Computation of Business Income of Non Residents.

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1. Introduction

In the previous articles we gave an introduction to the basics of taxation of non-residents in India highlighting details pertaining to the scope of income of non-residents and computation of non-resident Income in India. In this article we will cover Business Income earned by non-residents in India and their taxation in India.

A Non-Resident is liable to tax in India only on that income which is earned by him in India. Income which is earned outside India is not taxable in India. Income is earned in India if–

i. It is directly or indirectly received in India; or
ii. It accrues or arises in India or is deemed to accrue or arise in India.

The meaning of 'deemed to accrue or arise' in India has been laid down in Section 9 of the Income-Tax Act, 1961 ("Act"), which includes Income from a business connection in India (Sec 9(1)(i)).

Thus, under the Act, a non-resident is liable to tax in India if he has a business connection in India, as defined in s.9 (1) of the Act.

For determining the tax liability of a non-resident in respect of a transaction with a resident, it is necessary to determine the tax liability both under the Act and under the relevant Tax Treaty, if India has a Tax Treaty with the country of the non-resident. A tax treaty is an extension of domestic law and usually provides for lower rate of tax to be charged by the source state where as the balance tax would be charged by the state of residence of the Non Resident Tax Payer .

Usually, the provisions of the Act or of the Tax Treaty, whichever is more beneficial to the non-resident assessee will apply, except GAAR provisions which override the Tax Treaty benefits. The issue whether the provisions of the tax treaty override the provisions of the Act has been dealt with extensively in landmark judgments of UOI v. Azadi Bachao Andolan (2003) 263 ITR 706/132 Taxman 373/184 CTR 450 (SC) and Vodafone International Holdings BV v. UOI (2003) 341 ITR 1 (SC).

If India does not have a Tax Treaty with the country of the non-resident, for determining the tax liability of the non-resident in respect of a transaction with a resident, it is necessary to determine the tax liability only under the Act.

2. Income Deemed to Accrue or Arise from Business Connection in India – Section 9(1)(i)

Business income of a foreign company or other non-resident person is chargeable to tax to the extent it accrues or arises through a business connection in India or from any asset or source of income located in India, and to the extent such income is attributable to the operations carried out in India.

A business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in India which contributes to the earning of these profits or gains. There has to be an element of continuity between the non-resident and business activity in India. An isolated transaction is not normally regarded as a business connection.

Expansion of scope of Business connection to incorporate the changes introduced by Base Erosion and Profit Shifting (BEPS). The Finance Act 2018 expanded the scope of the 'business connection' test by introducing two changes. The first change was to align the scope of dependent agent stipulated in 'business connection' under the domestic tax law with the BEPS Action Plan 7 and Multilateral Instrument (MLI). The second amendment was to include 'significant economic presence test' for the purpose of determining the trigger of business connection for the entities in digital business.

2.1. Person Acting on behalf of the non-resident

i. The term 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 or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident (it does not cover the activity of only the purchase of goods or merchandise for the non-resident) and the contracts are—

I. in the name of the non-resident; or
II. for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
III. for the provision of services by 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

ii. However the above business connection will not include any business activity carried on by an independent broker, general commission agent having an independent status, and acting in the ordinary course of business *[R. D. Aggarwal, 56 ITR 20 (SC); Western Union Financial Services, 101 TTJ 56 (Del); U.A.E. Exchange Centre, 183 taxman 495 (Delhi)]*. Provided where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident or other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal 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 *[Reuters Limited Construction House, 48 SOT 256 (Mum ITAT); Rolls Royce Singapore, 13 taxmann.com 81 (Delhi)]*.

iii. A branch office a foreign company will fall under the purview of the above provisions and will be taxed in India for income earned in India.

iv. An Example to explain the above provision: XYZ company (foreign company in Singapore) has appointed Mr. Z an individual in India to solicit business on their behalf, secure orders for them and store the company's good in his go down for which Mr.Z charges a commission. In this case XYZ has a business connection in India and will be taxed on the income earned in India. However if Mr. Z was appointed as an agent by multiple foreign companies and Mr.Z was behaving as an independent agent, the company XYZ would not have a business connection in India and hence the income would not be taxable in India

2.2. Significant Economic Presence (SEP)- A Business Connection:

i. SEP was introduced in the Income Tax Act, 1961 in April 2018 expanding the scope of income of a non-resident which accrues or arises in India that results in a 'business connection' in India

ii. SEP definition was amended by the Finance Act 2020 and shall have effect from 1-04-2022. The amended definition is:

(a) transaction in respect of any goods, services or property carried out by a non-resident **with any person** in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or

(b) Systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed

iii. SEP to trigger irrespective of :

a) the agreement for such transactions or activities is entered in India; or

b) the non-resident has a residence or place of business in India; or

c) the non-resident renders services in India

iv. Activities that may be covered under SEP

a) Sale or purchase of goods, services or property through digital means
b) Provision of online training / gaming services
c) Websites, online database, cloud storage and computing services, with significant user base in India

v. Safeguards from SEP provisions

The double taxation avoidance treaties tax based on the concept of permanent establishment (PE) for taxing business profits of a non-resident and the inclusion of SEP in the ITA will not be read into the tax treaties unless they are amended.

It may be noted that apart from SEP, there is incidence of Equalisation Levy on digital transactions that was introduced by Finance Act, 2016

2.3. Expansion of scope of Business connection in India via Finance Act 2020

i. In the case of a business ,[other than the business having business connection in India on account of significant economic presence,] 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 ;

ii. The above income shall also include income from: - w.e.f. 1-4-2021
   a. such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;

   b. sale of data collected from a person who resides in India or from a person who uses internet protocol address located in India; and

   c. sale of goods or services using data collected from a person who resides in India or from a person who uses internet protocol address located in India.

iii. The provisions of clause ii shall also be applicable to income generated through significant economic presence in India - w.e.f. 1-4-2022

2.4. Objective of Broadening the scope of Business Connection

i. Taxation of Business profits on economic presence rather than only physical presence
ii. Widen the tax base to cover digitized business model
iii. Address the tax leakages and loopholes in the taxation scheme based on physical presence
iv. Implement the recommendation of BEPS Action plans 1 and 7

2.5. Share or interest in a company

i. An asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India – Explanation 5

ii. Explanation 5 will be applicable if on the specified date the value of such assets exceeds INR ten crores and represents at least fifty per cent of the value of all the assets owned by the company or entity – Explanation 6

iii. Specified date means:

   a) Date on which the accounting period of the company/entity ends preceding the date of transfer of a share or an interest; or
   b) Date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred to in sub-clause (i)

iv. As per Explanation 7 to section 9(1)(i), where the transferor along with its associated enterprise, has not held any voting power, share capital or interest in the foreign company whose share are being transferred in excess of 5% nor any right of management or control in such foreign company during the twelve months preceding the date of transfer, the income from transfer of shares of such foreign company for such transferors would not be taxable in India.

v. Further, Explanation 7(b) to section 9(1)(i) provides that where the foreign company holds other assets outside India besides the assets located in India, income only reasonably attributable to asset located in India would be taxable in India.

vi. Background and clarifications of Explanation 5, 6 and 7 of Sec 9(1)(i):

   a) Explanation 5 was introduced due to the Supreme Court's decision in the landmark case of *Vodafone BV International Holdings V. Union of India*, the Government of India vide Finance Act, 2012. However, the Finance Act, 2012 did not define the word 'substantially' occurring in Explanation 5. Subsequently, the Finance Act, 2015 ("FA 2015") introduced Explanation 6 and 7 to section 9(1)(i) of the ITA to clarify the particular situations to which Explanation 5 to section 9(1)(i) of the ITA would apply.

   b) In 2020 Authority for Advance Rulings ("AAR") pronounced a ruling that clarificatory amendments (Explanation 6 and 7) brought about to the indirect transfer tax provisions under the Income-tax Act, 1961 ("ITA") should be applied retroactively. The AAR ruled that the amendments that were brought about in the year 2015 viz. (i) the meaning of 'substantial'; (ii) small shareholder exemption; and (iii) determination of how much capital gains will be attributable to India in case of the indirect transfer provisions, are clarificatory in nature and have to be applied retroactively to render the indirect transfer provisions which were inserted in the ITA in the year 2012 workable.

vii. An Example to explain the above clause – ABC a foreign company is owned by an NRI Mr. X. The company has its presence globally through wholly owned subsidiaries, it also has a wholly owned subsidiary in India. ABC earns around 70% profits from its operations in India. In FY 2020 Mr X. sold 50% of his stake to another individual Mr.Y. This transfer will be taxed in India as indirect transfer since more than 50% of its value is derived from India (also assuming the value of such assets is more than INR 10 crores). However income only to the extent of assets attributed to India.

Above provisions of Indirect transfer of Shares of a Foreign Company will be subject to the provisions of the Tax Treaty under the Article of Capital Gains and hence the provision of Tax treaty will apply if that is more beneficial to the tax Payer.

2.6. Cases where Business Income is not deemed to accrue or arise in India for Non-Resident

i. Income from operations which are confined to the purchase of goods in India for the purpose of export.

ii. a person engaged in the business of running a news agency or of publishing newspaper, magazines or journals for activities, which are confined to the collection of news and views in India for transmission outside India

iii. In the case of a foreign company engaged in the business of mining of diamonds activities which are confined to display of uncut and unassorted diamond in any Special Zone notified by the Central Government in the Official Gazette in this behalf.

iv. An individual who is not a citizen of India or a firm which does not have any partner who is a citizen of India or who is resident in India or 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;

3. Tax Treaty and Business Connection

i. One of the most important aspects of a treaty-based law or Double Taxation Avoidance Agreement (DTAA) is the existence of Article 5 in the Tax Treaty, a Permanent Establishment (PE). As per general parlance, a non-resident taxpayer is not required to pay income tax on its business profits unless it has a Permanent Establishment in the source country and the profits are attributing from such PE. **Usually, as per Section 90(2) of the Income Tax Act, while ascertaining the tax liability of a non-resident, the provisions of the Income Tax Act and the DTAA are taken into consideration and whichever is more beneficial shall apply**. Business connection equivalent in a tax treaty is the Permanent Establishment concept though the depth and degree of threshold could vary.

3.1. Permanent Establishment as per DTAA

i. Article 5(1) - Permanent Establishment means a fixed place of business through which the business of the enterprise is wholly or partly carried on. There can be following types of PEs:

a) Fixed Place
b) Construction
c) Service
d) Agency
e) Subsidiary/ Holding

ii. Fixed Place PE: A fixed place PE of a foreign enterprise exists in the India (source country) when the following tests are satisfied:

a) Physical place: There must be a physical place of business. It usually means a premises, facilities or installation of the enterprise used for carrying on the business, whether or not it is exclusively used for business. It does not matter whether this place of business is owned or leased.

A place of business means all tangible assets (e.g., premises, facilities, machinery or equipment or installations) used for carrying on the business, whether or not they are exclusively used for business. Para 17 of the OECD Model Commentary states that a PE may exist if the business of the enterprise is carried on mainly through an automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment. The existence of Computer Server amounts to existence of a PE in India *[AREVA T&D, 18 taxmann.com 171 (AAR)]*. A PE will still exist if the enterprise which sets-up machines also operates and maintains them for its own account - whether operated by itself or by a dependent agent *[Amadeus Global, 11 taxmann.com 153 (Delhi ITAT)]*. It may also include a machinery or an equipment, e.g., an automatic vending machine or a gaming machine, or a race horse.

b) Location: The place of business must be a fixed place located at a certain area. The residence of an employee may also be treated as a PE if the same if used as office for business.

c) Permanence: The place of business must be for a fixed and reasonably longer period of time. There should be a reasonable degree of continuity and regularity.

d) At Disposal: The place must be at the disposal of the foreign entity whether owned by it or not (e.g., hired place of business) *[Seagate Singapore International Headquarters, 322 ITR 650 (AAR)]*. If the place of business is situated in the business premises of another enterprise and the foreign enterprise has certain part thereof at its constant disposal, that premises may be considered as having a PE in India.

The place has to be owned, rented or otherwise be at the disposal of the assessee; a mere occasional factual use of the place is not sufficient *[Airlines Rotables Ltd, 44 SOT 368 (Mum ITAT)]*.

No formal legal right to use that place is required. For instance, a PE could exist even where an enterprise illegally occupied a certain location where it carried on its business *[Para 4.1 of OECD Commentary and Amadeus Global Travel, 11 Taxmann,com 153 (Delhi ITAT)]*.

e) Business activity: Proper business activity must be carried out from such fixed place

Key jurisprudence on Fixed Place PE: In addition to a recent judgment in the case of Samsung *[DIT New Delhi Vs Samsung (Civil Appeal No. 12183 of 2016)]*, there have been quite a few landmark judgments on the matter of fixed place PE viz. DIT Mumbai Vs Morgan Stanley & Co. *(2007) 292 ITR 416*, CIT Vs Hyundai Heavy Industries Co. Ltd. *(2007) 7 SCC 422*, Ishikawajma-Harima Heavy Industries Ltd. v. DIT Mumbai *(2007) 3 SCC 481* and ADIT New Delhi Vs E-Funds IT Solution Inc. *(2018) 13 SCC 294*.

A reading of the aforesaid judgments makes it clear that when it comes to "fixed place" permanent establishments under DTAAs, the deciding factors are as follows:

a) The condition precedent for applicability of Article 5(1) of the DTAA and the ascertainment of a "permanent establishment" is that it should be an establishment "through which the business of an enterprise" is wholly or partly carried on.
b) The profits of the foreign enterprise are taxable only where the said enterprise carries on its core business through a permanent establishment.
c) The maintenance of a fixed place of business which is of a preparatory or auxiliary character in the trade or business of the enterprise would not be considered to be a permanent establishment under Article 5.
d) It is only so much of the profits of the enterprise that may be taxed in the other State as is attributable to that permanent establishment.

Thus although Business is carried out in India it will not be taxable in India unless minimum threshold of business Connection or the PE is achieved by the Non Resident Tax payer.

iii. Specific inclusions within PE. The following are specifically included in the PE definition:

a) Place of management. It exists where control and management of an enterprise reside. The term must be interpreted widely and it could also be a residential premises. Mooring/support vessels used for installation of pipelines may be a place of management *[Brown and Root Inc, 237 ITR 156 (AAR)]*

b) Branch. When a non-resident has a branch in a foreign country, then it is usually regarded as a PE unless it falls within one of the exceptions, such as use of that branch for the purposes of storage or display of goods or the only activity of making payments did not satisfy the condition of para 1 of Article 5 of carrying on business activity in India through a fixed place *[Whirlpool India, 140 TTJ 155 (Delhi ITAT)]*.

c) Office. The word “office” has various meanings and uses. It may mean a room, a set of rooms or a building where the business usually is carried on. It is generally mentioned for correspondence or contact purposes. There are contrary decisions for a “project office” to constitute a PE *[Micoperi S.P.A. Milano, 82 ITD 369 (Mum); BKI/HAM VOF, 70 TTJ 480 (Del)]*. It does not include a “representative office” or a “liaison office” *[UAE Exchange Centre, 138 Taxman 495 (Delhi); Vishakhapatnam Port Trust, 144 ITR 146 (AP); Motorola Inc, 95 ITD 269 (Del); Western Union, 101 TTJ 56 (Del)]*

d) Factory. It is a place where processing or manufacturing of goods is carried out.

e) Workshop. It is a place where an industrial process is carried on. It may mean any place in which collective manual labour, under an employer is done by way of trade or in making, repairing etc.

f) Mine, oil or gas, quarry or any other place of extraction of natural resource

iv. Construction PE and Service PE

a) Construction Rule PE: if an enterprise has a building site, a construction, assembly or installation project or supervisory activities in connection therewith, a PE would come into existence if such site, project or activities continue for more than twelve months. The clause related to Supervisory activities is included only in some of the tax treaties as far as India is concerned. The duration of the project and percentage of payment towards supervisory activity will vary from Treaty to Treaty with various countries.

b) Service Rule PE: if an enterprise furnishes services (including consultancy services) through employees or other personnel engaged by it for furnishing such services, a PE would come into existence. Generally, the Indian treaties provide for a threshold limit of 90 to 120 days if the services are rendered to unrelated enterprises and 1 to 30 days if such services are rendered to associated enterprise.

Construction PE and Service PE may be read without applying the condition of the Fixed Place PE of paragraph 1 and 2 of the Article 5.

Also attribution rule of the Sec 9 will apply where ever there is a possibility of the apportionment of the Income between India and the Non Resident State or any other Country.

Attribution is again a subject matter of various court decisions under ITA as well as attribution Rule as provided under Article 7 of the tax Treaty.

v. Specific Exclusions from the term PE:

a) Use of facility solely for the purpose of storage or display of goods belonging to the enterprise;

b) Maintenance of stock of goods belonging to the enterprise solely for the purpose of storage or display;
c) Maintenance of stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise;
d) Maintenance of fixed place of business solely for the purpose of purchasing of goods or for collection of information for the enterprise;
e) Maintenance of fixed place of business for carrying out activities of preparatory or ancillary character.
f) Maintenance of fixed place of business solely for any combination of above activities provided the overall activity of fixed place of business resulting from this combination is of preparatory or ancillary character.

vi. Dependent Agency PE (DAPE)
If a person resident in India represents or acts on behalf of the foreign enterprise, his presence in India may be regarded as presence of foreign enterprise PE in India on fulfilling the following circumstances:
a) A person is dependent on the foreign enterprise;
b) Such person acts on behalf of the foreign enterprise;
c) He has authority to conclude contracts on behalf of the foreign enterprise; and
d) He habitually exercises such authority to conclude contracts on behalf of the foreign enterprise.

In *SET Satellite (Singapore), 106 ITD 175 (Mum) and Airlines Rotables, 44 SOT 368 (Mum ITAT)*, the Tribunal described the rationale for dependent agent PE. However, an agent will not constitute a DAPE of its principal if he is an agent of an Independent status who is legally as well as economically independent of the foreign enterprise on whose behalf he acts.

vii. Subsidiary/ Holding PE
Mere existence of a subsidiary/holding Company in India does not by itself make the subsidiary/holding Company a PE of the Foreign Company. To constitute a PE, the business of the Foreign Company should be carried on through the subsidiary/holding company in India.
Where the parent sold parts/CKD to the subsidiary company on a principal-to-principal basis and no operations in respect of the manufacture and sale of parts were carried out by the parent in India, it was held that the parent did not carry out any operations in India, and therefore, could not be said to have a PE in this respect under Article 5(1) and 5(2) of the Indo-German Treaty *[Daimler Chrysler, 133 TTJ 766 (Mum ITAT)]*.

4. <u>Outcome of Establishing PE in India and computation of tax liability</u>

i. Once it is established that Foreign Enterprise has a PE in India, the profits attributable to its activities in India will be taxed as Income and the tax treatment of such income would depend upon the nature of the income, i.e., whether it is a business income or capital gain or income from shipping and air transport, dividend, royalty, fees for technical services, etc. For this purpose, usually there are separate articles in Tax Treaties dealing with the taxability of each type of income.

It is important to distinguish between tax treatment in case of income from activities when there is PE in India and when there is no PE in India. For example, in case of business connection in India, there is presence of PE in India and hence tax computation would be for business income under sections 28 to 44C of the Act, as may be applicable. Such tax computation would be on net basis i.e. after allowing deduction for all usual business expenses from the gross revenue. However, in case of income of non-resident from royalty or fees for technical services without the existence of PE in India, then such income shall be taxed under the special dispensation of section 115A which provides for tax rate of 10% and not the general tax rate applicable to non-residents or foreign companies. Refer Para 4(vi) below for detailed discussion on taxation of royalty and fees for technical services under section 44DA in case of existence of PE in India.

Similarly, it is important to distinguish between tax treatment of business income of a PE in India and business income derived from specified business activities which are subject to presumptive taxation under the Act. Under such presumptive tax provisions, a special tax treatment is provided which is applicable whether or that such activities are carried out by a PE in India. Under some presumptive tax provisions, income is taxable on gross basis (i.e. without deduction of any expenses) whereas under other provisions, income is taxable on net basis. Please refer to Para 4(vii) & (viii) below for detailed discussions on presumptive taxation.

ii. In case of business income of PE, though no guidelines are available to determine how much should be the business income reasonably attributable to the operations carried out in India, the same has to be determined on factual situation prevailing in each case.

The Act provides for Rule 10. Also, in various judicial pronouncements, the Courts have, in the past, used an ad hoc basis for estimating the profits attributable to India specific activities, based on facts of each case.

In the case of Anglo French Textile Company Ltd. v. CIT: 25 ITR 27, the Supreme Court returned a finding that in the facts of the case, 10% of profits were to be attributed to operations carried out in India.

Again, in Hukum Chand Mills Ltd. v. CIT: 103 ITR 548, the Supreme Court found that attribution of 15% of profits was reasonable in the facts of that case. More recently, in case of *Motorola Inc: 95 ITD 269,* the Special Bench of the Income Tax Appellate Tribunal, ('ITAT') held that attribution of 20% of profits was sufficient for role played by the PE in negotiation and conclusion of contracts and supply of equipment in India by the PE of the taxpayer. Similarly, in case of *Galileo International Inc. 114 TTJ 289,* 15% of total revenues were considered to be attributable to the Indian PE on the basis that the PE played a role in negotiating contracts.

While the Courts have in the past followed an ad hoc approach in determining profits attributable to PE, more recently, it is seen that the judicial view is veering towards more scientific and systematic way of attribution of profits, by relying on FAR analysis, using transfer pricing principles.

The Central Board of Direct Taxes ('CBDT'), vide circular no. 5 dated September 28, 2004, provided, inter alia, that profits to be attributed to a PE should be those which the PE would have made if, instead of dealing with the head office, it had been dealing with a separate enterprise under prevailing market conditions, thus bringing in the arm's length concept in profit attribution.

The Supreme Court, in *Morgan Stanley & Co. v DIT: 292 ITR 416*, categorically stated that profits attributable to a PE shall have to be determined based on FAR analysis, i.e. functions performed, assets employed and risks assumed, based on arm's length principles. This view has been upheld in a number of decisions.

iii. The analysis of attributing business profits to the PE has to be undertaken taking into account the Functions performed, Assets utilised and Risks assumed (FAR analysis) by the PE in India as laid down by the Transfer Pricing Regulations

iv. Tax computation for business income would be done under sections 28 to 44C of the Act, as may be applicable. Such tax computation would be on net basis i.e. after allowing deduction for all usual business expenses from the gross revenue.

v. A non-resident can choose to be taxed as per the provisions of the Income Tax Act or the DTAA, whichever is more beneficial.

vi. It should be noted that S.9(1) (vi) and (vii) respectively provide that where royalty or fees for technical services are receivable by a non-resident from a resident, they are deemed to accrue in India (subject to certain exceptions). However, s.44 DA introduced w.e.f. 1.4.2004 for taxability of royalty or fees for technical services is also relevant. This section provides that where royalty or fees for technical services are received by a non-resident from an Indian concern (a) in pursuance of an agreement made after 31.3.2003, (b) such non-resident carries on business in India through a PE in India, or performs professional services from a fixed place of profession in India, and (c) the right, property or contract in respect of which such income are paid is effectively connected with such PE or fixed place, then such income shall be computed under the head "Profits and gains of business or profession" in accordance with the provisions of the Act. In other words, all the deductions provided in the Act will be available.

No deduction shall be allowed in respect of (a) any expenditure or allowance which is not wholly and exclusively incurred for such PE / fixed place, or (b) in respect of amounts paid by the PE to its head office or to any of its other offices. If, however, the amount is paid by the PE to its head office etc., towards reimbursement of the actual expenses, then it would be allowed as a deduction.

For the purposes of s.44DA, the term "PE" has the same meaning as in s.92F(iiia) for the purposes of transfer pricing provisions

vii. As mentioned earlier, there are special provisions in the nature of presumptive taxation that apply to non-residents engaged in certain specified business where their income is taxed on gross basis. Certain provisions however provide for taxation on net basis at the option of the assesse. These provisions are summarized in the table below.

	Sec. 44B	Sec. 44BB	Sec. 44BBA	Sec. 44BBB
This section applies to -	Non-resident engaged in operating ships	Non-resident engaged in providing service / facilities or supplying plant / machinery for extraction or production of mineral oils (incl. petroleum & natural gas)	Non-resident engaged in operating Aircraft	Foreign company engaged in civil construction or erection, testing or commissioning of plant or machinery in connection with an approved turnkey power project
Deemed Income	7 ½% of gross receipts	10% of gross receipts	5% of gross receipts	10% of gross receipts
Computation of lower income	Not available	Available	Not available	Available
Effective Tax Rate under the Act	40% of 7.5% i.e. 3%	40% of 10% i.e. 4%	40% of 5% i.e. 2%	40% of 10% i.e. 4%
Tax rate as applicable to foreign companies is 40% excluding surcharge & cess				

In addition to the above special provisions on presumptive taxation applicable to non-residents, Section 172 applies to non-resident engaged in operating ships and is a code by itself as distinguished from Section 44B which also applies to non-resident engaged in operating ships as shown in table above. The provisions of Section 172 are notwithstanding the Act and allows for computation of lower income whereas Section 44B makes exception to Sections 28 to 44C and taxes on gross basis only.

viii. The presumptive taxation sections discussed above (except section 44DA) begin with a non-obstante clause which excludes applicability of the other provisions of the Act relating to computation of business income. Accordingly, all business deductions, including depreciation and unabsorbed depreciation shall be deemed to have been allowed to the assessee. However, other provisions of the Act, including those relating to aggregation of income and set-off or carry forward of losses, tax deduction at source, Transfer Pricing, payment of advance tax, interest, penalty, deductions under Chapter VI-A, will continue to apply.

ix. Computation of Business Income and tax liability:
To summarise, as PE does not have a separate or distinct identity, it derives its status from the status of its non-resident principal. Hence, as discussed in earlier paragraphs, it is essential to determine whether or not there are special provisions applicable to non-residents for certain income and also to determine the rate of tax applicable in a given case. Therefore, while computing the business income of non-resident under the Act, the following segregation of various elements of business income and their tax treatment needs to be kept in mind:

(a) Business income which is attributable to a PE in India (including royalty and fees for technical services which is effectively connected to such PE). Such business income is taxable on net basis after allowing various deductions under section 28 to 44C at normal tax rate applicable to non-residents or foreign companies.

(b) Business income subject to presumptive taxation irrespective of whether such activities are carried out through a PE in India. As discussed in Para 4(vii) & (viii) above, under certain presumptive tax provisions, the income is taxable on gross basis and under certain other provisions, assesse has the option to pay tax on net basis. Such income is taxable at tax rates specified under the relevant sections and not at the general tax rate applicable to non-residents or foreign companies.

(c) Income from royalty and fees for technical services which is not effectively connected with PE, if any, in India shall be taxable under section 115A at the specified tax rate of 10%.

In a very recent judgment dt. 02.03.2021 in the case of *Engineering analysis centre of Excellence Private Limited Vs CIT*, the Supreme Court has settled the long standing dispute regarding the taxability of sale of software. It has held that the amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software through EULAs/distribution agreements, is not the payment of royalty for the use of copyright in the computer software, and that the same does not give rise to any income taxable in India, as a result of which the persons referred to in section 195 of the Act were not liable to deduct any TDS under section 195 of the Act.

(d) The total income of the non-resident comprises the above-mentioned income as well as income taxable under other heads of income such as Capital Gains, Other sources, etc. The tax liability is computed based on specific rates for specified income discussed above (e.g. S. 115A, presumptive taxation, etc.) and at normal rate for the balance income. Such tax liability is compared for tax under MAT discussed below to the extent applicable.

(e) Minimum Alternate Tax ('MAT'):
Section 115JB, which deals with the levy of MAT, is applicable to foreign companies except in two instances – (i) if it is a resident of a country with which India has a tax treaty and it does not have a PE in India, and (ii) if the foreign company is a resident of a country with which India does not have a tax treaty but is not required to seek registration under Section 592 of the Companies Act 1956 or Section 380 of the Companies Act, 2013.

Thus, if the foreign company does not have a PE in India and there exists a tax treaty with its country of residence, its income as computed under the Act read with the treaty would be taxed without further reference to MAT. In case where treaty does not exist, applicability of MAT is exempt only if the foreign company in not required to seek registration in India under the Companies Act.

Further, as provided in Explanation 4A of section 115JB, the provisions shall not be applicable to an assessee, being a foreign company, where its total income comprises solely of profits and gains from business under presumptive taxation referred to in section 44B or section 44BB or section 44BBA or section 44BBB and such income has been offered to tax at the rates specified in those sections.

(f) Foreign Tax Credit ('FTC'):
Relief for taxes paid in foreign country is given to tax payer while taxing the same income in India under section 90 which governs the tax credit for countries where India has entered into a tax treaty and under section 91 which addresses credit for those cases where no tax treaty is in force with that overseas jurisdiction. FTC is available only for residents for the amount of foreign taxes paid by it in a foreign country. PE does not have a separate residential status from that of its non-resident principal. Therefore, as PE is not a resident of India, it cannot avail of FTC in India of tax paid on its income from a foreign country.

5. Changes brought in by Multilateral Instrument(MLI)

With the advent of the digital era, the idea of an establishment being geographically linked to incite a tax liability is fading away. The virtue of identity which was of utmost importance is losing prominence with more people moving to e-commerce model from brick and mortar. In order to incorporate the changes in the means of generating revenue, international tax rules needed to be amended.
It was observed that certain tax avoidance strategies were used to circumvent the existing PE definition. Changes to the scope and PE definition to address such avoidance strategies was felt to be a matter of utmost importance. The task was undertaken as a part of the BEPS

Action Plan 7. Three issues were identified for which amendments were suggested to the PE definition. They are:

i. Commissionaire arrangements: An arrangement through which a person sells products in a state in his own name but on behalf of the Foreign Enterprise. The enterprise is able to sell the products without having PE therefore avoiding taxation and the agent would offer the remuneration to tax rather than profits

ii. Anti-fragmentation: Large Multinational Enterprises would avoid PE status by breaking down a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities

iii. Contract Splitting: Mainly for construction sites where enterprises would bypass the time threshold that triggers PE by splitting long term contracts into short term contracts and/or structuring and dividing contracts to enable them to be considered of auxiliary or preparatory in nature

5.1. Amendment to PE Status by MLI

Part IV of the MLI is an outcome of BEPS Action 7 - ''Preventing the Artificial Avoidance of Permanent Establishment Status" and recommends amendment to Article 5 of the tax treaty on PE such as:

i. An extended dependent agency PE (DAPE) rule which covers a person who habitually plays the principal role leading to the conclusion of contracts - Article 12
ii. Stricter independent agent exclusion rule denying exclusion to the agents who work exclusively for an enterprise and its closely-related enterprises - Article 12
iii. Availability of specific activity exemption only if such activities qualify to be of preparatory or Auxiliary – Article 13
iv. An anti-fragmentation rule to prevent artificial disintegration of cohesive business activities done to avail specific activity exemption as Preparatory or Auxiliary – Article 13
v. Anti-splitting rule to prevent artificial splitting of contracts between related parties such that each contract covers a period which does not exceed the time threshold provided under the relevant treaty for trigger of construction PE – Article 14

Clause i and ii have already been incorporated in the Indian domestic laws.

5.2. India's Position with regard to MLI

India has been one of the first signatories to the MLI on 7th June, 2017. The MLI came into force in India on 1 October 2019 and will be effective for 20 tax treaties from 1st April 2020. These include treaties with key trade and investment jurisdictions such as Australia, France, Ireland, Netherlands, Japan, Singapore and the UK.

6. Conclusion

PE is an age old concept gone through multiple changes due to the change in way of doing business. The most crucial parameter for taxing the business profits of a non-resident is establishment of PE in that country. In case a non-resident demonstrates a no PE position, the source country cannot tax the business income of the non-resident.

The way of doing business has changed drastically with the advent of Digitization, where it is possible to operate the whole business without having a physical presence. In order to innovate with the changing landscape, the Indian tax authorities have introduced various provisions like SEP, equalization levy to tax non- residents on income generated in India via digital means.