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TAX FLASH NEWS

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Liaison office of overseas group entity constitutes fixed place PE and Indian subsidiary constitutes agency PE under the India-USA tax treaty

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of GE Energy Parts Inc.[1] (the taxpayer) held that the Liaison Office (LO) of overseas group entity of the taxpayer constitutes fixed place Permanent Establishment (PE) in India under the India-USA tax treaty (tax treaty) since activities carried on by GE India from LO premises were substantial and core, and not merely of preparatory or auxiliary character. Though, LO's premises was taken on lease the same was constantly used by expatriates who were working in India for taxpayer's overseas group entity. The said premises was also occupied by the employees of the other group company of the taxpayer who were working under the direct control and supervision of expatriates.

The Tribunal observed that the expatriates of overseas group entity and employees of group company were appointed to act as agent of multiple GE overseas enterprises. Expatriates and employees of group were acted as agents of dependent status. GE India had authority to conclude contracts on behalf of GE overseas, which leads to the conclusion that it has agency PE in India.

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[1] GE Energy Parts Inc. v. ADIT (ITA No. 671/Del/2011) – Taxsutra.com Note – There are various other issues dealt by the Delhi Tribunal in this decision. However, we have prepared flash news only on the issues with respect to fixed place PE, agency PE and attribution of profits.

Facts of the case

- The taxpayer is a company incorporated in the USA and is a part of the GE Group. The taxpayer supplies equipment to customers in India relating to oil and gas business, energy business, transportation business and aviation business.

- The taxpayer is engaged in various sales activities in India, for which the business heads are generally expatriates, who are appointed to head Indian operations, with the support staff provided by GE India and also by various third parties. These expatriates are on the payroll of GE International Inc. (GEII) but working for various businesses of GE group.

- One of the group entity of the taxpayer was having LO in India to undertake liaison activities. LO had entered into a Global Service Agreement (GSA) with an Indian company to provide certain support services to the group company. It does not include commercial activities.

- A survey was conducted by the tax authorities at the premises of LO whereby certain documents were found. On the basis of information gathered during the course of survey, it was revealed that in addition to the liaison activities, the taxpayer has provided commercial and trading activities. Therefore, the Assessing Officer (AO) issued notices to 24 group entities of the taxpayer.

- The AO observed that marketing and sales activities took place in India. Expatriates from GEII along with the employees of group entity constituting the Indian team (GE India) were always involved and participated in the negotiation of prices. Such negotiations of prices took place in India. The AO also held that the taxpayer had fixed place PE as well as a dependent agent PE in India. Since the taxpayer was making sales in India with the involvement of its PE in India, the profits attributable to such PE were chargeable to tax. The AO deemed 10 per cent value of supplies made to the clients in India as the profits arising from such supplies, and 35 per cent of such profit was attributed to the PE in India.

- The Commissioner of Income-tax (Appeals) upheld the order of the AO.

Tribunal's ruling

Fixed place PE

- The term 'fixed place of business' envisages that the place should be at the disposal of the enterprise with some degree of permanence. A place occupied just temporarily does not lead to the establishment of a fixed place PE. The character of 'fixed' should be attached to such a place, which means that it should be used with a certain amount of permanence.

- In the present case, GE India comprising expatriates from GEII were permanently using the LO premises of the group entity. Though the LO premises was taken on lease by the group company, the same was also being constantly occupied by these expatriates, who, though on the payroll of GEII, were working in India for the GE Overseas entities. The said premises was also occupied by the employees of other group company of the taxpayer who was working under the direct control and supervision of the expatriates.

- From the job descriptions and appraisal reports with the manager assessment, it indicates that the expatriates were India Country heads or working at the top positions, managing the business, securing orders and doing everything possible that could be done here qua the Indian operations of GE overseas entities in India.

- On reference to the emails found during the course of the survey, it indicates that GE India was in full command of the sales activities in India and not allowing GE overseas even to interfere with what they had agreed with the customer in India.

- On reference to the survey documents in harmony with the self-appraisals, manager assessments and job responsibilities given under the signature of the expatriates and employees of GEIIPL working for GE Overseas entities in India, it becomes clear that GE India was conducting business of GE Overseas in India and was directly and wholly involved in negotiating and finalising the contracts.

- The Tribunal relied on Supreme Court's decision in the case of Ahmedbhai Umarbhai & Co[2]. The Tribunal observed that marketing and sales are income yielding activities and if the core activity of marketing and sale has taken place in India, then profit from the sale, accrues or arises in India alone and the same to that extent should be charged to tax. In the instant case though the business of GE Overseas was partly carried out in India, but the core of sales activity was done from the LO premises.

- On reference to decision of the Supreme Court[3] and the High Court[4] it indicates that the test for determining a preparatory or auxiliary activity is not to see if the core activity can or cannot be performed without it. Rather, the test is that such activity merely supports the core activity and does not *per se* lead to earning of income. If the activity carried on from a fixed place in India is simply in aid or support of the core income generating activity and is remote from the actual realisation of profits, the same assumes the character of a preparatory or auxiliary nature.

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[2] CIT v. Ahmedbhai Umarbhai & Co. [1950] 18 ITR 472 (SC)
[3] DIT v. Morgan Stanley & Co. Inc. [2007] 292 ITR 416 (SC)
[4] National Petroleum Construction Company v. DIT [2016] 383 ITR 648 (Del)
U.A.E. Exchange Centre Ltd. v. Union of India and Ors. [2009] 313 ITR 94 (Del)

- Various survey documents, indicates that GE India was playing an important and proactive role in the finalisation of the deal and the terms and conditions with customers in India. The major activities about the sourcing of customers and finalising the deals with them were done by GE India in consultation, wherever required, with GE Overseas.

- The taxpayer is not dealing in off-the-shelf goods. Sales are made on the basis of a prior contract. In such cases, customer's requirements are first properly understood and thoroughly examined. Thereafter commercial and technical discussion meetings take place and proposals are prepared after negotiations on technical and commercial aspects taking Indian laws and regulations in consideration. These are all significant and essential parts of sales activity, which have to be necessarily done in India by GE India.

- The mere fact that the contracts were formally signed outside India by GE Overseas does not in any manner undermine the conduct of core activity of sales by GE India. With the doing of all the above activities, when MOU is prepared in India and the Indian customer signs it first in India, and then it is sent to GE overseas for signature, for all practical purposes, it will have to be concluded that core sales activity was undertaken by GE India alone.

- On reference to the OECD Commentary[5] explaining `preparatory or auxiliary activities' it becomes clear that if a fixed place of business is used for rendering services to more than one company of a group, as is a case under consideration, then such services cannot be treated as of preparatory or auxiliary character.

- The activities carried on by GE India from the LO premises were of substantial and core and not merely preparatory or auxiliary. All the three conditions for constituting a fixed place PE under Article 5 of the tax treaty are fully satisfied as LO premises is a fixed place from which business of GE Overseas is partly carried on in India and the activities carried out from such fixed place are not of preparatory or auxiliary character.

- The decisions[6] relied on by the taxpayer is distinguishable on the facts of the present case. Accordingly, it has been held that LO building constituted fixed place PE of the taxpayer and all the GE overseas entities.

Agency PE

- It is an admitted position that the expatriates were rendering services to multiple GE entities in India. The tax department claimed that the expatriates were looking after one of the three major lines of business, catering to various GE overseas entities. Thus, there is no doubt that GE India comprising expatriates and other employees of other group company, etc., were not working for a particular enterprise, but for multiple enterprises dealing in one of the three major businesses of GE group.

- Second part of Article 5(5) of the tax treaty provides that a person shall not be considered an agent of independent status if he satisfies both the conditions simultaneously. In other words, when the activities of such an agent are devoted wholly or almost wholly on behalf of an enterprise and the transactions between the agent and the enterprise are not at ALP, then, he shall not be considered an agent of independent status. Use of the word 'and' between the two conditions makes it amply clear that the concurrent satisfaction of both of them is a prerequisite for not considering such a person an agent of independent status. If only one condition is satisfied and the other is not, the person is considered as an agent of independent status. In the present case, although the transactions were not at Arm's Length Price (ALP), but, since GE India worked for multiple entities, it fails to fall within the exception carved in para 2 of Article 5(5) of the tax treaty.

[5] Para 26

[6] DIT v. E-Funds IT Solutions [2014] 364 ITR 256 (Del)
CIT v. Sumitomo Corporation [2016] 382 ITR 75 (Delhi)

- The expatriates of GEII and employees of other group company were appointed to act as an agent of multiple GE overseas enterprises. It is nobody's case that they were otherwise acting as agents of independent status working for other third parties in India. This proves that expatriates and employees of other group company acted as agents of dependent status in the first place itself.

- Although the number of GE overseas entities looked after by each of them is more than one, the fact that such entities were in one of the three broader lines of businesses of GE group, makes them agents of dependent status per se.

- Para 26 of OECD commentary, though dealing with the activities of preparatory or auxiliary nature, also acknowledges that a fixed place of business which renders services to more than one company would not fall in exemption provided in Article 5 of the tax treaty and hence, constitute PE. Therefore, it has been held that GE India consisting of expatriates of GEII and employees of other group companies, etc., are the persons covered in Article 5(4) acting in India on behalf GE Overseas entities.

- OECD Commentary is not conclusive in itself. If some member country has reservations on any part of the commentary, it can express so. In such a situation, the interpretation given in the Commentary bows down in favour of the observations given by such country in so far as the Conventions of such a country are concerned.

- The reservations given by India in the year 2008 cannot retrospectively amend its position qua the OECD commentary dealing with similar expressions used in the tax treaty with the USA, which was admittedly entered into much earlier. However, this does not apply to the Conventions entered into after India stating its position on the OECD Commentary, in which case, the position given by India overrides the OECD Commentary to that extent. Therefore, India's position on para 33 of the OECD commentary given in 2008, should be read as a part of the Commentary interpreting the tax treaty.

- Lack of active involvement by an enterprise may be indicative of grant of authority to an agent. 'Lack of' does not mean the absence of. It shows that if the enterprise is not fully involved in the transaction, which is concluded by an agent, it will give an inference of the agent having an 'authority to conclude contract' in the name of the enterprise.

- Thus, it is evident that the paras containing OECD commentary on the expression 'authority to conclude contracts in the name of the enterprise' do not have uniformity in the approach. There is some sort of contradiction between them. The essence of the matter is that selective reference to the OECD commentary is impermissible. One should understand and follow the spirit rather than individual lines divorced from the context.

- On reading Article 5(4)(a) of the tax treaty, it indicates that an agency PE is established if the person habitually exercises an authority to conclude contracts so long as his activities are not of preparatory or auxiliary nature. The term 'preparatory or auxiliary' refers to such activities, which are simply in support of the core income generating activity. They do not comprehend negotiating 'all elements and details of a contact.'

- The activities of the person leading to the `authority to conclude' a contract, so as to form an agency PE, should not be restricted to exemptions for the constitution of a fixed place PE, such as, preparatory or auxiliary etc. It means that the activities of such a person should be of core nature and not merely subsidiary to the main activities, which obviously rules out negotiating all elements and details of a contract.

- Reading clause (a) in totality gives a clear idea of constituting a PE when the activities of the person, other than an agent of independent status, are not of preparatory or auxiliary nature. It does not require doing of each and every aspect of the contract, howsoever minor.

- Having discussed the nature of activities done by GE India, which are of core nature and not merely preparatory or auxiliary, it has been held that they clearly indicate its authority to conclude contracts on behalf of GE Overseas. Therefore, GE India constituted agency PE of all the GE Overseas entities in India.

Attribution of income

- The attribution of income made by the AO is segregated in two parts, viz. calculation of total profit from the sales made by GE overseas entities in India has been worked out at 10 per cent and second, attribution of such profit to marketing activities, which the AO has taken at 35 per cent of 10 per cent.

- The AO invoked the provisions of Rule 10(iii) of the Income-tax Rules, 1962 (the Rules) and estimated profit at 10 per cent of sales made in India. The rate of 10 per cent was applied by drawing strength from Sections 44BB and 44BBB of the Income-tax Act, 1961 (the Act)[7]. The approach of the AO in estimating income at 10 per cent of sales made in India is correct and does not require any interference.

- As regards the second component of the share of marketing activities in the total profit, the AO applied 35 per cent by taking assistance from the decision taken by the Delhi Tribunal in the case of Rolls Royce[8]. Subsequently, the said decision has been upheld by the Delhi High Court[9]. Further, the Delhi Tribunal in ZTE Corporation[10] has also attributed 35 per cent of the profits attributable to marketing activities in India.

- There can be no hard and fast rule of attribution of profit to marketing activities carried out in India at a particular level. Attribution of profits to PE in India is fact based, depending upon the role played by the PE in the overall generation of income. Such activities carried out by a PE in India resulting in the generation of income, may vary from case to case. Attribution of income has to be in line with the extent of activities of PE in India.

- The taxpayer provided the chart showing the nature of activities done by Rolls Royce in India were more than those done by GE overseas entities. The similar chart has also been given showing the difference in the activities carried out by ZTE Corporation in India vis-à-vis the taxpayer. From such a comparative analysis, it has been observed that the activities carried out by Rolls Royce and ZTE Corporation in India are not similar to those done by the PEs of GE Overseas entities in India.

- Accordingly, the Tribunal cannot approve attribution of whole of 35 per cent of the profits relating to sales and marketing to the PE in India. Therefore, it has been held that GE India conducted core activities and the extent of activities by GE Overseas in making sales in India are roughly one-fourth of the total marketing effort.

- The Tribunal estimated 26 per cent of total profit in India as attributable to the operations carried out by the PE in India. Therefore, as against the AO applying 3.5 per cent to the amount of sales made by the taxpayer in India, it has been directed to apply 2.6 per cent on the total sales for working out the profits attributable to the PE in India.

Our comments

The issue of determination of a PE in India and attribution of profit to such PE has been a matter of litigation before the Courts/Tribunal.

In some of the cases[11] the Tribunal has held that LO does not constitute fixed place PE in India because the LO was carrying on operations within the restricted activities (i.e. preparatory or auxiliary) permitted by the Reserve Bank of India

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[7] Special provisions for computing profits and gains in connection with the business of exploration, etc. of mineral oils/operation of aircraft in the case of non-residents.
[8] Rolls Royce PLC v. DDIT [2007-TII-32-ITAT-DEL-INTL]
[9] Rolls Royce PLC v. DIT [2011] 339 ITR 147 (Del)
[10] ZTE Corporation v. ADIT [2016] 159 ITD 696 (Del)

[11] Mitsui & Co. Ltd [1991] 39 ITD 59 (Del), Sumitomo Corpn [2008] 110 TTJ 302 (Del), Motorola Inc [2005] 95 ITD 269 (Del) (SB), Western Union Financial Services Inv [2007] 101 TTJ 56 (Del), Metal One Corpn. [2012] 52 SOT 304 (Del)

(RBI). On the other hand in some of the decisions[12] it has been held that LO constitutes fixed place PE because it was carrying on certain commercial activities which were core activities of the taxpayer.

The Tribunal in the present case has held that the LO of overseas group entity of the taxpayer constitutes fixed place PE under the tax treaty since activities carried on by GE India from LOs premises were substantial and core in nature, and not merely of preparatory or auxiliary character.

As per Article 5(5) of India-USA tax treaty, an agent shall be considered to be dependent if it satisfies both conditions mentioned therein i.e. (i) its activities are wholly or almost wholly on behalf of foreign enterprise and (ii) the transactions between the two are not made under arm's length conditions. Where transactions between the agent and foreign enterprise are under arm's length conditions, the second condition would not be satisfied, if the agent devoted wholly or almost wholly to the foreign enterprise. The Delhi High Court in the case of E-Funds Corporation[13] upheld the same.

With respect to agency PE, the Tribunal observed that the concurrent satisfaction of both the conditions specified under Article 5(5) of the tax treaty is a pre-requisite for not considering a person an agent of independent status. If only one condition is satisfied and the other is not, the person is considered as an agent of independent status. Although the transactions were not at ALP, but, since GE India worked for multiple entities, it fails to fall within such exception.

In view of the above decision, the foreign entities carrying on business in India may regularly assess their possible PE exposure/risk.

[12] Brown and Sharpe Inc. (ITA No.219 of 2014) (Del), Jebon Corporation India [2011-TII-15-HC-KAR-INTL], Columbia Sportswear Company [2011] 337 ITR 407 (AAR)

[13] DIT v. E-Funds Corporation (ITA 738/2011), DIT v. E-Funds IT Solutions (ITA No. 736/2011 & 737/2011).

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