

The background of the cover features a complex, abstract arrangement of reflective, metallic spheres of various sizes, connected by thin, branching lines that resemble a molecular structure or a network. The spheres are highly reflective, showing highlights and shadows that give them a three-dimensional appearance. The overall composition is dynamic and intricate, filling the left and bottom portions of the cover.

Permanent Establishment

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PERMANENT ESTABLISHMENT

UNDERSTANDING THE INDIAN FRAMEWORK

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PERMANENT ESTABLISHMENT IN INTERNATIONAL TAX LAW AND THE INDIAN FRAMEWORK

I. Introduction

The concept of Permanent Establishment (PE) forms the jurisdictional backbone of international taxation. It determines whether and to what extent a country can tax the profits of a foreign enterprise operating within its borders. Traditionally rooted in the notion of a “fixed place of business” the PE doctrine was designed for a brick-and-mortar economy. However, globalisation, the rise of outsourcing models, and the digital economy have significantly outpaced the conventional legal framework, exposing gaps in coverage and enforcement.

In response, both international and domestic tax systems have sought to expand and redefine the PE threshold. Instruments like the OECD’s Base Erosion and Profit Shifting (BEPS) Project, the Multilateral Instrument (MLI), and the European Union’s evolving digital tax standards have influenced treaty negotiations and domestic legislation alike. India, while aligning itself with BEPS, has also independently introduced measures such as the Significant Economic Presence (SEP) test and the Equalisation Levy to capture tax from income arising through digital presence and offshore

services rendered to Indian users.

II. Types of Permanent Establishment

The meaning and types of PE are typically governed by bilateral tax treaties, especially those modelled on the OECD Model Tax Convention and the UN Model Double Taxation Convention between Developed and Developing Countries. These models, though similar in many respects, differ on crucial issues, notably, the UN Model adopts a broader source-based approach, better suited to India's interests as a capital-importing country.

Most Double Taxation Avoidance Agreements (DTAAs) define PE using Article 5 of the OECD and UN Model Conventions, referring to "A fixed place of business through which the business of an enterprise is wholly or partly carried on." Over the years, the PE concept has evolved to include several nuanced forms. The most prominent among these include:

1. **Fixed Place PE:** This is the most classical form of PE. Offices, factories, warehouses, branches, and workshops qualify if they are at the disposal of the enterprise and used for regular business activities.

2. **Agency PE:** A dependent agent is someone legally and economically bound to the enterprise who habitually exercises authority to conclude contracts on behalf of the foreign entity may give rise to a PE. This prevents avoidance through contract delegation.
3. **Construction or Installation PE:** Under many treaties, a construction site, building, or installation project constitutes a PE only if it lasts beyond a specific period typically 6 to 12 months. The UN Model and Indian treaties usually adopt the lower 6-month threshold.
4. **Service PE:** A broader notion especially found in Indian tax treaties, Service PE arises when foreign personnel or enterprises render services such as technical, consultancy, managerial within India for a continuous period exceeding a specified number of days for instance 90 days in a 12-month period, or 183 days depending on the treaty.
5. **Digital or Economic PE:** As digital businesses often have no physical presence in the market jurisdiction, newer legal interpretations and domestic amendments in India for example, Significant Economic Presence (SEP) under the Income Tax Act, 1961 through the 2018 amendment are

evolving toward recognising economic presence without physical infrastructure.

III. Legal Treaties and Frameworks

The governing legal framework comprises a combination of international treaty models, domestic tax statutes, and judicial interpretation.

At the international level, the two most authoritative models are the OECD and the UN Model Tax Conventions. The OECD Model Tax Convention, particularly under Article 5, offers a comprehensive definition of PE that includes fixed place of business, agency PEs, and more recently, service and digital PEs. The OECD framework is designed to facilitate consistency in treaties between developed countries, with a focus on limiting the source state's taxing rights and emphasising the principle of economic substance. In contrast, the UN Model Tax Convention caters more directly to the interests of developing countries by expanding the scope of PE definitions. It allows for greater taxation rights in the source state by introducing lower thresholds for service PEs and longer duration tests for construction PEs. This model provides an essential counterbalance by ensuring that income generated within a country's territory does

not escape taxation merely due to the enterprise's foreign residency.

Domestic laws also play a crucial role in determining the existence and taxability of a PE. In India, the Income Tax Act, 1961 governs this domain. Section 5 lays out the extent of taxable income for residents and non-residents, while Section 9 deems specific incomes to accrue or arise in India. Nevertheless, when a Double Taxation Avoidance Agreement (DTAA) exists, its provisions override those in domestic law (unless the domestic law provisions are more beneficial for the taxpayer) by virtue of Section 90 of the Act. This principle of treaty override has been upheld by Indian courts, including in the landmark judgment of *Azadi Bachao Andolan v. Union of India*¹, where the Supreme Court affirmed the legitimacy of treaty shopping and prioritised the DTAA's application in defining tax liability. In doing so, it decisively rebutted the apprehensions raised by the Delhi High Court, which had cast treaty shopping in a pejorative light. Drawing a parallel with deficit financing, the Court stated that treaty shopping, too, may be a deliberate and pragmatic policy choice, noting:

¹ (2004) 10 SCC 1

“There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long-term development. Deficit financing, for example, is one; treaty shopping, in our view, is another.”

In another pivotal decision, ***DIT (International Taxation) v. Morgan Stanley & Co. Inc.***², the Court held that where a PE exists, no additional tax liability would arise if the enterprise has remunerated the PE at arm’s length. The Supreme Court of India dealt with the question of whether a foreign enterprise could be said to have a permanent establishment (PE) in India under Article 5 of the India-US DTAA, merely by outsourcing functions to a related Indian entity. The Revenue contended that Morgan Stanley & Co. (MSCo) had a PE in India due to the activities of its Indian affiliate, Morgan Stanley Advantage Services Private Limited (MSAS). However, the Court emphasised that the existence of a PE required a detailed functional and factual analysis of the business activities conducted. It held that a fixed place PE could only be said to exist if MSCo was carrying on its core business through a fixed location in India. Even assuming the existence of a PE, the Court clarified that where the Indian affiliate

² (2007) 7 SCC 1

was remunerated at arm's length for its services, no further attribution of profits to the foreign enterprise was warranted.

India has entered into over 90 DTAA's, which draw substantially from the OECD and UN models. These agreements are designed to eliminate double taxation, allocate taxing rights between the residence and source countries, and provide clarity and predictability for multinational enterprises. They typically define PEs under Article 5 and govern the taxation of attributable profits under Article 7. The Supreme Court in *GVK Industries Ltd. v. ITO*³, further highlighting the function of these treaties in aligning India's domestic tax regime with international norms and promoting tax certainty in cross-border economic relations. Citing the centrality of the "source rule", the court noted that both the United Nations Commentary and the OECD reflect a global consensus that income should be taxed where it originates or arises, not where the enterprise merely resides. Further, they reason that under principles of international tax law, a State is prohibited from unilaterally extending its sovereign taxing powers to the territory of another State.

³ (2015) 11 SCC 734

IV. Judicial Stance on Permanent Establishment

The judicial understanding of a Permanent Establishment (PE) under Indian law has undergone significant refinement, particularly reflected by the Full Bench decision in a recent judgement from the Delhi High Court, *Hyatt International Southwest Asia Ltd. v. CIT*⁴. This landmark judgment critically departed from the reasoning in *CIT (IT) v. Nokia Solutions and Networks OY*⁵ by reaffirming the autonomous and taxable status of a PE, even in instances where the non-resident parent enterprise itself incurs global losses.

One of the major takeaways from the decision is that the concept of a PE is not merely a legal fiction but a functional economic unit, possessing independent business utility within the host state. The Full Bench stressed that economic activity undertaken in a source state is sufficient to trigger taxing rights under the PE doctrine, regardless of the residency of the foreign entity. By relying on precedents such as *Ishikawajima-Harima Heavy Industries Ltd. v. Director of Income Tax*⁶, as well as international authorities including Klaus Vogel's commentary on double taxation conventions, the court highlighted that the source of income, not

⁴ (2025) 472 ITR 53

⁵ (2023) 455 ITR 157

⁶ (2007) 3 SCC 481

the entity's global profitability must guide taxability. Accordingly, the judgment clarified that a PE, whether legally distinct or not, is to be treated as a notional independent enterprise for purposes of taxation. The Delhi High Court also emphasised that Article 7(2) of the OECD and UN Model Conventions mandates profit attribution on an arm's length basis, treating the PE as if it were dealing wholly independently with its parent.

This also aligns with the judicial pronouncements in *DIT (International Taxation) v. Morgan Stanley & Co. Inc.*⁷ and *Formula One World Championship Ltd. v. CIT*⁸, which held that a fixed and identifiable business presence in India carrying on economic activity is sufficient to trigger tax obligations.

In the latter judgement, the Supreme Court while evaluating whether Formula One World Championship constituted a Permanent Establishment (PE) of F1 in India under Article 5 of the India-UK Double Taxation Avoidance Agreement (DTAA) held that two key conditions which ought to be satisfied. First, that FOWC had a fixed place of business in India at its disposal and second, that it carried out business activity through this fixed place. Despite the

⁷ (2007) 7 SCC 1

⁸ (2017) 15 SCC 602

inherently itinerant nature of Formula One racing events, the Court stressed that the exclusivity of access and the duration for which the racing circuit was placed at FOWC's disposal coupled with the commercial exploitation of rights associated with the event, hence amounted to a fixed place of business. The Court clarified that substantiality of presence need not always be measured by long duration rather a combination of exclusive control and temporally sufficient use can fulfil the criteria for a "fixed" presence under Article 5(1).

Further, the Delhi High Court also addressed the role of sovereignty in taxation, referencing how the principle of source-based taxation evolved historically, that while global income taxation applies only to residents, source states retain the sovereign right to tax profits arising within their territorial domain. This doctrinal shift is reflected in Section 5 of the Indian Income Tax Act, 1961 and is harmonised with international treaty obligations through DTAA's.