Mere presence of a subsidiary and virtual projection of the enterprise in India, absent other relevant factors – No PE in India

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In brief

The Special Bench (SB) of the Delhi Income-tax Appellate Tribunal (Tribunal) in a recent ruling[1] has held that the relevant and determinative factor in a transaction involving sale of goods would be where the property in goods passes, immaterial from where the signing, network planning and negotiation of such supply contracts was carried out. Further, the independent onshore activities and virtual projection by the subsidiary will not lead to an inference of a permanent establishment (PE) unless other essential ingredients of a PE exist.

In detail

Facts

The taxpayer was a company incorporated in Finland engaged in manufacturing and trading of advanced telecommunication systems, and GSM equipment.

The GSM equipment manufactured in Finland was sold to Indian telecom operators from outside India on principal-to-principal basis under independent buyer-seller arrangements. The taxpayer also entered into installation agreements with its Indian customers.

Upon incorporation of a wholly owned subsidiary in India, contracts for installation were entered into and carried out by the Indian subsidiary in India. The tax officer (TO) opined that the taxpayer had a PE in India. However, on further appeal, both the Commissioner of Income-tax (Appeals) and the Tribunal, partly allowed the taxpayer's appeal.

Pursuant to the previous Tribunal ruling in this case, both taxpayer and Revenue filed an appeal before the High Court (HC).

The HC[2] remitted the matter back to the Tribunal to determine PE of the taxpayer on account of the activities of the taxpayer's Indian subsidiary as per the facts of the transaction.

Issues before the SB of the Tribunal

- Whether the Indian subsidiary of the taxpayer would constitute business connection or PE of the taxpayer in India?
- If yes, to what extent would profits be attributable in India on account of assigning, network planning and negotiation of offshore supply contracts in India?

Taxpayer's contentions

- Profits from offshore supply could not be taxed in India as no activity in connection with offshore supplies was carried out in India placing reliance on various judicial pronouncements. Indian subsidiary had no role to play in offshore supplies.
- Installation and onshore activities were carried out by the Indian subsidiary on principal-to-principal basis with Indian customers and was an independent activity

[1] ITA Nos. 1963 & 1964/Delhi/2001
[2] Delhi High Court ITA 1137 & 1138/2007

which was subject to tax in India.

- Indian subsidiary was not negotiating or concluding any contract for supply of equipment in India for the taxpayer. It had no authority to conclude contracts. After the employee of the taxpayer came under the payroll of Indian subsidiary, it did not sign any contract for offshore supply. Taxpayer had only signed installation contracts on behalf of the Indian subsidiary.
- Article 5(5) of India-Finland Double Tax Avoidance Agreement (tax treaty) provides that where activities of agents are restricted to activities listed in Article 5(4), it would not create a Dependent Agent PE (DAPE). The taxpayer's activities were preparatory and auxiliary in nature, and hence could not have satisfied the threshold of being DAPE under Article 5(5) of the tax treaty.
- The Indian subsidiary could not constitute fixed place PE of the taxpayer as the premises of Indian subsidiary was not at the disposal of the taxpayer and it did not have any control thereupon, placing reliance on various rulings[3]. Employees were working under control and supervision of Indian subsidiary.
- Indian subsidiary was undertaking marketing and after sale services on behalf of the taxpayer under a separate and independent contract for which it was remunerated at cost plus 5% mark-up. Hence, there could be no further attribution.
- Business profits could only be taxed in India if the taxpayer had a PE in India to the extent such profits arose out of the activities performed by such PE in India[4]. However, in the given case these were only preparatory activities.

Revenue's contentions

- The taxpayer had a PE in India through the Indian Liaison Office (LO) and Indian subsidiary.
- Employees of Indian subsidiary were working for the taxpayer as well for installation contract constituting a service PE[5]. Taxpayer's employees were involved in negotiating terms with various customers and were interacting with them on regular basis using the premises of the Indian subsidiary, which was at its disposal constituting DAPE as well as fixed place PE.
- Taking part in contractual negotiation, carrying out network planning could not be construed as preparatory or auxiliary activity. Indian subsidiary was a virtual projection of the taxpayer in India.
- 40% of the income was attributed in India from supply of hardware; 30% of profits were attributed to PE in India; and 30% of revenues were attributed towards supply of software taxed as royalty under provisions of Income-tax Act, 1961 (the Act) and India-Finland tax treaty.

SB of the Tribunal's ruling

- The Tribunal (in the first round of appeal) had held that LO did not constitute a business connection or PE of the taxpayer in India, which was further affirmed by the HC.
- On the issue of whether the Indian subsidiary constituted a business connection or a PE in India and whether profits would be attributable to the same in India, the matter was remitted back by the HC to the Tribunal.
- The Tribunal has held as under:
  - From material facts discussed in detail, entire contract for offshore supply of equipment had been done by the taxpayer outside India and no activity relating to offshore supply had been performed in India.
  - Indian subsidiary was an independent entity and its income from independent contracts had been subjected to tax in India. Employees of Indian subsidiary had not signed any supply contracts with Indian customers on behalf of the taxpayer.
  - Installation contracts had been executed independently on principal –to-principal basis with Indian customers and income therefrom offered to tax in India.
  - Marketing support agreement and technical support agreement in respect of the Indian subsidiary's installation projects with the taxpayer had no correlation with offshore supply contracts. Indian subsidiary had been remunerated at arm's length. Hence, no profit

[3] Formula One World Championship Ltd. *v.* CIT [2017] 394 ITR 80 (SC), ADIT *v.* E-fund IT Solution Inc. [2017] 399 ITR 34 (SC)

[4] CIT *v.* R. D. Aggarwal and Co. and Another [1965] 56 ITR 20 (SC)

[5] Relied on DIT *v.* Morgan Stanley & Co. Inc. [2007] 292 ITR 416 (SC) and Centrica India Offshore *v.* CIT [2014] 364 ITR 336 (Delhi).

could be attributed from these activities as held by the HC.

- Technical expatriates were in India to assist Indian subsidiary with performance of installation activities and not to carry out supply business of the taxpayer. Hence, there was no relevance *qua* the taxpayer's business.
- There was no question of examining installation activity for purpose of PE as no income from installation activities had been earned by the taxpayer in India.
- There was no concept of Service PE in the then existing provisions of Article 5 of India-Finland tax treaty. Hence, the same would not apply in this case.
- Following the Apex Court rulings *(supra)*, the SB of the Tribunal held that to constitute a fixed place PE there should be some physically located premises at the disposal of the taxpayer. Providing telephone, or fax, or conveyance services could not be equated with fixed place.
- The qualified character of agency was authorised to act on behalf of somebody else to conclude contracts. There was no material fact on record that the Indian subsidiary had any authority to conclude contracts for supply or book any orders binding upon the taxpayer.
- Employees of the Indian subsidiary attended meeting at the time of finalisation of contracts was of no consequence either for the purpose of fixed place PE or DAPE because for fixed place, disposal test needed to be satisfied and for DAPE, authority to conclude contracts which was binding on the taxpayer needed to be seen.
- Under Article 5 independence of an agent had to be both legal as well as economic independence. Legal independence had to be seen from the context, whether the agent's commercial activities for its principal was subject to detailed instructions or comprehensive control by the principal or not; or to what extent the agent exercised freedom in the conduct of its business on behalf of the principal; or the agent's scope of authority was affected by limitations on the scale of business which may be conducted by the agent.
- Economic independence had to be seen from the context as to what extent the agent bears the entrepreneurial risk or business risk. Agent's activities was not integrated with the principal, and whether the agent acted exclusively for the principal.
- *Qua* the supply contract nothing was being performed by the Indian subsidiary in India as agent of the taxpayer.
- The fact that the taxpayer issued guarantee to Indian customers for contracts executed by Indian subsidiary had no significance for determination of DAPE. Such a contention may only be relevant for composite contract situation which was not the consideration in the present case and did not have any bearing whatsoever in this matter.
- Mere signing, planning and negotiation or networking before supply of goods, was preliminary activities and therefore, under exclusion clause in Article 5 of the India-Finland tax treaty, there could not be any PE.
- Existence of a subsidiary did not by itself constitute a PE of the parent entity, since a subsidiary constituted an independent legal entity in the source state.
- The concept of virtual projection could not be in vacuum *dehors* any other parameters of PE as envisaged in Article 5 of the India-Finland tax treaty. Even without a fixed place, virtual projection itself would not lead to an inference of a PE.
- Even if it was held that the taxpayer had a business connection in India, then also if there was no PE in terms of Article 5 no income could be attributed to India under Article 7 of the India-Finland tax treaty.
- Since the transaction was relating to sale of goods, the relevant and determinative factor would be where the property in the good passes.
- In the present case, property had passed on high seas, payments had been received outside India, goods were manufactured outside India and even the sale had taken place outside India.
- Once this fact was established even in those cases where there was a one composite supply contract,

it had to be segregated from installation and only then would the question of apportionment arise having regard to section 9(1)(i) of the Act, which made the income taxable in India to the extent it arose in India relying on the HC decision in case of Nortel Networks[6].

- The SB of the Tribunal held that the income of the taxpayer from offshore supply of equipment in pursuance of supply contract could not be brought to tax in India.

The takeaways

- This ruling lays certain guidance on what constitutes preparatory and auxiliary activities *vis-à-vis* PE in cases where Indian subsidiaries of foreign contractors are undertaking separate onshore activities, while the foreign company is supplying goods.
- The SB made an important observation that concept of virtual projection by Indian subsidiary cannot alone infer a PE, without other parameters of PE under the relevant Article of the tax treaty not being satisfied.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

[6] Nortel Network India International Inc *v.* DIT [2016] 386 ITR 353 (Delhi)

Our Offices

Ahmedabad

1701, 17th Floor, Shapath V,
Opp. Karnavati Club,
S G Highway,
Ahmedabad – 380051
Gujarat
+91-79 3091 7000

Bengaluru

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bengaluru – 560 008
Karnataka
+91-80 4079 7000

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai – 600 006
Tamil Nadu
+91 44 4228 5000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Telangana
+91-40 44246000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata – 700 091,
West Bengal
+91-033 2357 9101/
4400 1111

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai – 400 050
Maharashtra
+91-22 6689 1000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City,
Gurgaon – 122002
Haryana
+91-124 330 6000

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
Maharashtra
+91-20 4100 4444

For more information

Contact us at
pwctrs.knowledgemanagement@in.pwc.com

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