



## **Activities carried on by the LO in India will not constitute permanent establishment if it were preparatory and auxiliary in nature**

Recently, the Indian authorities have pronounced two judgments dealing with the taxability of Korean entities having a Permanent Establishment (PE) in the form of Liaison Office (LO) in India.

The Authority for Advance Ruling (AAR) in case of K.T. Corporation<sup>1</sup> held that activities carried on by the LO in India were in support of the main activities and were preparatory and auxiliary in nature. Hence, the LO will not constitute a PE of the taxpayer.

Whereas the Bangalore Income-tax Appellate Tribunal (the Tribunal) in case of Jebon Corporation India Liaison office<sup>2</sup> observed that the LO was having a decision making authority and they were also empowered to conclude the contract to secure purchase orders. Accordingly, the Tribunal held that such an activity cannot be termed as a preparatory or auxiliary in nature and therefore, the LO constitutes a PE in India.

### **M/s. K.T. Corporation**

#### **Facts of the case**

- The taxpayer, a company incorporated in Korea was in the business of telecommunication carrier/reseller.
- The taxpayer set up a LO in India with the permission of Reserve Bank Of India (RBI) to act as a communication channel between the Head Office (HO) of the taxpayer and the concerned parties i.e. Indian companies, within the parameters listed out by the RBI.

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<sup>1</sup> K.T. Corporation v. Director of Income-tax (2009-TIOL-12-ARA-IT)

<sup>2</sup> Deputy Director of Income-tax v. Jebon Corporation India Liaison office (2009-TIOL-323-ITAT-BANG)

- The LO was also involved in (i) organising seminars, conferences (ii) receiving trade enquiries from the customers (iii) advertising for the taxpayer (iv) collecting feed back from the prospective customers/consumers, trade organizations etc. and has neither played any role in the pre-bid survey etc.
- Pursuant to the opening of the LO, the taxpayer entered into a Reciprocal Carrier Service Agreement (RCSA) with Vodafone Essar South Ltd. (VESL) to interconnect and to provide certain services to each other. In respect of each service, the parties were required to raise invoices during each calendar month and the invoiced party will make payments to the invoicing party.

### **Issue before the AAR**

Whether the LO can constitute a PE of the taxpayer under the India-Korea Tax Treaty (the tax treaty)?

### **The AAR's ruling**

- The expression PE means a 'fixed place of business' through which the business of a foreign enterprise was wholly or partly carried on in another contracting state. The activities listed in Para 4 of Article 5 of the tax treaty were exceptions to the basic concept of PE and are considered as preparatory or auxiliary vis-à-vis the main business activity of the foreign entity.
- As per statutory provisions, the activities of a LO were restricted and it could not legally secure orders from the customers in any manner either directly or indirectly. The LO may be a fixed place and the activities conducted by it may be a business activities but these are restricted to preparatory or auxiliary activities only.
- As per article 5(4)(e) of the tax treaty and OECD commentary a fixed place of business through which the LO exercises preparatory or auxiliary activity for the HO was deemed not to be a PE.
- The AAR observed that the LO did not break the parameters prescribed by the RBI and the RBI extended the LO status since the activities undertaken by the LO were in the nature of preparatory and auxiliary in nature.
- Thus, the AAR held that the services and work performed by the LO were in the nature of preparatory and auxiliary activities and therefore, in terms of tax treaty the LO did not constitute PE.
- The AAR also held that if the activities of the LO goes beyond the parameters fixed by RBI or if the department finds any concrete materials which substantially impact on the veracity of the taxpayer's version of facts, it is open to the department to take appropriate steps under law.

## **Jebon Corporation India Liaison Office**

### **Facts of the case**

- The taxpayer a Korea based company was doing a trading of semi-conductor components manufactured by various companies across the world.
- The taxpayer company opened a LO in India after getting approval from the RBI on accepting certain conditions.
- The operation of the LO includes promotion, marketing and sales of electronic components such as printed circuit boards and liquid crystal displays. The LO engineers were identifying the customers on the basis of their past sales experience.
- A survey under section 133A of the Income-tax Act, 1961 (the Act) was conducted in the premises of the LO. Pursuant to the survey operation, notices under section 148 of the Act were issued to file the return of income which the taxpayer failed to comply.
- The AO on the basis of information received from the survey and statements from employees of LO noted that
  - The LO was doing the primary task of identifying the customers
  - The LO employees were obtaining the purchase order from the customers and were sending the same to the HO. They were also involved in the price negotiations with the customers
  - The LO had an authority to conclude contracts on behalf of the taxpayer.
  - The LO also had the complete discretion to add the appropriate sales margin to the purchase price communicated by the HO and provide the same to the customers in India.
  - The LO was given annual sales target by the HO for the sales based on the forecasts given by the LO.
  - However, the payment for the goods was made directly to the HO by the customers.
- On the basis of above information the AO held that the LO constituted a PE of Jebon Corporation in India and hence, it was taxable under article 7 of the tax treaty.

### **Issue before the Tribunal**

Whether the activities of the LO constitutes a taxpayer's PE in India?

### **The Tribunal's ruling**

*Taxability under the Act*

As per section 5(2) of the Act, the income of a non-resident person arises or accrues or deemed to arise or accrues in India if it has business connection in India in respect of its source income.

- The Tribunal after observing the flow chart showing the operation of the LO filed by the LO, held that the LO was in continuation of the trading activities of the taxpayer and therefore, it constitutes business connection in respect of source of income in India and hence, the income of LO will be taxable in India.

#### *Taxability under the tax treaty*

As per the tax treaty the business profits of the non-resident taxpayer will be taxable if it has a PE in India.

- The Tribunal observed that the business of the taxpayer was partly carried on by the LO. Therefore, the Tribunal held that the office of the LO cannot be excluded from the word 'office' as contained in article 5(2) of the tax treaty.
- The Tribunal also noted that as per the article 5 of the tax treaty if a taxpayer maintains a fixed place of business solely for the purpose of advertising, supply of information, scientific research or any other activity which has a preparatory or auxiliary character in the trade or business of the enterprise will not be considered as PE.
- The Tribunal from the facts cited above observed that the LO was having a freedom to fix the sale price and to conclude the contract, and such contract cannot be termed as a preparatory or auxiliary character. Therefore, the Tribunal held that it cannot be said that the LO was solely for the purpose of supply of information or doing a preparatory or auxiliary character in the trade or business.
- Accordingly, the Tribunal held that business of the taxpayer was partly carried on by the LO and hence, it will constitute PE as per the article 5 of the tax treaty.

#### **Our Comments**

Even though the tax authorities in the above given two decisions have come to different conclusions it may be noted that the principle in both the decisions remains same that the activities carried on by the LO in India will not constitute PE if it were preparatory and auxiliary in nature.

Normally, LO does not constitute a PE in India. The Delhi Tribunal in case IAC v. Mitsui & Co. Ltd<sup>3</sup> did not regard a LO as a PE because the Indian office was conducting its operation within the restricted area permitted by the RBI.

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<sup>3</sup> IAC v. Mitsui & Co. Ltd [1991] 39 ITD 59 (Del) (SB)

In *Sumitomo Corpn. v. DCIT*<sup>4</sup> the Tribunal on similar grounds held that the taxpayer does not have a PE in India. In *Motorola Inc. v. DCIT*<sup>5</sup> the Delhi Tribunal held that LO does not constitute a PE in India since it was carrying on preliminary and preparatory activities. A similar view has also been taken in *Western Union Financial Services Inc. v. ADIT*<sup>6</sup>. In the case of *DCIT v. M/s Tokyo Marine & Fire Insurance co. Ltd*<sup>7</sup> the Delhi Tribunal held that preparatory and auxiliary activities undertaken by the LO, which did not carry out any profit earning activity in India, does not constitute PE in India. The AAR in case of *Angel Garment Ltd In re*<sup>8</sup> held that the income of a LO set up in India for the purchase of goods for the purpose of export is not taxable in India. The AAR in case of *M/s Gutral Trading Est In re*<sup>9</sup> held that the activities of a LO, confined to promoting products of another company does not constitute a business connection in India.

On the other hand the AAR in the case of *UAE Exchange Centre LLC*<sup>10</sup> held that a LO was having a PE in India because it was engaged in an essential activity of downloading the information, printing cheques and despatching the same through courier.

It may be noted from the above discussion that whether the LO constitutes a PE in India would depend upon facts and circumstances of each case. However, it may be noted that while RBI allows LOs to function as a communicating channel between the HO and companies in India, it specifically prohibits such LOs from undertaking any commercial, trading or industrial activities including any income generating activities in India.

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<sup>4</sup> *Sumitomo Corpn. V. DCIT* [2007] 110 TTJ 302

<sup>5</sup> *Motorola Inc. v. DCIT* [2005] 95 ITD 69 (Del) (SB)

<sup>6</sup> *Western Union Financial Services Inc. v. ADIT* [2006] 101 TTJ 56 (Del)

<sup>7</sup> *DCIT v. M/s Tokyo Marine & Fire Insurance co. Ltd* (2008-TIOL-86-ITAT-DEL)

<sup>8</sup> *Angel Garment Ltd In re* [2006] 287 ITR 341 (AAR)

<sup>9</sup> *Gutral Trading Est In re* [2005] 278 ITR 643 (AAR)

<sup>10</sup> *UAE Exchange Centre LLC* [2004] 268 ITR 9 (AAR)

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