The Indian company, having franchise rights from a foreign company, does not constitute agency PE of such foreign company in India under the India-U.S. tax treaty

Background
Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Domino’s Pizza International Franchising Inc1 (the taxpayer) held that Indian company with whom the taxpayer entered into franchise agreement does not constitute a dependent agent Permanent Establishment (PE) of the taxpayer in India under the India-U.S. tax treaty (tax treaty). The Indian company has no authority to maintain its stock or goods or merchandise on behalf of the taxpayer. No activities are carried out by the Indian company on behalf of the taxpayer. Therefore, it does not constitute PE in India.

Facts of the case
- The taxpayer is tax resident of the United States of America (USA), filed its return of income for Assessment Year (AY) 2012-13 declaring total income of INR16.53 million. The taxpayer entered into Master Franchises Agreement (MFA) with Jubilant Food Works Limited (Jubilant) for the franchise of Domino’s Pizza Store. The said MFA provide certain store/consultancy services to Jubilant.
- In terms of the agreement, Jubilant paid store opening fees for those services. The franchise fee is received by the taxpayer from Jubilant for ongoing use of Dominos trademark and also for the right to use the new technology, new product development and system improvement. As per MFA, the taxpayer is entitled to charge 3 per cent of the sales of the store of Jubilant and further 3 per cent on the sale of their sub-franchise store.
- The taxpayer claimed that the Jubilant has complete independence with regard to its business dealing and transaction and does not act on behalf of the taxpayer or under its instruction. The taxpayer has offered the income received from Jubilant in the nature of royalty taxable at 10 per cent under the tax treaty. The taxpayer has also offered the income from franchise fee and consultancy services provided to Jubilant for the opening of the store.
- The Assessing Officer (AO) held that Jubilant is dependent upon the taxpayer. The taxpayer has exclusive franchise right in India. Jubilant is not allowed any other activities other than activities prescribed in the agreement. Further, the quality of material and equipment used has to be approved by the taxpayer. The expenses on advertisement and marketing are also carried out in accordance with the provision of the agreement. On the basis of above observation, the AO held that Jubilant does not have economic independence and its modus operandi is not on principal to principal basis. Therefore, Jubilant is a dependent agent for the purpose of determining a PE. The AO treated the receipt from operations in India as a business receipt taxable at 40 per cent.
- The Dispute Resolution Panel (DRP) accepted the contention of the taxpayer that Jubilant is not a dependent agent and does not constitute a PE in India. The action of the AO in treating the royalty income as profit and gain from the business under Section 44DA of the Income-tax Act, 1961 (the Act) was also set aside.
- The tax department filed an appeal before the Tribunal.

Tribunal’s decision

- The sub-franchise agreement is executed between Jubilant and sub-franchise and not between the taxpayer and sub-franchise. The Tribunal on perusal of these facts from the copy of MFA and sub-franchise agreement (SFA) observed that the assertion of the taxpayer is correct.

- The SFA is signed on behalf of Jubilant and Travel Food Services Pvt. Ltd. for Mumbai and Delhi location. The profit and loss from the business belong to Jubilant or sub-franchise. It has been observed that certain clauses and the agreement entitles the taxpayer to examine the accounts, approve suppliers and allowing control over the advertisement, however, the Jubilant or sub-franchise are not storing any goods on behalf of the taxpayer. From the sub-franchise, the taxpayer is entitled to only royalty and store opening fees.

- On a perusal of Article 5 of the tax treaty, it has been observed that none of the conditions prescribed under clause (a) to clause (l) of Article 5(2) are attracted. The AO has relied upon Article 5(4) of the tax treaty. However, the Indian company has no authority to maintain in India its stock or goods or merchandise on behalf of the taxpayer. No activities are carried out by the Indian company on behalf of the taxpayer. In our view, none of the clauses of Article 5(4) of the tax treaty are applicable to the taxpayer.

- Therefore, considering the contents of the MFA and SFA, the Master franchise are independent business entity, the restriction provided in MFA and SFA are only to safeguard the brand value and to ensure the correct receipt of royalty income as concluded by the DRP. Hence, the Tribunal did not find any infirmity or illegality in the assessment order passed in pursuance of the direction of DRP.

- The decision relied by the tax department in the case of Formula One World Championship Ltd. is distinguishable on facts of the present case. In the said case, physical control of the circuit was with Formula One World Championship Ltd. and its affiliates from the inception. However, in the present case, there is no physical control on the business of franchise and sub-franchise by the taxpayer.

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.

After the landmark decision of the Supreme Court in the case of the Formula One World Championship Ltd. where the conditions for the constitution of PE have been explained at length, the Supreme Court delivered another decision in the case of E-funds IT Solutions Inc., dealing with the issue of whether the back office services that are outsourced by a foreign enterprise to its Indian subsidiary constitute a PE of the foreign enterprise in India. The Supreme Court upheld the High Court’s decision that E-funds India was neither authorised to exercise any authority to conclude contracts on behalf of the taxpayers, nor any factual foundation has been laid to attract any of the conditions of the agency PE clause under the India-U.S. tax treaty.

The Mumbai Tribunal in some of the cases held that the Indian subsidiary did not create a dependent agent PE in India since it did not have authority to conclude contracts nor have they habitually exercised such authority. However, the Mumbai Tribunal in the case of NGC Network Asia LLC held that the Indian group company of a foreign company has been habitually exercising in India an authority to conclude contracts on behalf of the foreign company which are binding on the foreign company. Therefore, the Indian company has been treated as a dependent agent PE in India under Article 5(4)(a) of the India-U.S. tax treaty.

The Delhi Tribunal in the present case has held that Indian company does not constitute a dependent agent PE of a foreign taxpayer in India under the India-U.S. tax treaty since the taxpayer has no authority to maintain its stock or goods or merchandise on behalf of the taxpayer. No activities are carried out by the Indian company on behalf of the taxpayer. Therefore, it does not constitute PE in India.

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2 Formula One World Championship Ltd. v. CIT [2017] 394 ITR 80 (SC)

3 ADIT v. e-Funds IT Solution Inc (Civil Appeal No. 6082/2015, dated 24 October 2017) (Supreme Court)


5 DDIT v. B4U International Holdings Ltd. (ITA No. 880/Mum/2005) (AY 2001-02), Reuters Limited v. DCIT (ITA No. 7895/Mum/2011) (Mum)

6 NGC Network Asia LLC v. JDIT (ITA No. 7994/Mum/2011) (Mumbai Tribunal)
The OECD BEPS report on Action 7 dealing with ‘preventing the artificial avoidance of PE status’ recommends an expanded scope of what is proposed to constitute a PE, focusing on the negotiation and final conclusion of contracts.\textsuperscript{7}

Considering BEPS suggestions, the Finance Act 2018 amended Section 9(1)(i) of the Act\textsuperscript{8} providing that ‘business connection’ shall include any business activity carried out through a person who, acting on behalf of the non-resident has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident.

However, this expanded scope has not been introduced in the Indian tax treaties. It would be interesting to see how the expanded scope would impact the determination of PE when India will be a party to a Multilateral Instrument (MLI) where countries have agreed to adopt such clause.

\textsuperscript{7}In paragraph 5 of Article 5 the phrase ‘habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise’ has been added

\textsuperscript{8}With effect from 1 April 2019 (Financial Year 2018-19)