

Global payment solution provider company has a permanent establishment in India

Background

Recently, the Authority for Advance Rulings (AAR) in the case of MasterCard Asia Pacific Pte. Ltd¹ (the applicant, a Singaporean MasterCard group company) dealt with an issue whether the global payment solution provider company facilitating various stakeholders² worldwide to use electronic forms of payment has a Permanent Establishment (PE) in India and whether payments for such services are taxable in India.

The AAR held that the applicant has MasterCard Interface Processor (MIP)³ and MasterCard's Network to provide transaction processing services to its customers in India. This constitutes a fixed place PE in India under the India-Singapore tax treaty (tax treaty) as the applicant is carrying out its business of facilitation of authorisation of the transaction through such MIPs and network which are situated in India and are at the disposal of the applicant. The AAR also held constitution of service PE on account of applicant's employees visiting India and constitution of Dependent agent PE on account of Indian subsidiary securing orders for the applicant.

A portion of the fees received by the applicant has also held to be categorised as royalty under the tax treaty. Further, AAR also clarified that as the payment is effectively connected with the PE in India, it would be taxable as business income under the tax treaty and not as royalty. With regard to the

attribution of income to the Indian PE, the AAR agreed that all the revenues received by the applicant from customers in India would not be attributed to the Indian PE since significant activities are also carried out by the applicant outside India. Thus, there is a need for attribution which is required to be done by the Assessing Officer (AO). On such attribution of income to the PE, the tax is required to be withheld at the full applicable rate at which the non-resident is subjected to tax in India.

Facts of the case

- The applicant belongs to the MasterCard Incorporated group of companies.
- The applicant is the regional headquarter for the Asia Pacific, Middle East and Africa (APMEA) region and carries out the MasterCard group's principal business of transaction processing and payment related services under a family of products including 'MasterCard', 'Maestro' and 'Cirrus' in the APMEA region.
- Pursuant to Master License Agreements (MLA), the applicant provided services to APMEA customers (Banks, Financial Institutions, etc.). In terms of MLA, the applicant charges its customers' transaction processing fees relating to authorisation, clearing and settlement of transactions. The applicant also receives assessment fees for building and maintaining a processing network that serves the needs of customers globally, for setting up and maintaining a set of rules that govern the authorisation, clearing and settlement process for every payment transaction. Additionally, it receives miscellaneous revenue for the provision of services which are ancillary to the transaction processing activities.

¹ MasterCard Asia Pacific Pte. Ltd (AAR No. 1573 of 2014) – Taxsutra.com

² Financial institutions, businesses, merchants, cardholders, and governments

³ MIP is about the size of a standard personal computer and is placed at the customers' locations in India. It is through the network and processing centers outside India that the applicant is able to facilitate the authorisation, clearing and settlement of payment transactions

- The processing of electronic payment transactions involves steps such as initial level verification and validation of the transaction, authorisation, and thereafter clearing and settlement. Till December 2014, MasterCard International Incorporated (MCI) had a Liaison Office (LO) in India. Thereafter, the applicant had shut down the LO and had transferred that work to the Indian subsidiary [MasterCard India Services Private Limited (MISPL)].
- The customer is provided with a MIP that connect to MasterCard's Network and processing centres. The applicant has a subsidiary in India and Indian subsidiary owns and maintains the MIPs placed at the customers' locations in India.
- In view of the above facts, the applicant filed an application before the AAR to determine the taxability of the services rendered in this regard.

AAR ruling

MasterCard Interface Processor – Fixed place PE

- The AAR discussed that automatic equipment can also create a PE⁴ and to create a PE, it is not necessary that the equipment should be fixed to the ground. It is sufficient compliance that it remains on a particular site⁵. This is also clear from the decision of the Supreme Court in the Formula One⁶. Thus, AAR held that even if MIPs are automatic equipment placed at the site of customer banks in India, meeting the test of permanency, they can create a PE provided other tests are satisfied.
- Article 5 of the OECD Model Commentary provides that the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to own or use that place is therefore required. Thus, AAR held that ownership of MIPs with Indian subsidiary is not relevant if other tests are satisfied.
- The preliminary validation activities carried out by MIPs involve PIN processing, validation of card codes, names and address verification, etc. In case of errors, the MIP would alert the Acquirer bank/financial institution on the need for a correction and the data is then not authorised. Therefore, AAR held that the role played by MIPs is significant in facilitating the authorisation

⁴ Formula one World Championship Limited v. CIT [2016] 390 ITR 199 (Del)

⁵ Note 5 of OECD commentary on Article 5 of Model Tax Convention

⁶ Formula One World Championship Limited v. CIT [2017] 394 ITR 80 (SC)

process, and without this initial verification/validation by MIPs, the authorisation would not happen. Thus, this is a significant activity for authorisation part of the transaction processing and cannot be said to be preparatory or auxiliary.

- The AAR relied on the Transfer Pricing (TP) report of the Indian subsidiary and held that the Indian subsidiary does not exercise any of the rights of an owner. All risk mitigation decisions are undertaken by the applicant or its overseas AEs on its behalf. Further, based on the TP report it has been stated that all intangibles are owned by the Applicant and not the Indian subsidiary.
- The applicant is charging a fee for the cost of installation of MIPs. Accordingly, it has been held that MIPs, though shown to be owned by an Indian subsidiary, are not under its control or disposal.
- In the case of Formula One, it was held that being 'at the disposal of' would mean right to use and having control over that place/equipment. The AAR held that in the present case, the applicant has right to use MIP and has control over it vis-à-vis the customer banks and thereby, the applicant had the MIPs at its disposal.
- The AAR held that the applicant is carrying out its business of facilitation of authorisation of the transaction through MIPs situated in India which are at its disposal. Further, the functions performed by MIPs in the facilitation of authorisation transaction are significant in nature and are not preparatory or auxiliary activities. Hence, MIPs create a fixed PE of the applicant in India.

MasterCard Network – Fixed place PE

- AAR notes that MIP is involved only in the authorisation part of the transaction processing while the MasterCard Network is involved in all the three phases of transaction processing, i.e. authorisation, clearance and settlement.
- The data relating to a transaction between two banks is transferred within India and outside India through transmission towers, leased lines, fibre optic cable, nodes and internet which is part of MasterCard Network. The raw data transferred outside by various banks using the two application software⁷ are also a part of MasterCard Network. Thus, the activity of transmission of information

⁷ i.e. Master Connect and Master Card File express

between various banks in India and uploading of raw data and receipt of final data using application software is performed in India.

- Further, AAR observed that significant activities relating to clearance and settlement take place in India.
- AAR noticed that MasterCard Network in India consists of MIP owned by an Indian subsidiary, transmission tower, leased lines, fibre optic cable, nodes and internet owned by third party service provider, and application software owned by the applicant. Like MIP, the network also passes the test of permanency and fixed place. It also passes the test of disposal as the TP report of Indian subsidiary provides that U.S. Group Company is responsible for management and maintenance of MasterCard Worldwide Network remotely from the U.S. Further, AAR held that the application software is owned by the applicant and controlled by them, and are therefore at the disposal of the applicant.
- The part of a network provided by third party service provider in India is also at the disposal of the applicant. The applicant admitted that the network in India is also secured by MasterCard to prevent fraud and to enhance security. Thus, AAR held that MasterCard Network in India is at the disposal of the applicant. The task performed by MIP (preliminary verification/validation part of authorization and encryption of data), network in India (transmission of data), application software (sending and receiving data) are significant activities when seen in the context of overall functions of transaction processing rendered to a third party.
- Accordingly, AAR held that MasterCard Network also satisfies the test of permanency, disposal and fixed place and thereby creates a fixed place PE of the applicant in India.

Role of the Bank of India premises – Fixed place PE

- For constituting space available at Bank of India (BOI) as fixed place PE of the applicant, it is necessary that the functions of the applicant are carried out through that space. The AAR observed that the actual settlement by passing debit or credit entry is done by BOI. This settlement activity is the function of the applicant, which is carried out by BOI on its behalf and with all responsibility of error on the applicant.
- Based on the aforesaid facts, AAR held that BOI carries out the settlement activity as an agent of the applicant under its instruction and responsibility. The settlement activity is not a

principal-to-principal transaction as the liability is always of the applicant and employees of BOI carry out their work as per the applicant's instruction. Thus, it was upheld that the employees of BOI carrying out this work are under the control and supervision of the applicant and the space occupied by them in BOI is at the disposal of the applicant.

- Accordingly, the AAR accepted the Revenue's plea that space where settlement activity takes place through employees of Bank of India creates a fixed place PE of the applicant.

Subsidiary PE

- Prior to December 2014, MCI had accepted its PE in India under MAP and attributed 100 per cent of income from transaction processing activity in India to such PE. However, after December 2014, with all operations remaining same, the TP report mentioned that the Indian subsidiary was undertaking only support functions and not actual transaction processing, which MCI was doing earlier. Thus, AAR observed that there are some functions and risk related to transaction processing which were earlier carried out by MCI in India and are still carried out by Indian subsidiary but not shown in the Functions, Assets, and Risk (FAR) of the Indian subsidiary. Therefore, the AAR held that the subsidiary company creates a PE of the applicant in India.

Service PE

- The AAR observed that the employees of the applicant visit India for understanding the future requirement, informing new products and to monitor the efficiency of the operation and not in connection with the signing of the contracts. Also, the threshold of 90 days in a fiscal year was also met. Further, the clients of the applicant were located in India. Thus, relying on the decision of the Supreme Court in the case of E-Funds IT Solutions Inc., the AAR held that the first test for creating Service PE is satisfied since service is provided to the Indian customers.
- The AAR also held that even in case of an automated process, employees are needed to check if the process is working alright; to interact with clients, to meet clients and take feedback, etc. These are part of the service rendered to clients in India and are not stewardship activities. Taking feedback is also part of service provider activity as it improves services to the customer. When employees visit India to inform clients about new products, this is also part of the service that would be provided by the applicant to these clients.

- Thus, the AAR observed that the employees of the applicant visiting India are providing services to Indian clients and hence, once they cross the threshold of 90 days in a year, a Service PE is created. The decision of Morgan Stanley relied on by the applicant is distinguishable on facts.
- Further, with regard to the employees of BOI, the AAR also held that such employees do not constitute service PE of the applicant.

Agency PE

- The AAR observed that the Indian subsidiary works only for the applicant. Although it was envisaged that subsidiary would also be rendering services to third parties but there is no service to third parties. The AAR agrees with the Revenue that the Indian subsidiary is legally and economically dependent on the applicant and gets its instructions and remuneration from the applicant.
- Indian subsidiary provides the proposals to the Indian banks that are prepared, validated and approved by the applicant. The proposals contain the rates at which the applicant proposes to provide services to the customer banks. In case the customer does not agree with the proposed terms and makes a counter proposal, the same is uploaded on the portal of the applicant outside India by the employees of the subsidiary. Thereafter, AAR observed that it depends on the applicant operating from outside India to accept the counter proposal of the customer or reject the same. For the new customers, there is constant interaction between the applicant and subsidiary. This process establishes that orders or agreements are routed through subsidiary though the finalisation of the contract is by the applicant in Singapore.
- The AAR observed that the above position may not satisfy the requirement of 'concluding contract' but it satisfies the requirement of 'securing order'. The AAR relied on Delhi Tribunal's decision in the case of Rolls Royce Plc⁸ which was subsequently affirmed by the Delhi High Court⁹. The Delhi Tribunal observed that the U.K. incorporated subsidiary habitually secures orders in India for the taxpayer, and as a practice, no customer in India sends its order directly to the taxpayer. They are required to be routed only through the subsidiary. Thus, the AAR held that Indian subsidiary constitutes a dependent agent PE under Article 5(8) of the tax treaty on account of habitually securing orders wholly for the applicant.

Royalty

- To decide whether a payment is a royalty or service, there are certain tests which had been laid down by the Delhi High Court in the case of Formula One World Championship Limited. The High Court held that the payment was not royalty as the use of logo, trademark, etc. is only incidental. On reference to the MasterCard Electronic License Agreement, AAR observed that MCI had granted licensee right to use various trademarks and marks owned by it, solely in connection with license's payment card programs. Thus, the dominant purpose of the agreement is to allow the use of intangibles for the payment card programs of licensees, i.e., banks and financial institutions.
- Through this license agreement, MCI US has granted to the applicant a non-exclusive license, with the right to grant sub-licenses, to use the IP in the territory (India in the present case) solely in connection with the promotion and sale of services. For the said rights and licenses granted by MCI US to the applicant, the applicant is paying a royalty to MCI US.
- The AAR discussed that the agreement between the applicant and customer banks is to license the trademark/mark and not for facilitating transaction processing. The licensing agreement between the applicant and MCI US, who is the real owner of the IP, indicates that the agreement and payment of royalty are for the use of IPs in India. AAR opines that this arrangement further establishes that a part of the payment made by the customer banks in India to the applicant is for the use of these IPs.
- Further, high spend on advertisement/promotion also supports the Revenue's contention that licensing of brand/trademark is not incidental but the main activity, so that people buy credit cards with MasterCard logo.
- Accordingly, the AAR held that the payment received by the Applicant represents consideration for the use of IPs in India and hence is to be classified as royalty.
- The AAR also held that since royalty is effectively connected with various types of PEs discussed above. Thus, it would get taxed as business income under Article 7.

⁸ Rolls Royce Plc v. DIT [2008] 19 SOT 42 (Del)

⁹ Rolls Royce Plc v. DDIT [2011] 339 ITR 147 (Del)

Equipment royalty

- The AAR observed that the MIPs are de facto owned by the applicant as they are charging a fee for the cost of MIP installation. Thus, the first test for equipment royalty is held to be satisfied. Further, AAR observed that the control of MIPs is with the applicant and not the customer banks. Accordingly, it has been held that the payment for the use of MIPs to be categorized as royalty and since they are effectively connected with PE of the applicant in India, taxable as business income.

Process royalty

- The AAR held that decision in the case of Verizon Communication is applicable in the present case and since both the equipment and the process are in India, it would be treated as process royalty and taxable under the tax treaty.
- Based on the list of patents filed by the applicant in India, AAR observed that there are a number of patents related to process used for transaction processing.
- The AAR observed that the fact that only three patents are granted so far in India would not have an impact on the inference that technology is patented and hence secret. They are patented and hence cannot be known to and be used by the public. Thus these are a secret process.
- On a perusal of press release of Master Card dated 4 February 2015, it has been observed that there is a use of a secret process and hence, the AAR held that a part of the fee paid to the applicant is also for the use of secret process and hence royalty. This royalty is also effectively connected to the PE in India.

'Use of software' amounts to royalty

- The applicant contended that there is no standalone provision of MIP and application software and the transaction is for the rendering of transaction processing service. However, the AAR observed that the classification done by the applicant is not important. There is a use of software, and the legal position is that use of software would amount to royalty.
- AAR stated that there is nothing like standalone provision of MIP and application software. The use of software inside MIP, and cards in the application software are an essential part of the transaction without which no transaction can be completed.
- Hence, the AAR relied on AAR in SkillSoft Ireland Limited [TS-429-AAR-2015] and rejected the Applicant's reliance on Infracsoft ruling [TS-592-HC-2013(DEL)] and held that the use of the software is royalty in nature. Further, since the payment is effectively connected to the PE, the payment would be taxable as business income under the tax treaty.

Fees for Technical Services

- On the question of applicability of FTS provision under the tax treaty, the Supreme Court in the case Kotak Securities Limited¹⁰ held that fees paid in connection with standard facility cannot be classified as FTS. Although the applicant has relied on Bharti Cellular Limited¹¹, however, in Kotak Securities, the Supreme Court held that in modern days scientific and technological developments might tend to blur the specific human element in an otherwise fully automated process by which such services may be provided. The Supreme Court held that human intervention is not the right test and the right test is whether the service provided is a standard facility.
- Relying on Delhi Tribunal's decision in the case of Asia Satellite Telecommunication Ltd¹² tax department contended that the relation between the banks and the applicant is for the use of the process, though the relation between a final user of cards and the applicant may be of use of a facility. The AAR is unable to agree with the stand taken by the tax department on the above issue. The AAR held that ultimately the beneficiary is the final consumer who is using the card. Whether a particular payment is a royalty or service or facility needs to be seen from his perspective. Banks are only a medium for payment of a fee to the applicant.
- Hence, the AAR held that the relation between final consumer and the applicant is of use of a standard facility and hence, transaction processing service rendered by the applicant cannot be taxed as FTS under the tax treaty.
- There are services other than transaction processing services. They are in the nature of warning bulletin fees for listing invalid or fraudulent accounts either electronically or in paper form, cardholder service fees, program management services, account and transaction enhancement services, holograms and publication fees and advisory services, etc. AAR observed that these services are not the standard facility and these specific services are required to be rendered to a specific customer who has requested for such services. Hence, these are technical services. However, they do not 'make available' technical knowledge, experience, skill, know-how to the service recipient. Hence, they cannot be classified as FTS under Article 12 of the tax treaty.

¹⁰ CIT v. Kotak Securities Limited [2016] 383 ITR 1 (SC)

¹¹ CIT v. Bharti Cellular Limited [2010] 330 ITR 239 (SC)

¹² Asia Satellite Telecommunications Co. Limited [2003] 78 TTJ 489 (Del)

Tax avoidance

- The AAR agreed with the applicant that there were reasons of business efficiency and commercial expediency for the operations to move from the U.S. to Singapore. It is not for the tax department to decide for the applicant as to what structure is most suitable to it and where the facilities should be set up. Such business decisions can only be taken by the business itself keeping its business interests in mind, in terms of profitability, efficiency and expediency.

Attribution of profit

- The applicant referred to the Supreme Court decision in the case of Morgan Stanley¹³. The AAR observed that the said decision deals with agency PE and not with the fixed place PE. Thus, where a subsidiary is a fixed place PE, the decision would not apply. The functions performed and risks undertaken by the applicant through the subsidiary were not fully captured in the FAR profile of the subsidiary. The FAR profile of the subsidiary does not capture all the functions performed, assets employed and risks undertaken by erstwhile PE. As the subsidiary constitutes a PE of the applicant, the AO may consider a further attribution to this PE.

Withholding of tax

- The AAR held that the applicant has a PE in India and that payment to the applicant constitutes a royalty. Further, since the applicant is carrying on business in India through a PE, and the right, property or contract in respect of which royalty is paid is effectively connected with such PE, the royalty is to be taxed on a net basis. Hence, the tax is required to be withheld at source at the full applicable rate at which the non-resident is subjected to tax in India.
- All the revenues received by the applicant from customers in India would not be attributed to the Indian PE since significant activities are also carried out by the applicant outside India. Thus, there is a need for attribution which is required to be done by the AO. On such attribution of income to the PE, the tax is required to be withheld at the full applicable rate at which the non-resident is subjected to tax in India.

¹³ DIT v. Morgan Stanley [2007] 292 ITR 416 (SC)

Our comments

With globalisation and changing technology, determination of PE as well as taxability of royalty/FTS have been subject matters of debate before the Courts/Tribunal.

Philip Baker, Klaus Vogel and OECD commentary (2017) emphasises that the fixed place should be available at the disposal of the enterprise. The Supreme Court in the case of Formula One World Championship Ltd. held that the international circuit constitutes a fixed place of business under the India-U.K. tax treaty since the international circuit was under control and at the disposal of the taxpayer.

The AAR in the present case has held that MIP and Mastercard network facilitate its services and the same constitute a fixed place PE in India under the tax treaty since the applicant is carrying out its business of facilitation of authorisation of the transaction through such MIPs and network which are at the disposal of the taxpayer.

These observations will have a far reaching impact on the e-commerce business model transactions. The taxpayers have to analyse these observations and consider its applicability to their business models in India. Further, the multinational companies may need to evaluate actual value attributed to their Indian entities with respect to functions performed, the risk taken and assets utilised in India.

The AAR while dealing with the Supreme Court decision in the case of Morgan Stanley observed that profit attribution on the basis of FAR analysis was inadequate and therefore the AO may consider a further attribution. On a similar footing, the Delhi Tribunal in the case of Daikin¹⁴ upheld that attribution of income needs to be undertaken when the FAR analysis is not adequate. The recent trends on the attribution of income in the absence of adequate FAR analysis may have an impact on multinationals having a presence in India.

Although the rulings of AAR are binding only on the parties involved in a particular case, it could have a persuasive value on taxability of similar transactions/fact pattern for other taxpayers.

¹⁴ Daikin Industries Ltd v. ACIT [2018] 94 taxmann.com 299 (Del)

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