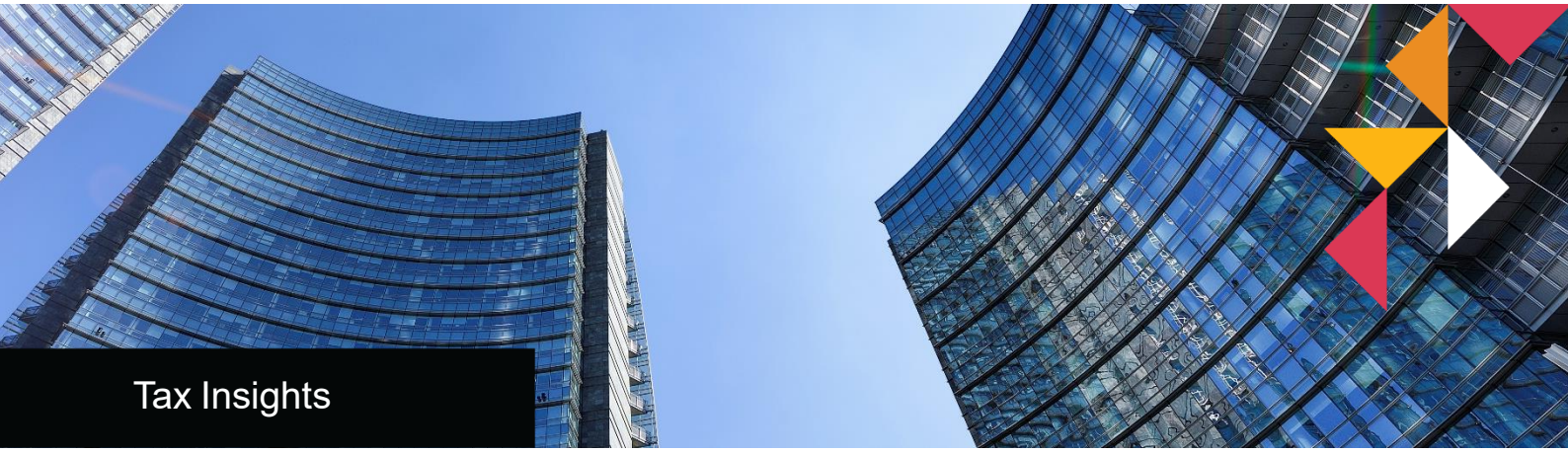

Tax Insights

26 September 2023

Indian AE providing marketing support services with no authority to conclude contracts does not constitute agency PE of foreign entity – Bangalore bench of the Tribunal

In brief

The Bangalore bench of the Income-tax Appellate Tribunal (Tribunal)[1] was of the view that the Indian group company [Indian associated enterprise (AE)] cannot be considered as an agency permanent establishment (agency PE) of the foreign company if the Indian AE does not engage in securing, negotiating or concluding contracts on behalf of the foreign company.

The Tribunal concluded that the statements of the employees of the Indian company clarify that the sales of the foreign company are in fact affected by the foreign company's distributors in India. The Tribunal, on perusal of the marketing support service agreement entered between the foreign company and the Indian AE, observed that the Indian company only engages in educating the customers about the products of the foreign company, and the final contracts are negotiated between the customer and the distributors of the foreign company.

In detail

Facts

- The taxpayer, being a foreign company based out of Ireland, had entered into a market research and support services agreement (agreement) with its Indian AE. Pursuant to this agreement, the Indian AE assisted the taxpayer in promoting its products in India by conducting market research, gathering data and performing other support services.
- A survey was conducted in the premises of the Indian AE which led the tax authorities to believe that the activities performed by the Indian AE were beyond what was prescribed under the aforesaid agreement, and there is taxable income which has escapement assessment.
- Based on the survey results, the Tax Officer (TO) initiated reassessment proceedings for assessment years (AYs) 2012–13 to 2017–18.
- During the course of the reassessment proceedings, the taxpayer contended that the Indian AE does not engage in concluding or securing orders in India and is merely involved in the provision of marketing support services.

[1] ITA 763 to 768/Bang/2022

- The TO, however, relying on the statements of the employees of the Indian AE inferred that the Indian AE is fully accountable for the taxpayer's sales activities in India and concluded that the activities of the Indian AE create an agency PE. Thus, adopting the global gross profit rate of 4.19% and after reducing admissible expenditure, the TO brought the resultant amount to tax in the draft assessment order.

- The Dispute Resolution Panel upheld the TO's draft assessment order, and the TO accordingly passed the final assessment order making the above additions.

Taxpayer's contentions

- The taxpayer drew the Tribunal's attention to the clauses in the agreement which specifically prohibited the Indian AE from negotiating or concluding a contract. The taxpayer highlighted that the Indian AE is only required to provide marketing support services, and once a potential customer is interested in the products, the taxpayer would get involved for contract conclusion.

- The taxpayer explained the entire process of procuring orders whereby it was explained that the role of the Indian AE was to educate the customers about the taxpayer's products via presentation, brochures, etc.

- By referring sample copies of purchase orders placed by the distributors on the taxpayer, it was submitted that all sales of the taxpayer in India were undertaken by third-party distributors only.

- The authorised representative (AR) of the taxpayer took the bench through the statements made by each employee and mapped them to various permitted activities under the agreement.

- It was also submitted that the Indian AE earns 90% of its revenue from software development and other services rendered to its other AEs, meaning thereby that the Indian AE is legally and economically independent of the taxpayer.

Tribunal observations and ruling

- The Tribunal observed that the definition of agency PE under Article 6 of the India-Ireland Double Taxation Avoidance Agreement (DTAA) is similar to the definition of agency PE under Explanation 2 to section 9 of the Income-tax Act, 1961 (the Act) (as applicable for relevant AYs).

- The Tribunal noted that the Indian AE does not and cannot engage in securing, negotiating or concluding contracts on behalf of the taxpayer and also because the statements recorded of the employees of the Indian AE also clarify that the orders are secured by the independent distributor and not by the Indian AE. Therefore, clauses (a) and (c) of Explanation 2 of section 9 of the Act are not attracted.

- Moreover, since the Indian AE neither procures goods, delivers them or collects payments for the taxpayer, clause (b) of Explanation 2 to section 9 of the Act will not apply in this case.

- The Tribunal noted that apart from the statements of the employees of the Indian AE, no other cogent material was brought on record by the TO to support his conclusion, whereas the AR of the taxpayer has sought to demonstrate that the employees' statements actually reflected that the permitted activities under the agreement were performed.

- The Tribunal, on perusal of the statements of the employees of the Indian AE, agreed with the AR of the taxpayer that the statements recorded did not clearly indicate that the Indian AE is responsible for concluding contracts for the taxpayer. The Tribunal also noted that the reliance on the statements of the employees is not conclusive of the existence of a PE.

- The Tribunal also drew support from the Delhi bench of the Tribunal's ruling[2], wherein under similar facts, the Tribunal concluded that the Indian company engaged in providing marketing support services with no authority to conclude contracts did not constitute a PE of the foreign entity.

- The Tribunal in view of the above concluded that the addition made by the TO in the final assessment order deserves to be deleted.

[2] Net App B.V. *v.* DDIT [2017] 78 taxmann.com 97 (Delhi - Trib.)

- Before concluding, the Tribunal also noted that Explanation 2 to section 9 of the Act has been amended *vide* Finance Act, 2018 to include within its purview that 'the Indian AE habitually playing a principal role leading to conclusion of contracts by the non-resident'.
- However, such amendments are not made effective in the India-Ireland DTAA for the impugned period and hence cannot be applied in this case.

The takeaways

Determination of agency relationship between a foreign entity and its Indian AE has long been a subject matter of debate. The determination of an agency relationship is generally a very fact-driven exercise. The Tribunal, in this case, has once again emphasised the importance of maintaining proper documentation. The tax authorities have started going one step ahead to verify the actual operationalisation of the documentation on record through the conduct of employees. This underlines the importance of the actual conduct of the taxpayers, their employees, their associated entities and employees of the associated entities in assessing the agency relationship between two parties.

Moreover, considering that with effect from 1 April 2019, the definition of agency PE has been amended to include instances of a taxpayer habitually playing a principal role leading to the conclusion of contracts by the non-resident and the same amendment is proposed in DTAAs through Multilateral Instruments, it is to be noted that this ruling will only be relevant in case of countries whose PE article in the DTAA with India does not include instances wherein the Indian entity habitually plays a principal role in the conclusion of contracts by the non-resident.

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