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Flash News

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Indian subsidiary of a foreign company providing back office support services does not constitute a PE in India under India-USA tax treaty – Supreme Court

Background

Recently, the Supreme Court in the case of E-Funds IT Solution Inc.[1] (the taxpayer) dealt with an issue whether the subsidiary of US company for back office support services constitutes a Permanent Establishment (PE) in India under the India-US tax treaty (the tax treaty). The Supreme Court relied on its own decision in case of Formula One World Championship Ltd.[2] and observed that there must exist a fixed place of business in India, which is at the disposal of the foreign companies, through which the business has been carried on. The appellate authorities did not give any findings with respect to availability of fixed place of business at the disposal of the taxpayer. No part of the main business and revenue earning activity of the taxpayer is carried on through a fixed business place in India which has been put at its disposal. Indian company only renders support services which enable the taxpayer in turn to render services to its clients abroad. This outsourcing of work to India would not give rise to a fixed place PE in India .

With respect to service PE, the Supreme Court observed that the requirement of Article 5(2)(l) of the tax treaty is that an enterprise must furnish services 'within India' through employees or other personnel. None of the customers of the taxpayer are located in India or have received any services in India. All its customers receive services only in locations outside India. Only auxiliary operations that facilitate such services are carried out in India. The first condition provided under Article 5(2)(l) is not satisfied. Therefore, the taxpayer does not have Service PE in India.

The Supreme Court relied on its earlier decision in the case of Morgan Stanley[3] and observed that the arm's length principle has been satisfied in the present case, and therefore, no further profits would be attributable even if there exists a PE in India.

With respect to findings of Mutual Agreement Procedure (MAP) in earlier years, the High Court had held that the MAP procedure and agreement is relevant but cannot be the primary basis to decide whether the taxpayer had PE in India. Whether or not PE exists is a matter of law and fact, and there has to be determination of the said issue on merits. The Supreme Court held that MAP cannot be considered as a precedent for subsequent years, and the High Court's conclusion on this aspect is correct.

Facts of the case

The taxpayers are companies incorporated in U.S. and are residents of U.S. They were assessed and have paid taxes on their global income in U.S. The taxpayers were engaged in the four businesses, namely, ATM management services, electronic

[1] ADIT v. E-Funds IT Solution Inc. [Civil Appeal No. 6082 of 2015] (SC) – Taxsutra.com

[2] Formula One World Championship Ltd. v. CIT (Civil Appeal No. 3849 of 2017)

[3] DIT v. Morgan Stanley and Co. Inc. [2007] 292 ITR 416 (SC)

payment management, decision support and risk management and global outsourcing and professional services. e-Fund India had performed back office operations in respect of the first three. This included data entry operations etc. in respect of decision support and risk management.

- Both the taxpayers have entered into international transactions with e-Fund India. The international transactions between the taxpayers and e-Fund India were made subject matter of arm's length pricing adjudication by the Transfer Pricing Officer (TPO) and the Assessing Officer (AO) with respect to the returns of income filed by e-Fund India.

- The AO held that income of the two taxpayers were attributable to India because the two taxpayers had a PE in India and should be taxed in India, irrespective of whether the said taxpayers had paid taxes in U.S. Income earned and taxed in the hands of e-Fund India was different from the income attributable to the two taxpayers. Thus, the income attributable to the two taxpayers, which was not included in income earned and taxed in the hands of e-Fund India, should be taxed in India.

- The AO held that the taxpayers had a fixed place PE from where they carried on their own business in India. Consequently, the taxpayers were liable to pay tax in respect of what they earned from the aforesaid fixed place PE in India.

- The Commissioner of Income-tax (Appeals) [CIT(A)] held that Article 5 of the tax treaty was attracted, not only because there was a fixed place business, but also because they were 'Service PEs' and 'Agency PEs' under Article 5 of the tax treaty. Subsequently, the Tribunal held that the CIT(A) was right in holding that a 'fixed place PE' and 'service PE' had been made out under Article 5 of the tax treaty.

- The High Court held in favour of the taxpayers. The High Court held that the Indian subsidiary does not create a fixed place PE under the tax treaty. Merely because the non-resident taxpayer to protect their interest, for ensuring quality and confidentiality has sent its employees to provide stewardship services, will not make the Indian subsidiary or another entity, a PE even if the employees of the non-resident taxpayer were taken on deputation. The High Court held that the activities, which were not undertaken by e-Fund India and the assets of the taxpayers located outside India, cannot be taken into account or attributed for earning/income of the taxpayers.

Supreme Court's decision

Fixed place PE

- The burden of proving the fact that a foreign taxpayer has a PE in India and therefore, suffer tax from the business generated from such PE is initially on the tax department. In the case of Formula One World Championship Ltd., the Supreme Court, after setting out Article 5 of the tax treaty, held that place of business qualifies only if the place 'is at disposal' of the enterprise.

- The Supreme Court in the present case observed that there must exist a fixed place of business in India, which is at the disposal of the U.S. companies, through which they carry on their own business. In the present case there is no specific finding in the assessment order or the appellate orders that applying the aforesaid tests, any fixed place of business has been put at the disposal of these companies.

- The lower authorities[4] adopted a fundamentally erroneous approach in saying that taxpayers were contracting with a 100 per cent subsidiary and were outsourcing business to such subsidiary, which resulted in the creation of a PE.

- The High Court has dealt with this aspect in more detailed manner and held that the lower authorities have primarily relied upon the close association between e-Fund India and the taxpayer and applied functions performed, assets used and risk assumed (FAR) criteria to determine whether or not the taxpayer has fixed place of business. This is not a proper and appropriate test to determine the location PE. The allegation that e-Fund India did not bear sufficient risk is irrelevant when deciding whether location PE exists.

- Similarly, the High Court held that the direct or indirect costs and corporate allocations in software development centre or BPO does not help or determine location PE. Assignment or sub-contract to e-Fund India is not a factor or rule which is to be applied to determine applicability of Article 5(1) of the tax treaty. Subsidiary company will not become location PE under Article 5(1) merely because there is interaction or cross transactions between the Indian subsidiary and the foreign Principal under Article 5(1) of the tax treaty.

[4] The AO, CIT(A), the Tribunal

- The High Court held that the Tribunal's finding that the taxpayers were a joint venture or sort of partnership with the Indian subsidiary was wholly incorrect. After citing Commentary of Klaus Vogel on Double Taxation Conventions, Arvid A. Skaar in PE, and the decision of Commissioner v. Bollinger[5], the High Court held that there is no fixed place PE in the facts of the present case. The Supreme Court agreed with the findings of the High Court.

- Reliance placed by the tax department on the United States Securities and Exchange Commission Form 10K Report was also misplaced. It is clear that the report speaks of the e-Funds group of companies worldwide as a whole, which is evident not only from going through the said report, but also from the consolidated financial statements appended to the report, which show the assets of the group worldwide.

- No part of the main business and revenue earning activity of the two American companies is carried on through a fixed business place in India which has been put at their disposal. The Indian company only renders support services which enable the taxpayers in turn to render services to their clients abroad. This outsourcing of work to India would not give rise to a fixed place PE and the High Court decision is, therefore, correct on this score.

Service PE

- The Supreme Court in the case of Morgan Stanley held that Service PE constituted if the multinational enterprise (MNE) renders services through its employees in India provided the services are rendered for a specified period. In the case of Morgan Stanley, the services were extended to two years on the request of company. Where the activities of the MNE entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the MNE or they continue to have their lien on their jobs with the MNE, a service PE can emerge.

- The Supreme Court observed that the requirement of Article 5(2)(l) of the tax treaty is that an enterprise must furnish services 'within India' through employees or other personnel. None of the customers of the taxpayer are located in India or have received any services in India. All its customers receive services only in locations outside India. Only auxiliary operations that facilitate such services are carried out in India. Therefore, it is clear that the first ingredient contained in Article 5(2)(l) is not satisfied. Therefore, the taxpayer did not have Service PE in India.

- The High Court held that in AY 2005-06, two employees of e-Fund were deputed to e-Fund India and the entire expenditure for these two employees were borne by e-Fund India. 75 per cent of the salary component of those two employees was paid abroad by e-Fund Corp but the same was reimbursed by e-Fund India. This was in accordance with and permitted under the Indian Exchange Control Regulations. No employees were present in India after 2005-06. Presence of employees in India is relevant under Article 5(2)(l) but the said employees should furnish services within the contracting State. These services should not be mere stewardship services. Further, the seconded employees were working under the control and supervision of e-Fund India. The Supreme Court has agreed with the approach of the High Court in this regard.

Agency PE

- Before the Supreme Court, the taxpayer argued that the 'agency PE' aspect of the case need not be gone into as it was given up before the Tribunal. The taxpayer is right as no argument on this score is found before the Tribunal. However, the Supreme Court observed that for the sake of completeness, it is only necessary to agree with the High Court, that it has never been the case of revenue that e-Funds India was authorized to or exercised any authority to conclude contracts on behalf of the US company, nor was any factual foundation laid to attract any of the said clauses contained in Article 5(4) of the tax treaty.

Profit attribution

- The Supreme Court in the case of Morgan Stanley held that the object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) of the tax treaty, not all profits of foreign company would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The Supreme Court held that once a

[5] Commissioner v. Bollinger 485 U.S. 340 (1988) (Supreme Court of United States)

transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE. If transfer pricing analysis does not adequately reflect the FAR by the enterprise, there would be a need to attribute profits to PE for those functions/risks that have not been considered.

- The taxpayer is correct in stating that as the arm's length principle has been satisfied in the present case, no further profits would be attributable even if there exists a PE in India.

MAP proceedings

- The taxpayer has referred to paragraph 3.6 of the OECD Manual on MAP Procedure[6]. A perusal of the same would indicate that a competent authority should engage in discussion with the other competent authority in a principled, fair and objective manner, with each case being decided on its own merits. The Supreme Court observed that where an agreement is not otherwise achievable, then both parties should look for appropriate opportunities for compromise in order to eliminate double taxation on the facts of the case, even though a principled approach is important.

- The tax department relied upon Best Practice No.1 of the said OECD Manual, which requires the publication of mutual agreements reached that may apply to a general category of taxpayers which would then improve guidance for the future. However, the Supreme Court in the present case observed that Best Practice No.1 relied on by the tax department has no application to the facts of the present case, as the agreement reached applies only to the respondent companies, and not to any general category of taxpayers.

- The High Court had held that the MAP procedure and agreement of earlier year is relevant but cannot be the primary basis to decide whether the taxpayer had PE in India. Whether or not PE exists is a matter of law and fact, and there has to be determination of the said issue on merits. The Supreme Court held that MAP cannot be considered as a precedent for subsequent years, and the High Court's conclusion on this aspect is correct.

Our analysis

Fixed place PE

Philip Baker in his commentary with respect to determination of PE has referred to various international precedents[7]. It has been stated that the fixed place of business should be at the disposal of the enterprise in the sense of having some right to use the premises for the purposes of its business and not solely for the purpose of the project undertaken on behalf of the owner of the premises.

Taking a cue from the word 'through' in Article 5, Klaus Vogel has emphasised that the place of business qualifies only if the place is 'at the disposal' of the enterprise. Enterprise will not be able to use the place of business as an instrument for carrying on its business unless it controls the place of business to a considerable extent. According to him, 'disposal' is the power (or a certain fraction thereof) to use the place of business directly.

A PE does not exist merely because an enterprise is present at a particular place, if that place is not at the disposal of the enterprise or, if that the presence and control is very limited or occasional or transitory[8].

As per Article 5 of the tax treaty the term PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The mere presence of a non-resident at a particular location in source state does not necessarily make that location a place through which its business is carried on[9].

In line with the above international precedents / commentary the Supreme Court observed that there must exist a fixed place of business in India, which is at the disposal of the foreign companies, through which they carry on their own business. No part of the main business and revenue earning activity of the taxpayer is carried on through a fixed business place in India which has been put at its disposal. Therefore, there was no fixed place PE of the taxpayer in India.

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[6] OECD Manual on MAP Procedure provides that competent authority agreements or resolutions are often case and time specific. They are not considered precedents for either the taxpayer or the tax administrations in regard to adjustments or issues relating to subsequent years or for competent authority discussions on the same issues for other taxpayers. In fact, the letters exchanged between competent authorities to resolve a case often state as much. This is because the competent authorities have reached an agreement that often takes into account the facts of the particular taxpayer, the differences in the provisions of the tax law in each country, as well as the effects of the economic indicators on the particular transactions at the relevant time. Any review or adjustments of subsequent years by a taxpayer or tax administration is best based upon the particular circumstances, facts and documentary evidence existing for those years

[7] Bundersfinanzhof, February 3, 1993, IR 80-81/91, IStR 1993, p. 226, (1993) BStBl., II, 462., Decision of the Lower Tax Court of Baden-Wurttemberg, 11 May 1992, decision No. 3K309/91, RIW 1993, 81, IStR 1992, p. 104, Decision of 10 November 1998, (199) Revue de Droit Fiscal, No. 25, comm.. 503, reported with translation in (1998) 1 ITLR 857

[8] UN Commentary (2011) para 3, OECD Commentary [2010] para 4.2, 4.4, Delmas France SA v. ADIT [2013-TII-18-ITAT-MUM-INTL]

[9] Golf in Dubai LLC [2008] 306 ITR 374 (AAR)

Service PE

Article 5(2)(l) of the India-USA tax treaty provides that PE includes the furnishing of services within a Contracting State by an enterprise through employees or other personnel. A question arises whether services have to be furnished within a contracting state. In other words whether services have to be furnished to customers in India.

The Authority for Advance Ruling (AAR) in the case of Petition No 8 of 1995[10] dealt a case where the foreign company is having a subsidiary company in India which provided consultancy services to such foreign company for its utilisation outside India. The AAR observed that foreign company has Service PE in India even though its Indian subsidiary provides services to such foreign company for its utilisation outside India.

The Supreme Court in the instant case while dealing with a service PE issue has given important observation that the services were not given to customers in India but outside India. Therefore, there is no service PE under Article 5(2)(l) of the tax treaty even though Indian company has provided support services to the taxpayer. The Supreme Court observed that requirement is that an enterprise must furnish services 'within India' through employees or other personnel. None of the customers of the taxpayer are located in India or have received any services in India. All its customers receive services only in locations outside India. Only auxiliary operations that facilitate such services are carried out in India. Therefore, the taxpayer did not have Service PE in India.

The High Court in the taxpayer's case had observed that employees of the E-Funds India were its employees and not of the US entities. Further two employees of E-funds US deputed to the Indian company were working under the control and supervision of E-funds India. Therefore, the taxpayer does not have service PE in India. The Supreme Court agreed with these observations.

Agency PE

With respect to agency PE the High Court had observed that subsidiary by itself cannot be considered to be a dependent agent PE of the Principal. However, a subsidiary may become dependent or an independent PE agent provided the tests as specified Article 5(4) and (5) are satisfied. In this case, conditions and requirements of agency PE are not satisfied.

Before the Supreme Court, the taxpayer argued that the 'agency PE' aspect of the case need not be gone into as it was given up before the Tribunal. However, the Supreme Court observed that for the sake of completeness, it is only necessary to agree with the High Court that it has never been the case of the tax department that E-Funds India was authorised to or exercised any authority to conclude contracts on behalf of the US company, nor was any factual foundation laid to attract any of the said clauses contained in Article 5(4) of the tax treaty.

Mutual Agreement Procedure

MAP of a particular year whether binding on the subsequent years has been a matter of debate. The Delhi Tribunal in the case of Intelsat Corporation[11] observed that MAP of a particular year, even if accepted by the taxpayer, is not binding on him for later years. In other words, though the facts in both the years are identical, a taxpayer is entitled to take a different view in subsequent years from the one agreed between the competent authorities in MAP of earlier year. On similar lines, the Supreme Court held that MAP cannot be considered as a precedent for subsequent years.

Conclusion

The Supreme Court has provided guidance on various aspects for determination of PE by group entity in outsourcing and sub-contract arrangements involving group companies. It will have significant impact on IT/ITeS sectors and other sectors where delivery centres are located in India. The Supreme Court has given clarity on various issues relating to determination of PE in India and it will help the foreign companies having a group entity for back office support services in India.

[10] P No. 8 of 1995 [1997] 223 ITR 416 (AAR)

[11] Intelsat Corporation v. ADIT (ITA No. 543/Delhi/2010)

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