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India, an emerging economy, is experiencing high growth in infrastructure, contract manufacturing and real estate development. Investment into these sectors has risen considerably but not without its share of tax consequences. When a foreign enterprise undertakes any work in India involving construction, assembly, installation or commissioning of any building or project or supervision of such contracts, a question arises whether these activities create a Permanent Establishment (PE) of such foreign enterprise in India. This issue assumes great significance since a PE situation may lead to corporate tax obligations, which has direct bearing on the cost of executing projects in India. Also, given that tax withholding is applicable on such transactions in India, any ambiguity over the PE situation can lead to higher tax withholding (over 42 percent) or even deferral of payments from the clients. In either case, it adversely impacts the foreign enterprise.

It is settled position in law that a foreign enterprise can only be taxed on its business income if it has established a PE in India. PE generally refers to a fixed place of business. It includes a construction site and installation project provided such activities last more than the specified period. As per Article 5 of the Indo-German Double Tax Avoidance Agreement ("Treaty"), a German enterprise will establish a PE in India if it undertakes site activities, project or connected supervisory activities for more than six months. In other words, if the activities last for six months or less, there will be no PE.

The big issue here is how to compute duration of the project. While the revenue authorities generally consider contract signing date as the trigger point of the six month threshold whereas tax payers argue date of project commencement/installation as more relevant since no economic substance is attached to the date of contract signing. Although each case is peculiar, one needs to strike a balance between such extreme views. Thus, preliminary activities such as occasional short visits for negotiations, contract signing, setting-up a bank account or activities such as sampling cannot be considered as a trigger for the start of six month threshold whereas preparatory stages leading to actual commencement of work such as gathering the equipment, arranging the infrastructure for carrying out the work should fall within the ambit of the project duration. Similarly, date of completion can be reckoned from the completion certificate and must take into account any seasonal interruptions, test runs etc.

Another key issue, though linked to project duration, is the work done through sub-contractors. Sub-contracting arrangements are most commonly followed in case of turnkey contracts wherein whole or part of the contract activities are performed by an approved sub-contractor. The contractor remains liable for job done by the sub-contractor. A question arises whether a sub-contracting arrangement can create a PE of foreign enterprise (contractor) in India. In other words, does the time spent by sub-contractor be considered in computing the threshold of six months? As a general rule, where the deliverables are a conjoint effort of both contractor and

sub-contractor and such sub-contractor is dependent on the contractor, there is a possibility of creating a PE through such sub-contractor. However, it would be inappropriate to consider every sub-contracting arrangement as a PE relationship unless the nature of arrangement, actual work performed by the sub-contractor and the extent of its dependence on the contractor is indicative of the same.

The Authority of Advance Ruling of India (AAR) has dealt with a similar issues arising in case of a German company i.e. Pintsch Bamag (PB). PB was awarded a contract by Tuticorin Port Trust (India) for design, fabrication supply, transportation, delivery, installation and maintenance on turnkey basis. PB sub-contracted most of the work to an Indian sub-contractor and undertook offshore services (viz. technical studies, designing), offshore supply of equipments and onshore supervision of installation activity on its own. PB argued that the process of supervision (onshore) was less than 60 days and thus it does not have a PE in India whereas the revenue authorities demonstrated a case for PE by including the time spent by sub-contractor at its factory in computing the contract duration threshold of six months. The AAR observed that the sub-contractor's workshop was set-up at a place far from the installation site and that the work done by the subcontractor was independent of any control of PB. The AAR did not find a nexus between sub-contracting and the installation activity and thus took a view that place of sub-contractor cannot be considered as PE in India.

The revenue authorities had put forth another proposition that the PE could come into existence at the stage when the personnel of PB inspect/visit the site for the purpose of designing, acquiring necessary technical data, supervising the fabrication work and submitting progress reports. The AAR did not find merit in this proposition. It observed that such preliminary activities may not involve regular/ constant presence of PB's personnel in India which is a pre-requisite for establishing PE.

Although the decision of AAR is not binding in nature, it sets a realistic precedence and provides clear guidance on some very key issues on the subject. Summing up – maintain documentation to decipher between preliminary and preparatory activities and ensure that the sub-contractor is independent and all dealings take place on a principal to principal basis. These basic steps will go a long way in mitigating the PE exposure on turnkey contracts.

PE is considered as a non-resident in India and its net income or profits are taxed at 42.02 percent. The unintended creation of a PE is a continuing and growing concern for foreign enterprises. Therefore, as far as possible, foreign enterprises should arrange their affairs in India in a manner that their activities do not create a PE in India. However, there may be circumstances where creation of a PE is unavoidable. In such cases, it is advisable to maintain substantive documentation to ensure that only the income arising through such PE gets taxed in India. Besides entering into separate contracts towards onshore and offshore portion of supply

and services, the foreign enterprises must ensure that PE is not instrumental in performance of contracts which are outside its purview (such as offshore supplies and services). It is equally important that each project is dealt independently and taxability arises only in respect of such contract which results into a PE.