Permanent Establishment & Business Profits - Practical Case Studies

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Introduction

• What is a PE?
  ▪ Business Profits primarily taxable only in residence country, unless PE
  ▪ Threshold for taxation of business income in source country
  ▪ Definition continuing for around a 100 years!

• Implications of PE in India
  ▪ Even a part of business carried on through a PE is sufficient for taxation.
  ▪ Business income is taxable at 40% on net profits.
  ▪ Company law; FEMA; TDS compliances.
  ▪ Books of accounts & audit may be required.
  ▪ Interest, Royalty and FTS may be taxed as business income.
  ▪ TDS obligation on payers
Taxability of business profits under Income-tax Act

• Non-resident’s income taxable only if it is received, accrues or arises in India
• Doing business IN the country and not just WITH the country.
• “Business Connection”
  ▪ Concept very wide and subject to interpretation
  ▪ Not defined under the Act
    ▪ Explained in judicial precedents
  ▪ “Inclusive” meaning under the Act
    ▪ Specifically includes Dependent Agent
  ▪ Exclusions
    ▪ For purchase of goods in India for export
    ▪ Collection of news and views in India for transmission out of India
    ▪ Shooting of cinematograph film in India
• PE under the DTA generally narrower in scope
  ▪ But the gap is reducing
Business Structuring possibilities - Regulatory

• **FEMA**
  - Business possible without investment
    ▪ Services
    ▪ E-commerce
  - Business ‘within’ India
    ▪ Can set up ‘place’ of business but only in certain ways
    ▪ Liaison Office, Project Office, Branch, JV, Subsidiary
  - Business outside India
    ▪ Investment in Branch
    ▪ Investment in Subsidiaries and JVs
      ▪ Investment through ODI & LRS-ODI
      ▪ Investment only allowed in ‘shares’
    ▪ FEMA applicable to overseas investments

• **Companies Act 2013**
  - Covers “foreign company” having a ‘place of business’ in India
    ▪ whether by itself or through an agent,
    ▪ physically or through electronic mode; and
    ▪ conducts any business activity in India in any other manner.
Constitution of PE
Types of PEs

Fixed place PE

Construction PE

Agency PE

Service PE

Insurance PE

Independent Agent

Exceptions to PE

Tests of all PEs are independently applied. No hierarchy.
Basic Rule PE

• For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

• Requisite conditions:
  ▪ An Enterprise
  ▪ Carrying on a business
  ▪ Through a ‘place of business’
  ▪ Which is a ‘fixed’ place
  ▪ Through which the business of the enterprise is wholly or partly carried on

• Basic Rule PE definition common under OECD Model, UN Model and Indian Income-tax Act
  • However, the scope is different under all the three.
Basic Rule PE – Determination Tests

• **Place of Business Test**
  - The business must be conducted through a ‘place’

• **Disposition Test**
  - The place of business must be at the disposal of the enterprise

• **Location Test**
  - The fixed place of business must be located in a certain territorial area

• **Permanence Test**
  - The use of the fixed place of business must last for a certain period of time

• **Business activity test**
  - The activities performed through the fixed place of business must be of a business character
Basic Rule PE – Place of Business Test

• Physical location is important.
• Presence to be ‘visible’ in the other contracting state
• Covers premises as well as tangible assets like equipment
• Cannot be Cyberspace. Website not a PE. But server of the enterprise can be a PE.
• Computers of NR at customer’s offices can be a PE
  ▪ Amadeus Global Travel Distribution S.A. [2011] 11 taxmann.com 153
  ▪ Galileo International Inc. [2008] 19 SOT 257
• Intangible property is not a PE.
  ▪ Software not a PE
    ▪ Western Union Financial Services Inc. [2007] 104 ITD 34
    ▪ Different from Business Connection where the footprint of the satellite can be a Business Connection.
• Financial assets – shares, etc. cannot be a PE.
• Human element not necessary
Basic Rule PE – Disposal Test

• Place should be at the disposal of the foreign enterprise for the purpose of its business activities
• The foreign enterprise should have the ability to exercise some right or dominion or control
• The place may be owned or rented or in any way available for use.
• Could be in another enterprises’ premises
• Legal right to use need not be the sole determinant; factual use or exercise of such right will have a greater bearing
  ▪ Even illegal occupation could constitute a PE
Basic Rule PE – Location Test

• Fixed location (of the person), (including equipments) through which business is wholly or partly carried on.

• Activities performed within a broader geographical area covered
  ▪ Mine or oil well
  ▪ Pitch in market place
  ▪ Requires both geographical & commercial coherence

• Activities carried out within a defined geographical location could constitute a PE:
  ▪ A diving offshore vessel functioning within a defined area
  ▪ Dealer selling merchandise from a mobile van or ship
Basic Rule PE – Permanence Test

• The place should be available for sufficiently long period of time
• No minimum threshold
  ▪ In general 6 month period considered
  ▪ An isolated activity cannot lead to establishment of a fixed base PE as the ingredients of regularity, continuity and repetitiveness are essentially missing
• If the nature of business is such that it is required to be carried on only for a short period of time, then the place of business where such business is carried on, may constitute a PE
  ▪ Fugro Engineers BV [2008] 26 SOT 78
• The activity need not be “permanent” in the literal sense
  ▪ Temporary interruptions does not affect PE
• Intent as well as actual conduct to be seen
Basic Rule PE – Business Activity Test

• Business should be carried on – wholly or partly
  ▪ A mere space (say an empty warehouse or office) is not sufficient
  ▪ Foreign Enterprise should be engaged in some part of the business
  ▪ Through personnel or equipment
  ▪ Regular, continued exercise

• Business performed “Through” a fixed place of business
  ▪ The place of business must ‘serve’ the business activity
  ▪ Simple occurrence of a business activity at the place of business is not sufficient – Golf in Dubai LLC [2008] 306 ITR 374 (AAR)
  ▪ US Company having an office in Canada only for compliance purposes not a PE

• Core business activity
  ▪ BPO performing back office operations
  ▪ Agent / sub-contractor although no Agency PE?
  ▪ Liaison office
Basic Rule PE – India’s Reservations

- **India’s view (OECD 2008):**
  - Lease of tangible or intangible properties may constitute a PE.
  - Industrial, Commercial or Scientific equipment may constitute PE.
  - Website can be a PE.

- **India’s view (OECD 2010):**
  - Satellite’s footprint can be a PE – India’s customer and equipments which enable it to receive a telecast can be a PE.
  - Roaming call can be a PE of the foreign telecom company.
  - Undersea cables within the Indian territory can be a PE.

- Reservations only relevant for interpretation of treaties entered in to after these observations are made
Basic Rule PE – Some common instances

- Secondment of employees / Labour contractor
  - Control & Supervision
- Leasing of equipment
- Foreign Investment Managers
- Local Brokers
- Delivery Agent
- Contract Manufacturer
- Distant Education
- Subsidiary
Case Study 1 - Manpower Company

Facts:
• US Co. is a company engaged in the business of man power recruitment
• India Co approaches US Co in relation to recruitment of few employees
• Based on the requirement of India Co, US Co interviews employees in USA and then deputes employees to India

Issue:
• Will the employees recruited constitute a PE of the US Co?
• Can fees paid by India Co to US Co in respect of employees deputed be taxed in India?
Case Study 1 - Manpower Company

Constitution of PE
- Employees recruited
- Who is the economic employer
- US Co whether the employer of the deputed employees
- Provision of employees vs Provision of services through employees

Case Laws
- Tekmark Global Solutions LLC
- Tekniskil (Sendirian) Behard
Fixed Place PE –
Indicative factors for Employee PE

- Business cards bearing the address or telephone numbers of India company issued
- Dedicated office/office space provided on a prolonged basis
- Use of India Company’s stationery by foreign company’s employees
- Dedicated phone, fax or email addresses provided to foreign company’s employees
- Unrestricted access to India Company’s office files, databases, etc.
- Dedicated computer provided to foreign Company’s employees
- Employee keys or entry cards (other than visitor cards)
- Listing of foreign company’s employees in Indian Company’s employee listing/directory
- Dedicated storage space at Indian Company’s office, unless such storage space is under the control of the building owner/lessee (and not under control of foreign Company). Storage of physical items (e.g., computers, paperwork, etc.) should not be an issue
- Dedicated secretarial or administrative assistance at Indian Company’s office
- Authority to make changes or alter any office space provided in Indian Company’s office
Case Study 2 – Subsidiary PE

**Facts:**
- US Co. is a company engaged in the manufacture of equipment
- US Co. establishes Indian subsidiary for manufacturing components and marketing
- Manufacturing in India based on the requirement of US Co

**Issue:**
- Will India Co. constitute a PE of the US Co?
Case Study 2 – Subsidiary PE

Constitution of PE:
• Subsidiary by itself will not constitute a PE – Article 5(8) of UN Model
• Does US Co. have access to a fixed place in Subsidiary
• Need to check other forms of PE
• Level of control over Subsidiary
• Morgan Stanley & Co (2007) 292 ITR 416 (SC)
• Rolls Royce PLC (2011) 339 ITR 147 (DELHI)
• Efunds
## Permanent Establishment v/s Subsidiary

<table>
<thead>
<tr>
<th><strong>Permanent Establishment</strong></th>
<th><strong>Subsidiary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Projection of Foreign Enterprise on Indian soil for tax purposes</td>
<td>Distinct entity from that of Holding company, with separate tax liability</td>
</tr>
<tr>
<td>Tax at 40%</td>
<td>Tax at 30%</td>
</tr>
<tr>
<td>Repatriation of profits possible without any tax cost – effective tax rate of 40%</td>
<td>Repatriation of profits only after payment of DDT – effective tax rate of 42.35%</td>
</tr>
<tr>
<td>Credit of taxes paid in India available in home country</td>
<td>Taxes paid in India not available as credit</td>
</tr>
<tr>
<td>Global accounts exposed to Indian tax</td>
<td>Only local accounts to be submitted for tax purposes</td>
</tr>
<tr>
<td>Losses incurred in India available for set-off in home country</td>
<td>Losses incurred in India only available as set-off against profits in India, if any</td>
</tr>
</tbody>
</table>

**Transfer Pricing provisions applicable**
Basic Rule PE – Article 5(2) Specific inclusions

• PE 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.

• Are the examples in article 5(2) PEs? Or is it necessary to satisfy article 5(1) also?
  ▪ Practically these are PEs.
  ▪ India’s view (OECD 2008) – The examples will always constitute PE.

• PE under DTA need not mean PE under ITA
Exceptions to PE

Preparatory & Auxiliary (P&A) activities are exempt from being considered as PE – even if actually there is a PE.

(a) The use of facilities solely for the purpose of storage or display 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 or display;
(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
Exceptions to PE

• P&A activities not explained. Activities of the Head Office (main enterprise) has to be considered.
• Such activities should be for the enterprise itself; & not for third parties, or other group entities.
• Does exception apply to all kinds of PEs?
• Disposal of movable property connected with P&A activities is also not taxable.
• India’s views (OECD 2008)
  ▪ Scientific research will not be P&A activity.
  ▪ Commercial representation office will be a PE.
  ▪ Participation in negotiation will mean the person has exercised his authority.
• BEPS Report on Action Plan 7
Case Study 3 – Liaison office in India

Facts:
• US Co intends to perform certain activities in India
• For performing such activities, the management of US Co has decided to set-up a branch in India
• The activities to be performed in India would be Support Services, Liaison Services and Follow-up services

Issue:
• Will the Indian branch constitute a PE of US Co?
• Will your answer change if US Co was to do core business activities through the branch?
• Alternate modes of presence in India
Case Study 3 – Liaison office in India

Constitution of PE
- No business activities in India through the branch
- Exclusion for Preparatory and Auxiliary
- If core business activities performed

Alternate Modes
- Liaison office – Limited activities
  - Nike Inc.
  - Columbia Sportswear Company
  - Jebon Corporation India
  - Brown & Sharpe Inc.
  - M Fabrikant and Sons
  - UAE Exchange - Delhi HC
- Subsidiary in India – Business activities
  - Mark-up – Transfer Pricing
LO – Indicative list of permitted activities

- Based on various judicial precedents, following are the activities which if carried out by a Liaison office, should be regarded as preparatory and auxiliary activities and should not constitute a permanent establishment in India:
  - Services like data processing, account reconciliation, etc
  - Basic operations carried out by a foreign enterprise before its business actually commences, like:
    - Industry analysis;
    - Market survey;
    - Furnishing of information about the business of the foreign enterprise;
    - Ensuring technical presentations to potential users;
    - Development of market opportunities
  - Providing a communications link between suppliers and customers;
  - Collecting feedback from the prospective customer / consumers;
  - Identifying Customers;
  - Supply of information regarding customer requirements and specifications.
Case Study 4 – Outsourcing Model

Facts:
- US Co. is a company engaged in the business of providing software services
- US Co gets a contract to provide these services to Customer in India
- US Co sub-contracts following support services to India Co:
  - Providing a communications link between US Co and customer;
  - Collecting feedback from the prospective customers;
  - Payment follow up services
- Employees of India Co render the above services in India to Customer

Issue:
- Will India Co constitute a PE of US Co in India
- Will the employees of India Co constitute a PE of the US Co?
- Will your answer change if the employees are working under direct supervision and control of US Co?
Case Study 4 – Outsourcing Model

**Constitution of PE**
- Business activity test
- Right of Disposal test
- Preparatory and Auxiliary exclusion

- If employees provide services under supervision and control of US Co
  - Can recourse still be taken of Preparatory and Auxiliary exclusion?
Construction PE

- Building site, Construction, Assembly, Installation, exceeding the specified number of months.
  - By nature, these are temporary offices. Therefore a specific clause based on number of days/months is provided for.
  - UN model – 6 months; OECD Model – 12 months
- Building site or construction or installation project including the construction of buildings, bridges or canals, excavating and dredging and the laying of pipelines
  - Planning and supervision covered only if carried on by the building contractor himself
  - Delivery of materials to a construction or assembly project is not itself a construction or assembly project
- Installation project means putting together or re-grouping of prefabricated elements such as the erection of steel scaffolding or units of production
  - Final assembling of moveable objects (eg airplanes) also covered
Construction PE

- Test has to be applied to each project.
- Meaning of a “project”?
  - Coherent whole commercially and geographically.
- India’s view (OECD 2008)
  - Series of consecutive sites will be a PE.
  - Commercial & Geographical coherence – Any one is sufficient to make it a PE.
- Considered as Construction PE:
  - Renovation
  - Demolition
  - Assembly of machines/aircraft
- Not Considered as Construction PE:
  - Maintenance of building
  - Redecoration
Case Study 5(a) – EPC (Splitting of Contracts)

Facts:
- US Co bids for an EPC contract where it has to undertake offshore supply of equipments, offshore services in the nature of design and engineering, onshore supply of spares and installation and commissioning of the equipments.
- While executing the contracts, it signs a contract for offshore portion and makes its Indian subsidiary sign the contract for onshore portion.

Issue:
- What are the tax issues that will be faced by US Co in India?
Case Study 5(a) - EPC (Splitting of Contracts)

Splitting of Contracts:
- Ishikawajima SC decision
- Vodafone International BV Holdings
- Dongfang – Kolkata ITAT
- Ansaldo Energia SpA (Mad HC) (178 Taxman 57)

Constitution of PE:
- Even if contracts are split can India Co be regarded as PE of US Co.
  - Nortel Networks

Issue:
- What are the tax issues that will be faced by US Co in India?
Case Study 5(b) - EPC (Splitting of Contracts)

Facts:
- US Co bids for an EPC contract where it has to undertake offshore supply of equipments, offshore services in the nature of design and engineering, onshore supply of spares and installation and commissioning of the equipments.
- While executing the contracts, it signs a contract for offshore portion and makes its affiliate US Co2 sign the contract for onshore portion.

Issue:
- What are the tax issues that will be faced by US Co in India?
Case Study 5(c) – EPC (Splitting of Contracts)

Facts:
- US Co bids for an EPC contract where in it has to undertake
  - offshore supply of equipments,
  - offshore services in the nature of design and engineering,
  - onshore supply of spares and
  - installation and commissioning of the equipments
- While executing the contracts, it signs a contract for offshore portion and makes its affiliate US Co2 sign the contract for onshore portion
- US Co2 in turn assigns part of onshore contract to its subsidiary - India Co -
- Balance portion of onshore contract executed by Installation PE

Issue:
- What are the tax issues that will be faced by US Co in India?
Case Study 5(c) – EPC (Splitting of Contracts)

Constitution of PE:
- US Co has no business activity in India - no PE
- US Co 2 has subsidiary in India
  - Independently managed
  - Only supervisory activities by US Co2
  - Deputed employees salary cross charged to US Co2
    - No subsidiary PE
    - Efunds
- Installation PE executing major portion of onshore activities
  - Falls out of Installation PE definition as number of days less than 120

To Consider:
- PE of ‘enterprise’ not of a single tax payer
- Philip Morris – Italian SC
- AOP exposure
Agency PE

• The primary test for an agency is the legal ability of the agent to bind the principal to a third party
• No PE if independent agent acts in ordinary course of business
• Preparatory & Auxiliary activities will not make it a PE
• Independent agent – no PE
  ▪ Legal independence
    ▪ Arrangement or agreement between an agent and foreign entity
    ▪ Entrepreneurial risk
  ▪ Economic Independence
    ▪ Business relations of foreign enterprise and the functioning of the business of the agent
    ▪ Single client
  ▪ However, he will not be considered an agent of an independent status
    ▪ when activities are devoted wholly or almost wholly on behalf of that enterprise, and
    ▪ conditions are made or imposed which would have been made between dependent enterprises
  ▪ If a person is not independent Agent, it does not mean he is a PE. Dependent Agent test has to be independently determined.
Agency PE

• Only dependent agent constitutes a PE who,
  ▪ Acts on behalf of an enterprise
  ▪ Has authority to conclude contracts on behalf of an enterprise
  ▪ Has no authority but habitually maintains stock of goods from which he regularly delivers goods on behalf of the enterprise
  ▪ Can be a non-resident

• India’s view (OECD 2008)
  ▪ Habitually securing orders will give rise to PE
Case Study 6 - Marketing Agent

Facts:
- US Co in business of manufacture and sale of industrial machines
- US Co appoints Independent Marketing Agent in India
- The activities performed in India by Agent are:
  - Soliciting customers in India
  - Marketing US Co. in India
  - Negotiating on behalf of US Co. in India
  - Passing on offers of US Co. to Customer and responses by Customer on offers to US Co.
  - US Co. delivers goods to Customer

Issue:
- Will the marketing agent constitute a PE of US Co in India?
Case Study 6 - Does US Co have Agency PE?

1. Is Agent an Independent Agent?
   - Yes: Activities preparatory - auxiliary in nature?
     - Yes: No Agency PE
     - No: Agency PE

2. Is he acting in ordinary course of business?
   - No: Are activities devoted wholly or almost wholly on behalf of US Co?
     - Yes: Independent Agent - No Agency PE
     - No: Are transactions at arm’s length?
       - Yes: Secures orders?
         - Yes: Agency PE
         - No: No Agency PE
       - No: No Agency PE

3. Has authority to conclude contracts?
   - Yes: Maintains stock & delivers?
     - Yes: Agency PE
     - No: No Agency PE

4. Does additional activities?
   - Yes: Secures orders?
     - Yes: Agency PE
     - No: No Agency PE
   - No: No Agency PE
Case Study 7(a) - Distributorship vs Agency

Facts:
• Jaguar UK intends to import cars in to India and sell to Indian customers through dealers in India
• The dealer will use the trade name, brand, logo, etc. of Jaguar
• Indian dealer will market and provide services on the instructions of Jaguar.
• Dealer will only provide services and not enter in to sale transaction.
• The invoices raised by Dealer would be on Jaguar’s letterhead as Dealer of Jaguar - bearing the name, brand, logo of Jaguar

Issue:
• Will Dealer constitute a PE of Jaguar?
Case Study 7(b) - Franchisee vs Agency

Facts:
- Mc Donald’s intends to sell its food products to Indian customers through franchises in India
- The Indian franchises will use the trade name, brand, logo, etc. of Mc Donald’s
- Indian franchises will work on the instructions of Mc Donald’s. A detailed list of guidelines will be provided by Mc Donald’s as to the manner in which the services are to be performed by Franchisee
- The invoices raised by Franchisee would be on Hardcastle’s letterhead as Franchisee of Mc Donald’s - bearing the name, brand, logo of Mc Donald’s
- Mc Donald’s will provide order taking systems & training services

Issue:
- Will Franchisee constitute a PE of McDonald’s?
Case Study 7 - Distributorship / Franchisee

PE Constitution:

- SOPs by themselves do not determine PE
- Does McDonald’s have access to Hardcastle’s office space?
- Any contracts entered into by McDonald’s in India for franchises?
- Service PE risks if
  - training services core business activity and
  - continue for a specified period of time on connected projects
- Terminals or software used may lead to PE constitution if forming part of core business activity
Agency PE – Indicative Factors

• What may not lead to an Agency PE:
• Identifying potential clients
• Assist in negotiations but not bind foreign Company in any way (ideally this activity should be restricted to the extent possible in view of the aggressive positions being taken by tax authorities)
• Assistance with review of agreements to be entered into with end customer

• What may lead to an Agency PE:
• Entering into a binding contract with the end customer
• Habitual maintenance of stock of goods & regular delivery thereof
• Negotiate the final terms of the contract
• Sign any contract or any similar document indicating an ability to bind the foreign enterprise
• Habitually securing orders – not present in all treaties
Service PE

• Furnishing of services by a nonresident in India through employees or other personnel may result in ‘Service PE’, provided the duration of such services exceeds the specified period
  ▪ Solar days vs. Man days
• Services may be rendered to an associated enterprise of the service provider or a third party service recipient
  ▪ Activities carried out for own benefit will not qualify. Morgan Stanley & Co. Inc. [2007] 292 ITR 416
• Place of provision of services plays an important role in determining where the PE exists
  ▪ The persons rendering the services and the persons availing the services may be in different locations
• Critical parameters in determining the existence of a PE or otherwise
  ▪ Commercial justification
  ▪ Enterprise which exercises control over the employee
  ▪ Existence or otherwise of a lien on employment with enterprise
• Interplay between
  ▪ Service PE and Independent Personal Services
  ▪ Service PE and FTS
Service PE – Secondment v/s Deputation

• The typical features of a secondment are:
  ▪ An employee of enterprise X in State X is seconded to enterprise Y in State Y; he continues on the payroll of enterprise X
  ▪ Employee resides and renders services in State Y; he reports to enterprise Y
  ▪ The employee may continue to be paid by enterprise X who in turn is reimbursed by enterprise Y

• The typical features of deputation are:
  ▪ An employee of enterprise X in State X is deputed to enterprise Y in State Y; he shifts to the payroll of enterprise Y
  ▪ Employee resides and renders services in State Y; he reports to enterprise Y
  ▪ Salary of the employee is paid by enterprise Y
  ▪ It may be possible to demonstrate that the employee does not retain a lien on his employment with enterprise X
Service PE - Indicative Factors

- Does authority to terminate not only the secondment, but also the employment, lie with the host entity?
- Is employee transferred on the payroll of the host entity?
- Is his work under supervision and control of host entity?
- Salary paid by host entity? Alternatively - Salary costs cross-charged to host entity?
- Reporting to Host entity?
- Does Home entity have lien over employees / or re-employ after termination of secondment?
- Does Employee have lien over foreign employment?
- Important documents to be reviewed:
  - Deputation letter between the assignee and the home country
  - Inter company agreement between the two companies
  - Employment letter between the assignee and the host country
Case Study 8 – Service PE (Threshold Limit)

Facts:
- Australia Co. is a company engaged in the business of providing consultancy services
- Australia Co gets a contract to provide consultancy services to India Co
- For providing the services, Australia Co is likely to depute employees to India for 160 days

Issue:
- Will the employees deputed to India constitute a PE of the Australia Co?
- Can the transaction be structured better?
## Service PE – Threshold Limit

<table>
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<th>Treaty</th>
<th>Exclusion for FTS</th>
<th>No of days</th>
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<tr>
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<tr>
<td>Australia</td>
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<td>One day</td>
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Case Study 9 – Outsourcing Model

Facts:
• US Co. is a company engaged in the business of providing consultancy services
• US Co gets a contract to provide consultancy services to Customer
• US Co sub-contracts with an India Co for provision of the said services to Customer
• Employees of India Co render the requisite services in India to Customer

Issue:
• Will the employees of India Co constitute a PE of the US Co?
• Will your answer change if the employees are working on direct supervision and control of US Co?
Case Study 9 - Outsourcing Model

Constitution of PE
- Employees or Other Personnel
- Meaning of ‘Other Personnel’
- Working at the instruction of US Co
- Lucent Technologies
- OECD Commentary to Article 5 - Para 10
- Force of Attraction – select treaties
Tax deduction from business profits

- Buyer’s Perspective – Issues to be kept in mind
- Clearly examine facts.
  - Checking of conduct and correspondence
  - Negotiations and conclusion of contract by whom?
  - Website details
  - NR employee’s visiting cards, etc.
- Undertaking essential from payee
  - Business is done outside India.
  - There is no office in India.
  - There is no PE / BC in India.
  - Tax residential status.
- Obtain a TRC.
- Obtain KYC – incorporation documents / passport copy.
- If no PE, no income chargeable to tax
  - Tax Residency Certificate essential
  - No tax required to be deducted at source, even if no PAN
  - Section 206AA does not apply
- Withholding taxes to be deducted in case of NR’s PE in India
  - Based on tax officer’s certificate in case of attribution
PE in Outbound Scenario
PE in Outbound Scenario

- Indian entity’s investment outside India can lead to PE in foreign country
  - Branch
  - Subsidiary
  - Management in India
- Taxation in PE Country
  - Filing of foreign tax returns
  - Local tax law to be analysed
- Claim credit of taxes in India
  - Limited to tax payable in India
- Careful selection of outbound jurisdiction
  - UAE
  - Cyprus
  - Singapore
  - Mauritius
Case Study 10 – Outbound PE – Underlying Subsidiary

Facts:
• India Co has a wholly owned subsidiary in UAE
• India Co intends to undertake business activities in Singapore
• For the purposes of undertaking the said business activities, it has to set-up a branch in Singapore
• It carries out its entire Singapore business through this branch in Singapore

Issue:
• Can this transaction be structured better?
Case Study 10 – Outbound PE – Underlying Subsidiary

Use of UAE Co
• Branch of UAE Co
• PE of UAE Co in Singapore
• Taxability of income earned by Singapore branch

Issues to be kept in mind
• Control and management of UAE Co
• Substance test to be satisfied
• GAAR provisions
• POEM
Case Study 11 – Outbound PE – Management PE

Facts:
• Indian Pharma Co has a branch set up in Spain
• It carries out its entire overseas sales business through this branch
• 2 Directors out of 5 in Spain Subsidiary reside in India
• POEM in Spain as day to day operation managed from Spain
• Tax officer in India claims Spanish Subsidiary has PE in India represented by 2 directors

Issue:
• Is the claim made by tax officer correct?
Case Study 12 – Outbound PE – Exemption Method

Facts:
• India Co has a branch set up in Malaysia
• It carries out its entire overseas business through this branch
• India Co wishes to claim that profits earned through and attributable to Malaysian branch should not be liable to tax in India

Issue:
• Is the claim made by India Co correct?
Case Study 12 – Outbound PE – Exemption Method

Profit from Overseas Business

Malaysia PE

India Co

Credit Method
• Credit Method vs Exemption Method
• India DTAAs follow which method
• Taxability in India

Judicial Backdrop
• PVAL Kuladangan Chettiar’s case
• Patni Computers (Pune ITAT)
• Notification under section 90
• Protocol under Malaysia DTAA
• Sivagami Holdings Pvt. Ltd.
PE in the Income-tax Act

- PE defined u/s. 92F(iii) as “includes a fixed place of business through which the business of the enterprise is wholly or partly carried on”
  - For the purposes of "enterprise" in section 92F(iii)
  - In Section 44DA of the Act
  - CBDT circular clarifying Finance Act 2001 stated that the term be understood with reference to India’s DTAAs

- Definition covers Fixed Place PE. Other PEs?
  - PE definition under the Act is inclusive. It includes service P.E., Agency P.E., Software P.E., Construction P.E., etc.
    - Morgan Stanley – SC 292 ITR 416
  - However, deemed PE only possible under DTA
    - Service PE, Construction PE, etc.
PE Business Structuring - Substance over Form

• Substance is key to all structuring
  ▪ “Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.”

• Specific Anti-avoidance provisions
• Transfer Pricing
• POEM
• GAAR
• BEPS
• CFC
BEPS Action Plan 7
BEPS – Preventing the Artificial Avoidance of Permanent Establishment Status

• G20 Nations mandate to OECD to minimise the issue of tax avoidance
  ▪ BEPS Action Plans 1 to 15
• Action 7 - Preventing the Artificial Avoidance of Permanent Establishment Status suggests changes in Model Treaty for
  ▪ Commissionaire arrangements
  ▪ Dependent/ Independent agent meaning
  ▪ Scope of Preparatory and Auxiliary Services
  ▪ Fragmentation of activity between closely related parties
  ▪ Splitting of contract - Principal Purpose Test (PPT)
BEPS Action Plan 7 - Commissionaire arrangements

- Commissionaire arrangements
  - An arrangement through which a person sells products in a given state in its own name but on behalf of a foreign enterprise that is the owner of these products
  - Organisations are able to prove that the goods have been sold by the subsidiary in its own name and thus take shelter under Article 5(6).

- Proposed Changes in Article 5(5) of OECD Model:

- Deletions for the phrases:
  - “habitually exercises an authority to conclude contract”
  - “other than an agent of an independent status to whom paragraph 6 applies”
BEPS Action Plan 7 - Commissionaire arrangements

- Cumulative conditions added:
  i) Person should act on behalf of an enterprise in the contracting state
  ii) He should habitually conclude contract
  OR
  habitually plays principal role leading to the conclusion of contracts
  iii) Contracts to be concluded without material modification
  iv) The contracts to be concluded in the name of the enterprise
  OR
  for the transfer of the ownership of,
  OR
  for the granting of the right to use property owned by that enterprise
  OR
  that the enterprise has the right to use
  OR
  for the provision of services by that enterprise
BEPS Action Plan 7 - Dependent/ Independent agent

• Proposed Changes in Article 5(6) of OECD Model:
  ▪ Whole of the existing provision is proposed to be replaced
  ▪ Provision to remove the words ‘a broker, general commission agent or any

• Paragraph 6 presently provides that a person will not be a dependent agent where person acting on behalf of the enterprise carries on the business in the COS as an independent agent in its normal course of business except where he is acting exclusively on behalf of the enterprise or on behalf of one or more enterprise to which the first mentioned enterprise is closely related
  ▪ Test brought in to define “closely related” as:
    ▪ One enterprise has control over other OR both the enterprise are under a common control, OR
    ▪ Person possesses directly or indirectly more than 50 % of beneficial interest in the enterprise and vice versa (in case of a company 50 % of voting rights), OR
    ▪ A third person possesses directly or indirectly more than 50 % of beneficial interest in the person and the enterprise.
BEPS Action Plan 7 – Preparatory and Auxiliary Services

• Proposed Changes in Commentary on Article 5(4) of OECD Model:
  - Making all the subparagraphs of art. 5(4) subject to a “preparatory or auxiliary” condition
    ▪ “Preparatory and Auxiliary” mentioned in para (e) deleted
    ▪ “Overall activity” mentioned in para (f) deleted and proviso added for the same applicable to all clauses
    ▪ Items mentioned in article 5(4) shall be exclusions to PE only if they are Preparatory and Auxiliary in nature. Scope increased.

• Preparatory Service:
  ▪ An activity undertaken for a short period of time before the main activity is carried out

• Auxiliary Service:
  ▪ An activity to support the essential or significant part of the activity of the enterprise
BEPS Action Plan 7 – Fragmentation of activity between closely related parties

- **New Anti-fragmentation Rule**
- Introduction of new paragraph 4.1 in Article 5
- Exceptions mentioned under Article 5(4) will not apply if a cohesive business operation has been fragmented into smaller operations by an enterprise and each of such small operations is carried out at fixed places of business maintained by such enterprise or by closely related enterprise

- The other conditions required to be met:
- The different places of business could be maintained at the same place or at different places in same country; and
- The activities must be complementary functions; and
  - At least one fixed place constitutes PE; OR
  - The overall activity should not be of a preparatory or auxiliary character
BEPS Action Plan 7 - Splitting of contract

- Abuse of threshold limit of 12 months for Construction PE is done by splitting up of contracts.
- Use of Principal Purpose Test (PPT) proposed by Action Plan 6 to counter this issue.
- Alternate provision:
  - Where an enterprise carries on activities in COS at a place that constitutes a building site or construction or installation project and these activities are carried for a period less than twelve months,
  - AND
  - Connected activities are carried on at the same place during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time are to be added to the period of time during which the enterprise has carried on activities at that place.
Attribution of Profits to PE
Attribution of Profits - Article 7 – Brief Overview

Distributive Principle - Article 7 (1)

Exceptions – Article 7(7)

Attribution – Article 7(2)

Deductions – Article 7(3)

Customary Method – Article 7 (4)

Exclusion – Article 7(5)

Consistency – Article 7(6)
Attribution of Profits - Article 7(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.
Attribution of Profits - Approach

- Profits will be attributed to the PE,
  - in each country,
  - as if it were distinct and separate enterprise,
  - engaged in same or similar activities,
  - under the same or similar conditions,
  - dealing independently of the HO.
- Expenses incurred for earning profits of PE shall be allowed (including executive and general expenses).
- No deduction of expenses shall be allowed for payments by PE to HO or any other office. Similarly income shall not be considered.
- Reimbursements shall be allowed.
- Profits to be attributed to a PE shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
- Profits derived by a PE from the mere purchase of goods or merchandize for the enterprise should not be a part of its taxable income
- Income dealt with by other articles will be considered as per those articles. E.g. Interest, royalty, etc.
Attribution of Profits - Approach

• Step One – hypothesizing the PE as a distinct and separate enterprise
  ▪ FAR Analysis:
  ▪ Functional and factual analysis
    ▪ Significant People Functions
  ▪ Attribution of Assets
    ▪ Tangible & Intangible Assets
  ▪ Attribution of Risks
    ▪ Attribution of ‘free capital’
  ▪ Recognition of dealings

• Step Two – determining the profits of the hypothesized distinct and separate enterprise based upon a comparability analysis

• FAR Analysis cumbersome

• Apportionment Method to be used if customary
  ▪ Should be in line with Arm’s Length Principles
  ▪ Rule 10 followed practically in India
Force of Attraction

• It expands the taxing scope of COS
• All income arising from all sources in a country, where the foreign enterprise maintains a permanent establishment, is subject to tax in that country. However limited to:
  ▪ Revenue from Sale of same or similar goods as are sold by the PE
  ▪ Revenue from other business activities of the same or similar kind as those carried on through the PE
• Article 7 of UN Model has this clause. However, no such clause mentioned in the OECD model.
• US Model – had General FOA rule. Revised model rejects FOA
• FOA present in many Indian treaties
• Indian Judicial Precedents
  ▪ Roxon OY (103 TTJ 891 [2006])
  ▪ SNC Lavalin/Acres Inc. (15 SOT 1 [2007])
  ▪ Sumitomo Corpn. (110 TTJ 302 [2007])
  ▪ Linklaters LLP (ITA No 4896/Mum/03 Date 16/07/2010)
  ▪ SET Satellite (Singapore) Pte Ltd. (108 TTJ 445 [2007])
Force of Attraction vs Section 9(1)

- Co. A is a car manufacturer in USA
- It does business of selling Car X through its Dependent Agent PE in India
- It also does business of selling Car X through an Independent Agent in India.

Issue:
What is the profit attributable to tax in India?

Does Section 9 restrict applicability of FOA?
Section 9 - Incomes deemed to accrue or arise in India

Explanation 1 to Section 9(1)(i):
in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India

Article 7(1) of India-US DTAA

Second limb:
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
(a) that permanent establishment;
(b)sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or
(c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.
Force of Attraction vs Section 9(1)

- FOA - expands scope of attribution under DTAA for a PE
- Limited by scope of taxable income under Section 5 r.w. Section 9
Attribution of Profits to HO - Case Study

Facts:
• Microsoft U.S. (MU) has Indian subsidiary Microsoft India (MI) for software development.
• MI charges MU for software with mark up of 15%. Assume that the mark up is at market prices.
• MI is a PE of MU.

Issue:
• Should there be any profit attributable to MU?
Attribution of Profits to HO - Case Study

Facts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of MI for software development</td>
<td>1,000</td>
</tr>
<tr>
<td>Mark-up @ 15%</td>
<td>150</td>
</tr>
<tr>
<td>MI raises an invoice on MU</td>
<td>1,150</td>
</tr>
<tr>
<td>MU Incurs marketing expenses</td>
<td>2,000</td>
</tr>
<tr>
<td>MU Sells software for</td>
<td>5,000</td>
</tr>
<tr>
<td>Net profit of MU</td>
<td>1,850</td>
</tr>
</tbody>
</table>

Issue:

• Should there be any profit attributable to MU?
Attribution of Profits to HO

• Morgan Stanley (SC)
  ▪ No generalization possible
  ▪ Answer to depend upon functional and factual analysis
  ▪ Data placed by taxpayer to be examined in each case
  ▪ Payments of ALP extinguishes any further attribution of profits to H.O.
    ▪ Only if Arm’s length analysis is exhaustive of functions, assets and risks
  ▪ In context of Service PE

• SET Satellite (307 ITR 205) Mum. HC
  ▪ Payment of ALP extinguishes further attribution of profits to HO.

• Rolls Royce Del HC [2011] 202 Taxman 309
  ▪ Determine profits attributable to agency PE.
  ▪ Reduce amount paid to Agent
  ▪ Balance taxable in India
Future of PE – Digital Economy
Future of PE - Digital Economy

- Tax avoidance under Digital Economy was the primary reason for BEPS discussion to start.
- Digital Economy does not require physical presence
  - Amazon, Google & Facebook
- New threshold is required.
  - PE definition linked to physical location archaic

- Scope under OECD
- Scope under Income-tax Act
- Profits of Digital Economy
Future of PE - Google tax planning

Google U.S. ✗ Google Ireland ✗ Google Ireland

Bermuda Subsidiary

Holds IPR. controlled in Bermuda. NR of Ireland.

Dividend

Receives royalty. No tax.

Receives royalty. Pay royalty. No tax.

Collects Revenue
Digital Economy – How to tax?

Global data base

Global users access

Google

Global advertisers

- What should be considered as source:
  - Users of database.
  - Servers where database is stored.
  - Servers where search software is stored.
  - Advertisers.
Case Study 13 – E-commerce

Facts:
- US Co provides online portal for travel services
- Portal hosted on cloud services managed by independent service provider
- Portal targeted for Indian users
- Accessed by Indian users from India for concluding transactions
- US Co appoints India Co. as Agent for marketing portal
- US Co appoints India Co 2 as Agent for soliciting customers for targeted ads at Indian users on travel portal

Issue:
- What are the tax issues that will be faced by US Co in India?
Case Study 13 – E-commerce

Constitution of PE:
• Virtual business activity
• PE definition based on Fixed Place
  • No Server, no fixed place in India

To consider:
• eBay International AG
• Right Florists Pvt Ltd
• Google’s tax issues in UK and USA
• BEPS Action 1 – Digital Economy
Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks.

Proposed solutions:

- Modify the list of exceptions to the definition of PE
  - to ensure that each of the exceptions is restricted to “preparatory or auxiliary” activities; and
  - to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.
• Modify the definition of PE
  ▪ to address artificial arrangements resulting in conclusion of contracts relating to the sales of goods or services of one company in a multinational group - such sales to be treated as if they had been made by that company.

• The revised transfer pricing guidance makes it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible
  ▪ Group companies performing the important functions, contributing the important assets and controlling economically significant risks will be entitled to an appropriate return.

• The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent co.
BEPS Report on Digital Economy – What next?

• No new treaty rule proposed. Existing rules tightened
• Reliance on other BEPS measures
• Review in 2020
• Other options were not recommended:
  ▪ New nexus in form of economic presence
  ▪ Withholding tax on certain digital transactions
  ▪ Equalisation levy
• Countries should however introduce any of these three options in domestic law, however respecting existing treaty obligations
BEPS Report on Digital Economy – Unresolved Issues

• BEPS Report only focuses on Base Erosion & Profit Shifting
• Is taxation of digital commerce required?
  ▪ To bring a level playing field by taxing all business activities irrespective of the manner in which they are conducted
  ▪ Possible under Digital Commerce to carry on huge business without any presence in Country of Market
  ▪ Countries are already feeling the pinch and have started unilateral actions to tax digital commerce
• If digital commerce is to be taxed, how should it be taxed?
  ▪ Present treaty and domestic tax rules are based on geographic connections
  ▪ Digital commerce is by definition location agnostic
  ▪ BEPS actions tighten existing treaty rules which are not designed, nor can apply to digital commerce
BEPS Report on Digital Economy – Probable solution

• A new tax on Cross-border Digital Commerce transactions to be introduced

• Source Rule
  ▪ Payer is source of income
    ▪ Country of Payment is Country of Source
  ▪ A low tax rate (say 4%)
    ▪ Tax payer may be subject to tax in multiple jurisdictions

• Virtual PE
  ▪ Based on threshold of revenue earned in COS
    ▪ Once threshold crossed, Virtual PE constituted
  ▪ Option for tax payer to file tax return or pay at low tax rate
• Thank you!

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India-US DTAA – Agency PE Article 5(4)

• 4. Notwithstanding the provisions of paragraphs 1 and 2, where a person -- other than an agent of an independent status to whom paragraph 5 applies -- is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State if:
  ▪ (a) he has an habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;
  ▪ (b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or
  ▪ (c) he habitually secures orders in the first-mentioned State, wholly or almost wholly 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 and the transactions between the agent and the enterprise are not made under arm's-length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.
Interplay of DTAA, PAN & TRC

1. Is the Payment liable to tax under ITA?
   - Yes: Go to Is DTAA Rate Beneficial?
   - No: Go to Is TRC Available?

2. Is TRC Available?
   - Yes: Go to Is Payee’s PAN Available?
   - No: No Tax Deductible, PAN not required

3. Tax as per ITA
   - Yes: Go to Is Payee’s PAN Available?
   - No: S. 206AA applicable: Higher of 20% or Rate as per Rates in Force

4. Is Payee’s PAN Available?
   - Yes: S. 206AA not applicable: Rate as per Rates in Force
   - No: S. 206AA not applicable: Rate as per DTAA

5. Is DTAA Rate Beneficial?
   - Yes: Is TRC Available?
   - No: Section 206AA not applicable: Rate as per DTAA

6. Is TRC Available?
   - Yes: Section 206AA applicable: Higher of 20% or Rate as per DTAA
   - No: No Tax Deductible, PAN not required
### Interplay of DTAA, PAN and TRC... contd.

<table>
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<tr>
<th>DTAA provisions are beneficial?</th>
<th>Is TRC available?</th>
<th>Is PAN available?</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>The beneficial DTAA rate can be applied as TRC is available. Section 206AA will not have any effect as PAN is available.</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>As TRC is not available, benefit of DTAA will not be available. Rate will be as per ITA. Section 206AA will not have any effect as PAN is available.</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>While the payer can take benefit of the DTA provisions, as PAN is not available, higher of 20% or DTA rate will be applicable.</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>As TRC is not available, benefit of DTAA will not be available. As PAN is not available, higher of 20% or ITA rate will be applicable.</td>
</tr>
<tr>
<td>No or DTAA not applicable</td>
<td>NA</td>
<td>Yes</td>
<td>Rate will be determined as per “rates in force” provided in Part II of First Schedule of the Finance Act of the relevant year. As PAN is available, Section 206AA will not be applicable.</td>
</tr>
<tr>
<td>No or DTAA not applicable</td>
<td>NA</td>
<td>No</td>
<td>Rate will be determined as per “rates in force”. If this rate is lower than 20%, tax would be deductible at 20% as PAN is not available.</td>
</tr>
</tbody>
</table>