

# Agency Permanent Establishment – Basic Concepts and Issues

In spite of infrastructure concerns and lack of clarity on policy reforms, India continues to remain a country of opportunities for global companies. India attracted its highest ever monthly inflow of FDI amounting to \$ 8.1 billion, in March 2012. Many times, global companies before setting up an entity in India choose to operate in India through principal-agent relationship for varied reasons like avoiding hassles of setting-up the infrastructure, saving operational costs, try out Indian business conditions etc. In this context, if the form or substance of Indian operations undertaken by foreign company through an agent is not structured carefully, the foreign enterprise might get exposed to the risk of constituting an Agency Permanent Establishment (Agency PE). The subject of Agency PE has been discussed and debated in great detail by every forum of the Indian courts – from Authority of Advance Rulings to Tribunals to the Supreme Court. In this article, efforts have been made to analyse basic concepts of Agency Permanent Establishment and circumstances in which a person can be considered as an agent of a foreign enterprise. The second and third part of the series would respectively deal with the concept of Dependent Agent PE and Attribution of Profits to PE.

## Introduction

Traditionally, the countries have taxed income if, under the laws of the country, the income is found to have some nexus with the territory. Residence based taxation or source based taxation are two generally practiced concepts in international tax.

Countries following source based taxation, tax income which has been sourced from the country. Such scheme of taxation is not concerned with the residential status of the enterprise. Countries following residence based taxation on the other hand tax income earned by its residents.

In such a situation, there is a possibility that the same income is taxed twice in two different jurisdictions on source and residence basis.

Hence, to prevent such double taxation of same income, normally countries enter into an agreement known as Double Taxation Avoidance Agreement ('DTAA'), which generally allocates rights of taxing a particular income between residence country and source country.

## Basic concepts – Permanent Establishment

The concept of Permanent Establishment ('PE') was introduced in the DTAA's to define; and allocate taxing rights of the Contracting Countries in relation to an income. Its basic purpose is that if a foreign enterprise undertakes activities in the source country which exists beyond a reasonable period and is also of enduring or permanent nature, the source country would have the right to tax the income of foreign enterprise attributable to such activities. Thus, in simple words, if a foreign enterprise has a PE in source country, the source country would get right to tax income attributable to such PE.

## Definition of PE under the Income Tax Law and DTAA

A permanent establishment is broadly defined to

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mean a fixed place of business through which the business of an enterprise is wholly or partly carried on.

However, under one exception to general rule of PE, if, under certain conditions, a person is acting on behalf of an enterprise, the enterprise is deemed to have a PE though it does not have any fixed place of business. This exception to the basic rule PE is referred to as Agency PE.

Under provisions of Income-tax Act, 1961 ('the Act'), the term 'business connection' is of relevance. As per provisions of the Act, income arising by a foreign enterprise through a business connection in India would be taxable in India. Thus, the term 'business connection' is akin to the principle of PE and marks the dividing line between doing business with a country and doing a business within that country.

As the Indian judiciary puts it; the words 'business connection' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.

### Basic concepts – Agency PE under the Act

The term PE has been inclusively defined as part of transfer pricing regulation. The clause (iiia) of Section 92F of the Act defines the term PE as follows:

*"PE includes a fixed place of business through which the business of the enterprise is wholly or partly carried on."*

As can be observed, a PE in the nature of an agency is not specifically covered in the definition.

However, under the Act, a non-resident would be taxable on income arising/accruing through or from any business connection in India.

Typically, the Courts consider any activity of a foreign enterprise carried on in India through the use of any asset, employees or other personnel as constituting a business connection in India. The Hon'ble Supreme Court in the case of R. D. Agarwal [1965] 56 ITR 20 (SC) has laid down the following tests for existence of a business connection in India:

- Business connection means something more than "business";
- There should be a relation between a business carried on and some activity in India which contributes to the earning of profits;
- There should be an element of continuity between the business and activity in India.

Under the business connection rule, explanation 2 to Section 9(1)(i) provides for rules of taxability of income arising in principal-agent relationship.

### Definition of Agency PE

#### Definition under the Act

Explanation 2 to Section 9(1)(i) of the Act states that the term 'business connection' would include any activity carried on through an agent if:

- a) The agent has and habitually exercise authority to conclude contracts, unless the activities are confined to purchase of goods or merchandise; or
- b) The agent habitually maintenance a stock of goods or merchandise and delivers them on behalf of foreign enterprise; or
- c) The agent habitually secures orders mainly or wholly for his principal.

However, a broker or a general commission agent or any independent agent is excluded from the above rule if he is acting in the ordinary course of his business. But, if such an agent works mainly or wholly on behalf of his principal, he may not considered as a broker, general commission agent or an agent of an independent status.

#### Definition of PE under the OECD and UN Model Convention

Different tax treaties define Agency PE in different manner. However, normally a tax treaty follows any one of the following Model Conventions:

- a) The 2011 United Nations Model Convention ('the UNMC'); and
- b) The 2010 OECD Model Convention ('the OECD MC')

#### Article 5(5) of OECD MC 2010 defines Agency PE as follows:

*Where a person — other than an agent of an independent status applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name 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.*

#### Exception to above rule of Agency PE - Article 5(6)

*An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that 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.*

*Article 5(5) of UN Model convention 2011 defines Agency PE as follows:*

Where a person — other than an agent of an independent status — 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 Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 (viz. general, preparatory or auxiliary activities) which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or
- b) 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.

*Exception to above rule of Agency PE - Article 5(7)*

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 conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

### **Analysis of the above definitions**

*As per provisions of the Act*

A bare reading of the definition of business connection given in 9(1)(i) of the Act shows that constitution of business connection does not require physical presence of the foreign enterprise and relationship with an agent is also covered. Following conditions are required to be satisfied for a business connection in nature of an Agency PE to arise in India:

- (A) An agent undertakes business activity on behalf of a foreign enterprise;

**AND**

- (B) Such an agent has and habitually exercises authority to conclude contracts on behalf of the foreign enterprise. However, activities undertaken by agent limited to only purchase of goods on behalf of non-resident would not be covered in this clause

**OR**

- (C) The agent has no authority but habitually maintains stock of goods from which goods are delivered on behalf of the foreign enterprise

**OR**

- (D) The agent habitually secures orders in India mainly or wholly for the foreign enterprise

Thus, if a foreign enterprise conducts business in India through an agent and fulfills condition (A) along with any of the conditions prescribed in (B) or (C) or (D) above, it would constitute business connection in India.

**Exception** – However, if the above activities are undertaken by an agent having an independent status and acting in its ordinary course of business, it would not constitute a business connection. Further, if such an independent agent works wholly or mainly for the foreign enterprise he would not become an agent of an independent status.

*Under OECD and UN Model Commentary*

The definition of the term 'Agency PE' given under OECD and UN MC are much narrower compared to the definition provided under the Act.

- The OECD MC postulates presence of two conditions for creating Agency PE i.e. Condition (A) pertaining to presence of an agent; and Condition (B) pertaining to authority to conclude contracts.
- Under the UN MC, Agency PE can be created upon fulfillment of above Condition (A) and Condition (B) as well as on fulfillment of Condition (A) and Condition (C).
- **Exceptions under OECD MC and UN MC**  
Further, under the exceptions provided under OECD MC and UN MC, Agency PE cannot be created if the agent is acting in its independent capacity and while undertaking ordinary course of business. Additionally, the UN MC specifically provides that the above exception would not apply if the independent agent's activity are wholly devoted on behalf of the foreign enterprise and conditions between the agent and the foreign enterprise are not at arm's length.

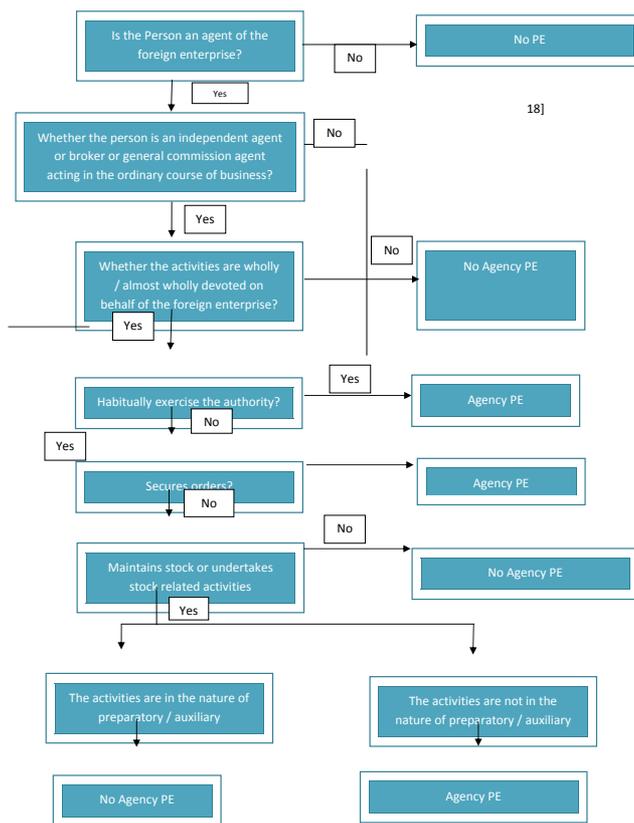
Comparison of the above definitions

Particulars	Explanation 2 to Section 9(1)(i) of the Income-tax Act	OECD Model	UN Model
<b>Conditions creating Agency PE (business connection under the Act)</b>			
<b>1. Authority to conclude contract</b>	Has and habitually exercises the authority to conclude the contract	Has and habitually exercises the authority to conclude the contract	Has and habitually exercises the authority to conclude the contract
<b>2. Maintain stocks of goods</b>	Has no authority to conclude contract but maintains the stock from which goods are delivered	Does not contain such clause	Has no authority to conclude contract but maintains the stock from which goods are delivered
<b>3. Authority to secure orders</b>	Habitually secures orders mainly or wholly for the enterprise	Does not contain such clause	Does not contain such clause
<b>Exclusion to the above conditions</b>			
<b>An agent of an independent status</b>	A broker or a general commission agent or an independent agent acting in its ordinary course of business is excluded	A broker or a general commission agent or an independent agent acting in its ordinary course of business is excluded	A broker or a general commission agent or an independent agent acting in its ordinary course of business is excluded
<b>Mainly/ Wholly clause</b>	Where the agent works mainly/ wholly for the enterprise, such agent is not considered as a independent agent	Does not contain such clause	Where the agent works mainly/ wholly for the enterprise <b>and condition between them are such that would not be made between two independent parties</b> , such agent is not considered as an independent agent

Thus, based on the above analysis, while ascertaining the existence of agency PE, the first test is to determine whether the person whose services are availed by the foreign enterprise may be regarded as an agent of the foreign enterprise as per commercial laws of the source country. If such person can be regarded as an agent of the foreign enterprise, the second step is to ascertain whether such an agent is independent *agent* acting in its ordinary course of his business or is dependent agent. If after determination of the above two steps, it is found that the agent is dependent or is independent but works wholly or mainly on behalf of his principal, the third step would be to ascertain whether he undertakes any of the activities in the nature of concluding contracts, securing orders or maintaining stock.

Based on the language used in the Section 9(1)(i) of the Act, the above conditions are pictorially explained in the flow chart below:

Flow chart depicting the above analysis



Issues arising in Agency PE

- When a person can be regarded as an agent**  
As mentioned above, the first step in ascertaining Agency PE would be to determine whether foreign enterprise undertakes business through an agent.

The term agent has not been defined with reference to Agency PE. Accordingly, one has to interpret the term having regard to the meaning assigned to it in the Indian Contract Act, 1872. **Section 182 of the Indian Contract Act, 1872** provides that

*"An "agent" is a person employed to do any act for another, or to represent another in dealing with third persons. The person for whom such act is done, or who is so represented, is called the "principal"."*

Under the principal-agent relationship, the agent has the authority to legally bind the principal and create legally enforceable obligations between the principal and third parties. In such relationship, the principal controls over the business activities (value creating activities) of the agent and continues to bear the entrepreneurial risks. Further, in order to determine whether a person is an agent or not, factual analysis apart from the legal agreement entered between the parties should be considered.

In order to constitute an agency PE, a person must be acting on behalf of the foreign enterprise and be regarded as an agent under the internal commercial laws of the source country. In other words, if a person is dealing with the foreign enterprise on principal to principal basis, presence of the person may not, per se, create agency PE exposure for the foreign enterprise in the source country.

### Jurisprudence on agency relationship under the commercial laws

#### a) **Galileo International Inc [2008] 19 SOT 257 (Delhi)**

The Delhi Tribunal has recognised the principle that prior to ascertaining whether an enterprise is a dependent agent or an independent agent, the enterprise has to first fulfill the test of agency under the commercial laws. The Delhi Tribunal in Para 17.3 observed as under:

*"....An agent is a person employed to do any act for another or to represent another in dealing with third person. What an enterprise can do directly but if not so done directly but done through an agent appointed for the purpose, it will be deemed to have been done indirectly."*

Further, the Delhi Tribunal held that the fact that the foreign enterprise has an agent in India or not has to be proved based on facts of the case and not only based upon the agreement entered between the parties. Hence, even if the agreement between the foreign enterprise with Indian person provides that the agreement is on principal to principal basis, the same may not be conclusive if on facts, it is found that agency arrangement exists.

Similar views were also taken by ITAT in the case of DHL Operations BV [2005] 142 TAXMAN 1 (Mum.) (Mag.) (ITA Nos 7987 and 7988 of 1992) and Amadeus Global Travel Distribution S.A. 113 TTJ 767 (Delhi).

#### b) **Laird Technologies India (P) Ltd. [2010] 323 ITR 598 (AAR)**

The AAR held that the Indian company was not actually required to act as an agent of the foreign enterprise in any sense while conducting the business. In this regards, it relied on review of the terms of the Agreement entered by the Indian company with the foreign enterprise, its actual practice as well as below mentioned facts:

- It had been carrying on its business operations by itself without any directions or instructions from the foreign enterprise;
- It bore the risk and responsibility of its business transactions. Further, the risk of pricing a product continued to exist with it;
- It supplied goods to its client not on behalf of the foreign enterprise but on its own and its transactions with its client have been on a principal-to-principal basis;
- Under the agreement entered with the foreign enterprise, it is left free to establish business relationships with other potential clients in India;
- It had recruited its own sales personnel for the task;
- It was neither dependent on the foreign enterprise economically nor it had been subjected to any





form of control by the foreign enterprise from functional point of view;

- It reserved the right to renegotiate on its own terms;
- Above all, there was nothing to show that its activities were devoted wholly or almost wholly to or on behalf of the foreign enterprise.

### Factors Influencing test of dependent vs. independent agent

Once it is determined that there exists agency relationship between Indian company and the foreign enterprise, the second step would be to determine whether the Indian company is a dependent agent or an independent agent.

Majority of the DTAA's entered by India exclude agents having independent status from the ambit of the Agency PE clause. These tax treaties provide that any person, though acting on behalf of the foreign enterprise, would not be regarded as dependent agent if such person is

- i) An independent agent;
- ii) Not legally and/or economically dependent on the foreign enterprise; and
- iii) Acts in its ordinary course of business.

Based on jurisprudence on the subject, some of the factors that can be considered as relevant to determine the status of an agent are discussed below.

#### *Economic and legal independence:*

The first criterion to determine whether the agent is an

independent agent or a dependent agent, it needs to ascertain if the agent is economically and/or legally dependent on the foreign enterprise. If the agent is economically and/or legally dependent on the foreign enterprise, he will, generally, lose his independent status.

#### *View given in Commentary on OECD MC and UN MC:*

The OECD MC and UN MC states that a person will be considered to be independent agent only if:

- a) he is independent of the enterprise both legally and economically,

#### **AND**

- b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

Both the above conditions have been explained in detail by OECD MC which in Para 38 states that following points should be considered while determining that enterprise is legally and economically independent.

- Whether agent's commercial activities are subject to detailed instructions or to comprehensive control by the foreign enterprise
- Whether the entrepreneurial risk has to be borne by the agent or by the enterprise the agent represents.
- Whether agent is responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out
- Whether agent exercises freedom in the conduct of business within the authority granted by the agreement.
- The extent of the obligations which an agent possesses vis-à-vis the enterprise.
- Number of principals represented by the agent, etc.

Additionally, OECD MC in Para 38.1 also states that while determining legal dependence, control exercised by parent company over its subsidiary in its capacity as shareholder would not be relevant while determining whether agent is dependent agent of PE.

UN MC also accepts the above view given in OECD MC.

#### *Ordinary course of business*

As explained above, apart from agent being engaged in independent capacity, he also needs to act in his ordinary course of business. An ordinary course of business presupposes that activities undertaken by an agent are such that would have been undertaken by similar independent agent.

(continued on page 131)

## Agency Permanent Establishment – Basic Concepts and Issues

(continued from page 92)

*View given in Commentary on OECD MC and UN MC:*

The OECD MC states that an agent cannot be said to act in his ordinary course of business, if it undertakes activities which belong to scope of operations covered by the enterprise rather than that of the agent. For example, if a commission agent not only sells goods of an enterprise but also exercises an authority to conclude contracts, he would be considered to be acting out of his ordinary course of business of being a commission agent.

Further, OECD MC also states that in deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, normal business activities undertaken by a broker, commission agent or other independent agent would need to be compared with activities undertaken by an agent.

The commentary on UN MC has also made observations similar to views given by OECD MC. The judicial precedents on the above points are discussed below.

*Jurisprudence on economic and legal independence*

### a) Galileo International Inc [2008] 19 SOT 257 (Delhi)

The Delhi Tribunal has held that if an agent is functionally and financially dependent on the principal, it can be said that the agent is not of an independent status.

*Jurisprudence on ordinary course of business activities*

### a) Galileo International Inc [2008] 19 SOT 257 (Delhi)

The Indian entity was carrying on two types of

activities viz. i) full fledged travel agency business; and

ii) maintain and operate the system for providing electronic global distribution services to airlines, hotels etc by connecting travel agents utilising a computerised reservation system.

Based on the facts, the Indian entity was totally dependent on the foreign enterprise in respect of rendering of services to the clients of foreign enterprise as *that part of the activities of the Indian entity* was carried on solely for the foreign enterprise.

### b) Western Union Financial services Inc [2007] 104 ITD 34 (Delhi)

The revenue authorities argued that agents of the appellant who was engaged in the business of money transfer services (viz. department of posts, commercial banks, NBFCs and tour operators) did not act in their ordinary course of business. According to the revenue authorities, though it was usual for the post offices and banks to provide money transfer services, traditionally these services were restricted to money transfers within India. Accordingly, facilitation of international money transfers was beyond ordinary course of business of the agents of the appellant.

Rejecting the contention of the revenue authorities, the ITAT held that it was normal for the banks etc to engage in money transfer business. It was not material that the money, in this case, was remitted from outside India instead of from within India.

*Activities – Mainly/wholly on behalf of other enterprise;*

Another criterion to ascertain the status of an agent is to evaluate whether, in the ordinary course of business, if the agent is mainly or wholly working for the foreign enterprise. If, based on the facts, it is demonstrated that the agent is working mainly or wholly for the foreign enterprise, it would be less likely that agent is of independent status.

*View given in Commentary on OECD MC:*

The OECD MC in Para 38.6 states that independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative and must be considered along with other factors.

*View given in Commentary on UN MC:*

UN MC apart from confirming the above views given in OECD MC further adds an agent would be not considered to be of independent status, if its activities



are devoted wholly or almost wholly on behalf of an enterprise **and** conditions between that enterprise and the agent are different from those which would have been made between independent enterprises. Thus, in other words, if the conditions between agent and enterprise are not at arm's length and agent works wholly or almost wholly on behalf of an enterprise, he would not be considered to be an agent of independent status. Further, it also states that the mere fact that the number of enterprises for which the independent agent acts has fallen to one does not of itself change his status from independent to dependent, though it might serve as an indicator of the absence of the independence of that agent.

*Jurisprudence on mainly/wholly on behalf of other enterprise*

**a) DHL Operations BV [2005] 142 TAXMAN 1 (Mum.) (Mag.) (ITA Nos 7987 and 7988 of 1992)**

The Tribunal held that the words in a statute or document take their colour from the context. The ITAT further held that while making enquiry relating to the activities of the non-resident vis-a-vis the activities of the agent of independent status, enquiry need not be made as to whether the agent is carrying on various activities other than the activity of being an agent of the non-resident. However, the relevant enquiry is as to whether the entire activities relating to the non-resident are carried on wholly or almost wholly by the agent on behalf of the non-resident enterprise.

**b) Speciality Magazines (P) Ltd., [2005] 274 ITR 310 (AAR)**

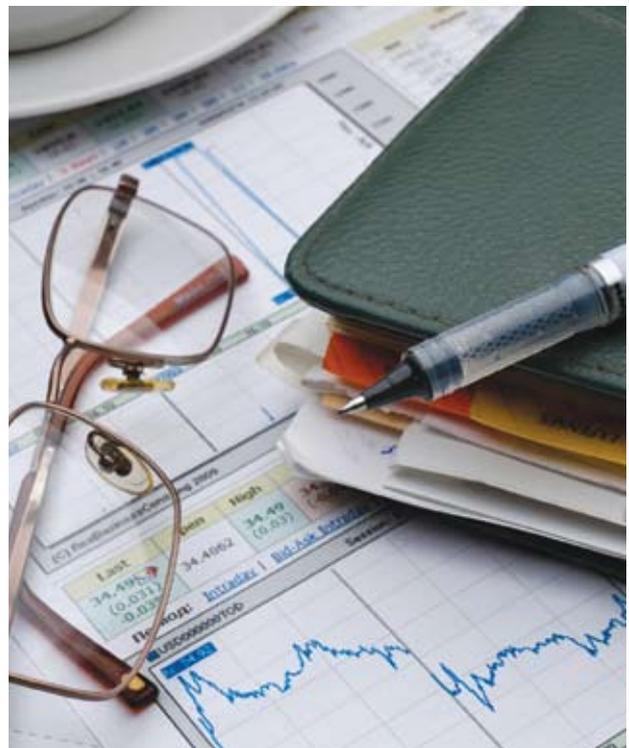
The AAR held that the terms 'wholly' and 'almost wholly' are not technical terms or terms of art. They must receive their ordinary meaning as understood by English speaking people. The word 'wholly' means entirely, completely, fully, totally; 'almost wholly' would mean very near to wholly, a little less than whole. In terms of percentage 'almost wholly' would mean anything less than 90%.

Since the applicant was earning income from other clients (the clients other than the foreign enterprise) between 22% to 25%, based on the facts, the AAR held that the activities of the applicant were not carried out wholly or almost wholly for foreign enterprise.

**India's position on Article 5(6) of the OECD MC**

Though India has made several reservations on the language and interpretation of Article 5(5), Article 5(6) and commentary on these articles, the following reservation may create significant issues.

*"India reserves the right to make it clear that an agent*



*whose activities are conducted wholly or almost wholly on behalf of a single enterprise will not be considered an agent of an independent status."*

Thus, as per the above reservation, Indian government has only reiterated the position given under existing second proviso to Explanation 2 to Section 9(1)(i) of the Act which also states that if an agent is wholly or mainly dependent on foreign enterprise, he would lose his independent status.

**Concluding**

As can be seen from the above discussions, subject matter of determining whether an agent is dependent or independent has been extensively discussed by the Indian courts and is the first step while analysing the concept of Agency PE. Further, it is pertinent to note that Direct Tax Code Bill 2010 has specifically defined Permanent Establishment, which includes Agency PE similar to the definition provided in various DTAA's signed by India. In light of the above discussions, foreign enterprises undertaking business in India through agency agreements would need to consider the above factors for determining whether their agent is an independent agent or dependent agent. Accordingly, once, it is ascertained that the agent is a dependent agent, the next question which would need to be considered is whether undertaking business through dependent agent would create Agency PE in India. ■