanent establishment since it has been originally thought that the latter concept should be reserved to commercial and industrial activities. The elimination of the Article 14 in 2000 reflected that there were no intended differences between the concepts of PE, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to Article 7 or 14.

Since more detailed description of the concept and history of evolution is found internationally in the context of PE, I have first discussed the concept of PE and than discussed the concept of Business Connection which exists in the Indian context.

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[1] The term "Convention" has been used in the context of the United Nations Double Taxation Avoidance Agreement ("**UN Model**") and the OECD Double Taxation Avoidance Agreement ("**OECD model**")

[2] A manual on the OECD Model Tax Convention on Income and on Capital by Dr. Philip Baker (hereinafter referred to as "**Commentary by Dr Philip Baker**"), page 5-2 para 5B.01

[3] In the case of CIT v. Visakhapatnam Port Trust reported in *[1983] 144 ITR 146 (Andhra Pradesh High Court)*

[4] Also referred to as 'contracting states' when used in the context of the OECD Model and the UN Model.

PERMANENT ESTABLISHMENT

Significance

One of the paramount objectives of a tax treaty[5] is to resolve the claims of competing jurisdictions where an enterprise is resident in one country and carries out business activities in another. Most often, domestic laws of countries prescribe the threshold for taxing business profits of a foreign enterprise carrying on business within their taxable territory. For instance in India, we have the concept of a 'business connection', which is discussed below, and is analogous to the concept of a PE. In the UK, the threshold is described as the point when a foreign enterprise trades *within* the UK, as opposed to merely trading *with* the UK[6]. The PE concept is therefore a major contribution to international tax law and is a significant feature of bilateral tax treaties in force throughout the world. Where a tax treaty is in operation, the crucial question is whether a foreign enterprise is carrying on business through a PE in the country where the profits are earned. If the enterprise does not have a PE then it can be taxed only in the country where it is a resident. However, where the enterprise operates through a PE, the profits attributable to it, may be taxed by the country where the PE is located, leaving the country of residence to give relief from double taxation. Thus it may be possible for an enterprise with overseas trading operations to avoid foreign taxes by carefully structuring its operations to come below the PE threshold. Where a PE is in existence, the country where it is located may also tax its capital gains, dividends, interest and royalties that are effectively connected to such PE.

Definition

Since the OECD Model is the most commonly used model in negotiation of tax treaties and the other models are generally deviations from it, for the purposes of this paper, I have considered the definition of PE as per the OECD Model. The definition of the term PE is reproduced in *Appendix I*. From this definition it can be seen that there are two types of PE contemplated. First, an establishment which is a part of the same enterprise and under common ownership and control- an office, branch, etc. This is covered by Article 5(1) to (4), which can be referred to as '*Associated PE'*. The second type is an agent who is legally separate from the enterprise, but is nevertheless dependent on the enterprise to the point of forming a permanent establishment. This is covered by Article 5(5) and (6), which can be referred to as '*Unassociated PE'*.

[5] The term 'Tax Treaty' as used in this paper refers to Agreement for Avoidance of Double Taxation, or DTAA
[6] Principles of International Double Taxation Relief, 1st Ed., - David R. Davies, at page 114

Analysis

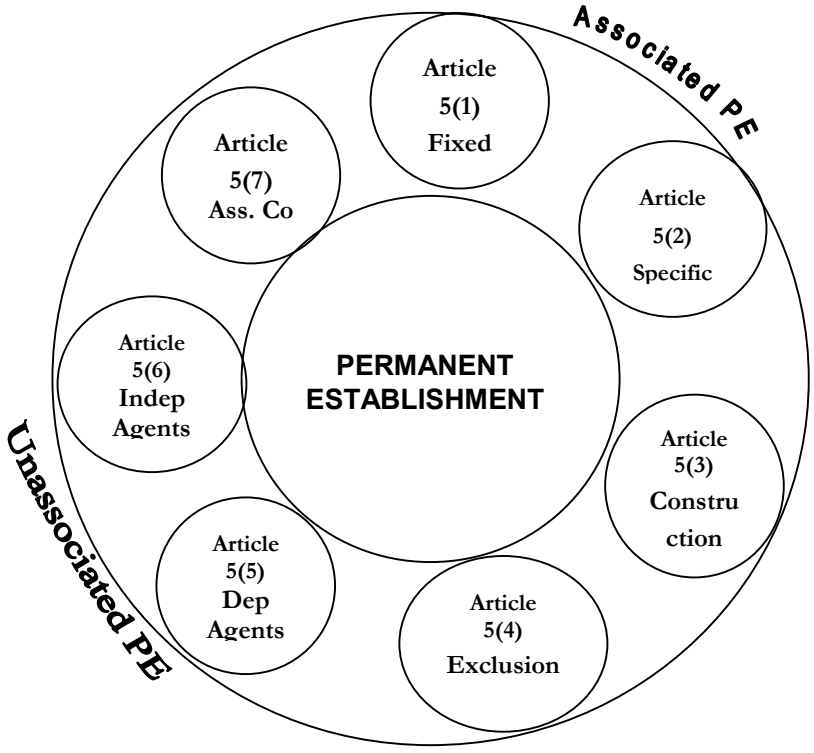


Diagram 1: Structure of PE clause

- **Article 5(1)** - The general rule: the PE must be a fixed place of business at the disposal of the enterprise through which the business of the enterprise is carried on.
- **Article 5(2)** contains a list of places of business, which prima facie constitute PE, provided they satisfy the requirements of Article 5(1).
- **Article 5(3)** - special rule for construction & installation sites - a limitation on Article 5(1).
- **Article 5(4)** lists activities, which may be carried on at a fixed place of business without giving rise to a PE.
- **Article 5(5)** provides that dependent agents constitute a PE.
- **Article 5(6)** identifies certain forms of independent agents who do not constitute a PE.
- **Article 5(7)** states that an associated company will not necessarily give rise to a PE.

Article 5(1)

The official commentary[7] on the OECD Model explains the basic criteria for the existence of a PE as follows:

- the existence of a *'place of business'*, i.e., a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be *'fixed'*, i.e., it must be established at a distinct place with a certain degree of permanence;
- the *'carrying on of the business'* of the enterprise through this fixed place of business. This means usually that persons who, one way or another, are dependent on the

[7] Para 2 of Article 5(1) of the commentary to the OECD Model

enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The place of business must be fixed and permanent; for example, a stand at a trade fair, occupied regularly for 3 weeks a year, through which the enterprise obtained contracts for a significant part of its annual sales, has also been held to constitute a PE[8]. ON the other hand, the US IRS has in one case ruled that the ten-week run of a French cabaret show created no PE at the resort hotel that it played in[9]. In contrast, a Danish restaurant at the New York World Fair was ruled as a PE, although it operated only six months in each of two years[10]. The supply of skilled labour to work in a country did not give rise to a PE in that other country[11].

Another important parameter to bear in mind is to constitute a PE the fixed place of business must be at the disposal of the enterprise. The OECD commentary makes it clear that the premises need not be owned or even rented by the enterprise. All that is required is that the premises should be at the disposal of the enterprise. This has given rise to some difficulties where premises are made available to a foreign enterprise for the purposes of carrying out particular work on behalf of the owner of the premises; in that situation, the space provided is not at the disposal of the enterprise since it has no right to occupy the premises but is merely given access for the purposes of the project. This is illustrated by a Canadian case[12]. In this case, the taxpayer was a resident of the US who was contracted to supply training to employees of a Canadian company. For the purposes of the training contract, the taxpayer was given various offices at the premises of the Canadian company, which he was only allowed to enter at normal office hours. He was allowed to use the client's telephone only on client's business. Although he spent a considerable amount of time in Canada, the tax court held that he had no fixed base at the premises since he had no right to use the premises as the base for the operation of his own business[13].

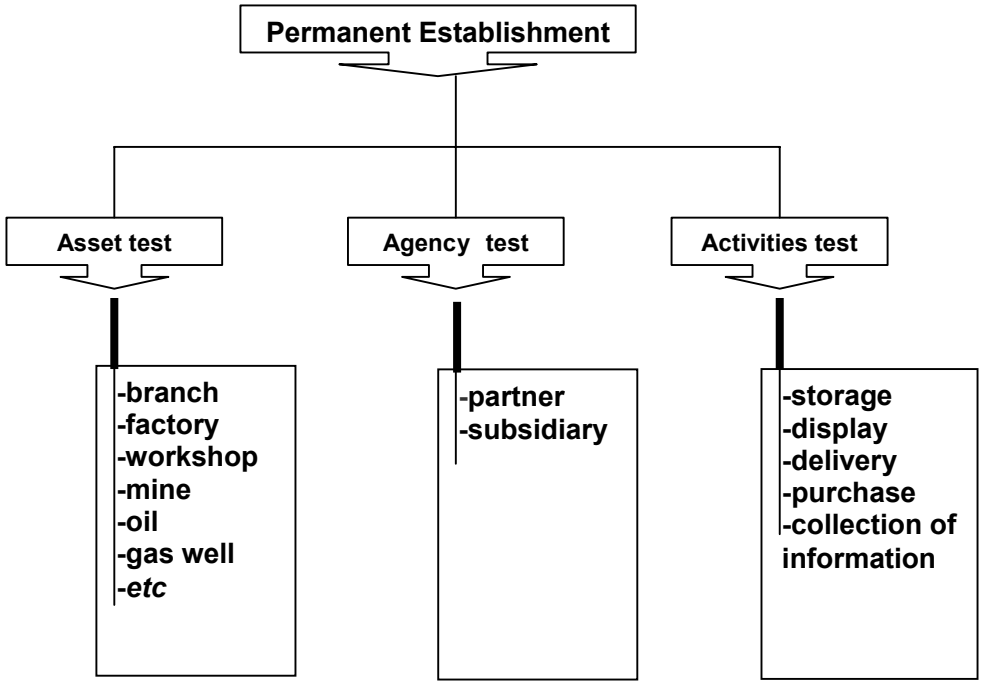
There have also been several German cases on this issue[14]. In a case generally referred to as Hotel Manager[15], the Bundesfinanzhof held that a UK hotel management company had a PE in Germany when it entered into a 20-year contract with a limited partnership which owned a hotel. The agreement required the UK company to supply a general manager. The general manager's office constituted the PE (and not the entire hotel) since the UK company had a secured right to use this office for the purposes of the agreement.

Article 5(2) to Article 5(7)

[8] Joseph Fowler v. M.N.R. (1990) 90 DTC 1834 (Tax Court of Canada)
[9] Ltr. Ruling 5903189290A
[10] Ltr. Ruling 6704066110A
[11] Tekniskil (Sendirian) Bhd. V. Commissioner of Income Tax (1996) 222 IT 551 (Authority for Advance Ruling)
[12] William Dudney v. Rreported in (1999) 99 DTC 147
[13] Commentary of Dr. Philip Baker, para 5B.08
[14] *Ibid,* para 5B.09
[15] Bundesfinanzhof, February 3, 1993, IR 80-81/91, IstR, p. 226, (1993) BStBl., II, 462

From the above definition it can be observed that the basic structure of the PE concept has been characterised as involving three acid tests; assets test, agency/relationship test and an activities test[16]. The acid tests can be diagrammatically represented as below:

Diagram 2: Acid Tests



We now analyze each of these acid tests:

Asset test

Paragraph 2 to Article 5 sets out a list of places, which *prima facie* will constitute a PE. In no way can this list be said to be exhaustive as it is mainly indicative. An important point to be borne in mind here is that the OECD observes that it is assumed the list of examples will be interpreted by treaty states in accordance with the principles of paragraph 1.

Place of management: Management means the possession of actual decision making power. The place where the person actually makes these decisions is crucial, irrespective of the title that he or she bears[17]. Further, it must be noted that management does not mean ownership. The simplest way of explaining the meaning of this phrase is as has

[16] *ibid,* at page 115
[17] Permanent Establishment - A Planning Primer, by John Huston and Lee Williams at page 18

been explained by Bischel[18], taking the case of a US parent corporation with subsidiary companies in Italy and the United Kingdom. If one of the managing directors of the Italian subsidiary is mainly based in London where the group's common management centre is located, the Italian subsidiary company may be held to have PE in the UK. In the Memorandum of Understanding attached to the 1965 Protocol to the US-Germany double tax treaty it was stated that the term 'place of management' does not include a 'hotel room or similar place *temporarily* occupied by officials of an enterprise'[19]. In the absence of such a provision in a particular tax treaty, it may be a good idea for executives who repeatedly visit a treaty country to engage in policy or oversight planning to regularly change hotels and conduct business meetings, where possible, in office premises of unrelated third parties[20].

Let us consider the following example to examine when a place of management can constitute a PE[21]:

Let it be assumed that a Luxembourg manufacturing enterprise enters into a contract with a US firm for the supply and installation of certain precision equipment at the US firm's plant located in the US. It is required that top-level personnel of the Luxembourg enterprise be present in the US for the purpose of directing and supervising the installation of the equipment delivered by the enterprise. Such personnel do not exercise any authority to conclude contracts in the name of the Luxembourg enterprise. The project lasts for less than 5 months and no office or branch is maintained in the US in as much as the Luxembourg firm does not generally carry on business in the US.

In such a case, it is true that important decisions with regard to the Luxembourg enterprise's business in the US are made at the place in the US where services contemplated in the contract are being performed. These are, however, in the nature of technical decisions relating to the completion of the task, which was undertaken by the manufacturer and would not be considered by the US government to constitute decisions involving the 'management' of the Luxembourg enterprise's business in the US. Therefore, for purposes of the imposition of the US tax under the tax treaty, no PE would exist in the US.

Branch: 'Branch' is one of the most common terms appearing in treaty specifications of PE. Surprisingly the term has not been defined! Generally, we understand a branch to mean an office or other establishment of a corporation incorporated under the laws of a country other than the one on which the branch is located.

Office: the term 'office' is used in almost all tax conventions entered into between countries. A single desk or even an office at home can be treated as an office leading to the constitution of a PE.

Factory: The term factory has been defined as a building in which goods are manufactured[22]. In a case the factory in question was owned and operated by an

[18] Bischel, Tax Treaties in International Planning (New York, 1975) at page 50
[19] *ibid,* page 117
[20] *supra* n. 17, page 21
[21] *supra* n. 17, page 19

Australian company, an entity separate and distinct from the taxpayer- an English company, which held shares in it but was not its parent. The Australian company produced articles and sold a portion of the production to the taxpayer company and was duly paid for the articles supplied. The Australian government argued that where there is a factory catering especially for the needs of the taxpayer company, it should be held to be a 'factory' within the PE clause. The taxation board of review declined to adopt the governments view on the ground that the factory simply did not belong to the English taxpayer[23]. From this case it can be seen that ownership is an important criteria for an enterprise to fall within this PE clause. However the OECDs official attitude towards foreign ownership would indicate that a factory need not be owned by a foreign enterprise in order to be its PE; leased premises would also suffice.

Workshop: This is a clause which hardly has ever led to the establishment of a PE. Its inclusion in 1928 probably carried some special weight in the US. A dictionary definition of that era explains that in Britain, the term had, by various acts of Parliament; been declared to be any place in which collective manual labour, under an employer having right of access to or control over the place, is done by way of trade or in making, repairing, or the like, articles to be sold, and in which no machinery moved or worked by any mechanical power is used.[24]

Building sites and installation projects: Article 5(3) deals with building sites and construction or installation projects[25].

The 1977 official commentary to the OECD Model states that the above term includes the construction of roads, bridges, canals, laying pipe-lines, excavating and dredging. The term also includes planning and supervision of the same only if carried on by the building contractor, but not if carried on by another enterprise whose only function is planning and supervision[26]. Furthermore, according to the 1977 OECD Model Commentary, if the enterprise carrying out purely planning and supervisory activities has an office, that will not constitute a PE (because it lasts for less than 12 months). Regarding this 12 month rule, the commentary states that it should include any period of interruption of work, for example due to bad weather, shortage of materials or labour difficulties. Further, periods of work undertaken by a sub-contractor will be included in the computation of the time spent by the main contractor. Must be borne in mind that the 12 month rule applies to each individual site or project, and this raises the problem of whether building, construction work, etc, carried out at a number of different places comprises one site or

[22] The Oxford Dictionary, 1993 Ed.
[23] Case No. F 85, 6 Tax'n Bd. Of Rev. 483,495. Permanent establishment a planning primer, by John Huston and Lee Williams at page 29
[24] Webster's New Int'l Dict, 2350 (1933). Permanent establishment a planning primer, by John Huston and Lee Williams at page 31
[25] An installation project would include an installation of machinery. Held in the case of CIT v. Visakhapatnam Port Trust (1983) 144 IT 146
[26] OECD Model Commentary 1977, pg. 62 para 16. Article 5(3)(a) of the UN Model Convention 1980 specifically includes supervisory activities connected to the building site, *etc*

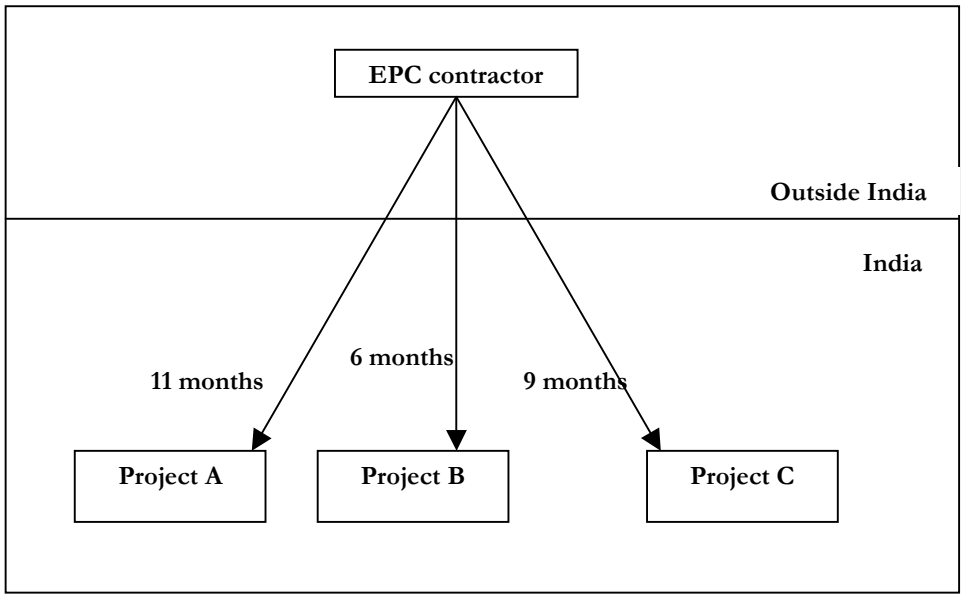
several sites[27]. The commentary on the OECD Model states that a 'building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically[28]. This article leads to interesting tax planning thoughts. For example, a housing development programme to be carried out in several neighboring places or a turnkey project involving various installations at different locations could be structured in a manner so as to minimize the exposure to the constitution of a PE.

Article 5(3) is in relation to the PE of contractors who carry out the work involved in the construction or installation project, and not the owners of the premises on which the project is carried out[29]. Thus, if an owner of land employs a contractor to construct a building on the site, the project lasting for more than 12 months, it is the contractor who has a PE and not the landowner.

Let us now consider an example on Engineering, Procurement and Construction Contracts:

[27] *Supra* fn. 3 at page 118
[28] Para 16 on Article 5 of the OECD Model Commentary 1977
[29] Commentary by Dr. Philip Baker, para 5B.16

Diagram 3 : EPC Contracts



In a situation where each of the contracts are performed for separate contractors/each project is an independent project, the period for which the EPC contract is present in India, will be considered independently for each such project. In the above situation, though the total period spent in India is more than 12 months, since such period is spent for different projects, the EPC contractor would not be regarded to have a PE in India.

The administrative court of appeal of Nancy in Paris in France held that the mere supervision of building works in Algeria did not give rise to a PE[30]. Similarly the Income Tax Appellate Tribunal[31], held that a French company did not have a PE in India when it merely supervised an Indian company installing telephone switching equipment.

In 1989 the revenue authorities of Belgium, the Netherlands and Germany issued an interpretation of tax treaty provisions. This interpretation had the following rules[32]:

1. *the length of time separate construction sites last does not have to be added up for computing whether a PE is formed;*

[30] Decision of May 9, 1996. case no. 94-914
[31] Deputy CITv. Alcatel (1993) 47 ITD 275
[32] 1989 E.T. 264

2. *work performed for separate principals may normally be treated as a separate project, unless it forms one unit with another project or series of projects, from an economic point of view;*

3. *different projects performed for one principal by virtue of one contract are treated as 'one' unless the different projects are not performed in any relationship to each other;*

4. *projects performed for one principal by virtue of several contracts are also to be treated as 'one' if the construction, although performed at different sites, is only part of a more global project and there is no appreciable interruption of the activity between the sites."*

Agency Test

Paragraph 5 states that a non-independent agent who has an authority to conclude contracts on behalf of an enterprise, and who habitually exercises that authority, will constitute a PE of the enterprise. However, if the enterprise carries on business through an independent agent such as a broker or general commission agent, paragraph 6 provides that such person will not constitute a PE of the enterprise. The official commentary on the OECD Model furthers states that a person will only have independent status if it is independent both legally and economically, and it acts in its ordinary course of business when acting on behalf of the enterprise[33]. If an agent acts almost exclusively for one enterprise it may be difficult for him to show that he is independent, and in some Indian treaties (for example the one with UK) it is expressly provided that in such a case the agent will be deemed not to have an independent status. Paragraph 7 recognizes that an overseas subsidiary company is a separate legal entity from its parent and as such cannot automatically be regarded as a PE. However, if the subsidiary functions as a non-independent agent/entity on behalf of its parent, it will constitute a PE.

The following case[34] where the Australian Board of Taxation review found no PE when a consignment sales arrangement existed between related parties who acted as exclusive suppliers/distributors is of interest:

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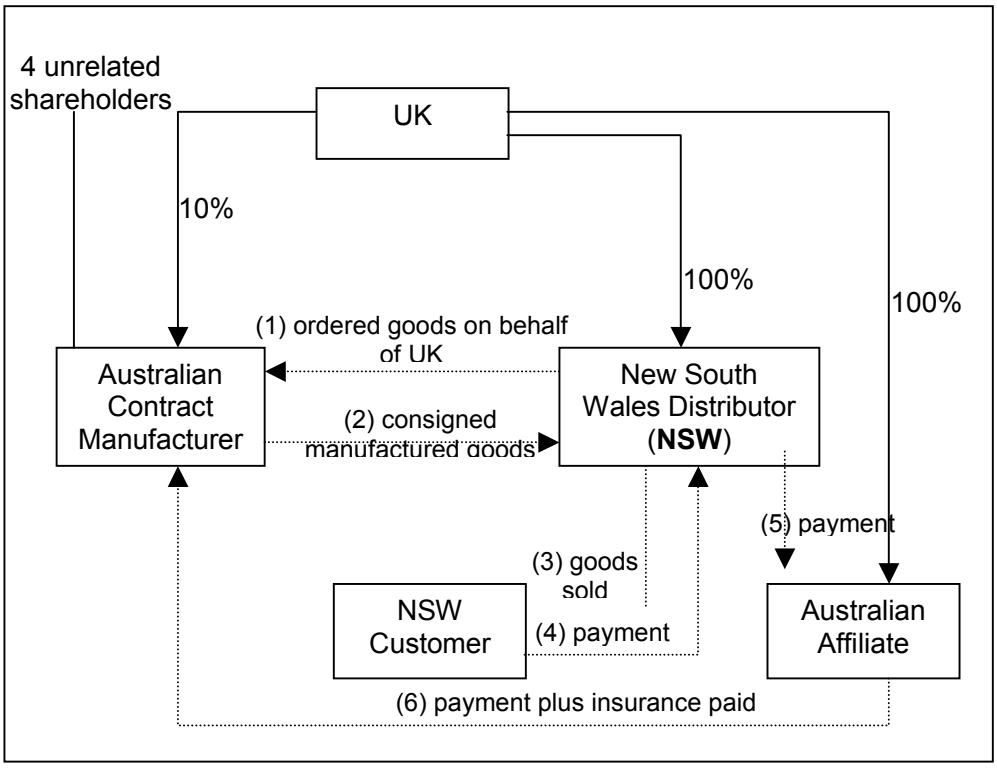
[33] para 36 of the OECD Model Commentary
[34] 6 T.B.R.D. (n.s.) 483 (Australia 1955). 'Permanent Establishment - A Planning Primer' by John Huston and Lee Williams at page 99

Diagram 4: Consignment Sales – Australian Case



In this case an Australian subsidiary of a UK supplier ordered the Australian contract manufacturer of goods for the UK supplier, which it then resold to third parties as an exclusive distributor for New South Wales and elsewhere. The Australian Board of Taxation Review found no PE. The Board held that the New South Wales distributor was not an agent filling orders on behalf of the UK company (because the UK company billed the New South Wales company of goods consigned to it). Nor was the contract manufacturer a delivery agent because it always had a backlog of orders and production was delivered to the New South Wales company as soon as completed. Finally, the Australian affiliate was not a PE because it was a mere collection and disbursing agent, the additional payment of insurance by it on behalf of the parent being viewed as irrelevant. Although the UK parent in effect set the retail price, the historical facts of the case are relevant. The provision that the New South Wales company was to sell all goods purchased from the UK company on its own account and not that of the UK company appeared in a distribution agreement. The New South Wales company (then unrelated to the UK company) agreed in addition not to sell at prices other than those set by the UK Company. Five years later, the UK company acquired a 10% interest in the Australian contract manufacturer company. In 1947, the UK company acquired the New South Wales distributor. This case is significant

because there was no PE in Australia although virtually all activities- from production through sale and collection occurred there. It is surprising that the agreement of the Australian subsidiary to sell at retail prices set by the UK parent was not conclusive of dependent agency.

Activities Test

Paragraph 4 of the OECD Model is of great significance as it sets out those activities, which even if carried on through a fixed place of business will not constitute a PE. Thus, if the operations are structured properly to fall within these exclusions, it could very well fall within the exceptions and avail of the benefits thereto. Perhaps the logic behind providing these exceptions was so as to exclude services that are really very remote from the actual realisation of profits. The exclusions given by sub-clause (e) offer significant opportunities where there is a double tax treaty, for enterprises wishing to maintain a presence overseas without actually incurring any foreign tax liability. The principle advantage of a representative office is that it is relatively simple and cheap to establish compared to say forming a subsidiary. Further most often the expenses of the representative offices will be deductible for tax purposes in the hands of the parent enterprise. Once established, a representative office would be entitled to (subject of course to the regulations prevailing in the country where it is established) have a telephone, maintain a bank account, *etc*.

A mere sales solicitation office is sufficient, whether intended for one's own goods or services or those of an unrelated supplier for the constitution of a PE.

Mailing address: The question arises as to whether the existence of a mailing address of the enterprise in a foreign country would lead to the existence of a PE. In a case[35] decided by the US court it was held that a Canadian company which only had a mailing address in the US, but had no office, telephone listing or bank account there, could not said as to having a PE in the US.

[35] Consolidated Premium Iron Ores Ltd (1957) 28 TC 127. The Ld' Judge further states that the term PE, normally interpreted suggests something more substantial than a license, a letterhead and isolated activities. It implies the existence of an office staffed and capable of carrying on the day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. The descriptive word 'permanent' in the characterisation 'PE' is vital in analysing the treaty provisions. It is the antitheses of temporary or tentative. It indicates permanence and stability

Trade fairs: Merely selling merchandise at the end of a trade fair or convention would not result in a PE in the state in which the trade fair is held[36]. The trade fair or convention clause would indicate that sales and delivery to customers from stock on any regular basis should produce the PE characterisation for the place of business, even if operated for relatively short periods of time[37]. The above ruling involving the solicitation by one entity of orders for the goods and services of another, suggest that PE status may be avoided by careful legal structuring. Consider for example, the creation by a foreign enterprise of a representative office in the source country. That office has as its purpose the creation of customer goodwill and product awareness through representative office brochures, advertising, participation in trade fairs, and customer visits (in which direct solicitation is avoided). Suppose further that the representative personnel share office space in the source country with personnel of an unrelated source –country corporation who attend to (and to whom are referred) all source country customer orders, bookings and the transmission to and acceptance by the foreign enterprise at a foreign location. If such separation of functions is required by agreement and adhered to in practice, the foreign enterprise has no PE in the source country.[38]

[36] Most of the US tax treaties have this specific clause, for example the US-Egypt, US – Philippines, US-Israel, etc

[37] This is one explanation for the conclusion that the temporary Danish pavilion restaurant at the 1964-1965 New York World's Fair constituted a PE. See Rev. Rul. 67-322,1967-2 C.B. 469. 'Permanent Establishment A Planning Primer' by John Huston and Lee Williams.

[38] 'Permanent Establishment A Planning Primer' by John Huston and Lee Williams at page 28

BUSINESS CONNECTION

BC is the Indian equivalent of PE. It is much wider in connotation and has been very effectively used by the revenue authorities to tax the income of non-residents in India. Despite being referred to in the ITA, the term was not defined till the Finance Act, 2003 inserted a somewhat cryptic explanation to Section 9 of the Indian Income Tax Act, 1961 ("**ITA**"). The definition of term PE was inserted in Section 92F(iiia) by the Finance Act, 2002. This definition is relevant only for the transfer pricing provisions and is an inclusive definition.

Definition

The term BC is discussed in Section 9(1)(i) of the ITA, which is reproduced below:

The following incomes shall be deemed to accrue or arise in India: -

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or ……"

Explanation 1—For the purposes of this clause—

(a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India ;

(b) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export;

(c) in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India;

(d) in the case of a non-resident, being—

(1) an individual who is not a citizen of India ; or

(2) a firm which does not have any partner who is a citizen of India or who is resident in India ; or

(3) a company which does not have any shareholder who is a citizen of India or who is resident in India,

no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India ;

Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

***Provided** that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :*

***Provided further** that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principle non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.*

Explanation 3.—Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

Definition of PE under Section 92F(iiia) of the ITA, which was inserted mainly for the purposes of transfer pricing provisions reads as under :

"Permanent Establishment", referred to in clause (iii), includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

Analysis

As per section 9(1)(i) any income earned, whether directly or indirectly, through or from any BC in India, would be deemed to accrue or arise in India and hence would be taxable in India. However the term "BC" has not been defined in the ITA. Thus rightly so, the Bombay High Court[39] has stated that since the term BC admits of no precise definition, the solution of the question must depend upon the particular facts of each case. Further, various High Courts[40] have also held that there is no definition of the words "BC" and the legislature has deliberately chosen words of wide (though uncertain) import.

Further, there is no determinative form, in which a BC exists. As has been held by the Supreme Court[41] in a landmark case, *"a business connection may take several forms: it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in India, which facilitates or assists the carrying on of that business."*

The meaning of the term business connection can be understood with the held of certain case laws as under:

Meaning of Business Connection

Perhaps the oldest case defining the term BC has been decided by the Rangoon High Court[42] as follows:

> *The expression "business connection" must denote something, which produces profits or gains and not a mere state or condition which is favourable to the making of profit. The word "business" must have the significance indicated in section 2(13) of the Act, and the word "connection" must have been used in the sense of "that with which one is connected".*

The Bombay High Court[43] held that all that is necessary for a BC to exist is that there should be:

(i) a business in India;

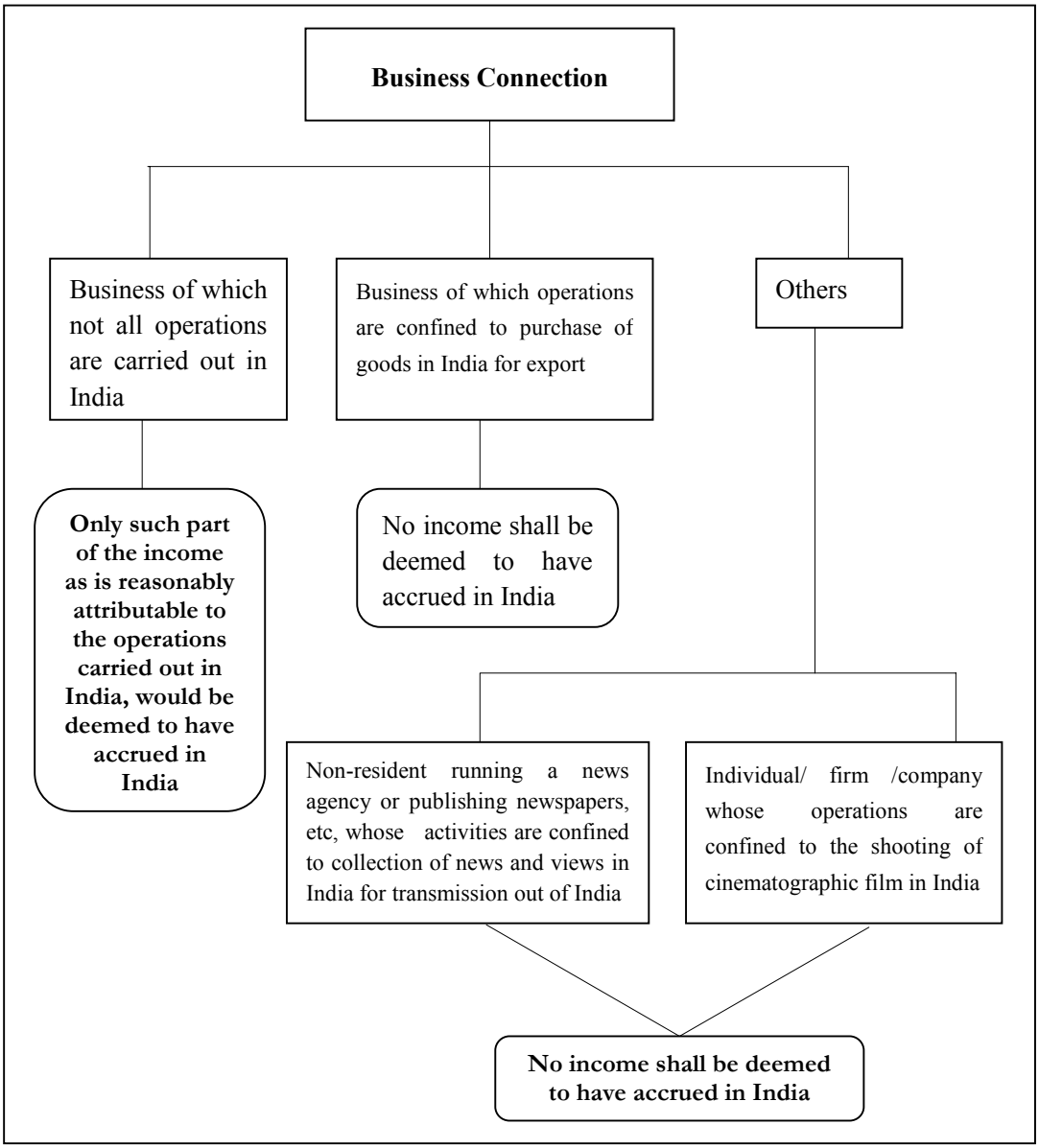
(ii) a connection between non-resident person or company and that 'business'; and

that the non-resident person or company has earned an income through such connection.

[39] Blue Star Engg. Co. (Bom) (P) Ltd v CIT [1969] 73 ITR 283 (Bom) following the principle laid in CIT v R D Aggarwal & Co. [1965] 56 ITR 20, 24 (SC)
[40] Bangalore Woollen, Cotton & Silk Mills Co. Ltd V CIT [1950] 18 ITR 423 (Mad); CIT v Evans Medical Supplies Ltd. [1959] 36 ITR 418 (Bom); Jethabhai Javeribhai v CIT [1951] 20 ITR 331 (Nag)
[41] *CIT v R D Aggarwal & Co* reported in *[1965] 56 ITR 20, 24*,
[42] *CIT v Visalakshi Achi* reported in *[1937] 5 ITR 448*
[43] CIT v National Mutual Life Association of Australia [1933] I ITR 350, 361 (Bom)

Section 9(1) of the ITA, relating to the term BC can be diagrammatically represented as follows:

Diagram 5 : Meaning of Business Connection



In the following paragraphs, we have discussed the meaning of BC, its principles, the various tests to be applied in order to determine whether a BC exists or not, and certain applications of BC.

Principles of Business Connection

There are various factors, which need to be kept under consideration while determining whether a BC exists in a particular situation, or not. The landmark judgment of the Andhra Pradesh High Court[44] compiles the ratios of various other judgments and lays down the following principles of BC:

(i) Whether there is a BC between an Indian person and a non-resident is a mixed question of fact and law which has to be determined on the facts and circumstances of each case;

(ii) The expression 'BC' is too wide to admit of any precise definition; however it has some well known attributes;

(iii) The essence of 'BC' is the existence of close, real, intimate relationship and commonness of interest between the non-resident and the Indian person;

(iv) Where there is control or management or finances or substantial holding of equity shares or sharing of profits by the non-resident of the Indian person, the requirement of principle (iii) is fulfilled;

(v) To constitute 'BC' there must be continuity of activity or operation of the non-resident with the Indian party and a stray or isolated transaction is not enough to establish a BC.

We have discussed below some of these principles and have also analyzed them in view of judicial precedents. The principles discussed herein are:

- Continuity
- Real and Intimate connection
- Attribution of income
- Common Control
- BC includes professional connection

Continuity

[44] *G V K Industries Ltd v ITO* reported in *[1997] 228 ITR* 564

In order to ascertain BC, one of the most important factors would be to determine whether the activity/ transaction under consideration is a one-off transaction or whether it is carried out by the non-resident in a regular manner, which predicates an element of continuity.

Let us consider here a case decided by the Supreme Court[45] in this regard, the facts of which are as under:

A Ltd, a company incorporated in the UK, owned a spinning and weaving mill at Pondicherry. A Ltd had appointed another company in Madras as its constituted agent for the purpose of its business in India. In a particular assessment year, A Ltd had not made any sales of yard or cotton manufactured by it in India, but all purchases of cotton required for the factory at Pondicherry were made by the agents in Madras and no purchases were made through any other agency. The question under consideration was whether A Ltd could be said to have a BC in India.

In this case, the Supreme Court held that: The activity performed by the Madras entity for A Ltd was not in the nature of an isolated transaction of purchase of raw materials. In this case, a regular agency was established in Madras for the purchase of the entire raw materials required for the manufacture abroad and the agent was chosen by reason of his skill, reputation and experience in the line of trade. The terms of the agency fully establish that the entity in Madras was carrying on an activity almost akin to the business of a managing agency in India of the foreign company and the latter certainly had a connection with the agency. *When there is a continuity of business relationship between the person in Madras who helps to make the profits and the person outside Madras who receives or realizes the profits, such relationship does constitute a business connection. [EMPHASIS PROVIDED]*.

Some of the relevant jurisprudence on this principle of continuity is summarized below:

- A single transaction would not fall within the ambit of the BC. If a manufacturer of a motor car in England or America sells it to a customer in India, there is no doubt a BC in relation to that sale between the manufacturer and the purchaser, and the manufacturer probably makes a profit, but nobody would suggest that in respect of the profit on that single transaction he is liable to pay British India income-tax. There must be some element of continuity in the relationship between the parties,

[45] Anglo French Textile Co Ltd v CIT reported in *[1953] 23 ITR 101 (SC)*

and in every case one has to look at the particular facts of the case to see whether it falls within the ambit of the section.[46]

- If the transactions are spread over the whole year and run into several lakhs, it will be difficult, if not impossible, to resist the conclusion that such purchasing operations do constitute business operations.[47]

- Existence of an agent is not necessary and where there is regularity and continuity of operations, there is a BC.[48]

- Raw material required by a foreign company was purchased by its agents in British India continuously for several years. The sale proceeds of the manufactured goods were collected by them in British India and were credited in their books to the account of the company as they acted also as bankers. They met all the expenditure out of the collections in their hands, paid for the purchase, and made also other payments referred to in the managing agents' accounts. They were given absolute discretion with reference to the purchases as to when to buy, where to buy and at what rate. The purchase of goods continuously to meet the requirements of manufacture in the mills required skill and judgment and that is exclusively vested in the managing agents. Practically the entire management of the business was left to the agents and though it is said that they had an office also at Bangalore it is clear that most of the activities connected with the management of the business at Bangalore were carried out in British India. In view of the above, it was not difficult to hold that the foreign company did have a BC in India.[49]

- It is not the length of time during which the connection has subsisted but the nature of the connection which would determine whether a BC within the meaning of this section has been established or not. A course of numerous dealings within a short time having an element of continuity about them would be sufficient to establish a BC.[50]

[46] CIT v Metro Goldwyn Mayer (India) Ltd [1939] 7 ITR 176 (Bom)
[47] Jamnadas Brij Mohan V CIT [1962] 46 ITR 233 (All)
[48] Bikaner Textile Merchants Syndicate Ltd v CIT [1965] 58 ITR 169 (Raj)
[49] Bangalore Wollen, Cotton & Silk Mills Co Ltd v CIT [1950] 18 ITR 423, 433 (Mad)
[50] Bikaner Textile Merchants Syndicate Ltd v CIT [1965] 58 ITR 169 (Raj); A P Damodara Shenoy v CIT [1954] 26 ITR 650 (Bom)

- To constitute a BC some continuity of relationship between the person in India who helps to make the profits and the person outside India who receives or realizes the profits, is necessary. Where all that has happened is that a few transactions of purchases of raw materials have taken place in India and the manufacture and sale of goods have taken place outside India, the profits arising from such sales cannot be considered to have arisen out of a BC in India. Where, however, there is a regular agency established in India for the purchase of the entire raw materials required for the purpose of manufacture and sale abroad and the agent is chosen by reason of his skill, reputation and experience in the line of trade, it can be said that there is a BC in India so that a portion of the profits attributable to the purchase of raw materials in India can be apportioned under the explanation (a) to section 9(1)(i).[51]

Real and intimate connection

In order to have a BC, there must be a real and intimate connection between the activity carried on by the non-resident outside India and the activity carried out in India. Further, such activity must be one, which contributes to the earnings of profits by the non-resident in his business**.** In this context, the case of CIT v. R. D. Aggarwal & Co.[52] is regarded as a landmark case. In the case of *R D Aggarwal & Co,* the facts were as under:

R Ltd, a company located in Amritsar, carried on business as importers and commission agents of non-resident exporters. R Ltd communicated orders canvassed by them from dealers in Amritsar to the non-residents for acceptance. If a contract resulted and price for goods purchased was paid by the Amritsar dealer to the non-resident exporters, the assessees became entitled to commission varying between 1.5% to 2.5% of the price. R Ltd carried out its activities as sole agents of certain non-resident exporters and as representatives for certain other non-resident exporters. The issue was whether the relationship between R Ltd and the non-resident exporters could be regarded as a BC.

In this case it was held that none of the activities of the non-resident exporters, such as procuring raw materials, manufacturing, sale or delivery of goods took place in India. R Ltd merely procured orders from merchants in Amritsar for purchase of goods from the non-residents. R Ltd did not have the authority to even accept the offers on behalf of the non-residents. Some commercial activity was undoubtedly carried on by the assessees in the matter of procuring orders, which resulted in contracts for sale by the non-residents of goods to merchants at Amritsar. Hence, this could in no way result in a BC of R Ltd with the non-residents within India.

Certain other relevant case laws in respect of 'real and intimate connection' are summarized below:

[51] Circular No 23, dated July 23, 1969, issued by the Central Board of Direct Taxes ("CBDT")

[52] CIT v. R. D. Aggarwal & Co., 56 ITR 20 (SC)

- BC undoubtedly would be a commercial connection but all commercial connections will not necessarily constitute BC within the meaning of the concept unless the commercial connection is really and intimately connected with the business activity of the non-resident in India and is contributory to the earning of profits in the said trading activity.[53]

- To confirm with the requirements of the expression "BC" it is necessary that a common thread of mutual interest must run through the fabric of the trading activity carried on outside and inside India and the same can be described as real and intimate connection. The commonness of interest may be by way of management control or financial control or by way of sharing of profits. It may come into existence in some other manner but there must be something more than mere transaction of purchase and sale between principal and principal in order to bring the transaction within the purview of BC.[54]

  Further, in order to have a BC in India, the non-resident should have had carried out at least some operations/activity in India which show that the Indian connection yields profits for the non-resident. In this regard, the following case laws are interesting to note:

- In a case, there was no systematic purchase of goods in the taxable territories, and neither was any agency employed for selective purchases. There was also nothing to show that the assessee was able to make higher margin of profits on account of purchases in taxable territories. It was held that since no "operations" were carried out by the assessee in India either by itself or through an agent, the provisions of section 9 of the ITA were not applicable and there was no justification for apportionment of any profits attributable to the purchases effected by the assessee in India.[55]

- The provisions relating to BC have no application unless according to the known and accepted business notions and usages, the particular activity is regarded as a well-defined business operation. Activities, which are not well defined or are of a casual or isolated character, would not ordinarily fall within the ambit of this rule. In the instant case, the raw materials were purchased systematically and habitually through an established agency having special skill and competence in selecting the goods to be purchased and fixing the time and place of purchase. Such activity appears to be well within the import of the term 'operation'. [56]

- An exporter of tobacco had appointed M/s Toshuku Ltd, a non-resident, as an agent to sell the exported tobacco in Japan for which it was entitled to commission. Even though no part of marketing operation was carried out in India the revenue treated the commission income as accrued or arisen in India as they

[53] Blue Star Engg. Co. (Bom) (P) Ltd v CIT [1969] 73 UTR 283, 291 (Bom)
[54] CIT v Hindustan Shipyard Ltd. [1977] 109 ITR 158, 170 (AP)
[55] CIT v Jiyajeerao Cotton Mill Ltd [1979] 118 ITR 72 (Cal)
[56] Anglo French Textile Co Ltd v CIT [1953] 23 ITR 101 (SC)

had either accrued or arisen through and from the BC in India that existed between M/s Toshuku Ltd and the exporter in India.

In this case, the Supreme Court held that the non-resident agent did not carry on any business operations in India. The receipt in India of the sale proceeds of tobacco remitted or caused to be remitted by the purchasers from abroad did not amount to an operation carried out by M/s Toshuku Ltd in India as contemplated by clause (a) of the explanation to section 9(1)(i) of the ITA. Hence, the revenue was not right in treating the commission income as accrued in India.[57]

Attribution of income

Circular No 23 issued by the CBDT is also instrumental circular in determining the attribution of income in cases where BC might exist in case of trade with non-resident entities. It states that section 9 of the ITA does not seek to bring into the tax net the profits of a non-resident, which cannot reasonably be attributed to operations carried out in India. Even if there be a BC in India, the whole of the profit accruing or arising from the BC is not deemed to accrue or arise in India. It is only that portion of the profit, which can reasonably be attributed to the operations of the business carried out in India, which is liable under the ITA.

The circular also clarifies various issues on whether any income should be attributed to India where a BC might exist due to certain transactions. These situations are discussed below:

- Non-resident exporter selling goods from abroad to Indian importer

  The Circular states that no liability will arise on accrual basis to the non-resident on the profits made by him where the transactions of sale between the two parties, are on a principal-to-principal basis (as discussed above). The circular goes further to answer the question whether in the above type of cases there is any liability of the non-resident under section 5(1)(a) of the ITA, on the basis of receipt of sale proceeds, including the profit in India. In this regard, the circular states that if any of the following are the only operations carried out by or on behalf of the non-resident in India, such receipts would not be taxed in India:

  1. If the non-resident makes over the shipping documents to a bank in his own country which discounts the documents and sends them for collection to the bankers in India, who present the sight or usance draft to the resident importer and deliver the documents to him against payment or acceptance by the latter;

  2. Even if the shipping documents are not discounted in the foreign country, but are handed over in India against payment or acceptance.

[57] CIT v Toshuku Ltd [1980] 125 ITR 525 (SC)

- Non-resident company selling goods from abroad to its Indian subsidiary

  The Circular when dealing with the issue of whether the dealings between a non-resident parent company and its Indian subsidiary can at all be regarded as being on a principal-to-principal basis. This issue arises since the former would be in a position to exercise control over the affairs of the latter. In this regard, the Circular states that if the transactions:

  – Are actually on a principal-to-principal basis;

  – At an arm's length; and

  – The subsidiary company functions and carries on business on its own, instead of functioning as an agent of the parent company,

  the mere fact that the Indian company is a subsidiary of the non-resident company will not be considered a valid ground for invoking section 9 of the ITA for assessing the non-resident. The Circular further states that where a non-resident parent company sells goods to its Indian subsidiary, the income from the transaction will not be deemed to accrue or arise in India under section 9, provided that:

  1. The contracts to sell are made outside India;

  2. The sales are made on a principal-to-principal basis and at arm's length; and

  3. The subsidiary does not act as an agent of the parent.

  Accordingly, the mere existence of a "BC" arising out of the parent subsidiary relationship nor will the fact that the parent company might exercise control over the affairs of the subsidiary lead to the attribution of any income in India if a transaction is on a principal to principal basis.

- Sale of plant and machinery to an Indian importer on installment basis

  Where the transaction of sale and purchase is on a principal-to-principal basis and the exporter and the importer have no other BC, the fact that the exporter allows the importer to pay for the plant and machinery in installments will not, by itself, render the exporter liable to tax on the ground that the income is deemed to arise to him in India. The Indian importer will also not, in such a case, be treated as an agent of the exporter for the purposes of assessment.

Rule 10 of the Income tax Rules, 1962 lays out the methods for determination of income in the case of non-residents. It gives wide powers to the assessing officers and prescribes one of the following methods that can be followed for attributing income to the Indian BC of a non-resident:

(i) at such percentage of the turnover so accruing or arising as the assessing officer may consider reasonable;

(ii) at such percentage that the global profits bears to the global turnover, as applied to receipts accruing or arising in India; or

(iii) in such manner as the assessing officer may deem suitable.

Common Control

Where the Indian entity and the non-resident entity are both held by the same person, or have common control, then the non-resident would be regarded as having a BC in India. This principle has been held by the Privy Council[58] in an old case. In that case, an Indian bank and a foreign bank were controlled by the same persons. The main function of the foreign bank was to finance the Indian bank. The loans advanced by the foreign bank to the Indian bank represented a large part of the capital of the foreign bank. The flow of business between the two banks was secured by the complete common control exercised over the business of both banks so that the loans could be made without security and for indefinite periods. The loans in question were made outside India through the foreign branches of the respective banks and were repayable outside India, but the moneys were used by the Indian bank in this country. On these facts it was held that a BC existed in India between the two banks.

Business connection includes professional connection

The expression business in the term "BC" does not necessarily mean trade or manufacture only. It is being used as including within its scope professions, vocations and calling from a fairly long time. In the context in which the expression 'BC' is used in section 9(1) of the ITA there is no warrant for giving a restricted meaning to it, excluding 'professional' connection from its scope.

This issue came up before the Supreme Court[59]. In that case, a firm of solicitors at Calcutta was instructed by certain solicitors in London who were acting for a German corporation. On their instructions the solicitors in India retained a barrister of London in the suit pending before the Calcutta High Court. The barrister argued the case for 15 days and went back to London. The issue, which arose, was whether there was a BC and whether the income was taxable? The Supreme Court held that there was a "BC" between the firm of solicitors and the barrister. There was a common connection between the Indian solicitor and the barrister which was real and intimate and not a casual one and that the barrister earned the fee arguing the case in India only due to that connection, and hence a BC existed.

However, here it is interesting to note the views of *Late* Mr Palkhivala, as reproduced in the *"Income Tax Laws" by Kanga and Palkhivala, Eighth Ed*. which reads as under:

> *"There is no warrant for (a) extending the doctrine of business connection to include a professional connection, (b) regarding the presentation of argument in a single case as constituting a business connection; (c) finding a*

[58] Bank of Chettinad Ltd v CIT [1940] 8 ITR 522
[59] *Barendra Prasad Roy v ITO* reported in *[1981] 129 ITR 295*

business connection to exist between the barrister and the Indian solicitors who neither briefed him nor paid him any fees, and (d) holding that any income arose to the barrister from the alleged business connection with the Indian solicitors. Neither on principle nor on precedent is the Court's judgment supportable on any of the four points. The fact that under the general law, the word "business" is wide enough to cover a profession is not a good reason for regarding the expression "business connection" as including a professional connection, particularly in a stature which has uniformly used in various places – including the very head of income "profits and gains of business or profession" – the words "business" and "profession" denoting distinct and different concepts.[60]"

Application of principles of Business Connection

FOB sales

There has been considerable discussion on sales made by non-resident exporters to Indian purchasers on FOB basis, foreign port (*i.e.* outside India). The general rule that is followed is the mere fact that a substantial part of a non-resident's output finds its way into the Indian market or is sold directly or through brokers to various customers in India would not amount to a business connection in India.[61]

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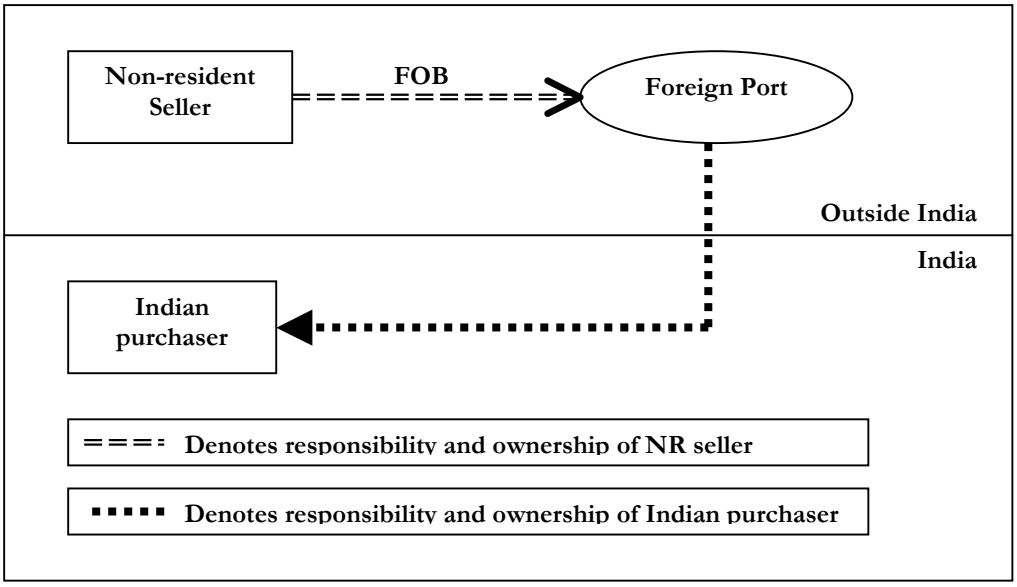
[60] K Thomas Verghese (Dr.) v CIT [1986] 161 ITR 21 (Ker)
[61] *supra*, n. 41; Hira Mills v ITO 14 ITR 417, 430; CIT v Bhumraddi 33 ITR 82

Diagram 6: FOB Sales



We have examined below the important BC issues regarding FOB sales in view of various circulars and case laws.

Transaction on principal-to-principal basis

Circular No 23 issued by the CBDT discusses that if the following conditions are met, a transaction would be inferred to be on a principal-to-principal basis:

- The purchases made by the resident are outright on his own account;
- The transactions between the resident and the non-resident are made at arm's length and at prices which would be normally chargeable to other customers;
- The non-resident exercises no control over the business of the resident and sales are made by the latter on his own account; or
- The payment to the non-resident is made on delivery of documents and is not dependent in any way on the sales to be effected by the resident.

The normal principle is that where FOB sales are on a principal-to-principal basis the same cannot lead to a BC in India. This principle has been upheld in various cases, some of which are discussed below:

- Where a person purchases goods from a foreigner without anything more, and the purchased goods are utilized in commercial operations in India by the Indian, then the Indian merchant or company is earning his own or its own income. The foreigner in such a case has nothing to do with the Indian assessee's transaction in India, as by selling his machinery abroad, he had no further interest in the

business in India. The term "BC" postulates a continuity of business relationship between the foreigner and the Indian. There is no question of continuing business relation when a person purchases machinery or other goods abroad and uses them in India and earns profit. The part of the foreigner has been played wholly abroad, so that there is no connection as such with any business in India.[62]

- In a case before the Bombay High Court[63], the assessee was a dealer of petroleum products, incorporated in UK having a wholly owned subsidiary in India. The non-resident received indents from time to time for the supply of the products from the Indian subsidiary and those orders were honoured by shipment. The prices charged were in c.i.f. terms. Once the goods were put on ship, there was no reservation of the right of disposal in the goods by the non-resident. On the question whether these transactions amounted to BC and whether any income was derived in India by the foreign company, it was held that the transaction between the non resident company and the Indian subsidiary were on a principal-to-principal basis and that the Indian subsidiary could not be regarded as the agent of the non resident company.

- Similarly, the Andhra Pradesh High Court[64] dealt with a case where the Hindustan Shipyard Ltd. entered into an agreement for the purchase of diesel engines with accessories from a Polish company. The property in the goods was to pass to the purchaser immediately on delivery on board the vessel named by the forwarding agents of the purchaser. The engines were agreed to be erected by the staff of the purchaser under the supervision of a supervising engineer placed at the disposal of the purchaser by the Polish company. The foreign company agreed also to supply an erector and an erecting supervising engineer for a period of 12 months for every ship free of charge and to provide free of cost one guarantee engineer for a period of six months. There was also a provision of further guarantee given by the Polish company including training of technical employees in Poland in batches. The expenses including traveling expenses were to be borne by the Polish company. It was held that though the Polish company had agreed to render certain limited services, the services were connected with the effective fulfillment of the contract of sale and were merely incidental to the contract. It was held on the facts that there was no BC since the transaction between the Indian company and the Polish company was one between principal and principal.

Thus, these cases uniformly lay down that there must be some activity in India with reference to which the non-resident is concerned, in order to constitute a BC in India.

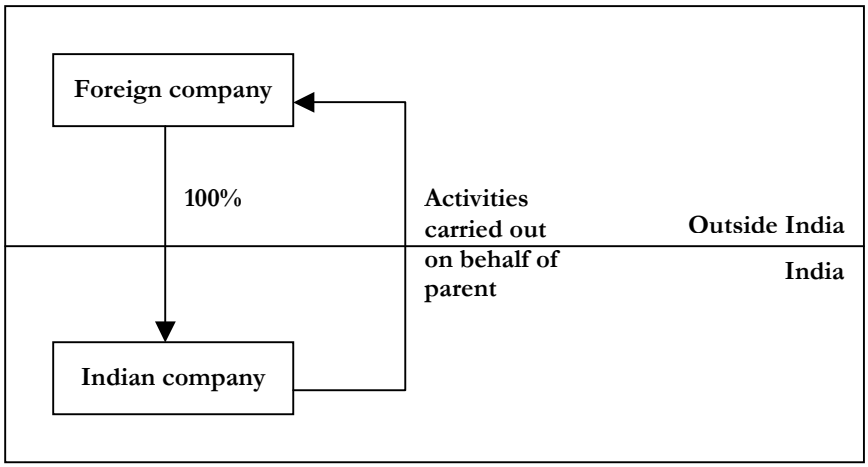
Parent-Subsidiary relationship

Whether the existence of a subsidiary would lead to a non-resident having a BC in India,

[62] CIT v Fried Krupp Industries [1981] 128 ITR 27
[63] CIT v. Gulf Oil (Great Britain) Ltd. [1977] 108 ITR 874 (Bom)
[64] CIT v. Hindustan Shipyard Ltd. [1977] 109 ITR 158

can be understood from the following judgments:

Diagram 7 : Parent-subsidiary relationship



In an advance ruling application[65], the scope of work of the proposed agreements between the subsidiary and its parent included not only clerical and secretarial assistance but supply of information in respect of global tenders; signing and submitting of tenders on behalf of the applicant, negotiating the terms of the tender with the tendering authority; and follow up of the tenders and finally signing the agreements. It was held on these facts that the business relationship between the parent and the subsidiary would not be based on any stray transaction but will be a continuous process in respect of the series of purchase and sale transactions undertaken by the parent company in India. The Authority held that such an intimate and continuous relationship would, constitute "BC" for purposes of section 9(1)(i) of the ITA.

Further, the fact whether the parent gets any kind of business from the Indian subsidiary would also be relevant in determining whether there exists a BC in India. In this context, there is an interesting judgment by the Privy Council[66], which is summarized below:

An American company formed a subsidiary company in Bombay for the express purpose of acquiring from the American subsidiary and carrying on in Bombay the American company's business of selling its products. Although no contractual obligation existed to compel the Bombay company to purchase any of the manufactures of the American company, the flow of business between the two companies was secured by the fact that the ultimate and complete control of the Bombay company was vested in the American company which owned all its shares. Held, a BC existed between the American company and the Bombay company and that the estimated profit at which the American company sold its manufactures to the Bombay company must be deemed to have accrued to the American company in India.

[65] Advance Ruling Application no P-8 of 1995, In re, (1997) 223 ITR 416 (AAR)
[66] CIT v Remington Typewriter Co (Bombay) Ltd 5 ITR 177 (PC)

In this regard, Circular 23 issued by the CBDT discusses the issue of sale of goods by a parent to its Indian subsidiary. The issue discussed is whether the dealings between the non-resident parent company and the Indian subsidiary can at all be regarded as on a principal-to principal basis since the former would be in a position to exercise control over the affairs of the latter. In such a case, if the transactions are actually on a principal-to-principal basis and are at arm's length, and the subsidiary company functions and carries on business on its own, instead of functioning as an agent of the parent company, the mere fact that the Indian company is a subsidiary of the non-resident company will not be considered a valid ground for invoking section 9 of the ITA for assessing the non-resident.

In view of all the above, the main principle which emerges is that simply the existence of a subsidiary in India would not lead to a non-resident company having a BC in India. However, if the Indian subsidiary carries out certain activities for the parent or carries out activities on behalf of the parent in India, then it is likely that the non-resident would be regarded as having a BC in India.

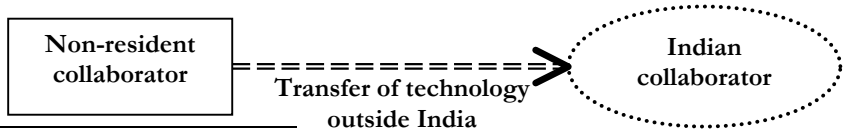
Provision of know-how /deputation of personnel

In cross border transactions involving the transfer of technology/know-how and deputation of personnel, the foreign entity would usually render services outside India. As a general rule, where a non-resident outside India renders services, the same would not attract taxes in India. However, such tax treatment might differ, depending on the facts of each case. Further, when evaluating whether such a transaction would attract the provisions of BC, it would be important to evaluate whether the same would be taxable in India under the provisions of "Royalties" or "Fees for technical services".

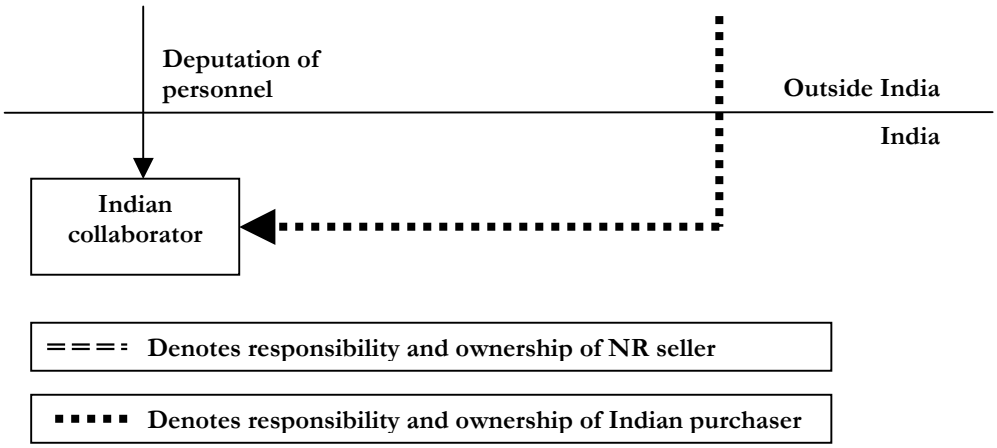
In this regard let us consider a case decided by the Andhra Pradesh High Court[67], the facts of which were as under:

An Indian company enters into a technical collaboration agreement with a foreign company. The foreign company was to supply machinery, equipment, *etc.*, and render technical co-operation for the construction of the plant in India, which involved rendering of consultancy services for the construction of the plant; deputation of design experts to India, assigning of production rights, general and assembly drawing, technical information and other documentation; continual exchange of information about the progress of deliveries and erection of works and supply of personnel who were in the payroll of the foreign company and also training of personnel. Both the Indian company as well as the non-resident have the right to change the composition and number of experts during the courts of performance of the consulting activity after mutual agreement.

Diagram 8 : Provision of Technical know-how



[67] Bharat Heavy Plate & Vessels Ltd v Addl. CIT reported in [1979] 119 ITR 986 (AP)



In this case, the Andhra Pradesh High Court held that the activities referred to in the sale of machinery agreement and the agreement for rendering technical co-operation satisfy the expression "BC". The Court said that there existed the element of continuity and real and intimate connection between the Indian company and the non-resident company and hence there existed a BC.

This case distinguishes the judgment of the Supreme Court in the case of *Carborandum Co v CIT* reported in *[1977] 108 ITR 335*[68] on the grounds that in the latter case, only the Indian company had control over the personnel deputed to India. Whereas in the case decided by the Andhra Pradesh High Court, the non-resident company as well as the Indian company had control over the personnel deputed to India, and hence the non-resident company was regarded as having a BC in India.

In order to understand the difference let us examine the facts of the latter case. In that case, the Indian company (assessee), a manufacturer of abrasive products, entered into an agreement with a foreign company for getting the benefit of technical know how in the manufacture. The assistance was in the shape of furnishing of technical information, providing technical management including factory design and layout, furnishing comprehensive technical information in the manufacture of the special products, providing the Indian company with a resident factory manager and training Indian personnel to replace the foreign technical personnel as quickly as possible.

Here, the Supreme Court held that the services were rendered by the non-resident outside India and that even assuming there was any BC, no part of the activity or operation could be said to have been carried on by the foreign company in India. It was held that no part of the fee paid to the foreign company accrued or arose in India.

However, the Andhra Pradesh High Court distinguished the facts of the Bharat Heavy Plate & Vessels Ltd case from those of Carborandum Co's case. As can be seen, the

[68] A similar principle has also been held in the case of Great Lakes Carbon Corporation v CIT [1993] 202 ITR 64 (Cal).

facts were almost identical, except in respect of the provision of foreign technical personnel. It was found that the services of the foreign personnel were made available to the Indian company outside India. The Indian company had taken these personnel as their employees, paid their salary and such personnel worked under the direct control of the Indian company. The services rendered by the American company in that connection were wholly and solely rendered in the foreign territory. On the basis of those findings, the Supreme Court held that there was no BC between the two companies.

Whereas in the instant case, the non-resident had made the services of the foreign personnel available to the Indian company within India. The Indian company did not take the foreign personnel as their employees nor did the Indian company pay them any salary. The personnel worked not merely under the control of the Indian company and both the Indian company and the non-resident company had control over the personnel. Both the companies had the authority to change the composition and the number. Accordingly, the ratio of the Supreme Court in the case of Carborandum Co could not be followed in the case of Bharat Heavy Plate and Vessels Limited.

In addition to the above, I have summarized below certain judgments laying down important principles relating to business connection in cases of transfer of technology and when the same can be regarded as constituting a BC in India.

- The assessee was an Indian company. It purchased machinery from a foreign company at a consolidated amount as sale consideration. Under two agreements, the foreign company deputed technicians for supervising erection of machinery and putting it into operation, free of cost for three months. Beyond that period, the Indian company was to pay towards reimbursement of further services of specialists together with their boarding and lodging expenses. There was no other trading between the two companies. It was held that since the said foreign company had no other interest in the Indian company except sale of machinery/accessories and deputation of personnel for erection of same and putting it into operation, there was no BC between foreign company and Indian company within the meaning of section 9 of the ITA.[69]

- The foreign company was charging the Indian company for the technical assistance and consultancy service rendered by it, in two ways, viz., (i) payment of salaries of the personnel deputed by it to India; and (ii) consultancy fee for rendering technical assistance, which the foreign company was to render to the Indian company, was to be rendered only through experts, or the personnel deputed by it. Such personnel had to be paid their salaries during their stay in India or during the period they were working for the Indian company by the Indian company. A major part of this service was rendered in India. In this case, the High Court held that the consultancy fee earned by the non-resident must be

[69] CIT v Navabharat Ferro Alloys Ltd [2000] 244 ITR 261 (AP)

deemed mainly to arise from its activity carried on in India and is, accordingly, taxable in the hands of its agent, i.e., the Indian company.[70]

- Under the collaboration agreement entered with the Indian company, the foreign company agreed to provide know how to the Indian company in Canada. The know-how was actually provided outside India and no operations of the foreign company were carried out in India. In view of the above, the entire transaction relating to the said transfer of know-how and secret know-how took place outside India. Accordingly, the foreign company could not be regarded to have a BC in India.[71]

The main principles regarding technology transfer/deputation of personnel equipment can be summarized as under:

- Where the transfer of know-how/technology takes place outside India, it cannot be said that the non-resident has any BC in India;
- In cases where the non-resident deputes certain technicians/personnel to India for executing the contract in India:
  - If the personnel are taken on the payroll of the Indian entity and they are completely under the control of the Indian entity, it cannot be said that there exists any BC;
  - However, if the personnel continue to be employees of the non-resident entity or are under the control of the non-resident entity, then the non-resident would be regarded to have a BC in India.

Agency

Amongst the various issues debated in respect of BC, the most controversial issue has been whether the non-resident having an agent in India would lead to the non-resident having a BC in India. The inclusive definition of BC, which has been inserted by Finance Act, 2003 also refers only to the situations where agency BC is envisaged in India.

Circular No 23 dated July 23, 1969 issued by the CBDT has extensively dealt with the issue of agency and in which circumstances would that lead to the non-resident having a business connection in India. The various situations envisaged by the circular are as under:

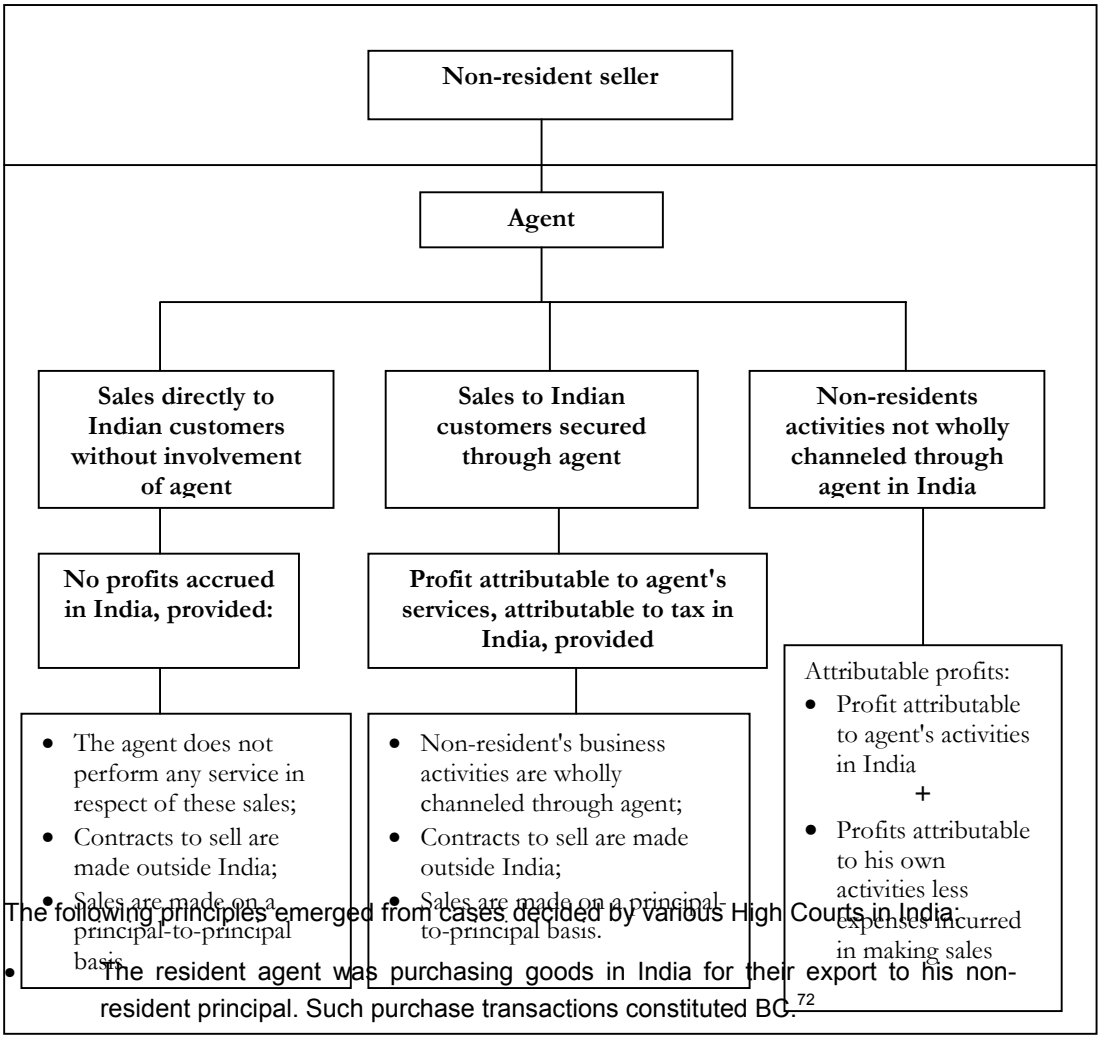
- Foreign agents of Indian exporters: A foreign agent of Indian exporter operates in his own country and no part of his income arises in India. His commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. Such an agent cannot be said to having any business connection in India and hence he cannot be made liable to income tax in India on the commission.

[70] CIT v Hindustan Shipyard Ltd [1977] 109 ITR 158 (AP)
[71] CIT v Atlas Steel Co Ltd [1987] 164 ITR 401 (Cal)

- Non-resident person purchasing goods in India: A non-resident will not be liable to tax in India on any income attributable to operations confined to purchase of goods in India for export, even though the non-resident has an office or an agency in India for this purpose. Where a resident person acts in the ordinary course of his business in making purchases for a non-resident party, he would not normally be regarded as an agent of the non-resident under section 163 of the ITA.

- Sales by a non-resident to Indian customers either directly or through agents: The clarifications provided by the circular in this regard, can be summarized in the following diagram:

Diagram 9 : Agency BC



The following principles emerged from cases decided by various High Courts in India:

- The resident agent was purchasing goods in India for their export to his non-resident principal. Such purchase transactions constituted BC.[72]

[72] Abdul Azees Dawood Marzook v CIT [1958] 33 ITR 154 (Mad)

- If a non-resident has a commission agent in India, who enters into transactions on its behalf, the non-resident would be regarded as having a business connection in India.[73]

- Profits earned by non-residents through sole selling agents are taxable in India[74]. In this case, the profit attributable to sales outside India through agents who were based in India, were deemed to be attributable to Indian BC and hence taxable in India.

Ratios laid by some of these cases may be affected by insertion of the definition of BC in the ITA. For example, an agent who is not wholly or mainly dependent on the foreign principal is now excluded from the definition of BC. Such an exemption was not found in the meaning of BC as laid out and relied upon by the courts in India. Though it is debatable whether the definition of BC would apply with retrospective effect. Interestingly, the Explanation 2, which was inserted in Section 9(1)(i), starts with the words '*For the removal of doubts, it is hereby declared that….*'. However, in the absence of specific provisions, it is likely that this narrower interpretation of BC will be applied prospectively.

[73] Abdullabhai Abdul Kadar v CIT [1952] 22 ITR 241 (Bom); A P Samodara Shenoy v CIT [1954] 26 ITR 650 (Bom)
[74] Soho House v CIT [1957] 31 ITR 727 (Bom)

IMPLICATIONS ON NEW ECONOMY

The businesses are always ahead of law. By the time law evolves, the commercial model for doing business undergoes change. This is especially true in case of high-tech industries and where trans-national transactions are concerned. International taxation and DTAAs on the basis of which countries agree on how to shares the tax revenues, is a consensus based process. By the time there is an agreement internationally on how the revenues arising from a certain source of income should be taxed, the economies of a business model may change. Many countries tend to take a short-sighted view and raise high demands from foreign tax payers, in the absence of clarity in the tax policy. E-commerce is one of the most talked about area, where India has taken the center stage in collecting huge revenues by raising irrational assessments. This may result in some of these companies fleeing the country.

As it is, the Indian jurisprudence is still underdeveloped when it comes to interpretation of tax treaties. By the time Indian revenue authorities get a grasp on the PE and its interpretation, it is likely that there will be a change in the definition of PE. At the OECD level, there are already initiatives taken to redefine PE for new-economy businesses. In an e-commerce transaction, often there is no need to have a fixed presence in the other country. This poses a problem in allocation of tax revenues between the country of source and country of residence.

Another industry, which is booming in India, is that of Business Process Outsourcing. India has become the '*back-office'* of the world. An office, by definition is linked to the PE. This highlights new issues of taxation. Can any part of the profits of foreign companies who are outsourcing work to India be attributed to the Indian service providers and taxed in India? One view on this subject could be that if there is an arm's length relationship between the foreign company and the Indian service provider, to the extent profits are attributable to operations in India, they are already taxable in the form of fee paid to the service provider. This should subsume the tax liability of the foreign company in India. However, in view of the wide powers vested in the assessing officers, they may seek to attribute a higher income to India and raise tax demands. This may prove fatal to the budding BPO industry in India.

CONCLUSION

As can be seen from the above, a careful tax planning and arrangement of activities can go a long way in keeping a business activity out of the PE and BC concept. This is a key concept in international taxation and has to be interpreted dynamically.

APPENDIX I

Definition Of Permanent Establishment As Defined In The OECD Model

"1. For the purposes of this Convention, 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, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

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