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TAX FLASH NEWS

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Indian subsidiary of a U.S. company does not constitute a PE in India under the India-U.S. tax treaty

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Gemological Institute of America[1] (the taxpayer) dealt with the issue of determination of Permanent Establishment (PE) in India under Article 5 of the India-U.S. tax treaty (tax treaty). The Tribunal held that Indian Group Company of U.S. entity does not constitute a PE in India under the India-U.S. tax treaty (tax treaty).

Facts of the case

The taxpayer, a non-resident company (a company incorporated in the U.S.), engaged in the business of diamond grading and preparation diamond dossiers. Prior to the setting up of the subsidiary, the taxpayer entered into a contract with a third party 'consolidator'. Under the consolidator arrangement, the consolidator coordinated the collection of diamonds from India, and the taxpayer graded the diamonds and issued grading reports. It was agreed between the parties to the consolidator arrangement that the cost to the consumers would be divided in the ratio of 90:10 (90 for the taxpayer and 10 for the consolidator). This arrangement existed even after formation of subsidiary in India. Whenever Indian subsidiary faces capacity and/or technical constraints, it sends stones for grading to other entities of the taxpayer's group across the globe, including the taxpayer. This was done in terms of a 'GIA Gem Grading Services Agreement' which had been entered into by the various entities of the group including the taxpayer and Indian subsidiary. Indian subsidiary only had the technical capacity to grade the diamonds below two carats and hence larger diamonds were being sent to other taxpayer's group entities for grading. Subsequently, with the increase in technical capacities, Indian subsidiary itself started grading diamonds up to 3.99 carats. In terms of the aforesaid agreement, there was a uniform pricing mechanism of 90:10 for grading services i.e. the entity of the group which was requesting for the grading services retains 10 per cent of the fees it collects from its customer and 90 per cent of the said fees was paid to the entity which provides the grading activity.

In the background of such an arrangement, the Assessing Officer (AO) held that the taxpayer has a PE in India in the name of Indian subsidiary through which it carries on its business in India. Accordingly, 50 per cent of the gem grading fees received by the taxpayer from Indian subsidiary has been held to be attributable to the Indian PE, and a profit percentage of 20.31 per cent has been applied thereon to determine the total income of the taxpayer, which has been held to be taxable in India.

Tribunal decision

Fixed place PE

On perusal of the agreements, the transaction of grading services between the taxpayer and Indian subsidiary cannot be considered to be in the nature of a joint venture, since Indian subsidiary has its own independent expertise but only due to its technology/capacity constraints, it forwards the stones to the taxpayer for grading purposes. It was not an arrangement between two parties where each party contributes its share in order to undertake an economic activity which was subjected to joint control. In fact, the arrangement was akin to an assignment or sub-contracting of grading services to the taxpayer, wherever Indian subsidiary does not have the requisite expertise or technology or capacity for carrying out the grading services. Further, the aforesaid arrangement has also been accepted as a mere rendering of grading services by the Transfer Pricing Officer (TPO) both in the case of Indian subsidiary and the taxpayer.

Indian subsidiary directly enters into agreement with the client and bears all the risks including credit risks, client facing risks, etc. Also, in terms of the agreement, Indian entity bears the risk of loss or damage to articles while in transit to and from the taxpayer and also during the time when the articles

[1] Gemological Institute of America v. ACIT (ITA No. 1138/MUM/2015)

are at or in the taxpayer's facilities. Therefore, the economic risks of the gem grading services rendered by the taxpayer vis-à-vis stones/diamonds of customers of Indian subsidiary shipped to it were borne by Indian subsidiary and hence, there was no joint venture arrangement whatsoever between the taxpayer and Indian subsidiary. Mere fact that a company has controlling interest in the other company does not by itself construe the other company to be its PE. Accordingly, the taxpayer does not have a 'fixed place' PE in India.

Service PE

The taxpayer renders 'grading services' and 'management services' to Indian subsidiary. In fact, two graders who were earlier employed with the taxpayer were employed with the Indian subsidiary and were on the payrolls of Indian subsidiary. They were working under control and supervisions of Indian subsidiary and therefore, no Service PE was created in India under the tax treaty. The Supreme Court[2] has affirmed the decision of the Delhi High Court in E-Funds wherein it has been held that two employees deputed to e-Fund India (maintain consistency) did not create a service PE as the entire salary cost was borne by e-fund India and they were working under control and supervision of e-fund India.

Agency PE

Further, considering the functions and the risks assumed by Indian subsidiary vis-à- vis its business activities in India (as has been recorded in the transfer pricing study report. Functional and risk analysis has been accepted by the TPO both in the case of Indian and in the case of the taxpayer), Indian subsidiary was an independent entity which was rendering grading services to its clients in India. Indian subsidiary also bears service risk and all client facing risks vis-à-vis the stones sent to the taxpayer for grading purposes (as has been recorded in the Transfer Pricing Study Report). Hence, Indian subsidiary was not acting in India on behalf of the taxpayer. Further, Indian subsidiary was not having any authority to conclude contracts and has neither concluded any contracts on behalf of the taxpayer nor has it secured any orders for the taxpayer in India. Thus, Indian subsidiary cannot be regarded as 'agency PE' of the taxpayer in India.

The Tribunal distinguished the decision of the Supreme Court in the case of Formula One World Championship[3] on the basis of facts and held that the Indian subsidiary was operating in an independent manner and there was nothing to show that the Indian subsidiary constitutes a PE of the taxpayer in India. Accordingly, it has been held that the taxpayer does not have a PE in India.

Our comments

The issue with respect to the determination of PE of a foreign company in India has been a subject matter of litigation before the Courts/Tribunal.

The Supreme Court in the case of E-Funds IT Solution Inc. dealt with an issue whether the subsidiary of a U.S. company for back office support services constitutes a PE in India. The Supreme Court relied on its own decision in case of Formula One World Championship Ltd. and observed that there must exist a fixed place of business in India, which is at the disposal of foreign companies, through which the business has been carried on. 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. The 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 requirements of Article 5(2)(l) of the tax treaty are not satisfied. Therefore, the taxpayer does not have Service PE in India. The Supreme Court agreed with the High Court's observations 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 U.S. company, nor was any factual foundation laid to attract any of the clauses contained in Article 5(4) of the tax treaty.

However, subsequently the Delhi High court in the case of GE Energy Parts Inc.[4] observed that GE India was located in the space leased by a group company. This space was at the constant disposal of such group comapny as evidenced by specific chamber/rooms and secretarial staff allotted to GE staff, and was used by GE staff for their work. The taxpayer's activities in India were wholly or partly carried on through such a fixed place of business. Accordingly, the High Court had held that the taxpayer had a fixed place PE in India. The High Court while relying on the Italian Supreme Court's decision in Philip Morris observed that if agents are involved even in a phase of a conclusion of a contract it equals to 'authority to conclude contract'. Therefore, GE India's activities constituted agency PE in India.

Determination of a PE in India is a fact specific exercise. It is important to analyse the facts of each case and the existing arrangements to mitigate a PE exposure in India.

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[2] ADIT v. E-funds IT Solutions Inc [2017] 86 taxmann.com 240 (SC)
[3] Formula One World Championship Ltd. v. CIT [2017] 394 ITR 80 (SC)
[4] GE Energy Parts Inc and Others v. CIT (ITA No. 621/2017, dated 24 May 2018)

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