Delhi HC holds profits attributable to a PE should be taxed in the source state irrespective of the profit/loss earned globally

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Summary

In a recent judgement[1], the full bench of the Delhi High Court (HC) held that a permanent establishment (PE) is an independent taxable entity. Consequently, the tax obligations of such an establishment should be assessed separately, irrespective of the global income of the enterprise at the entity level.

The HC overturned the division bench judgement[2], where the division bench held that when an enterprise recorded a global net loss, no profit could be attributed to the PE[3].

Key observations of HC

The existence and identity of a PE are separate and distinct from its principal

- The tax treaty defines PE to include a variety of establishments that do not necessarily have to be in the form of a separate legal identity. The scope of what constitutes a PE extends from management places to mines or construction sites, illustrating that it is not confined to juridical entities as typically understood in legal terms.

- For taxation purposes, a PE is viewed as a separate and distinct centre[4]. The concept of PE revolves around executing economic activities within a specific country, regardless of where the enterprise is based. This concept aligns with a conglomerate or an entity with multiple arms or independent units operating across different fiscal jurisdictions.

- The PE concept creates a functional relationship and connects the principal entity and the place of business whose activities give rise to income or profit.

- Once the tax treaty confers an independent identity upon the PE, it would be erroneous to determine taxability based on the activities or profitability of the parent company or the entity that seeds and sustains the PE.

- A distinction is to be drawn between a PE with respect to the income earned in the country where it is domiciled or deemed to exist and the global enterprise of which it may be a part[5].

- The concept of a PE serves as the crucial boundary in the source country that allows for taxation outside the enterprise's home country. This approach makes sense, as the right to tax in the source country is tied to the economic activities of the transnational enterprise, anchored by the presence of a PE.

- Furthermore, it is important to note that the source country's right to tax is limited to profits that can be allocated to the PE. Therefore, it has been established that the existence and identity of the PE are separate and distinct, and it is taxable only for the activities it undertakes in a country different from where its principal is based.

Understanding of tax treaty[6]

- On a plain reading of the tax treaty, it is evident that the profits of a country's enterprise are ordained to be taxed only in that country. However, if the enterprise conducts business in another country through a PE, the profits from activities

[1] Hyatt International Southwest Asia Ltd vs. ADIT [TS-693-HC-2024(Delhi HC)]
[2] CIT vs. Nokia Solutions and Networks OY [2023] 147 taxmann.com 165 (Delhi HC)
[3] The division bench of HC had upheld the decision of the tribunal in the case of Nokia Solutions and Networks OY vs. ACIT [2022] 143 taxmann.com 53 (Delhi - Trib.) which was based on the special bench judgement in the case of Motorola Inc. vs. DCIT [2005] 95 ITD SB 269 (Delhi Trib.) (SB)
[4] International Management Group (UK) Limited vs. CIT 2024 [2024] 164 taxmann.com 225 (Delhi HC)
[5] DIT vs. Morgan Stanley & Co. Inc [2007] 162 Taxman 165 (SC)
[6] Article 7(1) of the tax treaty

carried out by this establishment are subject to taxation in that other country. This taxation is limited to the profits that can be attributed to the activities of the PE.

- The usage of the phrase *"...so much of them as is attributable to the permanent establishment"* in the tax treaty is a clear indicator of the tax treaty warranting the PE being liable to be viewed as an independent centre of revenue.

- Therefore, the tax treaty, in unequivocal terms, constructs a dichotomy between the profits that may be earned by an enterprise on a global scale and those that are attributable to a PE situated in another country.

- The OECD commentary on the tax treaty[7] explains that the source country's right to tax depends on the existence of a PE because this establishment engages in economic activity within the source country's territory. In this context, the commentary describes PE as a 'separate source of profit.' It also notes that profits can be attributed to the PE even if the entity as a whole has not earned those profits, provided there is a PE present.

Profit attribution vis-à-vis the global performance of the entity

- The profits attributable to a PE are not liable to be ignored based on the profitability or performance of the entity as a whole.[8]

- The notion that a PE is only taxable if the entire entity is profitable does not reflect the intent of the tax treaty. Such a view could lead to situations where, despite the entity being profitable, when the PE incurs a loss, the tax authorities would still have grounds to impose taxes, which is incorrect.

- Additionally, the tax treaty focuses specifically on the profits or income attributable to the PE without extending its scope to a transnational enterprise's overall operations or profitability. The taxability of income earned by a PE in a country is entirely independent and not connected to the broader operations of the enterprise of which it is a part.

- Thus, the HC opined that the argument of global income or profit being relevant or determinative is totally unmerited and misconceived.

HC's ruling

- The activities of a PE are liable to be independently evaluated and ascertained to evaluate tax obligations in the source state.

- It is important to consider the well-established rule of source that guides the underlying principles of taxation. Under this rule, the right of the source country to tax a PE should not be influenced by the global financial status of the parent entity. This ensures that taxation rights are based strictly on the economic activities conducted within the source country itself.

Our comments

The HC's decision emphasises the principle that a PE's tax obligations are determined by its economic activities within a country, independent of the global profits or losses of the parent company. This reinforces the need for multinational corporations to ensure precise accounting of their Indian operations, as these are assessed independently for tax purposes. This distinction ensures that companies cannot utilise global losses to diminish taxable profits generated by their PEs in India, thereby upholding the fiscal independence of the source country.

[7] Article 7 of the tax treaty
[8] Ishikawajma-Harima Heavy Industries Ltd. vs. DIT (2007) 3 SCC 481; Morgan Stanley and Co. Inc (supra)

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