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TAX FLASH NEWS

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Indian subsidiary of group holding company of Netherlands entity does not constitute permanent establishment in India

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of NetApp B. V.[1] (the taxpayer) held that Indian subsidiary of group holding company of the taxpayer which was in the business of selling storage system equipments and products including embedded software and rendering certain services in India does not constitute Permanent Establishment[2] (PE) of such entity in India under India-Netherlands tax treaty (the tax treaty).

Facts of the case

- The taxpayer is a non-resident company situated at Netherlands, part of NetApp group, engaged in the business of selling storage system equipments and products including embedded software and rendering certain services in India.
- The taxpayer sales NetApp products and services in India through third party distributors who are appointed on non-exclusive basis and they purchases NetApp products and services from the company on principal to principal basis and resale the same to customers or to other resellers. The taxpayer also provides services through NetApp India Private Limited (Indian company), subsidiary of NetApp U.S. company in terms of agreements entered with them by the taxpayer.
- The company also engages in direct sales contracts and the title of the goods passes directly to the customer to enable them to claim indirect taxes such as customs, etc. However, the distributor is responsible for the sale process.
- The taxpayer earns income in India from sale of storage products, sale of subscriptions and provision of support services.
- The subscriptions for software are sold independently with respect to NetApp products and it charges for product upgrades, enhancements, bug fixing and release of patches. The software contained in NetApp products is specifically designed for hardware of NetApp and is not general-purpose software.
- The taxpayer also provides installation, warranty and professional services with respect to data migration, data integration and disaster recovery services.
- The taxpayer deals with the distributors in India on principle-to-principle basis, hence, it is claimed that it does not have any income on sale of these products in India.
- Indian company, belonging to NetApp Group, provides some services to the taxpayer such as marketing and sales support, assistance in organising trade shows, ascertaining market trends, competition analysis and assistance in pre-sales marketing as promotional material for NetApp products and services.

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[1] NetApp B. V. v. DDIT (ITA No. 4781/Del/2013) – Taxsutra.com

[2] It does not constitute Fixed Place PE, Subsidiary PE and Agency PE

- For Assessment Year (AY) 2008-09, the taxpayer filed its return of income showing 'Nil' income and claimed refund of tax withheld by the distributors and customers amounting to INR3 crore. As the taxpayer is a company incorporated in the Netherlands, having valid tax residency certificate, it was entitled to the benefits of the tax treaty.

- The Assessing Officer (AO) held that the taxpayer has a business connection in India under Section 9(1) of the Act, therefore its income is chargeable to tax in India as it deemed to accrue and arise in India in terms of Section 9(1)(i) of the Act.

- It was also held that the taxpayer has a PE in India in accordance with Article 5 of the tax treaty because of existence of NetApp India. One of the main reasons for reaching at this conclusion is that Indian Subsidiary of NetApp Group performs services that are in the nature of marketing and other services which are attached to the sale of NetApp products.

- Further Indian company is a dependent agent of the taxpayer as economic and legal dependence of the NetApp India is obvious as it earns its revenue only from its foreign associated enterprise. Accordingly, the taxpayer has an agency PE in India

- Payment received by the taxpayer towards licensing of the software are taxable as royalty and further this software payment are effectively connected with the PE in terms of Article 12 and 7 of the tax treaty, the same shall be chargeable to tax as business income in India.

- With regard to service fees on account of services rendered to its Indian clients, AO was of the view that the services are predominately technical in nature and further, it is falling within the definition of royalty. It is also effectively connected to PE of the taxpayer, therefore chargeable to tax under Article 7 of the tax treaty.

- The AO contended that part of the profits arising from payment towards hardware is also attributable to the activities of PE in India. Accordingly, attributed 90 per cent of the profit applying the gross profit margin of 26 per cent to PE.

Tribunal's ruling

Subsidiary PE

- As per Article 5(7) of the tax treaty, a company which is a resident of one of the state controls/controlled by a company which is a resident of the other state, or which carries on business in the other state (whether through a PE or otherwise), shall not of itself constitute a PE of the other company.

- The taxpayer has not deputed any of its personnel in India and also the Directors of the Indian company have not functioned for the business of the taxpayer. Further, the control over the financial and administrative activities of the Indian company by the taxpayer i.e. the Indian company shall account for expenditure and receipts, and shall also report and provide general administrative services to the taxpayer, cannot be result into the control over the Indian entity by the taxpayer resulting into PE. Therefore it cannot be said that taxpayer controls or is controlled by the Indian company or vice a versa.

- With respect to the tax department's contention that Indian company is not providing mere back office support services, but engaged in the capacity building of the NetApp India group, the Tribunal observed that Indian entity is carrying on its own business as a service provider and not the business of the taxpayer is being carried out by the Indian entity. Merely because there are certain transactions between the Indian subsidiary and the foreign company it does not mean that the Indian subsidiary constitutes a PE for such foreign company in India. This has been conclusively held by the Delhi High Court in e-funds IT solutions[3].

- Accordingly, the Tribunal rejected the contention of the tax department that since it is a group subsidiary in India of the NetApp Group, it becomes a PE of the taxpayer.

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[3] DIT v. E Funds Solutions Group Inc. [2014] 42 taxmann.com 50 (Del)

Fixed place PE

- On reading of the agreement between the taxpayer and Indian company, it is apparent that Indian company is a service provider to the taxpayer and it does not have any authority to conclude any contracts on behalf of the taxpayer. The Indian company is a separate legal entity, which has its own board of directors, premises, employees, contracts, etc. and the employees of Indian company work under the control and supervision of Indian company only and not the taxpayer for provision of its services to the taxpayer.

- The AO has not put forth any evidence which leads to the fact that it is not the business of the Indian company, but it is the business of the taxpayer being carried out in India through the Indian entity.

- On the contention of the tax department that the Indian entity constitutes a place of management for the taxpayer is devoid of any merit as the tax department has not led to any evidence to establish that the taxpayer does take significant and strategic decisions relating to its global business in India. In fact it was contended that the board meetings of the appellant company is held outside India and, therefore, there cannot be any fixed place of PE in India.

- In the present case, the tax department contended that the Transfer Pricing Officer (TPO) of the Indian entity made an adjustment to the marketing and sales support function and appeal of the Indian entity by the first appellate authority has decided against the Indian entity. Therefore, the transaction between the Indian entity and the appellant are not at arm's length.

- Transfer-pricing dispute in the assessment proceedings of the Indian entity does not have any bearing on determination of PE of appellant in India. It is a matter of dispute between the tax department and the Indian entity only. Therefore, following the decision of the Delhi High Court in Adobe System Incorporated[4], the Tribunal rejected the contention of the tax department that there is a PE of the taxpayer in terms of Article 5(1) of the tax treaty.

Agency PE

- Common directors of the taxpayer and Indian company are not engaged in the day-to-day activities of the taxpayer's renegotiation of any contracts or performing any marketing functions in India on behalf of the taxpayer. Merely because there are common directors, one cannot say that the Indian company has an authority to conclude contracts on behalf of appellant.

- The reliance is aptly placed on the decision in the case of Pubmatic India (P.) Ltd.[5] wherein it has been held that merely because one of the Directors is common in both the companies does not constitute the taxpayer as PE.

- Even otherwise the common Director and holding of the company by itself does not constitute either company as PE of the other as per Article 5(6) of the tax treaty.

- For holding PE in terms of Article 5(5) of the tax treaty, it is imperative that the agent has and is habitually exercising that authority to conclude contracts on behalf of the taxpayer. The tax department failed to establish with credible evidence that such authority is vested in Indian company and Indian company habitually exercises that authority.

- The activities of Indian entity are only part of its marketing support services and are for the business of the Indian entity and cannot be said that they are made for sales in India by the taxpayer through Indian entity.

- For an agent to be of an independent status, (i) the agent must be legally independent of the principal, (ii) the agent must be economically independent of the principal; and (ii) the agent must represent the principal in the ordinary course of business. Legal Independence of the agent must be tested on the line of agent's obligation.

[4] Adobe Systems Incorporated v. ADIT (Writ Petition (C) 2384/2013 & CM 4515/2013) (Delhi)

[5] ITO v. Pubmatic India (P.) Ltd. [2013] 158 TTJ 398 (Mum)

- In the present case, the tax department has not brought it on record that the activities of the agents are subject to detailed instructions or comprehensive control. Further mere persuasive control is not enough. The tax department should establish the comprehensive control over the entity. Further the income stream of the Indian company itself suggests that its revenue is not wholly or substantially derived from the activities of the taxpayer but from other AEs also.

- It was submitted that 85 per cent to 90 per cent of the revenue of Indian company is from IT/ITEs services and not from marketing support services. Further the risk matrix of the Indian company is also not brought on record by AO. Further, it is not the case of the tax department that Indian company is performing wholly and exclusively for the taxpayer. Therefore, in absence of any evidence of economic and legal dependence of the agent the argument of the tax department cannot be sustained.

- No evidence has been submitted which even remotely suggest that Indian entity discusses all terms with the distributors, negotiates discounts to the resellers and decision on sale is taken by the Indian entity in India.

- With respect to the purchase orders the Indian entity do not solicit or accept purchase orders on behalf of the taxpayer but the purchase orders raised on the taxpayer are through distributors. The receipt of the purchase orders by the Indian entity is only for facilitation for onward transmission to the taxpayer. In this aspect, the tax department has totally ignored the functions performed for getting purchase orders by the distributors. Even otherwise this function alone do not constitute PE under the provisions of the tax treaty.

- In view of above, the Tribunal observed that the taxpayer does not have agency PE in India.

Other

- With reference to the storage of the goods for the purpose of demonstration, Article 5(4)(a) of the tax treaty clearly excludes that use of facilities solely for the purpose of storage display of goods or merchandise belonging to the enterprise shall not constitute as PE. Therefore, storing of the goods falls into the exclusionary clause of PE.

- In the present case the Indian company has performed many functions but has not reached at the threshold of becoming a PE of the taxpayer according to Article 5 of the tax treaty.

- The AO has merely examined the documents submitted by the taxpayer and has not carried out detailed exercise to arrive at the facts and unless that exercise is carried out it is difficult to demonstrate existence of fixed place PE and Agency PE.

BEPS

- Base Erosion and Profit Shifting (BEPS) Action Point 7 is also on the issue to address the tax experience that the foreign enterprise is able to avoid the application of Article 5(5) of the Organisation of Economic Co-operation and Development (OECD) Model Tax Convention, to the extent that the contracts concluded by the person acting as a commissionaire are not binding on the foreign enterprise. Since Article 5(5) of OECD Model Tax Convention relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms of contracts without material changes in the functions performed in a State.

- Commissionaire arrangements as it is in the present case have been major pre-occupations of tax. In most of the cases that went to court, the tax administration's arguments were rejected. The only answer to that would be factually establishing the role of the Indian companies regarding their actual authority of concluding the contracts. Therefore while deciding the appeals before us; we were led by the facts for the year under appeals only.

Service income

- As the services rendered by the assessee are installation services, warranty services and professional services. It cannot be said that they are made available to the customers using NetApp B. V. products. In fact, the warranty service is taken by the buyer of the product to keep the goods purchased in good condition for its lifespan.

- In view of this, the argument of the tax department that such services fees are chargeable to tax as fees for technical services was rejected.

Income from sale of hardware

- As the taxpayer did not have PE in India, the income of the taxpayer was not chargeable to tax with respect to sale of the hardware products in India.

Income from sale of software and subscriptions

- In view of the Delhi High Court decision in the case of Infrasoft Ltd[6], the Tribunal sent back the issue to the file of AO to decide it afresh

Our comments

The issue of determination of PE of a foreign company in India has been a matter of debate before the courts/tribunal. The issue gets even more complex when the foreign company has a subsidiary in India. Courts/Tribunal have held that having a subsidiary in another state itself does not result into PE in that state. The subsidiary can become a PE of the holding company if it satisfies the conditions of PE Article of the tax treaty.

The Delhi High Court, in the case of Adobe Systems Incorporated, observed that where a holding company in another contracting state exercises certain control and management over a subsidiary, would not render the subsidiary as PE of the holding company. However, it was observed that the fact that a subsidiary company is a separate tax entity does not mean that it could never constitute PE of its holding company. In certain circumstances, where the specified parameters defining PE are met, a subsidiary would constitute PE of its holding company. However, in determining whether the requisite parameters are met, it is necessary to bear in mind that a subsidiary is a separate legal entity.

Based on the facts of the instant case, the Delhi Tribunal observed that the Indian subsidiary does not satisfy the conditions of PE Article of the India-Netherlands tax treaty and therefore, such Indian subsidiary does not constitute a PE in India.

[6] DIT v. Infrasoft Ltd [2014] 264 CTR 329 (Del)

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