RECENT DEVELOPMENT ON PERMANENT ESTABLISHMENT

BY ADVOCATE DIVESH CHAWLA AND ADVOCATE MANISH KANTH

BACKGROUND - PERMANENT ESTABLISHMENT (PE) CONCEPTS

- Article 7 ► "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."
- Article 5(1) ► "… the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on."
- Article 5(2) ► "The term 'permanent establishment' includes especially"
- Article 5(3) ► "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."
- Article 5(4) ► Exemption for specific activities (e.g., storage, display or delivery of goods) and activities that are preparatory or auxiliary in nature.

BACKGROUND - PERMANENT ESTABLISHMENT (PE) CONCEPTS

- Article 5(5) ► "Where a person, other than an independent agent, has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, the enterprise is deemed to have a permanent establishment in that State."
- Article 5(6) ►" Not 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 person are acting in the ordinary course of the business'.
- Article 5(7) ►"resident of the contracting states controls or is controlled by a company which is a resident of the contracting state, or which carries on business in that other state(whether through a permanent establishment or other state (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the order"

‘BUSINESS CONNECTION’ CONCEPT UNDER INDIAN TAX LAWS

- A foreign company needs 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
- Explanation 2 provides for inclusive definition of ‘business connection’ and include any business activity carried out by a person on behalf of a foreign company, where the person

  A) has the authority to conclude contracts on behalf of the foreign company and exercises this authority, or

  B) habitually maintains a stock of goods in India and regularly delivers these on behalf of the foreign company, or

  C) habitually secures orders for the foreign company or its group companies in India.
- The activities mentioned above are undertaken by an independent agent of a foreign company in India, in the ordinary course of its business, the agent may not be its Business connection in India. Certain other exclusions have been made, e.g., for sourcing activities, where the operations of the foreign company are restricted to purchase of goods in India for the purpose of export, its activities including collection of news and views in India for transmission out of the country, and so on.

MASTERCARD ASIA PACIFIC PTE. LTD. SINGAPORE

AAR, NEW DELHI – 6 JUNE 2018

[2018] 94 TAXMANN.COM 195

FACTS

- The Applicant (MCAPPL) belongs to the MasterCard group and is a wholly owned indirect subsidiary of Delaware incorporated MasterCard group company i.e., MasterCard International Incorporated (MCI)
- The Applicant is situated in and is a tax resident of Singapore
- It is the regional headquarter for the Asia Pacific, Middle East and Africa region (APMEA) and carries out the MasterCard group's principal business of **transaction processing** and payment related services
- The MasterCard Business is structured in a manner, in which the cardholder and merchant relationships are managed principally by the Applicant's customers which are primarily banks and financial institutions ('Customers')
- The Applicant itself does not issue cards, extend credit to cardholders, set cardholder fees or determine interest rates or fees charged to cardholders using MasterCard products
- The transaction processing services are provided by charging various fees pursuant to the Master License Agreements (MLA), which the applicant signs with every customer in APMEA region (which includes India)

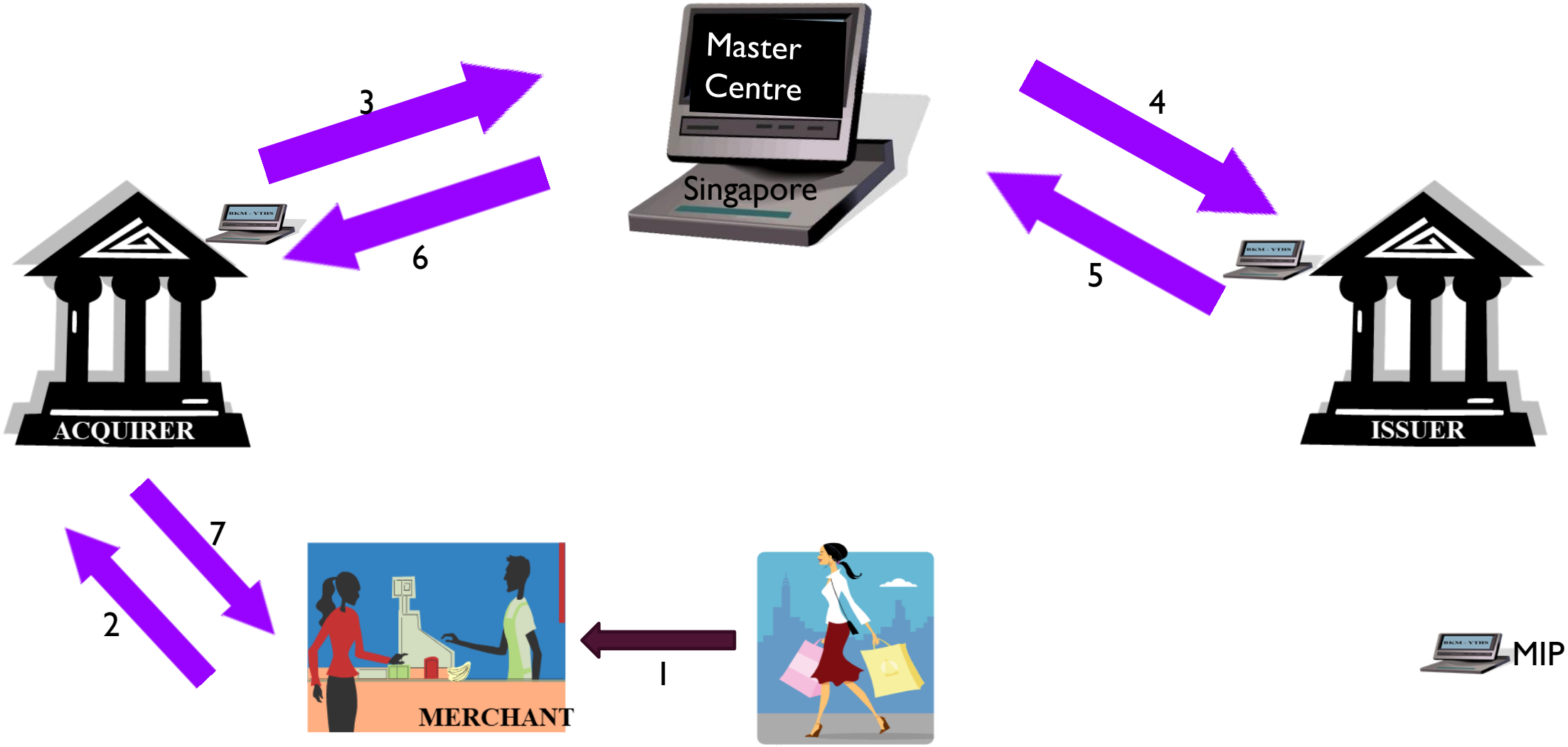
TRANSACTION PROCESSING SERVICE / ACTIVITY

- Transaction processing activity consists of electronic processing of payments between bank of merchants (Acquirer) and banks of cardholders (Issuer) through the use of MasterCard worldwide network (Network)
- The network facilitates various steps involved in processing of any transaction in various steps on a proprietary global payment system
- Various steps involved in such transaction processing activity are authorisation, clearing and settlement
- Consequent to the terms of the MLA, the Applicant charges its Customers transaction processing fees relating to authorization, clearing and settlement of transactions, in addition to various other fees
- A typical transaction processed over the Network involves four entities in addition to MasterCard:
  - Cardholder,
  - Merchant
  - Issuer (the cardholder's bank) and
  - Acquirers (the merchant's bank)

TRANSACTION PROCESSING SERVICE / ACTIVITY

- The processing activity as per the applicant happens significantly through MasterCard's processing centre which are all located outside India in USA, Belgium and Singapore
- The relevant Singapore located processing centre is owned by the Applicant
- The Customer in India has been provided with a **MasterCard Interface Processor (MIP)** that connects MasterCard's network and processing centre with the customer
- Applicant also has a subsidiary in India i.e. MasterCard India Services Private Limited
- MIPs as per the applicant were owned and maintained by MISPL (Indian subsidiary)
- MIP is placed at the customers locations in India
- Till December 2014, MasterCard International Incorporated (MCI) had a LO in India. Thereafter, the applicant had shut down the LO and had transferred that work to the Indian subsidiary (MISPL)

TRANSACTION FLOW



ISSUE BEFORE THE AAR

1. Whether the Applicant has a PE in India u/Article 5 of India – Singapore DTAA in respect of the services to be rendered with regard to use of a global network and infrastructure to process card payment transactions for customers in India?
2. Without prejudice to the above, whether arm's length remuneration to the Indian subsidiary would absolve any further attribution of the global profits of the Applicant in India if a PE of the Applicant (in the form of its Indian subsidiary) is found to exist in India?
3. Whether fees received would be chargeable to tax in India as royalty or FTS?
4. Whether any TDS would be required?

APPLICANT'S ARGUMENT

- Applicant does not have any presence in India
- Applicant does not own or maintain any network or MIPs in India
- No fee is charged for displaying the MasterCard logo since it is incidental to the processing services activity
- Detailed processing of the transaction is undertaken through the MasterCard Processing centres located outside India
- Transaction data is transmitted outside India with the help of MIPs which are owned by India
- MIPs are used for undertaking preliminary validation of information at the point of authorisation which are incidental and auxiliary in nature
- Cost of MIPs is merely a fraction of cost of the processing centre located outside India

MIP – FIXED PLACE PE

- Ownership of MIPs with MISPL is not relevant if other tests are satisfied
- To create PE, three tests of: permanency, a fixed place and disposal has to be passed
- Automatic equipment can also create PE *(Relied on Swiss Server decision quoted by Delhi HC in Formula One judgement)*
- Fixed place does not mean fixed to the ground
- No dispute that MIPs pass the test of permanency
- Preliminary validation activities such as PIN processing, validation of card codes, name and address verification, etc along with encryption and communication of data by MIPs is significant in facilitating the authorisation process. Thus, this is a significant activity for authorisation part of the transaction processing and cannot be said to be preparatory or auxiliary
- Indian subsidiary does not exercise any rights of an owner. All risk mitigation decisions are undertaken by the Applicant or its overseas AEs on its behalf.

MIP – FIXED PLACE PE

- Software in MIPs owned by the Applicant
- The Applicant charges a fee for the cost of installation of MIPs, thus, they are not under the control or disposal of the Indian subsidiary
- All costs related to maintenance and upgradation ultimately gets charged to the Applicant
- No agreement between the Indian subsidiary and customer banks in India
- The Applicant has the right to use MIP and has control over it vis – a – vis the customer bank, thus, the Applicant had the MIP at its disposal
- Thus, MIPs create a fixed PE of the Applicant in India
- Involvement even in one step can create a PE if it is significant
- Distinction of three stages important for profit attribution and not for creation of PE
- Distinguishes Australian favourable ruling in applicant's own case due to difference in treaty wordings

MASTERCARD NETWORK – FIXED PLACE PE

- MasterCard Network is involved in all the three phases of transaction processing:
  - Authorisation
  - Clearance
  - Settlement
- The activity of transmission of information between various banks in India and uploading of raw data and receipt of final data using application software is performed in India
- TP Report of MISPL says that Network includes the MIPs in India
- MasterCard Network in India consists of:
  - MIP owned by MISPL
  - Transmission tower, leased lines, fibre optic cables etc. owned by third party service provider
  - Application software (Master Connect & MasterCard File Express) used for data upload owned by the Applicant

MASTERCARD NETWORK – FIXED PLACE PE

- MasterCard Network is involved in all the three phases of transaction processing:
- Applicant accepted in its application that domestic INR settlement happens in India
- Domestic INR settlements account for more than 90 per cent of the transactions
- The Network is at the disposal of the Applicant since it is owned and controlled by the Applicant
- Follows Delhi ITAT ruling in case of Galileo and Amadeus
- MIPs doing more in India than CRS in Galileo
- Revenue generating activity happening in India
- Thus, the Network is fixed place PE

THE ROLE OF THE BANK OF INDIA PREMISES – FIXED PLACE PE

- Actual settlement by passing debit or credit entry is done by Bank of India (BOI)
- This settlement activity is the function of the Applicant, which is carried out by BOI on its behalf and with all responsibility of error on the Applicant
- BOI though not a dependent agent but still is an agent of the Applicant
- Remuneration of only USD 1500 cannot determine significance of the activity
- Interest free money at the disposal of BOI is sufficient remuneration for BOI
- It is not a P2P transaction as the liability is always of the Applicant and employees of BOI to carry out their work according to the instruction given by the Applicant.
- Thus, the employees of BOI carrying out this work are under control and supervision of the Applicant and the space occupied by them in BOI is at the disposal of the Applicant
- Thus, BOI premise constitutes fixed place PE of the Applicant

SUBSIDIARY PE

- MCI had liaison office till December 2014
- MCA filed return and disclosed income at full 100% attribution for 10 years with global net profit rate of 50%
- Applicant's reliance on Efunds SC judgement to say that aforesaid returns were pursuant to MAP and to buy peace of mind were not accepted
- AAR notes that only one year was accepted in MAP and remaining years were voluntary by MCA
- There are some functions and risk related to transaction processing which were earlier carried out by MCI in India and are still carried out by MISPL
- Morgan Stanley distinguished as FAR not properly reflected in MISPL's case as it was shown to be only providing support services
- Therefore, the subsidiary company creates a PE of the Applicant in India.

SERVICE PE

- Through employees visiting for more than 90 days in India
  - The employees of the Applicant visit India for understanding the future requirement, informing new products and to monitor the efficiency of the operation and not in connection with the signing of the contracts.
  - The threshold of 90 days in a fiscal year was also met
  - The clients of the Applicant were located in India
  - Even in an automated process, employees are needed to check if the process is working alright, to interact with clients, etc. These are part of the service rendered to clients in India and are not stewardship activities

- The employees of BOI do not constitute a service PE of the Applicant

AGENCY PE

- MISPL works only for the Applicant
- MISPL is legally and economically dependent on the Applicant and gets its instructions and remuneration from the Applicant
- MISPL provides the proposals to the Indian banks that are prepared, validated and approved by the Applicant.
- This process clearly establishes that orders or agreements are routed through MISPL though the finalization of the contract is by the Applicant in Singapore
- The above position may not satisfy the requirement of "concluding contract" but it certainly satisfies the requirement of "securing order" as used in Article 5(8)(c) of the India – Singapore DTAA
- Follows Delhi ITAT ruling in Rolls Royce and holds that treaty wording similar are similar
- Thus, MISPL constitutes a Dependent Agent PE

ATTRIBUTION AND OTHER ISSUES

- FAR disclosed by MAIPL does not reflect the functions/risks of the applicant correctly
- Therefore, ALP payment by the applicant to MAIPL – the Indian subsidiary would not absolve the applicant from any further attribution of its global profits
- Entire revenues from India not to be attributed to PE in India as significant activities are also carried outside India
- A part of fees received by the applicant was also held to be royalty under Article 12 of DTAA on account of use of equipment (MIP) and use of software
- Taxable under Article 7 as the same is effectively connected to PE
- Part of fees not royalty cannot be FTS but taxable as business income

M/S NOKIA NETWORKS OY V JT. COMMISSIONER OF INCOME TAX, NEW DELHI

ITAT, SPECIAL BENCH, NEW DELHI 94 TAXMANN.COM 111

5 JUNE 2018

FACTS

- Assessee – Nokia Networks OY incorporated in Finland
- Nokia is engaged in manufacturing of advanced telecommunication systems and equipment (GSM Equipment) which are used in fixed and mobile telephone networks. It also traded in telecommunication of hardware and software.
- 30.03.1994 – Nokia established an LO
- ➢ The GSM equipment manufactured in Finland was sold to Indian Telecom operators from outside India on P2P bases under independent buyer-seller agreements as well as contracts for installation were entered.
- 23.05.1995 – Wholly owned subsidiary incorporated and named as Nokia India Pvt. Ltd. (NIPL)
- ➢ While the sale was directly carried on, the installation activities were now carried out by NIPL under its independent contract with the Indian Telecom operators.
- ➢ 2 Agreements (Modi Telstra and Skycell Communication) were signed prior to the incorporation of NIPL. These contracts were subsequently assigned to NIPL.
- For AY 1997-98, the Assessee did not file its return of income in India. Subsequently, the assessee filed a return in response to the notice issued under section 142(1) of the Income-tax Act, 1961 (Act). In the return of income, it did not offer any income taxable in India on the basis that it did not have a Permanent Establishment (PE) in India under the India-Finland tax treaty. It also claimed that there was no business connection in India as goods were sold outside India to the customers on a principle-to-principle basis.

AGREEMENT

1) Supply contracts directly between the Assessee and the Customer.
2) Installation Contract between NIPL and the Customer, directly. (2 Contracts were assigned to NIPL)
3) Marketing Support Agreement between the assessee and NIPL. NIPL was compensated at cost plus 5%.
4) Technical Support Agreement between NIPL and the customer.

CASE HISTORY

- **Assessment Order**

- Both the LO and NIPL were held to constitute a PE of Assessee in India. 'Installation PE' was also constituted on the basis that the assessee had supported NIPL in discharging its obligation under the installation contracts.
- LO was treated as Fixed place PE, NIPL was treated as DAPE. They both have business connection in India.
- The Assessing Officer [AO] attributed 70% of the total revenue to sale of hardware and the remaining 30% towards supply of software, and taxed it as royalty. Out of the 70% of the revenue attributed to sale of hardware, the AO determined 40% as the income from supply of hardware and attributed 30% of such profits to the PE.
- The AO also taxed notional interest from vendor financing and delayed payment as per the specific clause in the offshore supply contract.
- Accordingly, additions in relation to the following incomes were made by the AO: ☐ Profit on sale of hardware; ☐ Profit on licensing of software; and ☐ Notional Interest

CASE HISTORY

- CIT(A)
- The contract of supply was not merely to supply the equipment but also to install and provide related services.
- Nokia has its presence in India in the form of the liaison office and NIPL.
- India specific profit and loss statement that was audited to be rejected as no supporting document.
- First Round - Special Bench
- Liaison office neither constituted a Business Connection under the Act nor a PE of Nokia under Article 5 of the Treaty.
- Sale of Hardware took place outside India and no income from sale of hardware accrued to Nokia in India.
- Nokia has a PE in India in the form of NIPL, on the basis that Nokia virtually projected itself in India through NIPL and MR. Jann Karavitra (Country Manager of the LO and Managing Director of the NIPL).
- The guarantee to customers - Not to dilute its shareholding in NIPL below 51% without written permission.
- NIPL a wholly owned subsidiary, the Assessee would have direct and complete control over the activities.
- NIPL could be considered PE of the Assessee in India being subsidiary as it is the virtual projection of the company in India.
- Payment for supply of software was not in the nature of "Royalty"

CASE HISTORY

- **High Court- Assessee and Revenue appeal.**
  - Decided in favour of the Assessee that the LO did not constitute a PE in India, nor did it have any business connection in India. ☐ The income from supply of software could not be treated as royalty.
  - Mistake in the order
  - Whether NIPL constitutes a PE- Assessee specifically points out the factual errors in the orders.
  - Facts considered in the case of Ericsson Case (other Assessee before the Special Bench) and the facts were held to be common. The relevant incorrect facts are as under:

1. NIPL was executing contracts on behalf of the Assessee through its employee.
2. From 1996 onwards all the expenses of Indian office were shifted to the Indian Subsidiary.
3. The employees of the Indian office were responsible for the execution of the contracts with operators.
4. No compensation was paid to LO for marketing and support services prior to 1997.

  - NIPL was incurring huge loss, and the transaction was not arm's length – Concede by the Revenue
  - NIPL was executing contracts on behalf of the Assessee through its employees- contracts were signed in India.
  - NIPL signed certificate of acceptance on behalf of the Assessee.
  - Whether NIPL constitutes a PE was remanded back by the High Court.

ISSUES

- The Special Bench, while analyzing the scope of adjudication of grounds remanded back by the High Court, identified that in relation to this issue, four contracts have been referred to by the lower authorities. The following issues were remanded back:
  - Whether the Indian subsidiary of the assessee would provide business connection or a permanent establishment in India
  - Even if so, then is there any attributes of profits on account of signing, networking planning and negotiation of off-shore contract supply in India and if yes then to what extent and basis thereof
  - The question of notional interest on delayed consideration received for supply of equipment and software, is taxable in the hands of the assessee as interest from vendor financing.

ISSUE SETTLED BY STILL DECIDED

- The erstwhile Special Bench has held that so far as the LO is concerned, it neither provided any business connection nor constituted a PE of assessee in India, which matter as reiterated above has attained finality from the stage of the Hon'ble High Court
- Accordingly, the Tribunal proceeded with the adjudication of the fixed place PE *qua* NIPL. In para (1) of Article 5, one of the crucial terms used is *'fixed place of business* ***through*** *which the business of an* ***enterprise is wholly or partly carried on***'

FIXED PLACE PE- "THROUGH"

- Fixed place of business *through* which the business of an enterprise is wholly or partly carried on.
- The Word through assumes a great significance, because it enlarges the scope of a fixed place, in as much as, where no fixed premises may belong to an enterprise, but even if a particular space is made available *at its disposal* then such place is reckoned to be place of business.

FIXED PLACE PE - "AT THE DISPOSAL"

- **At the disposal** of the enterprise means when the enterprise has the **right to use the said place and the control** thereupon
- The key sequitur and proposition which is culled out from the judgment of the Hon'ble Supreme Court is that;
  - *firstly*, the fix place should be where the commercial and economic activity of the enterprise is carried out;
  - *secondly,* such a fix place acts as a virtual projection of the foreign enterprise;
  - *thirdly*, PE must have three characteristics, stability productivity and dependence; and
  - *lastly*, fixed place of the business must be at the disposal of the foreign enterprise through which it conducts business
- The decision of the Andhra Pradesh High Court in the Case of Vishakhapatnam port Trust 144 ITR 146

FIXED PLACE PE - "AT THE DISPOSAL" - FACTS

- Telephone or fax or a car cannot be reckoned as physically located premise
- A fixed place alludes to some kind of a particular location, physically located premise or someplace in physical form.
- Nowhere is it borne out that any kind of physically located premise or a particular location was made available to the assessee which was at the disposal of the assessee for carrying out wholly or partly its business through that place.
- Even the co-location of earlier LO office and NIPL was only in the initial year of 1995, and later on, LO office has moved out which is also evident from the statement of the Managing Director.
- Thus, providing such kind of administrative support services to the assessee' s employees visiting India will not form fixed place PE.
- The "force of attraction rule" is not applicable – Separate agreements for marketing and technical support that would not correlate with the supply contract.

FIXED PLACE PE- "AT THE DISPOSAL"- FACTS

- The High Court has accepted that after incorporation of NIPL, the assessee has not carried out any other activity other than **offshore supply**, and therefore any activity performed by NIPL under the independent contract cannot be reckoned to constitute a PE. Further, the assessee has not performed any activity under the independent contract of NIPL and its customers, from which it has received or accrued any income in India or through an asset in India. NIPL entered into installation contract directly with the customer (although guarantee was given by the assessee), the income from which was offered to tax in its hands
- Regarding the allegation that expatriates employees of assessee in India were assisting the NIPL and hence used the office of NIPL, is of no relevance *qua* assessee' s business, because, the **technical expatriates** were in India to **assist/help NIPL** with performance of **installation activities of NIPL** and **not** to **carry out the business of the assessee which was manufacturing and sale of network equipment**
- The Tribunal has held that even otherwise the **activities carried out by employees of the assessee** travelling to India, i.e., network planning, negotiation and signing of contracts are in the **nature of preparatory and auxiliary** and thus there could **not be any fixed place PE** as there is a specific exclusion for such activities under the tax treaty
- On the contention of the Revenue that the employees of the assessee were seconded to NIPL and thus it constitutes a PE, it was held that these facts may be relevant while analyzing service PE; however, there is no concept of service PE in the tax treaty

DEPENDENT AGENT PE

- Under a DAPE the character of the agent can be said to be determined;
  - *firstly*, his **commercial activities** for the enterprise is **subject to instruction or comprehensive control**; and
  - *secondly*, he does **not bear the entrepreneurial risk**
- NIPL neither has any authority to conclude contracts for supply nor any of the orders has been booked by NIPL which can be said to be binding upon the assessee
- NIPL is an independent entity carrying out activities of installation, technical support services for the equipment installed are being carried out on P2P basis independently with Indian customers; and marketing support agreement is an independent agreement with the assessee for which it is remunerated at arm's length and none of its activities even remotely relate to supply of equipment, leave alone habitually exercising any authority to conclude contract
- NIPL bears its own entrepreneurial risks
- On the Revenue's contention that the assessee has given guarantee to Indian customers that it will get the installation contracts executed by NIPL, it is observed that such guarantee has no significance for determination of agency PE; because such contention may be relevant in a situation of composite contract which is absent in the present case

AGENT OF INDEPENDENT STATUS

- Paragraph 7 of Article 5 deals with **'agent of independent status'**
- Independence of an agent has to be both legal as well as economic independence
- **Legal independence** has to be seen from the context, whether the agent's commercial activities for his principal are subject to **detailed instructions or comprehensive control by the principal or not**; or to what extent the agent exercises **freedom in the conduct of his business** on behalf of principal; or the agent's **scope of authority** is affected by limitations on the scale of business which may be conducted by the agent
- **Economic independence** has to be seen from the context as to what extent the agent bears the **'entrepreneurial risk" or "business risk"** and agent's **activities are not integrated** with those of the principal; and whether the **agent acts exclusively** for the principal. The tests for determining the independent status has to be seen from what kind of activities is being carried out by the agent for his principal

OTHER FORMS OF PE

- **Article 5(4)** excludes any activities solely for preparatory or auxiliary in nature.

Singing, network planning and negotiation falls within the scope and realm of preparatory or auxiliary, and negotiation or networking before supply of goods are preliminary activities

- **Article 5(8)** merely because a non-resident controls a company, itself will not constitute a PE.

A subsidiary cannot constitute a PE merely because the foreign enterprises control it. For the purpose of taxation, a subsidiary company constitutes an independent legal entity in the source state.

- **VIRTUAL PROJECTION**

The concept of virtual projection cannot be in vacuum dehors any other parameters of PE. In other words, virtual projection is in relation to either fixed place or in relation to any other parameters or conditions envisaged in Article 5.

The concept of virtual projection does not mean that even without a fixed place, virtual projection itself will lead to an inference of a PE.

If on facts there is no establishment of a fixed place and disposal test is not satisfied, then virtual projection itself cannot be held to be a factor for creation of a PE. Thus, the concept of virtual projection brought in by the AO will not lead to any kind of establishment of PE.

BUSINESS CONNECTION

- In the context of LO, the High Court has decided that there is no material or evidence on the basis of which it can be said that LO is a business connection of the Assessee in India and it does not constitute PE of the Assessee in India.
- Similarly, in relation to supply of offshore equipment, which has been done outside India, the High Court has decided that such activity cannot be held to be taxable in India.
- The Tribunal accordingly held that these principles would mutatis mutandis apply to NIPL as well, as there is no material change in the facts.
- The bench place reliance on the Supreme Court decision in Ishikawajima Harima Heavy Industries Ltd v/s DIT _____ & Delhi High Court decision in the case of Nortel Network India International Inc v/s DIT 386 ITR 353(Del)

DISSENT

- When a subsidiary company is merely an ***alter ego***, or virtual projection, of its parent company, in the sense that it has no significant activities of its own or on behalf of persons other than the non-resident parent company, it must be treated as a permanent establishment of the non-resident parent company for that reason alone. (Based on the ruling in ABC *In Re* (Application No. P- 8) [(1997) 223 ITR 416 (AAR)])

DISSENT- REASONS

- The High Court has merely setaside to decided the issue –confided with the facts of the case of the assessee.
- The Assessee has provided guarantee to the Indian Customer on services to be provided by the NIPL.
- The Assessee would not reduce the shareholding below 51% until the technical support agreement remains outstanding.
- NIPL is a PE of the Assessee company under the **basic rule on interdependence and interplay of activities.**
- The Foreign Company has direct and complete control over the activities of the subsidiary.
- NIPL less than one year in existence – when the marketing support agreement was signed all the expertise's with the expatriates employees of the Assessee.
- Mr Hannu was part of both the companies (Assessee and NIPL)
- The Marketing and Technical support agreements are more a device to artificially block creation of PE.
- The commercial arrangement between NIPL and assessee in the normal course of the business between two independent enterprises.
- Role played by the Assessee company in ensuring business for its subsidiary and the role played by the subsidiary in furtherance of the business interests of the assessee company.
- All contracts of Installation was awarded to NIPL
- Assessee played the decisive role in deciding as to who should be awarded the erection contract.

DISSENTING MEMBER'S OPINION ON DAPE

- There is not even whisper of a reasoning in support of any of the ingredient of the DAPE under article 5(5). The existence of a DAPE, under Article 5(5), comes into play when a person "**has, and habitually exercises in that state (i.e. India, in this case), an authority to conclude contracts in the name of the enterprise (i.e. the assessee company)**" in certain circumstances, **or** when such a person "**has no such authority but habitually maintains in the first mentioned state (i.e. India, in this case) a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of that enterprise (i.e. the assessee company)**"
- No case has been made out for satisfaction of these conditions, and, therefore, it is not even case of the Assessing Officer, in terms of the legal connotations of 'dependent agent permanent establishment", that the Indian subsidiary constituted PE of the assessee company

DISSENTING MEMBER'S OPINION ON ARTICLE 5(8)

- There is no bar on the subsidiary of a foreign company being treated as a PE of the parent company, mere existence of the subsidiary of a company resident in the treaty partner country would not imply that such a foreign enterprise has a PE in India
- The underlying rationale of Article 5(8) is the presumption about independence of the principal and subsidiary in day to day operations and management of their business as separate entities but once this presumption is demolished, the very *raison d'etre* for exclusion of subsidiaries from being permanent establishments of the overseas parent companies and *vice versa* ceases to hold good

DAIKIN INDUSTRIES LTD.

ITAT, NEW DELHI – 28 MAY 2018

[2018] 94 TAXMANN.COM 299

FACTS

- DIL (the assessee) is a company incorporated and tax resident of Japan
- Engaged in the development, manufacturing, assembly and supply of air conditioning and refrigeration equipment's
- DIL has a wholly owned subsidiary in India i.e. DAIPL
- During AY 2006-07, DIL sold ACs worth INR 55.15 cr to DAIPL
- In addition it claimed to have made direct sales worth INR 45.40 crore to third parties in India
- AO during assessment held DAIPL to be dependent agent of DIL in India and also attributed some income
- AO on the basis of information obtained observed that price charged from direct sales was higher than what was charged from DAIPL for the same product
- DIL also paid commission to DAIPL @10% for rendering marketing services in connection with direct sales

ISSUES INVOLVED

1. Whether the DAIPL constitutes the Dependent Agent PE of DIL in India?
2. Whether arm's length payment to the PE will not require any further attribution of income to PE in India?
3. Attribution of income

DEPENDENT AGENT PE

- The provision of services as per the Commission agreement says DAIPL's role was only to act as a communication channel for forwarding of customer's requests to DIL, and quotation and contractual proposals to the customer
- AO sought details as who identifies customers, approaches them, make presentations / demonstrations, negotiates and finalises the price in respect of direct sales
- Assessee submitted that details are not traceable
- AO further asked for email correspondences with its customers in India but assessee failed to furnish the same
- Assessee's claim of direct sales to institutional customers also found to be incorrect as several sales were for less than INR 25,000
- DAIPL on the other hand was found to have heavy selling and distribution expenses of INR 14.38 crore
- Not a case of assessee dealing with single customer
- Some emails the assessee and DAIPL were filed which as per the ITAT shows price negotiation by DAIPL

DEPENDENT AGENT PE

- Held in absence of any evidence by the assessee – the inescapable conclusion which follows is that the entire activities were done by DAIPL in India for both direct sales and sales through DAIPL
- Therefore, DAIPL was held to be negotiating and finalising the sale claimed to have been made by the assessee from Japan
- The fact of signing of contracts by the assessee in Tribunal's view does not alter the position and DAIPL was held to be habitually exercising authority in India to conclude contracts and therefore DAPE under Article 5(7)(a) of the India – Japan DTAA
- It further held that DAIPL also constitutes DAPE of DIL under Article 5(7)(c) of DTAA as DAIPL was securing orders in India almost wholly for the assessee

ATTRIBUTION

- Holds that Morgan Stanley judgement of the Supreme Court is not applicable as no TP analysis undertaken by the assessee
- TPO in case of DAIPL has accepted the FAR as disclosed by the Indian subsidiary
- DAIPL carried out whole range of services including negotiating and finalising contracts not reflected in its TP study
- Holds that the Supreme Court itself in Morgan Stanley judgement has carved out the need for further attribution to PE for FAR that has not been considered
- Profit @ 10% rate is estimated and applied to the revenue from direct sales under Rule 10
- Further, 30 % of the estimated profit is held to be attributable to the activities of PE in India
- In addition, the net commission income earned by DAIPL from DIL was also directed to be deducted in computing the additional income taxable in India in the hands of DIL

FRS HOTEL GROUP (LUX) S.A.R.L. (NOW FRHI HOTELS AND RESORTS S.A.R.L.)

AAR, NEW DELHI 94 TAXMANN.COM 23

24 MAY 2018

FACTS

- Applicant - FRS Hotel Group (Lux) S.a.r.l. (Now FRHI Hotels and Resorts S.a.r.l.) – incorporated under the laws of Duchy of Luxembourg - Principal Operator - FRHI Group outside North America
- The Applicant provides service in connection with hotel management and includes:
  - Establishing hotel standards and policies
  - Sales and Marketing
  - Centralised reservations
  - Purchasing
  - Other services as per the operational requirements of the hotel owners to meet the hotel brand requirements
- M/s. Bengal Ambuja Housing Development Limited (BAHDL), developed and owned a 5 Star deluxe hotel (Swissotel Kolkata in Kolkata) and engaged the Applicant to provide certain services in different phases of hotel development and operation of Swissotel Kolkata.

FACTS

- The Applicant and BAHDL entered into a Centralized Services Agreement (CSA) on 1 September, 2009 under which the Applicant has agreed to provide BAHDL with the following services in relation to Swissotel Kolkata:
  - (a) Global Reservation Services – to facilitate reservation / booking of rooms, banquets etc. in Indian hotel property;
  - (b) Centralized Services – miscellaneous support services as required by the Indian hotel owner at its option, including but not limited to global sales & marketing, finance support, human resources support, operations support, and technology support;
  - (c) Corporate Design & Construction services – for providing advisory services in connection with any capital improvements proposed by the Indian Hotel owner in relation to the hotel property, including refurbishing, maintenance, repairs or other capital improvements etc.; and
  - (d) Purchasing services –Assistance in purchases of goods, supplies and services as required by the Indian Hotel owner in relation to operation of the Indian hotel commensurate with the brand of the Hotel
- Other four agreements form part of the record for the purpose of this Ruling:
  - Hotel Management Agreement ("HMA")
  - Hotel License Agreement ("HLA")
  - Hotel Advisory Agreement ("HAA")
  - Technical Services Agreement ("TSA")

ISSUE

- Whether on the facts and circumstances of the case, payments received by the Applicant from the Indian hotel owner for provision of global reservation services ("GRS") would be chargeable to tax in India as "Fees for Technical Services" or "Royalty" under the provisions of section 9(1)(vi) / 9(1)(vii) of the Income Tax Act, 1961 ("the Act") read with provisions of Article 12 of the Double Taxation Avoidance Agreement between India and Luxembourg?

RULING – EXISTENCE OF A FIXED PLACE AND AT THE DISPOSAL

- The Hotel is entirely at the disposal of the Applicant.

Prior Construction

- At the very stage of inception, i.e. the **construction of the Hot**el, the **Applicant** is called upon to **oversee the design and construction** of the property to ensure that it is compliant with the brand standards of the Applicant.
- BAHDL is to submit progress **reports of construction** to the Applicant, who is to **mark out the deficiencies then as it deems fit**. Such defects are to be rectified by BAHDL in the designated period of three months. (Technical Service Agreement).

Post Construction

- Once the hotel is constructed, its **operation and management rests with the Applicant**. **BAHDL** has undertaken that it will **not interfere** in the **Applicant's exercise of the exclusive authority over such operation and management**. Right from the **employment of the hotel staff** (including the managerial personnel) to taking decisions over **capital improvements**, every possible operational right stands vested in the Applicant.
- The **owner is barred** from even **contacting directly any of the hotel staff**. Furthermore, the **owner has bound** itself to the terms of this agreement for a **period of 10 years** extendable by another **40 years**. (Hotel management agreement)

RULING – EXISTENCE OF A FIXED PLACE AND AT THE DISPOSAL

- Some of the core functions of the operation of the hotel such as **sales and marketing, reservation etc. have also been outsourced to the Applicant.** For providing such services, the hotel owner has undertaken to cooperate with the Applicant to arrange for visas, licenses, authorisations for the Applicant, its consultants, employees etc. to carry out such services at the hotel premises.
- As regards **purchasing services, the Applicant has undertaken to designate a suitable vendor** who would supply goods and services for the operation and management of the hotel. With regard to these services as well, the **Applicant has been given complete autonomy** with no interference from the owner. (Centralized services agreement)
- Three test to determine fixed place PE laid down by the Hon'ble Supreme Court in Formula 1 (394 ITR 80)

1. Existence of A Fixed Place
2. Fixed place at the disposal of the Non-resident
3. The Non-resident Carrying out business (wholly or partly) through Fixed Place

RULING – CARRYING ON BUSINEES WHOLLY OR PARTLY

- The Applicant is admittedly engaged in the business of operation and management of the hotels
- As a result of the agreements, the Applicant has, in substance, taken over all the important functions in relation to the operation and management of the Indian hotel. It is referred to as:
  - "Operator" in the Hotel Management Agreement,
  - "Advisor" in the Centralized Services Agreement and Hotel Advisory Agreement,
  - "Licensor" in the Hotel License Agreement and
  - "Consultant" in Technical Services Agreement.
- The Applicant is performing different functions under different agreements under different names. The fact is that the **Applicant** irrespective of its different nomenclature in different agreements, is engaged in **complete management of its business operations in India**
- It is, therefore, apparent that the Applicant has taken over the operation and management of the Indian hotel by entering into different agreements and has earned income through all of such agreements

RULING- FINAL FINDING

- **Swissotel Kolkata**, satisfies all the three tests and does **constitute a fixed place PE**. The Applicant is carrying on its entire business operations from this fixed place. The existence of a PE of the Applicant in India gets established within the meaning of Article 7 of the DTAA

ACTION 7 – PREVENT THE ARTIFICIAL AVOIDANCE OF PE STATUS

- Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues

NEED FOR BEPS ACTION PLAN 7

- The *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013a) called for a review of the definition of PE **to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition**, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by ***commissionnaire* arrangements**, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country
- Changes to the PE definition are also necessary to **prevent the exploitation of the specific exceptions to the PE** definition currently provided for by **Art. 5(4) of the OECD Model Tax Convention** (2014), an issue which is particularly relevant in the **digital economy**

COMMISSIONNAIRE ARRANGEMENT

- A ***commissionnaire* arrangement** may be loosely defined as an arrangement through which a person **sells products in a State** in its **own name but on behalf of a foreign enterprise that is the owner of these products**
- Through such an arrangement, a **foreign enterprise** is able to **sell its products** in a State **without technically having a permanent establishment** to which such **sales may be attributed for tax purposes** and without, therefore, being taxable in that State on the profits derived from such sales
- Depending on the circumstances, activities **previously considered to be merely preparatory or auxiliary** in nature may **nowadays correspond to core business** activities
- As a **matter of policy**, where the **activities that an intermediary exercises in a country** are **intended to result** in the regular **conclusion of contracts to be performed by a foreign enterprise**, that **enterprise** should be **considered to have a sufficient taxable nexus in that country unless** the **intermediary** is performing these activities in the **course of an independent business**

PROPOSED PARAGRAPH 5 OF ARTICLE 5

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) in the name of the enterprise, or

b) 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

c) for the provision of services by that 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, unless the activities of such person are limited to those mentioned in paragraph 4 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.

CONDITIONS THAT NEED TO BE MET FOR THE APPLICATION OF PARAGRAPH 5

- A person acts in a Contracting State on behalf of an enterprise;
- In doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
- These contracts are either 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

PROPOSED PARAGRAPH 6 OF ARTICLE 5

- 6. a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise
- b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise

ARTIFICIAL AVOIDANCE OF PE STATUS THROUGH THE SPECIFIC ACTIVITY EXEMPTIONS

- **Art. 5(4)** of the OECD Model Tax Convention includes a list of exceptions (the "specific activity exemptions") according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph. BEPS concerns related to Art. 5(4) also arise from what is typically referred to as the "**fragmentation of activities**"
- Given the ease with which **multinational enterprises (MNEs)** may **alter their structures** to obtain **tax advantages**, it is important to clarify that it is **not possible to avoid PE status by fragmenting a cohesive operating business into several small operations** in order to **argue** that each part is merely engaged in **preparatory or auxiliary activities** that benefit from the exceptions of Art. 5(4)

PROPOSED PARAGRAPH 4 OF ARTICLE 5

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery 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, display or delivery;
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;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

PROPOSED PARAGRAPH 4.1 OF ARTICLE 5

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

OTHER STRATEGIES FOR THE ARTIFICIAL AVOIDANCE OF PE STATUS

- The **exception in Art. 5(3),** which applies to construction sites, has given rise to **abuses** through the practice of **splitting-up contracts** between **closely related enterprises**
- The **Principal Purposes Test (PPT) rule** that will be added to the OECD Model Tax Convention as a result of the adoption of the **Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*)1** will address the BEPS concerns related to such abuses

SPLITTING UP OF CONTRACTS

- The **splitting-up of contracts** in order to **abuse the exception in paragraph 3 of Article 5** is discussed in paragraph 18 of the Commentary on Art. 5:

  *"18. … The **twelve month threshold** has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) **divided their contracts up into several parts**, each covering a **period less than twelve months** and **attributed to a different company** which was, however, owned by the same group."*

STRATEGIES FOR SELLING INSURANCE IN A STATE WITHOUT HAVING A PE THEREIN

- As part of the work on Action 7, BEPS concerns related to situations where a **large network of exclusive agents** is used to **sell insurance for a foreign insurer** were also examined. It was ultimately concluded, however, that it would be **inappropriate** to try **to address these concerns** through a **PE rule** that would treat **insurance differently** from other types of businesses and that BEPS concerns that may arise in cases where a large network of exclusive agents is used to sell insurance for a foreign insurer should be addressed through the **more general changes to Art. 5(5) and 5(6)**

ISSUES RELATED TO ATTRIBUTION OF PROFITS TO PES

- The changes to the definition of PE will be among the changes proposed for inclusion in the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan
- Also, in order to provide greater certainty about the determination of profits to be attributed to the PEs that will result from the changes included in this report and to take account of the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profits issues related to Action 7 will be carried on with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument

Thank You

Divesh Chawla

diveshchawla72@gmail.com

9821333556

Manish Kanth

Manishkkanth@gmail.com

9920219799