



Tax Insights

15 January 2024

LO constitutes a PE in India as per the India–Germany DTAA if its activities go beyond merely acting as a communication channel between HO and clients in India – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal¹ (Tribunal) concluded that activities of the Liaison Office (LO) of a German company in India constitutes a permanent establishment (PE) as per Article 5 of the India-Germany Double Taxation Avoidance Agreement (DTAA) where the activities involved pertained to determining the book titles to be published, procuring orders, determining selling price and profits, etc. and thus, were not preparatory or auxiliary in nature.

In detail

Facts

- The taxpayer is a German company engaged in the business of publishing scientific, technical, medical books and journals.
- It set up an LO in India with the approval of the Reserve Bank of India (RBI) for the sole purpose of carrying out liaising activities, i.e. to act as a communication channel between the Head Office and clients in India.
- The taxpayer did not file any return of income in India with the view that LO is carrying out activities which are preparatory or auxiliary in nature and hence, it does not constitute a PE as per Article 5(4) of the India-Germany DTAA.
- The Tax Officer (TO), based on certain documents found during the course of a survey and statements recorded from employees who were working at the LO, formed a belief that the LO constituted a PE in India and that income had escaped assessment since the LO was involved in various activities which were not preparatory or auxiliary in nature. Accordingly, the TO reopened the assessments for assessment years 1999-2000 to 2002-03 under section 147 of the Income-tax Act, 1961 (the Act). Moreover, the TO attributed 15% of the total sales made in India as income of the LO.

¹ ITA Nos. 643 to 645/Del/2005 & 3660/Del/2009

Tribunal's ruling

- With regard to the validity of reopening of the assessment under section 147 of the Act, the Tribunal ruled that the information gathered at the time of survey operation (i.e. documents impounded and the statements recorded from the officers working at LO) constitute tangible material to hold a *prima facie* view that the income chargeable to tax has escaped assessment. Moreover, whether such information would ultimately result in assessment of escaped income need not be dealt with at the time of recording of the reasons. The Tribunal further was of the view that, there is a direct nexus between the material available on record and the formation of belief for reopening the assessment.
- Based on the following, the Tribunal ruled that the activities of the LO with regard to printing of books at the Export Processing Zone (EPZ) in India (through the third-party printers) are of much wider magnitude than merely preparatory and auxiliary character.
 - Two officers who were working at the LO stated that the LO conducted activities including – (a) visiting over 200 institutions to meet scientists and academicians to discuss and promote the publications of the taxpayer and to ascertain customers' requirements; (b) discussing profitability and willingness to undertake such sales with the distributors; (c) obtaining quotations from printers and working out the profitability for each title and sending the quotes to the head office (HO).
 - The quotes sent by the LO for approval at the HO in Germany are accepted in 90-95% of the cases and very rarely a query is raised by the HO. Moreover, even though purchase orders are issued directly by the HO to the printers, they are asked to take instructions from the officer of the LO.
 - Report by a person at an authoritative position at the taxpayer company appreciating the efforts of the LO towards increasing sales of the taxpayer in India.
- Based on above, the Tribunal noted that the LO not only procures orders but also works out the cost components and margin of the books to be reprinted at EPZ and sends quotes for acceptance to the HO. It also notes that the facts clearly reveal that the LO has a major say with regard to not only the titles to be reprinted in India, but even their pricing.
- Based on the above, the Tribunal ruled that the LO constitutes a PE of the taxpayer in India in terms of Article 5(1) read with Article 5(2) of the DTAA in relation to reprinting of books at the EPZ since it was procuring orders as well as fixing the price for the same.
- The Tribunal concluded that the PE had no role to play in sale of journals and books printed abroad, as, these are direct transactions between the taxpayer and buyers in India without any intervention of the LO, and thus, only attributed income in relation to the books reprinted in the EPZ to the PE.
- The Tribunal observed that the taxpayer had, later on, set up a subsidiary in India which was remunerated with a mark-up of 11% of gross receipts while rendering services of similar nature as those which were rendered by the LO. Based on this, the Tribunal concluded that it is reasonable to estimate net profit of the LO at 11% of the total sales in India, of which 80% would be attributed as income of the PE as a major role is played by the PE with regard to EPZ sales with a direction to the Revenue to consider deduction of expenses incurred towards making sales in India, HO expenses, depreciation, etc.
- Moreover, the Tribunal has not considered the taxpayer's argument that the statement of the officers of the LO taken on record by the TO under section 133A(3)(iii) of the Act does not carry any evidential value and taxpayer's reliance on the Supreme Court decision² in this regard.
- Separately, the taxpayer's argument that no allegations were raised by the RBI (for violating the conditions of the approval to set up an LO by indulging in commercial activities) was not found relevant by the Tribunal to ascertain the PE.

The takeaways

- The Delhi bench of the Tribunal concluded that activities of the LO to procure orders in India and determine the cost components and margins and fixing price of the books to be reprinted at EPZ go beyond being merely preparatory and auxiliary in nature, and accordingly, a PE of a foreign company is formed in India. Moreover, the mark-up of 11% as remunerated to the Indian subsidiary of the foreign company for similar services was considered as net profit and, out of this, 80% was attributed to income of the PE considering the major role played by the PE with regard to EPZ sales.

² Commissioner of Income-tax, Salem v. S. Khader Khan Son [2013] 352 ITR 480 (SC)

- This ruling underscores that facts and documentation are critical to determine PE. While an LO can carry out only liaison or non-commercial activities, the statements of the LO officials recorded in this case suggested that the activities may be wider and thus, can form the basis to determine PE by the tax authorities. Accordingly, the actual conduct of the business is critical to determine PE.

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