*   **IN THE HIGH COURT OF DELHI AT NEW DELHI**

% **Judgment reserved on: 05 July 2024**
Judgment pronounced on: 19 September 2024

\+ **ITA 216/2020**
HYATT INTERNATIONAL SOUTHWEST
ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

ADDITIONAL DIRECTOR OF INCOME TAX ...Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 217/2020**
HYATT INTERNATIONAL SOUTHWEST
ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

DEPUTY COMMISSIONER OF INCOME TAX ..Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 218/2020**
HYATT INTERNATIONAL SOUTHWEST
ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

ASSISTANT DIRECTOR OF INCOME TAX ...Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 219/2020**
HYATT INTERNATIONAL SOUTHWEST
ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu

Mehta, Advs.

versus

ADDITIONAL DIRECTOR OF INCOME TAX ...Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 140/2021**
HYATT INTERNATIONAL SOUTHWEST ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

DEPUTY COMMISSIONER OF INCOME TAX ...Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 36/2022**
HYATT INTERNATIONAL SOUTHWEST ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

ASSISTANT COMMISSIONER OF INCOME TAX ...Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 201/2023**
HYATT INTERNATIONAL SOUTHWEST ASIA LTD ..... Petitioner
Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

ACIT(INTERNATIONAL TAXATION)-2(1)(1), NEW DELHI .....Respondent
Through: Mr. Sanjay Kumar & Ms Easha, Advs.

\+ **ITA 215/2023**

HYATT INTERNATIONAL SOUTHWEST ASIA LTD ..... Petitioner

Through: Mr. S. Ganesh, Sr. Adv. with Mr. U.A. Rana, Mr. Himanshu Mehta, Advs.

versus

ACIT (INTERNATIONAL TAXATION)-2(1)(1), NEW DELHI .....Respondent

Through: Mr. Sanjay Kumar & Ms Easha, Advs.

CORAM:
HON'BLE MR. JUSTICE YASHWANT VARMA
HON'BLE MR. JUSTICE SANJEEV NARULA
HON'BLE MR. JUSTICE PURUSHAINDRA KUMAR KAURAV

J U D G M E N T

YASHWANT VARMA, J.

1. This Full Bench has been constituted as a consequence of a Division Bench of the Court doubting the correctness of the view expressed in **Commissioner of Income-tax (international taxation) vs. Nokia Solutions and Networks OY[1].** The Division Bench, while referring the question for our consideration had doubted the view expressed in *Nokia Solutions* that profit attribution to a **Permanent Establishment[2]** would be warranted only if the enterprise as a whole, and the PE constituting merely a component thereof, had earned profits.

2. The appellants appear to have argued that in case the enterprise at an entity level had suffered a loss in the relevant **Assessment Year[3]**, no profit or income attribution would be warranted insofar as the PE is concerned. When these batch of appeals were initially considered by

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[1] 2022 SCC OnLine Del 5088
[2] PE
[3] AY

the Court on 16 January 2023, the following order came to be passed:-

> "1. One of the questions arising in the present petitions is whether any taxable income can be attributed to the Permanent Establishment (hereafter "**PE**") in India if the overseas entity has incurred a loss in the relevant assessment years.
>
> 2. Mr. S. Ganesh, learned Senior Counsel appearing for the appellant, submits that Article 7 of the Double Taxation Avoidance Agreement (hereafter "**DTAA**") entered into between the Government of United Arab Emirates and the Republic of India applies only in cases where the assessee earns profit.
>
> 3. If it is accepted that Article 7 of the DTAA doesn't apply; the questions that would next follow are whether DTAA applies in the context where there is a loss, and whether recourse to DTAA is necessary for taxing the income of a permanent establishment in India as an independent assessee.
>
> 4. According to the respondent, notwithstanding that an overseas entity incurs a loss, if there is positive income attributable to the PE, the same would be taxable notwithstanding Article 7(1) of the DTAA.
>
> 5. Mr. Ganesh submits that the aforesaid questions are squarely covered by the decision of the coordinate Bench of this Court ***Commissioner of Income Tax (International Taxation)-2 v. M/s Nokia Solutions And Networks OY; ITA 503 of 2022***, decided on 02.12.2022. He has also drawn the attention of this Court to Paragraph 11, 13 and 13.1 of the said decision, which read as under:
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> *** **** ***
>
>> "11. The Tribunal has returned a finding of fact, that the respondent/assessee recorded a "global net loss" in the relevant assessment year, and therefore no profit been attributed to it.
>>
>> 13. We may also note, that a plain reading of the Article 7 of the Double Taxation Avoidance Agreement between India and Finland also persuades us to take the same view as that which is taken by the Tribunal.
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>> 13.1 A plain reading of the Article 7(1) would show, that the issue of taxability would arise qua the respondent/assessee only if profits accrue to the respondent/assessee, and that too only to the extent they can be attributed to its PE in India."
>
> 6. He submits that in view of the said decision, the question whether any taxable income could be attributed to PE, would not arise in the event, the assessee incurs a loss.
>
> 7. It is noted that although the observations made in the said decision

appear to be squarely in favour of the appellant, it is also apparent that various other contentions relevant for addressing the said question have not been considered. This is also perhaps because the Court had not framed any question regarding the applicability of Article 7 of the DTAA.

8. *Prima facie*, this Court is of the view that if Article 7(1) of the DTAA – which concerns with the attribution of profits of the assessee – is not applicable in case the assese incurs a loss, the other provisions of the Income Tax Act, 1961, would be applicable and any income arises or accrues within the territories of India would be chargeable to tax.

9. *Prima facie*, if the establishment in India is generating profits, but the other entities of the assessee overseas are incurring a loss, the profits generated by the establishment, if otherwise chargeable under the Income Tax Act, would be required to be assessed and taxed.

10. In this view, we are inclined to observe that the aforesaid issue be referred to a larger Bench.

11. Mr. S. Ganesh submits that there are other questions which arise in the present appeal and if those are decided in favour of the assessee, the aforesaid issue may not be relevant.

12. He states that at the threshold, it is the assessee's case that it has no Permanent Establishment in India and if this issue is held in favour of the assessee/ appellant, it may not be relevant to address the issue as noted above.

13. Learned counsel for the respondent states that he is not prepared to argue on the questions as framed earlier and requests for an adjournment.

14. At his request, list on 13.02.2023.

15. The hearing fixed on 31.01.2023 stands cancelled."

3. The aspect of profit attribution to a PE again arose for consideration as would be evident from a reading of the order dated 14 March 2023 and which is extracted hereinbelow: -

"1. On 05.07.2021, this Court had framed the following questions for consideration in ITA 216/2020:

"(i) Has the Tribunal misconstrued the provisions of Article 7(1) of the DTAA entered into between the Government of United Arab Emirates and the Government of the Republic of India?

(ii) Whether the findings recorded by the Tribunal, in paragraphs 56, 57 and 59 are perverse and contrary to the terms of the Strategic Oversight Services Agreement

(SOSA)?

(iii) Whether the Appellant has Permanent Establishment in India within the meaning of Article 5(1) dehors the parameters prescribed in Article 5(2) of the DTAA?

(iv) Whether, in the given facts and circumstances, the provisions of Article 5(2) would prevail over the provisions of Article 5(1) of the DTAA?

(v) Whether the Tribunal misdirected itself both in law and on facts in holding that service charges received by the Appellant under the various SOSA Agreements were taxable as royalty?"

2. Similar questions were also raised in other connected appeals.

3. After hearing the parties, this Court is of the view that the questions require to be slightly modified. The questions that arise for consideration in these appeals are restated as under:

(i) Whether the Tribunal misdirected itself both in law and on facts in holding that service charges received by the Appellant under the various SOSA Agreements were taxable as royalty?

(ii) Whether the Appellant has Permanent Establishment in India within the meaning of the Double Taxation Avoidance Agreement?

(iii) Whether the findings recorded by the Tribunal, in paragraphs 56, 57 and 59 are perverse and contrary to the terms of the Strategic Oversight Services Agreement (SOSA)?

(iv) <u>Is Article 7(1) of the DTAA at all applicable to the Appellant, having regard to the fact that it has incurred losses in the relevant financial years</u>?

4. <u>Insofar as the fourth question is concerned, this Court had, on 16.01.2023, expressed its view that the said question is required to be considered by a larger Bench, considering this Court's reservation regarding the decision of the coordinate Bench of this Court in the case of ***Commissioner of Income Tax (International Taxation)-2 vs. M/s Nokia Solutions and Networks OY; ITA 503 of 2022***, decided on 02.12.2022.</u>

5. <u>Mr. Ganesh, learned Senior Counsel appearing for the appellant states that, at this stage, the appellant does not wish to press the fourth question as stated above because the appellant's appeals can be decided on the basis of the first three questions.</u>

6. <u>He, however, reserves the right for pressing the said question at an appropriate stage if the need so arises.</u>

7. <u>In view of the above, this Court considers it apposite to examine</u>

> the first three questions as set out above in the first instance.
>
> 8. Learned Counsel for the parties agree that if the decision in any of the three questions is in favour of the appellant, it would not be necessary for this court to consider the fourth question and the same will be taken as given up finally.
>
> 9. Arguments have been partly heard on the first three questions.
>
> 10. List for further proceedings on 20.04.2023".

4. It is on the aforesaid basis that the Court appears to have proceeded to consider the challenge which stood raised and the issue of applicability of Article 7 of the **Double Taxation Avoidance Agreement**[4] between India and the United Arab Emirates, in case losses had been suffered at an entity level was reserved for further consideration. The appeals were ultimately decided in terms of a final judgment rendered on 22 December 2023. The Court had identified the four principal questions which merited determination as being the following:-

> "(i) Whether the Tribunal misdirected itself both in law and on facts in holding that service charges received by the Appellant under the various SOSA Agreements were taxable as royalty?
>
> (ii) Whether the Appellant has Permanent Establishment in India within the meaning of the Double Taxation Avoidance Agreement?
>
> (iii) Whether the findings recorded by the Tribunal, in paragraphs 56, 57 and 59 are perverse and contrary to the terms of the Strategic Oversight Services Agreement (SOSA)?
>
> (iv) Is Article 7(1) of the DTAA at all applicable to the Appellant, having regard to the fact that it has incurred losses in the relevant financial years?"

5. As would be evident from the final decision rendered, Questions (i) and (ii) came to be answered in the affirmative. The Court while considering Question (iii) came to hold that the findings rendered by the **Income Tax Appellate Tribunal**[5] on payments being liable to be

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[4] DTAA
[5] Tribunal

viewed as royalty under Article 12 were unsustainable.

6. Question (iv), in light of the earlier orders of 16 January 2023 and 14 March 2023, was reserved and referred for our consideration. It however becomes pertinent to take note of the following observations which appear in the final judgment insofar as the issue of attribution is concerned. We deem it apposite to extract paragraphs 33 to 36 of the final judgment hereinbelow: -

> "***Re: Question No. (iv)***
>
> 33. One of the principal contentions advanced by the Assessee is that even if it is assumed that the Assessee has a PE in India, there is no question of attributing any amount as income chargeable to tax under the Act to its PE, as it has incurred a loss on an entity level (global basis). According to the Assessee, income chargeable to tax under the Act could be attributed to its PE in India only if the Assessee had made profit on an entity level. Concededly, the said issue is covered in favour of the Assessee by a decision of the Coordinate Bench of this Court in ***Commissioner of Income Tax (International Taxation)-2 v. M/s Nokia Solutions and Networks OY***. However, we have some reservations regarding the said view.
>
> 34. The profits attributable to the Assessee's PE in India are required to be determined on the footing that the PE is an independent taxable entity. It is, thus, possible that an Assessee makes a net loss at an entity level on account of losses suffered in other jurisdictions, which is partly offset by profits arising from India. In these circumstances, if it is held that the Assessee has a PE in India, prima facie the Assessee would be liable to pay tax on the income attributable to its PE in India notwithstanding the losses suffered in other jurisdictions. This aspect was not deliberated in the case of ***Commissioner of Income Tax (International Taxation)-2 v. Nokia Solutions and Networks OY***.
>
> 35. This Court was of the view that the fourth question as raised by the Assessee ought to be referred to a larger Bench. This was recorded by this Court in an order dated 14.03.2023. However, the learned senior counsel appearing for the Assessee had requested this Court to consider the other questions and had asserted that the Assessee would not press the fourth question, if the Assessee's appeals are disposed of in its favour on the basis of the other questions as framed. The learned counsel for the parties had also agreed that if the appellant succeeded before this Court in respect of the first three questions, the Assessee would finally give-up the fourth question without any recourse.

36. In view of the above, this Court is confining further deliberations to the first three questions as set out above."

7. As is apparent from the tentative observations entered by the Division Bench, it found itself unable to concur with the submission that income attribution would be impermissible if the enterprise had on a global level suffered a loss. The Division Bench observed that the issue of attribution of profits to a PE in India would have to be determined on the basis of the latter being considered to be an independent taxable entity. It thus opined, prima facie, that once it is found that the assessee has a PE in India, it would be liable to pay tax on such income in India notwithstanding the losses that the enterprise as a whole may have suffered in other jurisdictions.

8. *Nokia Solutions* was considering a challenge to a decision rendered by the Tribunal and which in turn had sought to draw sustenance for holding that global profit or loss would constitute a relevant factor for attributing income to a PE on the basis of a decision rendered by a Special Bench of the Tribunal in **Motorola Inc. Vs. Deputy Commissioner of Income Tax, Non-Resident Circle New Delhi (and vice-versa)[6].**

9. While noticing the aforesaid, the Court in *Nokia Solutions* had held as follows:-

> "**10.** We may note, that the impugned order passed by the Tribunal has proceeded on the basis, albeit on a demurrer, that the respondent-assessee has a permanent establishment ("PE") in India, and thereafter gone on to discuss, as to whether any profits could be attributed to it.
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> **11.** The Tribunal has returned a finding of fact, that the respondent assessee recorded a "global net loss" in the relevant assessment year, and therefore no profit could have possibly been attributed to it.

[6] 2005 SCC OnLine ITAT 1

11.1 A discussion on this aspect is set forth in the following paragraphs of the impugned judgment passed by the Tribunal (page 88 of 97 ITR (Trib)) :

> "The assessee emphatically denies that the appellant has a permanent establishment in India. However, without any prejudice to that basic contention, the assessee submitted that even assuming without conceding that the assessee has a permanent establishment in India, no profit or income can at all be attributed to the permanent establishment as the net profit of the assessee is loss and there are no taxable attributable profits available. The Assessing Officer has incorrectly determined the profits taking into gross profit into consideration and if the net profit is taken into consideration rightly, then the issue as to whether the assessee has a permanent establishment in India would end up as an academic issue.
>
> The attribution of profits (net profit) stands covered in favour of the appellant by the judgment of the Special Bench in the case of Nokia Corporation for the assessment year 1997-98 and 1998-99 (involving same business as carried out by the appellant) as mentioned in the paper book Volume C-page 936, at 949-950 (para 287). The Special Bench held that the appellant-company's world wide net profit margins as per its audited accounts are to be applied for determining the quantum of the income to be attributed to the permanent establishment. The effect being if the appellant-company is in net loss as per its audited accounts or the calendar years 2009 and 2010, which relate to the present assessment year 2010-11, there would be no profit or income attributable to the permanent establishment. There are losses in both years as per the audited accounts. Paper book- Volume A of compilation page 164, at 169 and page 180 at 185. The relevant portion of the said Special Bench Judgment is quoted herein below (page 287 of Volume C, at page 949-950) :
>
> > '287 ... Taking all these into consideration, we consider it fair and reasonable to attribute 20 per cent. of the net profit in respect of the Indian sales as the income attributable to the permanent establishment.
> >
> > The following steps are involved in computing the income attributable to the permanent establishment :
> >
> > First the global sales and the global net profit have to be ascertained. From the accounts presented before us as well as before the Income-tax authorities, the global net profit rate has been ascertained at 10.8 per cent. and 16.1 per cent. by the Commissioner of Income- tax (Appeals), to which no objection has

> been taken by either side. This percentage has to be applied to the Indian sales and by Indian sales, we mean the total contract price for the equipment as a whole and not the bifurcated price which the Assessing Officer has referred to in the assessment order. This will also be consistent with our view that the software and the hardware constitute one integrated equipment. The resultant figure would be the net profit arising in respect of the Indian sales. Out of this figure of net profit 20 per cent. shall be attributed to the permanent establishment to cover the three activities mentioned above. The Assessing Officer is directed to compute the income of the permanent establishment as directed above.'

The Revenue appealed before the hon'ble Delhi High Court against the said Special Bench judgment and the only ground raised by the Department was with regard to the rate of net profit (20 per cent.) applied by the Special Bench and not with regard to the method of taking the net profit rate of the foreign enterprise. The Revenue Department has thus accepted the finding of the Special Bench with regard to the net profit margin method and has allowed that finding to become final. The same method of attribution of profits to the permanent establishment on the basis of the net profit rate of the foreign enterprise has been applied by the Revenue in the cases of three other assessees who were in the same field of business as the appellant, viz., ZTE, Huawei and Nortel. Each of these assessees was engaged in the supply of telecom equipment to Indian telecom operators. The Income-tax Appellate Tribunal order passed in the case of Notel specifically records that in the cases of each of these two assessees, the Revenue had adopted the net profit rate of the foreign enterprise for determining the amount of profit income which was attributable to each enterprise's respective permanent establishment. Hence, applying the said Special Bench judgment to the facts of the present case, as the appellant has global net loss as per its audited accounts, no profit or income can be attributed to the assessee in India.

To mention Special Bench ruling is in line with the provisions of article 7(1) of the India Finland Double Taxation Avoidance Agreement (DTAA), which is set out at page 719, at 723 of Volume B of the compilation. For the sake of convenience, article 7(1) is reproduced hereunder:

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

> the enterprises carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.'
>
> Article 7(1) thus provides as under :
>
> '(a) The profits of an enterprise can ordinarily be taxed only by the country in which it is located.
>
> (b) If however, the enterprise has a permanent establishment located in another country (which is also a signatory to the Double Taxation Avoidance Agreement), through which it carries on its business, then a portion of its profits, to the extent it is attributable to the permanent establishment can be taxed in the other country.'

On a plain reading of article 7 (1) of the Double Taxation Avoidance Agreement, the question of attributing profits to the permanent establishment arises only if the foreign enterprise is making a profit. This is the condition precedent. If it is making a loss then no question arises at all of attributing any profit to the permanent establishment, which would be taxable in India.

The Assessing Officer has taken gross profit margins of the appellant-company for 2009 and 2010 as per its audited accounts instead of the net profit margins. The gross profit margins of the appellant-company for 2009 and 2010 were positive, and that was how the Assessing Officer could attribute profits to the permanent establishment. In so adopting the gross profit margins of the appellant-company, the Assessing Officer has acted in a manner which is directly contrary to article 7(1) of the Double Taxation Avoidance Agreement and also contrary to the said Special Bench judgment. It is the net profit margins which are to be considered as for attribution as per the Double Taxation Avoidance Agreement.

The computation made by the Assessing Officer in his assessment order is incorrect as the Assessing Officer has not allowed the payments made by the appellant to NSN India for the services rendered by NSN India as a deduction from the profit attributable to the alleged permanent establishment. If the said payments are allowed as a deduction from the gross profit figures taken by the Assessing Officer, then again the resultant figure would be losses. Consequently, even if the method of attribution adopted by the Assessing Officer is considered to be correct, in any event, there would be no profit/income

attributable to the permanent establishment. The computation is as under :

xxxx **xxxx** **xxxx**

29. Consequently, even if the appellant has a permanent establishment in India, no profit or income can in law at all be attributed to permanent establishment which would be taxable in India. Hence, we hold that, the adjudication on issue of permanent establishment would be academic in nature.

12. Having regard to the following finding of fact returned by the Tribunal, we are of the view that the proposed questions of law, i. e., A and B would not arise for consideration.

13. We may also note, that a plain reading of the article 7 of the Double Taxation Avoidance Agreement entered into between India and Finland also persuades us to take the same view as that which is taken by the Tribunal.

13.1 A plain reading of the article 7(1) would show, that the issue of taxability would arise qua the respondent-assessee only if profits accrue to the respondent-assessee, and that too only to the extent they can be attributed to its permanent establishment in India.

14. Given this position, we are not inclined to entertain the appeal."

10. It becomes pertinent to note that the Tribunal while considering the appeal preferred by *Nokia Solutions* had noticed the decision of the Special Bench in the assessee's own case and which formed part of a batch of connected appeals including the one preferred by *Motorola Inc.* in the following context. Apart from a host of other issues which were raised for the consideration of the Special Bench of the Tribunal, the penultimate question was with respect to attribution of income. This becomes apparent from a reading of paragraphs 423 to 427 and which read as follows: -

"423. We have considered the matter of attribution of income to the PE carefully. For the assessment year 1997-98 the Assessing Officer has first bifurcated the value of the total supply of equipment i.e. both hardware and software into 70% for hardware and 30% for software. 70% of the supply value comes to Rs. 102,63,12,952/-. He has estimated the income at 40% thereof which comes to Rs. 41,05,25,180. From this figure he has deducted 5% as permissible expenses u/s 44C of the Income-Tax Act which comes to Rs.

2,05,26,259. The balance of Rs. 38,99,98,921 has been taken as the taxable income from hardware and is taxes @ 55%. A similar procedure has been adopted in the assessment year 1998-99, except that tax has been charged @ 48%. The CIT (Appeals) in paragraph 7 of his order for the assessment year 1997-98 has reduced the income to 5% of the sales to Indian parties. While doing so he has noted that the profit and loss account relating to Indian operations of the assessee is not substantiated with any documents and is, therefore, not reliable for the purpose of computing the income from sale of hardware. He has accordingly taken the assistance of Rule 10 of the Income-tax Rules to compute the profits on the basis of assessee's global accounts. He has noted that the global accounts showed a net profit of 10.8%. The net profit on Indian sales was, therefore, taken at 10.8% but the CIT (Appeals) held that since the whole of this profit cannot be attributed to the Indian operations as the activities relating to manufacture and development of the products were undertaken outside India, he has ultimately held that the profits attributable to operations in India should be taken at 5% of the sales to the Indian parties. For the assessment year 1998-99, he has taken 7.9% of the sale value considering the fact the net profit on Indian sales was 16.1% as against 10.8% in the preceding year.

424. The Department in its appeals has taken the ground that the CIT(Appeals) was not justified in reducing the income from 40% of the value of the hardware to 5% of the sales to Indian parties. Actually, for the assessment year 1998-99, the ground should be that the CIT(Appeals) was not justified in reducing the income to 7.9%. It appears to be a mistake in drafting the ground No. 1. On the other hand the assessee in its appeals has taken up several contentions including the contention that no income can be attributed to the PE at all primarily because whatever expenses that are incurred by it are compensated by the assessee on cost plus basis, that if the expenditure incurred by the PE is taken into account then there will be no income left to be assessed, that there are several activities which do not lead to the existence of the PE and, therefore, they cannot contribute to the revenues of the PE, that no income can be attributed to the supervision because the supervision is only an incident of the sale and does not constitute an operation by itself, that the India specific accounts were wrongly rejected by the CIT (Appeals) and that at any rate the adoption of 5% and 7.9% of the sales to Indian parties is arbitrary and excessive.

425. We have carefully considered the argument raised by the Department as well as the assessee. In the present case it cannot be disputed that the research and development activities and the manufacture of the GSM equipment took place wholly outside India. W have also found, for reasons stated earlier, that the title and risk in the equipment also passed wholly outside India. The only activities which the assessee carried on in India through its PE were:

a) Net work planning,

b) Negotiations in connection with the sale of equipment, and

c) The signing of the supply and installation contracts.

426. In the case of *Ahmadbhai Umarbhar*, 18 ITR 472, the Supreme Court held that the income attributable to the manufacturing activity should be more then the income attributable to the activity of sale. In the case of *Annamalia Timber Trust & Co.* v. *CIT*, 41 ITR 781, the Madras High Court approved the tribunal's decision that 10% of the income can be attributed to the signing of the contracts in India. The Calcutta High Court also approved the same percentage as income attributable to the signing of the contracts in India in the case of *CIT* v. *Bertram Scott Ltd.*, 31 Taxman 444. We have kept the principles laid down in these judgments in mind. In the present case, as already noted, in addition to the signing of the contracts in India, the preliminary negotiations for the contracts and the network planning were carried out through the PE. We may clarify here that the network planning activity is different from the activities which are of the preparatory or auxiliary character. In respect of signing of contracts, alone, the income attributed is 10% in the decisions cited above. Two more activities have been carried out by the PE in India and, therefore, we have to attribute a higher income than what was attributed in the decided case. The negotiations which ultimately lead to the signing of the contracts may involve more effort on the part of the PE and the signing of the contracts is only the fructification of those efforts. Obviously, therefore, the income attributable to the negotiations part should be more and in addition to the income attributable to the signing of the contracts. Some income has to be attributed to the net work planning also. Taking all these into consideration, we consider it fair and reasonable to attributable 0% of the net profit in respect of the Indian sales as the income attributable to the PE. The following steps are involved in computing the income attributable to the PE.

427. First the global sales and the global net profit have to be ascertained. From the accounts presented before us as well as before the Income-tax authorities, the global net profit rate has been ascertained at 10.8% and 6.1% by the CIT (Appeals) to which no objection has been taken either side. This percentage has to be applied to the Indian sales and by Indian sales, we means the total contract price for the equipment as a whole and not the bifurcated price which the Assessing officer has referred to in the assessment order. This will also be consistent with our view that the software and the hardware constitute one integrated equipment. The resultant figure would be the net profit arising in respect of the Indian sales. Out of this figure of net profit 20% shall be attributed to the PE to cover the three activities mentioned above. The A.O. is directed to compute the income of the PE as directed above."

11. As is evident from the aforesaid extracts of that decision, the

reference to global sales and global net profit was made in the backdrop of the parties having failed to produce adequate material which may have independently established the profit margin of the PE in India. It was in the aforesaid backdrop that the Special Bench of the Tribunal ultimately appears to have held that a net profit of 20% should be attributed to the PE.

12. By the time the issue again arose for consideration of the Tribunal for AY 2010-11, it proceeded on the basis that the question of attribution already stood answered in light of the judgment handed down by the Special Bench pertaining to AYs' 1997-98 and 1998-99. It was on the aforesaid basis that the Tribunal observed that since the Special Bench had already held that it would be Nokia's worldwide net profit margin which was to be applied for determining the quantum of income attributable to the PE, the same principle should apply and govern the issue for AY 2010-11. It thus held that since Nokia on a global scale had suffered a net loss, no profit or income could be attributed to its PEs'.

13. The Tribunal also appears to have borne in consideration the fact that the Revenue while pursuing its appeal before this Court against the judgment rendered by the Special Bench in *Motorola Inc.* had confined it to the ultimate rate of net profit which had been applied. It thus took the view that the Revenue would be deemed to have accepted the legal position as propounded by the Special Bench, namely, of global profit or loss being relevant and determinative.

14. Our Court while ultimately upholding the view taken by the Tribunal in the case of *Nokia Solutions* dismissed the appeal of the Revenue holding that the view expressed by the Tribunal did not merit

consideration. However, while doing so, the Court also observed that a plain reading of Article 7 persuades it to affirm the view that was taken by the Tribunal. This was further reiterated with the Court observing that the issue of taxability could arise only if profits had accrued to the assessee and that too only to the extent attributable to its PE in India.

15. Appearing for the assessee, Mr. S. Ganesh, learned senior counsel, at the outset contended that once the Revenue had accepted the formulation of the legal position by the Special Bench of the Tribunal in *Motorola Inc.* and had restricted its challenge only to the prescription of a profit percentage, it would not be permissible for them to re-agitate those questions.

16. Apart from the above, Mr. Ganesh commended for our acceptance the view expressed by the Court in *Nokia Solutions* when it had observed that the question of taxability would arise only if profits had accrued to the assessee at a global level. According to learned senior counsel, a plain and textual reading of Article 7 of the DTAA would also lead us to the same conclusion.

17. According to Mr. Ganesh, on a reading of Article 7 of the DTAA, it would be apparent that the profits of an enterprise based in UAE would ordinarily be taxable only in that State and not in India. It was his submission that if the enterprise based in the UAE were making a loss, the question of taxability either in UAE or in India would not arise at all. According to learned senior counsel, only if an enterprise were making a profit, could a PE through which it carries on business be subjected to tax and that too restricted to so much of the profit as is attributable to that PE. Consequently, according to Mr. Ganesh, for a foreign enterprise to be taxed in India, the following three conditions

precedent would have to be conjunctively satisfied: -

A) The foreign enterprise must be making a profit;

B) The foreign enterprise has a PE in India; and

C) At least a part of the profit made by that enterprise is attributable to its PE in India and that part alone being liable to be taxed.

Learned senior counsel thus submitted that if a foreign enterprise like the appellant were making a loss, the question of attributing any profit to its PE in India would not arise and consequently that enterprise would have no tax liability in India.

18. Appearing for the Revenue, Mr. Kumar addressed the following submissions for our consideration. Learned counsel at the outset, submitted that the judgment of the Court in *Nokia Solutions* is clearly being read out of context and is distinguishable on facts. It was submitted that although the decision of the Special Bench of the Tribunal was subjected to an appeal before this Court, the same came to be dismissed with the Court refraining from even framing a question of law. Mr. Kumar contended that the Court in *Nokia Solutions* had refrained from rendering any definitive findings as would be apparent from the operative parts of that decision. Learned counsel sought to make good the aforesaid submission by inviting our attention to the following observations as appearing in that order of dismissal: -

> "**12.** Having regard to the following finding of fact returned by the Tribunal, we are of the view that the proposed questions of law, i. e., A and B would not arise for consideration.
>
> **13.** We may also note, that a plain reading of the article 7 of the Double Taxation Avoidance Agreement entered into between India and Finland also persuades us to take the same view as that which is taken by the Tribunal.
>
> 13.1 A plain reading of the article 7(1) would show, that the issue of taxability would arise qua the respondent-assessee only if profits

> accrue to the respondent-assessee, and that too only to the extent they can be attributed to its permanent establishment in India.
>
> **14.** Given this position, we are not inclined to entertain the appeal."

19. It was thus sought to be contended by Mr. Kumar that this Court ultimately declined to entertain the appeal of the Revenue in light of the findings of fact which had come to be rendered by the Tribunal. According to learned counsel, the decision of this Court in *Nokia Solutions*, and the correctness of which has been doubted by the Bench while referring the matter for our consideration, came to be rendered primarily influenced by the fact that the Revenue had failed to question the method of attribution and the net profit rate as was adopted by the Special Bench. According to learned counsel, the same must consequently be read as confined to the peculiar facts which obtained and that the said decision cannot possibly be read as an authority for the proposition of a global profit being an aspect of import insofar as attribution under Article 7 is concerned.

20. Proceeding then to the DTAA itself, it was Mr. Kumar's contention that the Convention clearly contemplates an exercise of attribution being undertaken under Article 7 in light of the PE being treated as a separate and distinct enterprise in itself. According to Mr. Kumar, Article 7 mandates the attribution of profits to a PE acknowledging it to be a distinct and separate enterprise and thus such an exercise being undertaken independently.

21. According to learned counsel, the determination of business profit as per Article 7 is mandated to be undertaken on the basis that the PE is a separate enterprise and is operating independently of the enterprise of which it may be a PE. According to learned counsel, a reading of the provisions of the DTAA would lead one to the irresistible

conclusion that the only relevant consideration for answering the question of business profit is the activities undertaken by the PE at its individual level and uninfluenced by the activities of the enterprise of which it may be a part.

22. In view of the aforesaid, it was contended that the taxability of the profit of the PE would have no connection with either the profit or the loss which the assessee earns or suffers at a global level. In view of the above, it was contended that the view expressed by the Court in its judgment of 22 December 2023 should be affirmed and the tentative view expressed therein confirmed as being representative of the correct position in law.

23. Mr. Kumar also sought to draw support for the aforenoted submissions from paragraphs 11 and 12 of the Commentary on Article 7 of the **Model Tax Convention on Income and on Capital-Condensed Version**[7] dated 17 July 2008 and which read as follows:-

> "11. When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole. Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the phrase "profits attributable to a permanent establishment". In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

[7] OECD Commentary 2008

> 12. Clearly, however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise."

24. Having noticed the submissions which were addressed by respective parties, it would be appropriate to deal with the submission of Mr. Ganesh who had argued that once the Revenue had accepted the decision of the Special Bench in *Motorola Inc.* it would not be permissible for it to take a contrary stand or contend that the profit or loss of an enterprise at a global level would be irrelevant.

25. We find ourselves unable to sustain that submission for the following reasons. Firstly, and at the outset, it must be borne in mind that this Full Bench is called upon to consider a question of law which stands referred for its consideration. It is clearly not concerned with whether the Revenue could have maintained an appeal or not as also whether it was estopped from taking a particular position in law notwithstanding the dismissal of its appeal preferred against *Motorola Inc.* We thus find ourselves unable to recognise any impediment restricting the Revenue from advocating the acceptance of a particular position on a question of law.

26. More importantly, and in our considered opinion, the arguments of the appellants based on the decision of the Special Bench in *Motorola Inc.* are clearly misconceived and rest merely on a stray observation which appears in that decision. The Tribunal while deciding *Nokia Solutions* also appears to have similarly misconstrued

those observations as would be evident from the discussion which ensues.

27. As is apparent from a careful reading of paragraphs 423 and 424 of *Motorola Inc.*, the Special Bench found that authorities had found themselves unable to place any credence on the profit and loss account of the Indian PE since it had not been substantiated. It then proceeded to outline the steps that would be involved in computing the income attributable to the PE. It was in the aforesaid context that it observed that *"First the global sales and the global net profit have to ascertained."* It then proceeded to observe that the global net profit had been identified to be 10% and 6.8% in the first appeal proceedings. It thus held that it would be appropriate to set apart 20% of that figure as the net profit of the PE.

28. It is therefore apparent that the observations appearing in *Motorola Inc.* have clearly been misinterpreted and read wholly out of context. The decision of the Special Bench cannot possibly be read as being an authority for the proposition which is canvassed for our consideration by the appellants in these proceedings. The Tribunal in *Nokia Solutions* had ultimately held that "*....as the Appellant has global net loss as per audited accounts, no profit or income can be attributed to the PE.*" The Tribunal too appears to have completely misconstrued *Motorola Inc.* as purporting to enunciate a binding legal principle of global loss being pertinent for the purposes of considering whether income is allocable to the PE. We thus find ourselves to read or construe the decision of the Special Bench as lending credence to the contentions which were canvassed at the behest of the appellants in these proceedings. The aspect of a failure on the part of the Revenue to question or assail the observations entered by the Special Bench,

consequently, pale into insignificance.

29. However, and this we do propose to clarify. The observations that appear hereinabove are rendered solely in the context of our endevour to enunciate the correct legal position which would obtain and are not intended to shroud the ultimate judgment which the Court rendered and would continue to bind parties.

30. Having put the preliminary submissions to rest, and before we commence our discussion on the principal question that stands posited, it would be appropriate to notice the salient provisions of the DTAA Article 3(1)(g) defines the expressions "*enterprise of a contracting state and enterprise of the other contracting State*" as follows: -

> "ARTICLE 3
> **GENERAL DEFINITIONS**
>
> 1. In this Agreement, unless the context otherwise requires:
>
> **xxx xxx xxx**
>
> (g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively, an enterprise carried on by a resident of a Contracting State and an enterprise carried only a resident of the other Contracting State ;

31. A PE is defined by Article 5 in the following terms: -

> "ARTICLE 5
>
> **PERMANENT ESTABLISHMENT**
>
> 1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
>
> 2. The term "permanent establishment" includes especially :
>
> (a) a place of management ;
> (b) a branch ;
> (c) an office ;
> (d) a factory ;
> (e) a workshop ;
> (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources ;
> (g) a farm or plantation ;
> (h) a building site or construction or assembly project or supervisory activities in connection therewith, but only where

such site, project or activity continues for a period of more than 9 months ;

(i) the furnishing of services including consultancy services by an enterprise of a Contracting State through employees or other personnel in the other Contracting State, provided that such activities continue for the same project or connected project for a period or periods aggregating more than 9months within any twelve-month period.

3. 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.

4. Notwithstanding the provisions of paragraphs (1) and (3), where a person - other than an agent of independent status to whom paragraph (5) applies - is acting on behalf of an enterprise and has, and habitually exercises in a Contracting State an authority to conclude contracts on behalf 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 the purchase of goods or merchandise for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other 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. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of independent status within the meaning of this paragraph."

32. The subject of business profits and its taxability is regulated by Article 7 which reads as under: -

"ARTICLE 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

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

[3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the tax laws of that State.]

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph (2) shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary ; the methods of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by the permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

(7) Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article."

33. It becomes pertinent to note that Article 5 while defining the expression "*PE*" brings within its ambit a varied nature of

establishments and which need not necessarily be those which have a separate legal persona. As we view Article 5**,** it becomes apparent that the nature of establishments which are included within the meaning of the phrase "*PE*" range from a place of management to a mine or a building site and thus not being confined to a juridical entity as is ordinarily understood in law.

34. The fact that a PE for the purposes of taxation is viewed as a separate and distinct centre, was one which was noticed by us, albeit briefly, in **International Management Group (UK) Limited vs. Commissioner of Income Tax-2**[8] as would be evident from the following extracts of that decision: -

> "**107.** We also bear in mind the submission of Mr. Vohra who had laid stress upon the memorandum of understanding and the services agreement being an indivisible contract and constituting a singular source of the income in question. Undisputedly, the income was earned by and was liable to be remitted to IMG. The service permanent establishment was undoubtedly not a separate legal entity which could have been possibly called upon to satisfy the test of economic ownership as suggested. <u>While Conventions do accord an independent identity upon a permanent establishment, they do so for the purposes of taxation alone. A permanent establishment, however, need not in all circumstances be a juridical entity as is recognised in law.</u> It is perhaps these and other limitations which constrained Vogel to express the following reservations with respect to the test of "economic ownership" (page 893):
>
> > "The effectively connected rule is not based on the force of attraction rule (No. 31 of OECD Model Convention 2014 Comm. on article 10; No. 24 of OECD Model Convention 2014 Comm. on article 11; No. 20 of OECD Model Convention 2014 Comm. on article 12; No. 15 of UN Model Convention 2011 Comm. on article 10). This means that dividends, interest and royalties flowing to a resident of a Contracting State from a source situated in the other State must not, by a kind of legal presumption, or fiction even, be related to a permanent establishment or a fixed base, as the case may be, which that resident may have in the source State, so that this State would not be obliged to limit its tax jurisdiction in such a case. The shares, debt claims, rights

[8] 2024 SCC OnLine Del 4558

or property must form part of the assets of the permanent establishment respectively the fixed base or must be otherwise effectively connected with that establishment or base. This view is also put forward in *Tech Mahindra Ltd.* v. *Commissioner of Taxation* [[2016] FCAFC 130; 2016 ATC 20-582; (2016) 103 ATR 813.] , where the Australian Federal Court stated that profits which are made liable to tax in the source State under the 'force of attraction' notion are not attributable to a permanent establishment and therefore not effectively connected with it. The US Technical Explanation gives the example of dividends derived by a dealer in shares or securities from shares or securities that the dealer held for sale to customers. However, in respect of debt claims, rights and property, the UN Model Convention allows a limited force of attraction under article 7(1)(c) : Business activities in the source State of the same or similar kind as those effected through the permanent establishment may also be taxed in the source State. Consequently, interest received from debt claims and royalties received from rights and property effectively connected with such business activities may also be taxed unrestrictedly in the source State (No. 20 of UN Model Convention 2011 Comm. on article 11; No. 17 of UN Model Convention 2011 Comm. on article 12). For example, the proviso applies whenever both the permanent establishment's business activities and the head office's business activities carried out in the permanent establishment State consist of managing or trading shares, granting loans or licensing. However, it does not apply if the head office's or the permanent establishment's activities consist only of disposing of capital by buying shares or depositing funds into bank accounts. Such activities are not the business activities referred to in article 7(1)(c) of the UN Model Convention.

The risk that the permanent establishment proviso may be abused through the transfer of shares, debt claims, rights or property to a permanent establishment set up solely to benefit from privileged tax regimes in the permanent establishment State may be remote (No. 32 of OECD Model Convention 2014 Comm. on article 10; No. 25 of OECD Model Convention 2014 Comm. on article 12; No. 21 of OECD Model Convention 2014 Comm. on article 12). First of all, a permanent establishment can only be identified if a business is carried on therein. Secondly, the condition that the shares, debt claims, rights or property must be effectively connected to such a location requires more than merely recording these assets in the books of the permanent establishment for accounting purposes. Next to

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> this, the OECD believes that domestic anti-abuse rules can be an adequate weapon.
>
> According to the OECD, shares, debt claims, rights or property form part of the assets of a permanent establishment if the 'economic' ownership of these is allocated to that permanent establishment (No. 32.1-32.2 of OECD Model Convention 2014 Comm. on article 10; No. 25.1-25.2 of OECD Model Convention 2014 Comm. on article 12; No. 21.1-21.2 of OECD Model Convention 2014 Comm. on article 12). 'Economic' ownership means the equivalent of ownership for Income-tax purposes by a separate enterprise, with the attendant benefits and burdens, such as the right to the dividends, interest or royalty attributable to the ownership of a holding, debt claim, right or property, as the case may be, and the potential exposure to gains or losses from the appreciation or depreciation of that holding, debt claim, right or property. In the opinion of this author, the term 'economic' ownership is not appropriate for the allocation of assets to a permanent establishment. A permanent establishment itself can never be owner of an asset because it is not a separate legal entity. As a result, it can never be the 'economic' owner of an asset as well. The term is therefore misleading. It also guides away attention from what is actually relevant for answering the question of what assets must be allocated to a permanent establishment : The significant people's functions. The author believes that this is an activity test and has nothing to do with an ownership test, and therefore is of the opinion that the relevant test is, or should be, whether the shares, debt claims, rights or property, as the case may be, are managed and their exploitation is directed and controlled by people active in or from a permanent establishment. If so, the asset concerned is effectively connected with that permanent establishment and the income received from it (i.e., dividend, interest respectively royalty must be attributed to that permanent establishment (see supra m.No. 124)). Whether the economic strength of a permanent establishment is enhanced is, as such, not a relevant criterion. Assets cannot create economic activity by themselves."

35. The separate treatment which is liable to be accorded to the functioning of a PE is an aspect which also emerges from the following observations rendered by the Supreme Court in **DIT (International**

Taxation), Mumbai vs. Morgan Stanley & Co. Inc.[9]:-

> "**19.** Under Article 7, the taxability is of MNE. What is to be taxed under Article 7 is income of MNE attributable to the PE in India. The income attributable to the said PE is the income attributable to foreign company's operations in India, which in turn implies the income attributable to the activities carried on by MNE through its PE in India. Therefore, there is a difference between the taxability of PE in respect of its income earned by it in India which is in accordance with the Income Tax Act, 1961 and which has nothing to do with the taxability of MNE, which is also taxable in India under Article 7, in respect of the profits attributable to its PE. Under Article 7, the taxability is of MNE. What is taxable under Article 7 is profits earned by MNE. Under the said IT Act, the taxable unit is the foreign company, though the quantum of income taxable is income attributable to PE of the said foreign company in India."
>
> **xxx** **xxx** **xxx**
>
> **34.** Article 7 of the UN Model Convention inter alia provides that only that portion of business profits is taxable in the source country which is attributable to PE. It specifies how such business profits should be ascertained. Under the said article, a PE is treated as if it is an independent enterprise (profit centre) dehors the head office and which deals with the head office at arm's length. Therefore, its profits are determined on the basis as if it is an independent enterprise. The profits of the PE are determined on the basis of what an independent enterprise under similar circumstances might be expected to derive on its own. Article 7(2) of the UN Model Convention advocates the arm's length approach for attribution of profits to a PE."

36. **Klaus Vogel on Double Taxation Conventions**[10] succinctly explains the origins of the concept of a PE in the following words[11]:-

> **"A. General Issues**
>
> **I. Overview and Main Features**
>
> Article 5 OECD and UN MC is the last but most elaborate of the articles which contain **general definition of terms** relevant throughout many different treaty articles (infra m.no. 4 et seq.). The article determines the threshold that functions as the **essential demarcation line** between short-term or ephemeral activities in the source State and 'permanent establishments' (PEs) (i.e., solidified sources of income which serve as a (primary or secondary) basis for

[9] (2007) 7 SCC 1
[10] Vol. I, Fifth Edition
[11] Vol. I, Fifth Edition, page 389

the taxpayer in a State other than his or her State of residence). To a large extent, a PE does not only resemble the concept of residence in appearance but may also trigger similar, though not identical legal consequences.

Since the early 1920s, the PE threshold has been commonly used in DTCs to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates Wherever distributive rules use the PE concept (infra m.no. 4 et seq.). they reconcile requirements of international justice (prerogative of source-based taxation) and practical prudence (prerogative of residence-based taxation). In connection with those rules, Article 5 OECD and UN MC serves to simplify and facilitate taxation of cross-border activities. At the same time, it is in line with trends to encourage liberalization of international trade. Thus, the PE principle was adopted to accomplish three main objectives:

- **assigning tax revenue** to the source State

- **maintaining practicability** by establishing a minimum threshold (i.e., by preventing pure and unconditional source-based taxation where the contact of the taxpayer to the source State is only occasional or peripheral (ef. no. 132 et seq. OECD MC Comm. on Article 5)); and

- placing the PE on **equal footing** with a local (i.e., resident) entrepreneur for the purposes of various articles, thus providing neutrality between the different forms of a secondary establishment available to foreign investors."

37. The working of an enterprise in a Contracting State through the agency of a PE, the "functional integration" between the two and the import of the word "through" as it appears in Article 5 was lucidly explained in Vogel as under[12]:-

"7. 'Through': Functional Integration

134 Article 5(1) OECD MC (since 1977; see *supra* m. no. 45) requires that the business of an enterprise (for these terms, see supra m. no.27 et seq.) is carried on **through** the fixed POB. The preposition 'through' specifies the **functional relation** between the **POB** and the activities of the **taxpayer**. This relation can be described best by the notion of a functional integration of the POB in the enterprise of the taxpayer. Such functional integration contains several aspects which need to be carefully distinguished from one another. Their common denominator, however, is the type and degree of proximity of the POB to, or even identification with, the

[12] Vol. I, Fifth Edition, page 414 to 416.

taxpayer's paramount economic activity.

135 The first function of the term 'through' is to make it clear that the taxpayer has to control the PE (see *supra* m.no. 106 et seq. for details).

136 Secondly, functional integration presupposes that the taxpayer 'wholly or partly **carrie[s] on' his business** (Article 5(1) OECD MC; the OECD MC Comm. uses the verb 'carried out' synonymously (no. 35 OECD MC Comm. on Article 5)). However, like 'business' and 'enterprise' (cf. *supra* m no.27 et seq.), these words do not function as a substantive filter either. While early draft Model Conventions contained the condition that the fixed POB should have 'a productive character', this requirement was never adopted by the OECD Model (see no. 35 OECD MC Comm. on Article 5). None of the current MCs provide a specific productivity test. It follows that POBs may constitute a PE even if they perform activities which have mainly or exclusively expenditures to show for.

137 Likewise, the 'carrying-on' requirement does not imply an activity in the sense of an **active and visible work**. It includes even **stand-by services and omissions**. This gains significant relevance where the omission is profitable (e.g., in the case of a POB earning money in the source State simply by fulfilling, for whichever period of time, a non-competition agreement relating to the territory of that State).

138 However, a **diffuse passivity** which equals a (temporal or lasting) suspension of the activities which the POB has been designed for may indicate that the POB is not 'permanent'. For details, see *supra* m.no.87 et seq.

139 Thirdly, the phrase 'through which' indicates that the taxpayer makes use of the POB in that he employs it as an **instrument** (equalling or resembling an operating asset) for his **entrepreneurial activities**. This third aspect of the functional integration is by far the most disputed one.

140 Historically, the instrumental character of the POB for the carrying-on of the enterprise could not be taken for granted. Between 1963 and 1977, the OBEC/OECD MC did not employ this term. Rather, it was sufficient that the taxpayer carried on his business **'in' the POB** (see *supra* m.no.45). Based on the old Model, some older DCs use the words 'in which' still today. While some authors have denied any divergence in substance , the 1977 amendment is a strong reason to assume a semantic shift indeed.

141 In a different context (viz., in Article 5(4.1) of the OECD and UN MC, as amended in 2017), the OECD and UN have returned, in one specific regard, to this old line by stating that an enterprise should carry on business 'at the same place'. However, the simultaneous use of this language on the one hand and the terms

'used or maintained by an enterprise' on the other, in one and the same sentence in the initial phrase of Article 5(4.1) OECD and UN MC, proves how careful and attentive the 2017 Models have been drafted. This dualism is another good reason to stipulate a different meaning of ‘through’, as opposed to ‘in’ or ‘at’. For all of these reasons, we do see a **substantial difference** between both terms.

142 It follows that on the one hand, the activities mentioned in Article 5(1) OECD and UN MC need no longer be carried on 'in' or 'at' the POB. In this respect, the **1977 change** of Article 5(1) OECD MC has **enlarged the scope** of the PE definition. Especially if one thinks of an activity as a human behaviour, one can now (unlike before 1977) easily subsume unmanned facilities under the PE definition (see *supra* m.no. 45 and see, e.g., no. 127 OECD MC Comm. on Article 5).

143 On the other hand, the requirement of an **instrumental character of the POB** has become irrefutable. Even stronger than the English amendment (‘through which’ instead of ‘in which’), the corresponding modification of the French text ('par l'intermédiaire de laquelle' instead of 'où') has stressed the functional integration of the POB in the business.

144 The **OECD MC Comm.** has weakened the meaning of ‘through’ since 2003. The Commentary holds the view that the requirement a functional integration is met as soon as the taxpayer exercises the business **in a fixed POB** which is at his disposal (no. 20 OECD MC Comm. on Article 5 (added on 28 January 2003.)) This is the reason for the characterisation of the famous painter example (i.e., the fictitious case of a painter who, for two years, spends three days a week in the large office building of its main client) as a service PE. In substance, the view of the OECD MC Comm. limits the meaning of 'through' to the first two instead of all three semantic aspects required by Article 5(1) OECD MC (supra m.no. 135 et seq. and 139 et seq.).

145 This abridging interpretation of Article 5(1) OECD and UN MC is not convincing, though. It sets the term ‘through’ as a synonym of; in’ or ‘at’. It is certainly not harmful, under Article 5(1) OECD and UN MC, if the taxpayer carries on his business also ‘in’ the POB. However, it is not sufficient. Given that the terms 'in' or 'at' have been used in a considerable number of bilateral DCs and, above all, that the OECD Model has intentionally **replaced the word ‘in’ by ‘through’ in 1977** (supra m.no.45), the deviation in the text of the OECD MC is to be **regarded as meaningful**. The ordinary meaning of 'through' and 'par l'intermédiaire de' is different from, and goes beyond, the ordinary meaning of 'in' or 'at' (cf. Article 31(1) VCLT). Before the background of the 1963 OECD MC, it is least among OECD Member States that ‘through’ has been given a special meaning as opposed to ‘in’ (cf. Article 31(4) VCLT). A reconsideration might be reasonable and recommendable from a

policy viewpoint. It can only be realized, however, by a modification of the text of Article 5(1) OECD and the UN MC itself.

146 Given that the POB may be a complex and heterogeneous object, the issue arises whether every single element or component part needs to be used. This is not required. It is sufficient that **the POB as a whole is functionally integrated**, in the aforementioned sense, into the business of the taxpayer. It should be noted, however, that a too narrow use might trigger the application of Article 5(4) OECD and UN MC even if the POB as a whole would not have fallen under Article S (4) OECD and UN MC by virtue of its outward appearance."

38. The imperatives of viewing the PE as a separate and independent centre for the purposes of fiscal treatment and taxation is necessitated for reasons of attribution and recognition of income generated by it independently. This becomes apparent from a reading of paragraph 24 of the **Organisation for Economic Co-operation and Development**[13] Commentary on Article 7, which is reproduced hereinbelow: -

> "24. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (e.g. the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to

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[13] OECD Commentary on Model Tax Convention on Income and on Capital 2017

the permanent establishment to reflect what a separate and independent enterprise would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between State R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty."

39. The OECD Commentary then proceeds to summarize the scope and extent of paragraph 1 as under:

> "Paragraph 1
>
> 10. Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (e.g. income derived by an enterprise in respect of personal activities of an entertainer or sportsperson).
>
> 11. The first principle underlying paragraph 1, i.e. that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.
>
> 12. <u>The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully</u>

taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

13. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase "profits that are attributable to the permanent establishment" found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its

own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 81 of the Commentary on Article 1)."

40. The Commentary on the **United Nations Model Double Taxation Convention between Developed and Developing Countries 2021**[14] while explaining the concept of a PE makes the following pertinent observations: -

> "7. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a "productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (see Commentary on paragraph 4)."

41. The concept of a PE is more lucidly explained in the commentary as follows: -

> "41. Also, a permanent establishment may exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which

[14] UN Model Convention 2021

sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

42. It follows from the definition of "enterprise of a Contracting State" in Article 3 that this term, as used in Article 7, and the term "enterprise" used in Article 5, refer to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two persons each carrying on a separate enterprise decide to form a company in which these persons are shareholders, the company constitutes a legal person that will carry on what becomes another separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business activities, will not share the profits thereof and will not be liable for each other's activities related to that project even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project. In such a case, it would be difficult to consider that a separate enterprise has been set up. Although such an arrangement would be referred to as a "joint venture" in many countries, the meaning of "joint venture" depends on domestic law and it is therefore possible that, in some countries, the term "joint venture" would refer to a distinct enterprise.

43. In the case of an enterprise that takes the form of a fiscally transparent partnership, the enterprise is carried on by each partner and, as regards the partners' respective shares of the profits, is therefore an enterprise of each Contracting State of which a partner is a resident. If such a partnership has a permanent establishment in a Contracting State, each partner's share of the profits attributable to the permanent establishment will therefore constitute, for the purposes of Article 7, profits derived by an enterprise of the Contracting State of which that partner is a resident (see also paragraph 56 [of the Commentary on Article 5 of the 2017 OECD Model Tax Convention] below).

44. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the

> fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business".

42. The concept of a PE is based upon the undertaking of economic activity in a particular State irrespective of the residence of an enterprise and the same being understood to be in the nature of a conglomerate or an entity which may have many arms or independent functional units situate in various fiscal jurisdictions. Any entrepreneurial activity which gives rise to income or profit thus becomes liable to be taxed at source irrespective of the ultimate recipient or owner of that income. Source here would mean the location which gives rise to the accrual of profits or income or which is the location where the same arises. The PE principle thus enables the assignment of tax to the State which constitutes the source. The PE concept thus creates a functional relationship and connect between the principal entity and the place of business whose activities give rise to the income or profit. It is this fictional creation of an independent economic center in a Contracting State which informs the allocation of taxing rights. Once the DTAA confers an independent identity upon the PE, it would be wholly erroneous to answer the question of taxability basis either the activities or profitability of the parent or the entity which seeds and sustains the PE.

43. The Contracting State in which this imagined entity is domiciled and undertakes business thus becomes identified as an independent profit or revenue earning center which is liable to be taxed. Once such

an entity is found to exist in one of the Contracting State, it is viewed as a unit which contributes to the economic life of that State and thus be liable to tax. It is these basic precepts which convince us to debunk the theory of taxation in the source State being dependent upon a global profit or taxation being subject to income or profit having been earned at an entity level.

44. The identity which attaches to a PE for the purposes of ascertainment of a taxing liability cannot possibly be doubted bearing in mind the succinct observations of the Supreme Court in *Morgan Stanley* and where their Lordships without a degree of equivocation acknowledged the distinction that is liable to be drawn between a PE with respect to income earned in the Contracting State where it is domiciled or deemed to exist and the global enterprise of which it may be a part. Vogel explains the PE concept as constituting the threshold and the "essential demarcation line" in the source State which sanctions the imposition of a tax in a fiscal jurisdiction other than the State of residence. This would clearly appeal to logical since the right of taxation which inheres in the source State is connected to the "economic life" of that transnational enterprise which is moored and berthed by virtue of the existence of a PE which may be found to exist. Regard must also be had to the fact that right of the source State to tax does not extend to profits which are not allocable to the PE. All of the above, thus clearly leads us to hold that the existence and identity of the PE is separate and distinct and subject to tax to the extent of activities that it may undertake in a State distinct from that of its principal.

45. It would also be pertinent to note that a cross-border entity may structure its operations in a manner where it operates in more than one taxing jurisdiction. If it be open for such an entity to assert that its

global profits and income are not liable to be taxed on the basis of the source principle, it would be wholly impermissible for it to contend that the income which accrues or arises in the Contracting State is also exempt from tax. In any case, the usage of the phrase *"...so much of them as is attributable to the permanent establishment."* is a clear indicator of the DTAA warranting the PE being liable to be viewed as an independent center of revenue.

46. The identifiable parts of Article 7 not only restrict the right of one of the Contracting States to tax, it also provisions for the extent to which a tax may be imposed by that State. This becomes evident from it freeing a trans-border entity from the specter of a tax liability if it does not have a PE in the introductory part of that covenant. It then proceeds to restrict the impost by adopting the principle of attribution. It thus constructs an objective criterion for identification of a PE and when a foreign enterprise with sufficient economic presence would become subject to tax. All of the above, convinces us to hold against the argument of a PE not being taxable on an independent evaluation being misconceived.

47. On a jurisprudential plane, the sovereignty concept is based on a State's power over a territory and a set of subjects which accept its authority. It was these aspects which governed and regulated the right of a State to levy a tax. However, as trade and commerce transcended boundaries and borders, nations were confronted with profits and incomes being shifted and claimed as exempt. It is the aforenoted factors which appear to have moved the League of Nations in the early 1920s' to constitute a group of economists to study the issue of double taxation. That group is stated to have identified the fundamental factors worthy of consideration to be (a) the origin of wealth or income, (b) the

situs of income, (c) enforcement of rights connected with the above and (d) domicile of the person vested with the power to use or dispose of that income or wealth. It was the factor pertaining to "origin" of income which led to the enunciation of the source rule bearing in mind the need to identify the primary source of creation of income and the residence of its owner. It is these fundamental precepts which led to the formulation of measures to determine the economic presence of an entity in a given State and the functional integration of such an entity in the economic activity undertaken in that State.

48. Vogel while speaking on taxing rights of nations makes the following pertinent observations[15]:-

> "***Paragraph 1***
>
> 10. **[Taxing rights on business profits]** Paragraph I incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (e.g. income derived by an enterprise in respect of personal activities of an entertainer or sportsman).
>
> 11. **[Requirement of a PE]** The first principle underlying paragraph 1, i.e., that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be

[15] Vol. I, Fifth Edition, page 551 to 552

regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.

12. [**Threshold of attribution**] The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general 'force of attraction' according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with that the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

13. [**Reference to paragraph 2**] As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent

establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase 'profits that are attributable to the permanent establishment' found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

14. [**Scope of Paragraph 1**] The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 81 of the Commentary on Article 1.

Paragraph 2

15. **[Determination of attributable profits]** Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same and similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that the rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

16. **[Fiction of independence: arm's length principle]** The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

17. **[Separability of PE profits**] Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead requires that the profits attributable to a permanent establishment be determined as if it a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may rest in no profits being attributed to a permanent establishment even though the enterprise as whole has made profits.

18. **[Double taxation difficulties]** Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23A or 23B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent establishment is located attempts to tax profit that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

19. [**Guidance feature of 2010 Report**] As indicated in paragraphs 8 and 9 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2010. The Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.

20. [**Two-step determination**] As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the OECD Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (e.g. risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent

establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

21. [**First step: analysis**] Under the first step, a functional and factual analysis is undertaken which will lead to:

- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- the identification of other functions of the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment."

49. Of equal significance are the following observations as appearing in the judgment of the Supreme Court in **Ishikawajma-Harima Heavy Industries Ltd. vs. Director of Income Tax, Mumbai**[16]**:-**

"**37.** Section 9 raises a legal fiction, but having regard to the contextual interpretation and furthermore in view of the fact that we are dealing with a taxation statute the legal fiction must be construed having regard to the object it seeks to achieve. The legal fiction created under Section 9 of the Act must also be read having regard to the other provisions thereof. (See *Maruti Udyog Ltd.* v. *Ram Lal* [(2005) 2 SCC 638 : 2005 SCC (L&S) 308] .)

38. For our benefit we may notice the provisions of Section 42 of the Income Tax Act, 1922. It provided that only such part of income as was attributable to the operations carried out in India would be taxable in India.

39. <u>Territorial nexus doctrine, thus, plays an important part in assessment of tax. Tax is levied on one transaction where the operations which may give rise to income may take place partly in one territory and partly in another. The question which would fall for</u>

[16] (2007) 3 SCC 481

our consideration is as to whether the income that arises out of the said transaction would be required to be proportioned to each of the territories or not.

40. Income arising out of operation in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. If that be so, it may not be correct to contend that the entire income "accrues or arises" in each of the jurisdiction. The Authority has proceeded on the basis that supplies in question had taken place offshore. It, however, has rendered its opinion on the premise that offshore supplies or offshore services were intimately connected with the turnkey project.

xxx **xxx** **xxx**

82. In *Klaus Vogel on Double Taxation Conventions*, it is stated:

> "(*g*) *No force of attraction principle*.—The second sentence of Article 7(1) allows the State of the permanent establishment to tax business profits, 'but only so much of them as is attributable to that permanent establishment'. The MC has thus decided against adopting the so-called 'force of attraction of the permanent establishment' i.e. against the principle that, where there is a permanent establishment, the State of the permanent establishment should be allowed to tax all income derived by the enterprise from sources in that State irrespective of whether or not such income is economically connected with the permanent establishment. In line with the domestic law then prevailing in the USA, such a 'force of attraction' was, for instance, incorporated in Germany's 1954 DTC with USA [second sentence of Article III(I)]. In contrast, the second sentence of Article 7(1) MC allows the State of the permanent establishment to tax only those profits which are economically attributable to the permanent establishment i.e. those which result from the permanent establishment's activities, which arise economically from the business carried on by the permanent establishment (cf. also para 5, MC Comm. Article 7, supra m 10). As regards the profits made by the enterprise in the State of the permanent establishment, a distinction must always be made between those profits which result from the permanent establishment's activities and those made, without any interposition of the permanent establishment, by the head office or any other part of the enterprise (also for mere assembly permanent establishment: BFH 37 RIW 258 (1991). It is only when there is a connection with the permanent establishment that the State of the permanent establishment is entitled to impose tax. Conversely, losses incurred in connection with direct transactions may not be set off against a permanent establishment's profits. Since a DTC may not increase tax liability, the USA, it is true, imposes tax at the lower amount that would ensue if the

permanent establishment's business and direct transactions were combined and treated as if no DTC existed (of course, the taxpayer may, in such event, not only set off the result of individual direct transactions, which amounted to a loss against the permanent establishment's positive operating result: I.R.S. Rev. Rul. 84-17, 1984-I Cum Bull 308). According to that ruling, the taxpayer is in such cases entitled to elect taxation which discounts the DTC (see supra Article I, at m 44)."

xxx **xxx** **xxx**

88. Therefore, in our opinion, the concepts of profits of business connection and permanent establishment should not be mixed up. Whereas business connection is relevant for the purpose of application of Section 9; the concept of permanent establishment is relevant for assessing the income of a non-resident under DTAA. There, however, may be a case where there can be overlapping of income; but we are not concerned with such a situation. The entire transaction having been completed on the high seas, the profits on sale did not arise in India, as has been contended by the appellant. Thus, having been excluded from the scope of taxation under the Act, the application of the Double Taxation Treaty would not arise. The Double Taxation Treaty, however, was taken recourse to by the appellant only by way of an alternate submission on income from services and not in relation to the tax of offshore supply of goods.

xxx **xxx** **xxx**

92. Global income of a resident although is subjected to tax, global income of a non-resident may not be. The answer to the question would depend upon the nature of the contract and the provisions of DTAA.

93. What is relevant is receipt or accrual of income, as would be evident from a plain reading of Section 5(2) of the Act. The legal fiction created although in a given case may be held to be of wide import, but it is trite that the terms of a contract are required to be construed having regard to the international covenants and conventions. In a case of this nature, interpretation with reference to the nexus to tax territories will also assume significance. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle. An endeavour should, thus, be made to construe the taxability of a non-resident in respect of income derived by it. Having regard to the internationally accepted principle and DTAA, it may not be possible to give an extended meaning to the words "income deemed to accrue or arise in India" as expressed in Section 9 of the Act. Section 9 incorporated various heads of income on which tax is sought to be levied by the Republic of India. Whatever is payable by a resident to a non-resident by way of fees for technical services, thus, would not always come within the purview of Section 9(1)(*vii*) of the Act. It must have sufficient

territorial nexus with India so as to furnish a basis for imposition of tax. Whereas a resident would come within the purview of Section 9(1)(*vii*) of the Act, a non-resident would not, as services of a non-resident to a resident utilised in India may not have much relevance in determining whether the income of the non-resident accrues or arises in India. It must have a direct live link between the services rendered in India, when such a link is established, the same may again be subjected to any relief under DTAA. A distinction may also be made between rendition of services and utilisation thereof."

50. In *International Management Group*, we had an occasion to notice some of the salient principles with respect to source state taxation as propounded in **GVK Industries Limited and Another vs. Income Tax Officer and Another**[17]. This becomes evident from a reading of paragraph 118 of our decision and which is reproduced hereinbelow: -

> **"118.** The territorial nexus which must imbue the issue of taxability was duly recognized by the Supreme Court in *GVK Industries*, where it held as follows:
>
> > "23. At this juncture, it is demonstrable that NRC is a non-resident company and it does not have a place of business in India. The Revenue has not advanced a case that the income had actually arisen or received by NRC in India. The High Court has recorded the payment or receipt paid by the appellant to NRC as success fee would not be taxable under section 9(1)(i) of the Act as the transaction/activity did not have any business connection. The conclusion of the High Court in this regard is absolutely defensible in view of the principles stated in *CIT* v. *R.D. Aggarwal and Co.* [(1965) 56 ITR 20 (SC); 1964 SCC OnLine SC 214.] , *CIT* v. *T.I. and M. Sales Ltd.* [(1987) 166 ITR 93 (SC); (1987) 3 SCC 132; 1987 SCC (Tax) 240.] and *Barendra Prasad Ray* v. *ITO* [(1981) 129 ITR 295 (SC); (1981) 2 SCC 693; 1981 SCC (Tax) 149.] . That being the position, the singular question that remains to be answered is whether the payment or receipt paid by the appellant to NRC as success fee would be deemed to be taxable in India under section 9(1)(vii) of the Act ? As the factual matrix would show, the appellant has not invoked Double Taxation Avoidance Agreement between India and Switzerland. That being not there, we are only concerned whether the 'success fee' as termed by the assessee is 'fee for technical service' as enjoined under section 9(1)(vii) of the Act. The said provision reads as follows:

[17] (2015) 11 SCC 734

xxx **xxx** **xxx**

25. The principal provision is clause (b) of section 9(1)(vii) of the Act. The said provision carves out an exception. The exception carved out in the latter part of clause (b) applies to a situation when fee is payable in respect of services utilised for business or profession carried out by an Indian payer outside India or for the purpose of making or earning of income by the Indian assessee, i.e., the payer, for the purpose of making or earning any income from a source outside India. On a studied scrutiny of the said clause, it becomes clear that it lays down the principle what is basically known as the 'source rule', that is, income of the recipient to be charged or chargeable in the country where the source of payment is located, to clarify, where the payer is located. The clause further mandates and requires that the services should be utilised in India.

26. Having stated about the 'source rule', it is necessary to appropriately appreciate how the concept has developed. At the time of formation of 'League of Nations' at the end of 1920, it comprised of only 27 countries dominated by the European States and the United States of America. The United Nations that was formed after the Second World War, initially had 51 members. Presently, it has 193 members. With the efflux of time, there has been birth of nation States which enjoy political independence and that has led to cross-border and international trade. The State trade eventually has culminated in formulation of principles pertaining to international taxation jurisdiction. It needs no special emphasis to state that the said taxation principles are premised to promote international trade and to allocate taxation between the States. These rules help and further endeavour to curtail possibility of double taxation, tax discrimination and also to adjudicate resort to abusive tax avoidance or tax evasion practices. The nation States, in certain situations, resort to principle of 'tax mitigation' and in order to protect their citizens, grant benefit of tax abroad under the domestic legislation under the bilateral agreements.

27. The two principles, namely, 'situs of residence' and 'situs of source of income' have witnessed divergence and difference in the field of international taxation. The principle 'residence State taxation' gives primacy to the country of the residency of the assessee. This principle postulates taxation of worldwide income and worldwide capital in the country of residence of the natural or juridical person. The "source State taxation" rule confers primacy to right to tax to a particular income or transaction to the State/nation where the source of the said income is located. The second rule, as is understood, is transaction specific. To elaborate, the source State seeks to tax the transaction or capital within its territory even when the income benefits belongs to a non-resident person, that is, a person resident in another country. The aforesaid

principle sometimes is given a different name, that is, the territorial principle. It is apt to state here that the residence based taxation is perceived as benefiting the developed or capital exporting countries whereas the source based taxation protects and is regarded as more beneficial to capital importing countries, that is, developing nations. Here comes the principle of nexus, for the nexus of the right to tax is in the source rule. It is founded on the right of a country to tax the income earned from a source located in the said State, irrespective of the country of the residence of the recipient. It is well settled that the source based taxation is accepted and applied in international taxation law.

28. The two principles that we have mentioned hereinabove, are also applied in domestic law in various countries. The source rule is in consonance with the nexus theory and does not fall foul of the said doctrine on the ground of extra-territorial operation. The doctrine of source rule has been explained as a country where the income or wealth is physically or economically produced. (See League of Nations, Report on Double Taxation by Bruins, Einaudi, Saligman and Sir Josiah Stan (1923)). Appreciated on the aforesaid principle, it would apply where business activity is wholly or partly performed is a source State, as a logical corollary, the State concept would also justifiably include the country where the commercial need for the product originated, that is, for example, where the consultancy is utilised.

29. From the aforesaid, it is quite vivid that the concept of income source is multifaceted and has the potentiality to take different forms (See *Klans Vogel, World-wide* v. *Source Taxation of Income-Review and Revision of Arguments (1988)*). The said rule has been justified by Arvid A. Skaar in Permanent Establishment; Erosion of Tax Treaty Principle on the ground that profits of business enterprise are mainly the yield of an activity, for capital is profitable to the extent that it is actively utilised in a profitable manner. To this extent, neither the activity of business enterprise nor the capital made, depends on residence."

51. Vogel while explaining the circumstances in which issues relating to double taxation arise makes the following pertinent remarks[18]: -

"A. Double Taxation and Its Avoidance

I. Circumstances Giving Rise to 'Double Taxation'

[18] Volume I, Fifth Edition, page 14 to 15

2 International **juridical double taxation** mainly arises today because the vast majority of States, in addition to levying taxes on domestic assets and domestic economic transaction, levy taxes on capital situated and transactions carried out in other countries to the extent that they benefit resident taxpayers. For example, the foreign income or foreign capital of a resident natural or juridical person is often subject to taxation based on the 'principle of residence' (taxation of **worldwide income** or **worldwide capital**). At the same time, however, no State waives its taxation of transactions or capital within its own territory even if they benefit, or belong to, non-resident persons (**principle of source**; the term 'territoriality principle' is avoided here because a variety of different meanings have been attributed to it)." As a consequence, tax claims of different States necessarily overlap.

3 Secondly, double taxation may also arise when a person is deemed a resident simultaneously by two (or more) States or because source rules overlap (i.e., because two (or more) States treat the same economic transaction or item of capital as having occurred or being situated in their territory). Thirdly, double taxation may arise because certain States tax the worldwide income of their citizens even when they are residents of another State (in particular the US and Eritrea; Bulgaria, Mexico, Myanmar, the Philippines and Vietnam gave up their earlier citizenship-based taxation).

4 By contrast, the term **'economic double taxation'** is used to describe the situation that arises when the same economic transaction, item of income or capital is taxed in two or more States during the same period, but in the hands of different taxpayers (so-called 'lack of subject identity'). Economic double taxation will occur if assets are attributed to different persons by the domestic law of the States involved, as, for example, when the tax law of one State attributes an item of capital to its legal owner whereas the tax law of the other State attributes the item of capital to the person in possession or economic control. Economic double taxation may also arise if, for example, alimony paid by a husband to his wife is considered income and taxed in her hands while not being allowed to be deducted as an expense by the husband in his residence State or if one State taxes a legal entity at its place of residence whereas another State disregards the legal entity and taxes its income or capital by attributing it to a resident shareholder. Furthermore, economic double taxation can result from conflicting rules regarding the inclusion or deduction of positive and negative elements of income and capital as, for example, in cases of transfer pricing. Occasionally, the term 'economic double taxation' is also used to describe the taxation of a corporation's income that is taxed initially at the corporate level and subsequently at the shareholder level (the so-called 'classical system of corporate taxation').

5 The concept of 'double taxation', its prerequisites and its limitations, have been subject to much **academic controversy**.

> Application of tax treaties, however, is merely a matter of interpretation of the respective treaty. What conceptually is- and what is not- 'double taxation' is therefore of no importance for the treaty's application.
>
> **6** The law of double taxation is a branch of what is commonly called **'international tax law'**. Traditionally, this term has been used to refer to all international as well as domestic tax provisions relating specifically to situations involving the territory of more than one State, so called 'cross-border situations'."

52. Article 7 of the DTAA postulates that the profits of an enterprise shall be taxable only in that State. It thus, and as a matter of first principle, restricts the taxation of profits of an enterprise only to and in the State of which it may be a resident. However, it then proceeds to expand the scope of taxability by taking into consideration the activities that may be undertaken by such an enterprise in the other Contracting State through a PE situate therein. This is further explained with Article 7(1) prescribing that if the enterprise were carrying on business through a PE situate in the other Contracting State, its profits would become liable to be taxed in the other State, restricted however, to the extent that those profits are attributable to that PE.

53. On a plain reading of Article 7(1), it becomes apparent that while the profits of an enterprise of a Contracting State are ordained to be taxed only in that State, if that enterprise were to carry on business in the other Contracting State through a PE, the profits earned from activities undertaken by such an establishment would become subject to tax in the other State coupled with the rider of the same being confined to the extent to which those profits are attributable to such an establishment.

54. As we read Article 7, it becomes evident that Paragraph (1) clearly envisages the profits of a PE being liable to be independently taxed notwithstanding that PE being a constituent of a larger enterprise

which may be domiciled in the other Contracting State. The exemption from taxation which stands accorded to an enterprise of a contracting State would cease to be applicable by virtue of the use of the word "*unless*" which precedes the Article taking into consideration the existence of a PE of that enterprise in the other Contracting State. Article 7(1) proceeds to clarify that if the enterprise were carrying on business through a PE in the other Contracting State, its profits to the extent attributable to that PE would become subject to tax in the other State.

55. Article 7(1) thus in clear and unequivocal terms constructs a dichotomy between the profits that may be earned by an enterprise on a global scale and those which are attributable to a PE situate in the Contracting State. This becomes further evident from a reading of Paragraph (2) of Article 7 and which stipulates that where an enterprise carries on business through a PE in the other Contracting State, profits would be liable to be attributed to that PE as if it were a distinct and separate enterprise engaged in similar activities and independent of the enterprise of which it may be a part.

56. This aspect is further amplified when we bear in consideration Article 7(2) employing the phrase "*dealing wholly independently with the enterprise of which it is a permanent establishment*". Article 7(2) thus clearly bids us to view the PE as a distinct and separate entity engaged in undertaking business activity in its own right in a Contracting State. It would consequently and on a fundamental plane be incorrect to fuse the incomes generated by an enterprise as a whole with the income that may be earned by a PE in one of the Contracting States.

57. It would also be incorrect to interpret Article 7 as requiring us to

ignore the income that may be generated pursuant to activities undertaken by a PE in one of the Contracting States and making the exercise of attribution dependent upon the profits or the income that the enterprise may otherwise earn at an entity level. In fact, Article 7(1) itself excludes the profits of an enterprise from being subjected to tax till such time as such an entity carries on no business in the other Contracting State through a PE.

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

59. The view that we have taken above also finds support from the OECD Commentary on Article 7 and relevant parts whereof have been extracted in paragraph 39 of this judgment. As the Commentary succinctly explains, the taxation right of the source State is dependent upon the existence of a PE. That since such an establishment participates in economic activity within the territory of the source State. It is in the aforesaid context that the Commentary refers to it as constituting a *"separate source of profit"*. Of equal significance are the observations in the Commentary and which bids us to bear in consideration the possibility of profits being attributed to the PE even though the entity as a whole had never earned the same.

60. Proceeding further to explain the ambit of Paragraph 2 of Article 7, the OECD Commentary observes: -

"***Paragraph 2***

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

18. Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23 A or 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise."

61. Global income, as a fundamental precept, has always been invoked in respect of residents of a Contracting State. Most Nations have ultimately reverted to the source rule for purposes of taxation. We

are thus called upon to deal with a regimen which concerns itself with the source from which income accrues or arises. This precept also stands mirrored in Section 5 of the **Income Tax Act, 1961**[19] and which jettisons the principle of territoriality only in respect of income earned by a resident. Thus, taxation based on worldwide income stands confined to natural residents. However, no Nation avowes or waives its right to tax capital or transactions which are anchored to its own territory. It is this basic precept of source which continues to bind.

62. The distinction which needs to be borne in mind with regard to the income of a non-resident as opposed to an entity domiciled and stationed in one of the Contracting States stands duly acknowledged in Section 5 of our Act and which subjects the global income of a resident alone to taxation. For non-residents, it is the principles of income accruing or arising which are decreed to govern. It is these broadly accepted and well recognised principles which imbue the DTAA also.

63. As was noticed hereinabove, the profits of an enterprise do not become subject to taxation unless it be found that it functions in the other Contracting State through a PE. Article 7 further postulates that it is only such income which is attributable to the PE which would be subjected to tax in the source State. As is pertinently noted in the OECD and UN Commentaries, it would be wholly incorrect to found taxation on the basis of the overall activities or profitability of an enterprise. The source State is ultimately concerned with the income or profit which arises or accrues within its territorial boundaries and the activities undertaken therein. As those commentaries pertinently observe, the profits attributable to a PE are not liable to be ignored on the basis of the performance of the entity as a whole. This position also

[19] Act

finds resonance in the decisions of the Supreme Court in *Morgan Stanley* and *Ishikawajama* and relevant parts whereof have been extracted above.

64. If the submission of the appellants were to be accepted, the Revenue would be recognised to have the power to tax even in a situation where although the entity be profitable, the PE may have incurred a loss. If the aforesaid logic were to be applied, in a converse situation, the Contracting State would be countenanced to have the right to tax only if the assessee at a global level were found to have earned profit. That is clearly not the import of Article 7 of the DTAA. While protecting the right of an enterprise to be subject to tax in the State where it be resident, Article 7 places a negative stipulation in respect of cases where a PE is found to exist coupled with an attribution exercise being undertaken in respect of the domestic enterprise. The contention of the respondents essentially requires us to confer a judicial imprimatur upon the principle that the domiciled entity, namely a PE, would be liable to be taxed only if the global enterprise were profitable. This even though the income of that entity, by virtue of Article 7, stands restricted to the extent of income being attributable to the PE. In fact, Article 7 itself restricts the taxability of the enterprise to the extent of income or profit attributable to the PE. We are thus of the firm opinion that the argument of global income or profit being relevant or determinative is totally unmerited and misconceived. The submission is clearly contrary to the weight of authority which has been noticed hereinabove.

65. Regard must also be had to the fact that Article 7 does not expand its gaze or reach to the overall operations or profitability of a transnational enterprise. It is concerned solely with the profits or

income attributable to the PE. The taxability of income earned by a PE existing in a Contracting State is not even remotely linked or coupled to the overall operations of the enterprise of which it may be a part. The argument of world-wide income is thus rendered wholly untenable.

66. On an overall consideration of the above, we come to the firm conclusion that the submission of global income being determinative of the question which stood referred, is wholly unsustainable. The activities of a PE are liable to be independently evaluated and ascertained in light of the plain language in which Article 7 stands couched. The fact that a PE is conceived to be an independent taxable entity cannot possibly be doubted or questioned. The wealth of authority referred to hereinabove clearly negates the contention to the contrary and which was commended for our consideration by the appellants. Bearing in mind the well-established rule of source which applies and informs the underlying theory of taxation, we find ourselves unable to countenance the submission of the source State being deprived of its right to tax a PE or that right being dependent upon the overall and global financials of an entity. The Division Bench in these appeals rightly doubted the correctness of taxation being dependent upon profits or income being earned at the "entity level". The decision of the Special Bench in *Motorola Inc.* has clearly been misconstrued and it, in any case, cannot be viewed to be an authority for the proposition which was canvassed on behalf of the appellants. Article 7 cannot possibly be viewed as restricting the right of the source State to allocate or attribute income to the PE based on the global income or loss that may have been earned or incurred by a cross border entity.

67. We would thus answer the Reference by holding that the tentative view expressed by the Division Bench in these set of appeals

as well as the doubt expressed with respect to the findings rendered in *Nokia Solutions* was well founded and correct. The Reference stands answered in terms of our conclusions set forth in paragraph 66 above.

68. The papers of these appeals may now be placed before the appropriate Roster Bench for disposal in light of our conclusions recorded hereinabove.

YASHWANT VARMA, J.

SANJEEV NARULA, J.

PURUSHAINDRA KUMAR KAURAV, J.

SEPTEMBER 19, 2024/neha