

Effective Connected' and 'Attribution'- Are They the Same? A Myth

Attribution of income to a permanent establishment ('PE') and the connection of income with a PE are often used interchangeably. However, these terms may appear similar, though have distinct implications. The attribution of income to a PE is a more advanced concept, involving a deeper level of assessment than merely establishing a connection between income and a PE.

The interconnected nature of activities carried out by the foreign company's head office ('HO') and the PE often blurs the line between what constitutes business profits and what qualifies as passive income. While every income attributable to a PE inherently has some connection with it, the converse is not always true.

This nuanced distinction plays a crucial role in determining the taxability of multinational companies operating across borders. Understanding this difference is key to ensuring compliance with applicable tax laws and mitigating potential litigation on taxation of PE.

Understanding term PE

PE is defined as a fixed place of business through which the business of a foreign company is wholly or partly carried on or through an agent who habitually exercises an authority to conclude contracts or habitually secures orders or customarily maintains stock of goods/merchandise on behalf of a foreign company. In addition, PE may arise from employees working in source country on behalf of the foreign company.

This is where the international tax concepts of PE and profit attribution come into play. These determine the right of a country to tax the business profits earned by the foreign company through a PE in the source country. They lay down the principles and factors to be considered for the constitution of a PE, and the consequent profit attribution methods.

Effective Connection: Meaning and Scope

India's bilateral tax treaties allocate passive income's primary right of taxation to the resident state which provides that such income may also be taxed in source state but at a limited rate of tax. An exception to this allocation right exists where such passive income earned in source state is effectively connected with PE in source state. In such cases, provisions of Article 7 shall apply.

This arises the need to address whether the 'permanent establishment exception' in passive income articles will apply only where such passive income is fully attributable to the PE and hence taxable in the source state.

Placing reliance on the judicial precedents, 'effectively connected' is not merely the opposite of 'legally connected'; it connotes a real and substantive nexus between the PE and the assimilated passive income. Cosmetic staffing or fleeting site visits cannot suffice.

Effective connection pertains to the degree to which a foreign company's income is directly or indirectly linked to its PE. For income to be construed as effectively connected, the PE must play a significant role in generating, facilitating, or holding the asset from which the income arises. This becomes pertinent when a foreign company earns passive income such as royalties, interest or fees for technical services ('FTS'), in a jurisdiction where it also maintains a PE.

Further, India acknowledges the aforesaid concept under its domestic tax laws through section 44DA of the Income-tax Act, 1961 ('Act' or 'ITL'). Under this provision, passive income such as royalties or FTS earned from India and that income is effectively connected with a Indian PE or fixed place of profession, the income shall be taxed on a net profit basis under the head 'Profits and gains of business or profession', allowing only those expenses that are wholly and exclusively incurred for the PE while disallowing the HO allocations.

'Business Connection' concept under ITL

ITL provides for the concept of a 'business connection'. A foreign company is required to pay taxes in India on income received or deemed to have been received in India, or on income that accrues or is deemed to accrue or arise through a 'business connection' in India. ITL provides for an inclusive definition of 'business connection' and include business activity carried out by a person on behalf of a foreign company, where the person:

has the authority to conclude contracts on behalf of the foreign company and exercises this authority.

OR

habitually maintains a stock of goods in India and regularly delivers these on behalf of foreign company.

OR

habitually secures orders for the foreign company or its group companies in India.

Where a foreign company establishes a business connection, profit attribution is only permissible on part of its income that is 'reasonably attributable' to its operations in India. In order to determine the appropriate level of profits to be attributed, a methodology for attribution of profit has been provided in the Income-tax Rules. Further, Indian judiciary (in case like Hyatt International Southwest Asia Ltd., Hyundai Heavy Industries Co. Ltd, and Galileo International Inc.)¹ have repeatedly supported application of Arm's Length Price ('ALP') for attribution of profits which should be based on substance and economic reality of functions, risks, and assets deployed locally.

Attribution of Profits: Meaning and Scope

The attribution of profits arises when a foreign company constitutes PE under Article 5 of DTAA. Once established, the PE's profits are treated as 'Business Profits' under Article 7, which stipulates,

"The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in that 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"

The aforesaid framework lays the foundation for determining the quantum of income that rightfully belongs to the PE. In order to formulate a definite methodology for attribution of profits to a PE, the OECD provided the 'Authorised OECD Approach' ('AOA') on July 22, 2010. The AOA was based on the 'separate entity approach', where PE is recognised as hypothetically being a separate and independent entity vis à vis its HO and laid a two-step approach for determination of profits attributable to PE:

- ✓ Step 1: A functional and factual analysis of the PE, aligned with a Functions, Assets and Risks Analysis ('FAR Analysis'), as recommended in TP guidelines
- ✓ Step 2: A comparability analysis to determine the appropriate arm's length remuneration for the PE's transactions, based on the FAR analysis

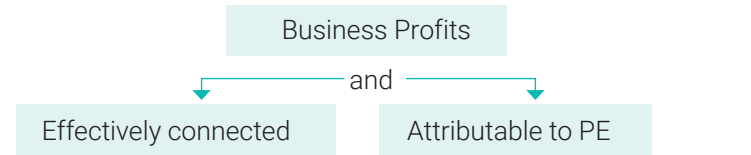
Regardless of PE's classification (fixed place, service, or agency) profits attributable must be determined on an arm's length footing. Indian jurisprudence has repeatedly affirmed the indispensability of a transfer pricing analysis while attributing profits. Accordingly, a PE's factual and functional aspects are essential for evaluation of profit attribution, and these must be embodied in its profit attribution study, sustaining the foreign company's position, should the need arise.

Interplay between effective connection and attribution

Under the Indian tax laws read with the bilateral tax treaties, passive income earned w.r.t. royalties, interest and FTS are taxable as business profits only where the two limbed gateway is crossed:

Firstly, there must be a clear connection between the income earned and the PE, establishing that income is effectively linked to PE's operations, that gives the income its economic situs in India.

Secondly, having established nexus, only the slice of income that could be traced, through a proper attribution analysis to the functions performed, assets employed, and risks assumed by PE is taxable on a net basis. The balance, representing services performed entirely outside India, escaped Indian tax notwithstanding the effective connection. Only when both these conditions are satisfied, the passive income can be accurately attributable to the PE and taxed as business profits.



The Indian Judiciary have interpreted the words 'effectively connected' and 'attributable to' differently, even if offshore services were connected. They have consistently drawn a sharp distinction between the two tests and held while offshore services (preparation of design, basic engineering services, etc.)

¹ *Hyatt International Southwest Asia Ltd. vs. Additional Director of Income-tax [2025] 176 taxmann.com 783 (SC)*, *Commissioner of Income-tax, Meerut vs. Hyundai Heavy Industries Co. Ltd. [2007] 161 Taxman 191 (SC)*, *Galileo International Inc. vs. Deputy Commissioner of Income-tax, Non-Resident Circle, New Delhi [2009] 116 ITD 1 (Delhi)*.

were carried out abroad, may be effectively connected because PE facilitates such income, however, only that portion of the consideration that is directly or indirectly attributable to PE's economically significant functions within India can be brought to tax .

Several judicial precedents reinforce this principle. In instances where FTS was effectively connected, the tribunals limited India's taxing rights to the portion truly attributable to PE. Accordingly, the 'permanent establishment exception' embedded in passive income articles operates to the extent of income that can be attributed to PE, not to FTS or royalty as a whole.

Below we have highlighted some judicial precedents to understand the intricacies of effectively connected and attributable profits in a detailed manner:

***Ishikawajma-Harima Heavy industries Ltd. V Director of Income tax*²**

Facts: The Ishikawajma-Harima Heavy Industries Ltd. a company incorporated in Japan entered into contract with Petronet LNG Ltd., India for setting up a Liquefied Natural Gas receiving storage and degasification facility in India. The contract includes offshore services along with supply and onshore activities.

Issue: Whether the income from offshore supply and services earned by assessee was effectively connected and attributable to the PE and taxed as business profits in India.

Held: The supreme court held that the term 'effectively connected' and 'attributed to' are to be construed differently even if offshore services are connected to the PE and outlined if the offshore services rendered outside India and have nothing to do with PE it cannot be said to attributable to PE and will not be taxable in India.

²*Ishikawajma-Harima Heavy Industries Ltd. vs. Director of Income-tax [2007] 158 Taxman 259 (SC).*

³*Nippon Kaiji Kyokoi vs. Income-tax Officer, International Taxation, Ward-3(1) [2011] 12 taxmann.com 477 (Mumbai).*

***Nippon Kaiji Kyokoi vs Income-tax officers*³**

Facts: Nippon Kaiji Kyokai ('NKK'), a Japanese classification society, provides marine-inspection and certification services worldwide. Where an NKK surveyor is unavailable, the PE hired independent 'acting surveyors'; the head office raises invoices on foreign clients, retains 45 per cent of the fee and remits the balance to the acting surveyor.

Issue: Whether the portion of FTS retained by HO was effectively connected to PE and if so, attributable to that PE or taxable on a gross basis under Art. 12(2) of DTAA.

Held: PE directed, supervised and bore costs for acting surveyors Therefore, fees were effectively connected under Art. 12(5). Only profits attributable to the PE's Indian functions were taxable. Tribunal capped this at 10 % of gross receipts as business profits under Article 7; balance escaped Indian tax. Once effective connection is established, Art. 12(2) is displaced.

Conclusion

The Indian judiciary's fidelity to the principle "ut res magis valeat quam pereat", i.e., to make a legal provision workable rather than redundant, ensures that 'effectively connected' and 'attributable' remain reinforceable not redundant. The income must be directly generated from the activities carried out by the PE, and the nexus must be sufficiently material to justify attribution. Thus, the degree of connection is crucial, and income may not be attributable if the connection is too remote or incidental. Each condition must be evaluated independently. This twostep evaluation embodies sophisticated cross border tax planning and a potent shield against litigation.