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What's New

Tax Insights

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Expressed reservation towards co-ordinate bench's decision on PE attribution in case of global losses and referred matter to a larger bench while upholding fixed place PE of a UAE-based taxpayer in India – Delhi High Court

In brief

The Delhi High Court[1] held that the taxpayer has a permanent establishment (PE) in India at the premises of its Indian service recipient. The court dismissed the taxpayer's contention that profits cannot be attributed if the taxpayer had incurred losses at a global level, which was held in the coordinate bench decision in the case of Nokia Solutions Network[2]. Therefore, the court, expressing its reservation against the said coordinate bench decision, has referred the instant case for consideration by a larger bench.

As regards the consideration for fee received in terms of the service agreement, alleged as 'royalty' by the Revenue—the court noted that the taxpayer provided know-how in furtherance of the oversight and strategic planning services. Thus, the court concluded that such fee is business income and not royalty.

In detail

Facts

- The taxpayer is a tax resident of the United Arab Emirates (UAE). It entered into two strategic oversight services agreements (SOSAs) with an Indian company operating in the hotel industry with respect to the latter's hotels in Delhi and Mumbai.
- Under the terms of the SOSA, the taxpayer agreed to provide strategic planning services and 'know-how' to ensure the Indian company develops and operates its hotel as an efficient and high-quality international full-service hotel.
- Simultaneously, the taxpayer also entered into HOSA (Hotel Operation Service Agreement) with its affiliate in India, whereby its affiliate agreed to provide day-to-day operations, management assistance and technical assistance services to oversee the implementation of the overall strategic planning and know-how

1 ITA 216/2020 & CM Nos. 32641/2020, 32643/2020 & 56179/2022, ITA 217/2020 & CM Nos. 32644/2020 & 32646/2020, ITA 218/2020 & CM Nos. 32647/2020 & 32649/2020, ITA 219/2020 & CM Nos. 32650/2020 & 32652/2020, ITA 140/2021 & CM Nos. 30258/2021, 30259/2021 & 30260/2021, ITA 36/2022 & CM APPL. 11636/2022, ITA 201/2023 & CM APPL. 16442/2023, ITA 215/2023 & CM APPL. 18200/2023

2 Commissioner of Income Tax (International Taxation)-2 *v.* Nokia Solutions and Networks OY (ITA 503/2022)

provided by the taxpayer.

- The taxpayer claimed that the consideration it had received in terms of the SOSA was non-taxable in India. This is because no specific article exists in the India-UAE Double Taxation Avoidance Agreement (DTAA) to tax such receipt as fees for technical services (FTS), and the taxpayer does not have a PE in India to tax such receipts as 'business income'.
- During the assessment proceedings, the tax officer (TO) asserted that it is the taxpayer who operates the hotel in India through the continuous presence of its employees and other personnel at the hotel premises. Moreover, the taxpayer provided central reservation system services, which also constituted a fixed place of business in India.
- The TO also concluded that, apart from operating the hotel, the taxpayer provided its proprietary written knowledge, skill, experience, operational and management information and associated technologies, etc. for the operation of the hotel.
- The TO thus contemplated the taxpayer's business connection under section 9(1)(i) of the Income-tax Act, 1961 (the Act), and its PE under Article 5 of the India-UAE DTAA. Then, the TO considered that the receipts under SOSA are royalty or FTS under section 9(1)(vi)/(vii) of the Act as well as royalty under Article 12 of the India-UAE DTAA. Consequently, the TO computed the tax payable at 10% of the gross receipts (assuming that the taxpayer's net profit is 25% of the receipts), even when the taxpayer incurred losses globally.
- The taxpayer objected to the draft assessment order before the Dispute Resolution Panel, which sustained the TO's view.

Tribunal's ruling

- On appeal by the taxpayer, the Delhi bench of the Income-tax Appellate Tribunal (Tribunal) concluded as follows:
  - Amounts received by the taxpayer were royalties.
  - The Indian company's hotel premises were at the disposal of the taxpayer during the period of stay of its employees in India to render the services.
  - The Tribunal confirmed the TO's observation that the taxpayer is involved in the maintenance and operations of running the hotel, whereas the hotel's owner plays a minimal role.
  - It affirmed the existence of the taxpayer's fixed place PE in India, in terms of Article 5(1) of the India-UAE DTAA, by relying on the Supreme Court decision in the case of Formula One[3] and other judgements rendered by the Supreme Court[4] and the Mumbai bench of the Tribunal[5].
  - The Tribunal directed the TO to attribute profit to the PE upon production of the working of revenue, losses, etc. on a financial year (FY) basis by the taxpayer.

Issues before the High Court

- Whether the service charges received by the taxpayer under various SOSAs were taxable as royalty?
- Whether the taxpayer had a PE in India within the meaning of the India-UAE DTAA?
- Whether the Tribunal's findings regarding the existence of a PE in India were perverse and contrary to the terms of the SOSA?
- Whether Article 7(1) of the India-UAE DTAA is applicable to the taxpayer, considering that the taxpayer had incurred losses in the relevant FYs?

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3 Formula One World Championship Limited *v.* Commissioner of Income Tax, International Taxation-3, Delhi & Anr (Civil Appeal No. 3849 of 2017)

4 DIT *v.* Morgan Stanley & Co. [2007] 292 ITR 416 (SC); UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC) and DIT *v.* E-funds IT Solutions Inc. [2017] 86 taxman.com 240 (SC)

5 Airlines Rotables *v.* DIT [2010] 131 TTJ 385 (Mumbai)

High Court's decision

Taxability of service fee as royalty

- Examining the various articles of the SOSA in detail, the Delhi High Court addressed the question of taxability of service receipts as 'royalty'.
- The taxpayer played an overarching role in the management of the hotel, albeit at the policy level. The taxpayer also had the right to oversee the policies' implementation to ensure that the hotel is operated as per the taxpayer's standard operating procedures.
- The court further noted that the service fee is not a consideration for the use of or the right to use any process or information based on commercial or scientific experience. Rather, such service is incidental to the services set out in the SOSA. Merely because the extensive services covered in the SOSA also includes 'access' to written knowledge, processes and commercial information in furtherance of the services, the fee the taxpayer received cannot qualify as 'royalty' under Article 12 of the India-UAE DTAA.
- Since such services pertain to the management of hotels, the income must be classified as income from business.

Existence of PE in India

- While affirming the Tribunal's view on the existence of a PE in India, the Delhi High Court noted the following.
    - It is not necessary to examine whether the taxpayer had a PE under Article 5(2) of the India-UAE DTAA, as the Tribunal had proceeded on the finding that the taxpayer had a PE in terms of Article 5(1) of the India-UAE DTAA.
    - Although the taxpayer was not required to carry on day-to-day management of the hotel, it is erroneous to accept that the agreements entered into with the Indian company (SOSA and other agreements with the taxpayer's affiliate) did not provide the taxpayer pervasive control over the Indian company.
    - The taxpayer's discretion to send its employees at its will without concurrence of the Indian company or its affiliate indicates that the taxpayer exercised control over the hotel premises. Moreover, the premises were sufficiently at the taxpayer's disposal, through which the taxpayer carried on its business.
    - No bar in the SOSA prevented the taxpayer from managing other hotels while being stationed at the hotel premises in question.
- Noting the above, the court concluded that the hotel premises were at the disposal of the taxpayer regarding its business activities; therefore, the taxpayer had a PE in India in the form of a fixed place through which it carried on its business.

PE profit attribution

- The Delhi High Court observed that a PE in India must be considered as an independent taxable entity for any attribution of profits. Even if the taxpayer had incurred a net loss at an entity level because of losses suffered in other jurisdictions, it is required to pay tax on income attributed to its PE in India. The court expressed reservation towards the coordinate bench's decision[2] on the issue of attribution of income to the PE in India if the taxpayer did not make profits at an entity level. Accordingly, the Delhi High Court placed the matter before the Chief Justice of India to refer the question of profit attribution to a larger bench.

The takeaways

The Delhi High Court meticulously analysed the SOSA and determined that the fee received to oversee the hotel operations; implement upscale hotel standards; and provide written knowledge, skills, experience, operational information, etc. is not 'royalty' but business income.

To determine the constitution of a fixed place PE, the court relied on various judgements and concluded that the hotel premises were at the disposal and under the control of the taxpayer through its employees (even if they were present in India for less than nine months, being the threshold provided in Article 5(2) of the India-UAE DTAA). Moreover, for PE attribution in case of the taxpayer having global losses, the court requested the constitution of a larger bench to revisit the conclusion of the coordinate bench, holding that the PE is an independent taxable entity. The development in this regard needs to be closely watched by taxpayers claiming 'nil' income to be taxed in India, contending that the PE does not require attribution due to losses at a global level.

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