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TAX FLASH NEWS

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Since activities of Foreign company's project office were preparatory or auxiliary in nature, such project office does not constitute a fixed place PE in India

The Supreme Court in the case of Samsung Heavy Industries Co. Ltd.[1] (the taxpayer) held that the Project Office (PO) set-up by a Korean Company in India for executing a contract of ONGC does not constitute a Permanent Establishment (PE) in India under the India-Korea tax treaty (the tax treaty). The PO was not involved in the core activities of the taxpayer. The PO was solely an auxiliary office, meant to act as a liaison office (LO) between the taxpayer and ONGC. The activities carried on by the PO were in the nature of preparatory or auxiliary character and therefore PO does not constitute a PE in India.

Facts of the case

ONGC (an Indian company/Ind Co 1) awarded a contract to a consortium comprising the taxpayer (a Korean Company) and another Indian company (Ind Co 2). The contract involves carrying out surveys, design, engineering, procurement, fabrication, installation and modification at existing facilities, and start-up and commissioning of entire facilities at the project. The taxpayer set up a PO in India to act as 'a communication channel' between the taxpayer and Ind Co 1 in respect of the said project. Pre-engineering, survey, engineering, procurement and fabrication activities which took place abroad. Subsequently, these platforms were then brought outside India to be installed at the project.

During the AY 2007-08, the taxpayer filed nil income showing loss incurred in relation to the activities carried out in India. The Assessing Officer (AO) held that the aforesaid project was a single indivisible 'turnkey' project, whereby Ind Co 1 was to take over a project that is completed only in India. Resultantly, profits arising from the successful commissioning of the project would also arise only in India. The work relating to fabrication and procurement of material was a part of the contract for execution of work assigned by Ind Co 1. The work was wholly executed by PE in India. PE in India was associated with the designing or fabrication of materials. Accordingly, the AO attributed 25 per cent of the revenues earned outside India as being the income of the taxpayer in India. The Dispute Resolution Panel (DRP) upheld the order of the AO.

The Tribunal on reference to the resolution of board of directors' meeting observed that PO was opened for co-ordination and execution of project. All the activities to be carried out in respect of the contract will be routed through the PO only. Pre-surveys were to be first conducted which will determine the nature of the designing on the basis of which pre-engineering and pre-designing was to be done with respect to the entire project. The taxpayer had obtained insurance with respect to the entire project in India for which the taxpayer has received major payment during the year itself. The said policy was not only restricted with regard to activities of the taxpayer outside India. Accordingly, the Tribunal confirmed the order of the AO and DRP that the contract was indivisible.

The High Court observed that the question with respect to PO to be held as a PE within the meaning of Article 5 of the tax treaty would be of no consequence. There was no finding that 25 per cent of the gross revenue of the taxpayer outside India was attributable to the business carried out by the PO of the taxpayer. Accordingly, to the High Court held in favour of the taxpayer.

[1] DIT v. Samsung Heavy Industries Co Ltd. (Civil Appeal No. 12183 of 2016) – Taxsutra.com

Supreme Court decision

Relying on various decisions[2] the Supreme Court observed that in order to constitute a 'fixed place' PE under the tax treaty, there should be an establishment 'through which the business of an enterprise' is wholly or partly carried on. Further, the profits of the foreign enterprise would be taxable only where the said enterprise carries on its core business through a PE.

Maintenance of a fixed place of business which is of a preparatory or auxiliary character in the trade or business of the enterprise would not be considered as a PE under Article 5 of the tax treaty.

On reference to the board resolution, it indicates that the PO was established to coordinate and execute delivery of documents in connection with construction of offshore platform for modification of existing facilities for I Co 1. However, the Tribunal relied upon only the first paragraph of the board resolution and held that the PO was for co-ordination and execution of the project itself. Therefore, the Tribunal's finding, that the PO was not a mere LO but was involved in the core activity of execution of the project itself was clearly perverse.

Further, when it was pointed out that the accounts of the PO showed that no expenditure relating to the execution of the contract was incurred, the Tribunal rejected the argument, stating that as accounts are in the hands of the taxpayer and mere mode of maintaining accounts alone cannot determine the character of PE. This is another perverse finding which was set aside.

The Supreme Court observed that the finding of the tax authorities that onus was on the taxpayer and not on the tax authorities to demonstrate that the PO constitutes a PE in India, was against the decision in the case of E-Funds IT Solution Inc.

Further the Tribunal had ignored the fact that there were only two persons working in the PO and neither of them was qualified to perform any core activity of the taxpayer.

Therefore, no PE was set up within the meaning of Article 5(1) of the tax treaty, as the PO cannot be said to be a fixed place of business through which the core business of the taxpayer was wholly or partly carried on. Further, the PO, would fall within Article 5(4)(e)[3] of the tax treaty as the office was involved solely in an auxiliary activities, meant to act as a LO between the taxpayer and I Co 1.

[2] DIT v. Morgan Stanley & Co. [2007] 292 ITR 416 (SC), Ishikawajma-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC), DIT v. E-Funds IT Solution Inc. [2016] 240 Taxman 298 (SC), CIT v. Hyundai Heavy Industries Co. Ltd [2007] 291 ITR 482 (SC)

[3] Article 5(4)(e) provides exemption from PE to the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character

Our comments

The issue with respect to a foreign company's PO/LO constituting a PE in India has been a subject matter of debate before the Courts/Tribunal. To determine the taxability of PO/LO in India, it is relevant to examine whether it is carrying out an important part of the business activity of the foreign company or it is merely carrying out preparatory or auxiliary activities.

In some of the cases[4], the Courts/Tribunal have held that LO does not constitute a fixed place PE in India because the LO was carrying on operations within the restricted activities (i.e. preparatory or auxiliary) permitted by the RBI. However, in some of the cases[5], the Courts/Tribunal have held that LO constitutes a fixed place PE in India because it was carrying on certain commercial activities which were core activities of the taxpayer.

However, with respect to activities of PO/LO, the Delhi High Court in the case of National Petroleum Company Construction[6] observed that an LO can act as a channel of communication between the principal place of business and the entities in India and cannot undertake any commercial trading or industrial activity. However, a PO can play a much wider role. A PO can undertake all activities that relate to the execution of the project and its function is not limited only to act as a channel of communication.

On one hand, the AAR/Mumbai Tribunal[7], without discussing Article 5(4)(e), held in some of the decisions that a PO constitutes a PE in India . On the other hand, some of the Courts/Tribunal[8] held that the activities of the PO were auxiliary or preparatory in nature, and therefore, it could not be construed as the foreign company's PE in India.

With respect to LO, the matter went upto the Supreme Court in the case of UAE. Exchange Centre[9]. The Supreme Court while dealing with an issue whether activities of LOs of a UAE based company constitute a PE in India observed that activities carried on by LOs in India were in the nature of 'preparatory or auxiliary character'. Since the activities are specifically exempt under Article 5(3)(e) of the India-UAE tax treaty, LO does not constitute a PE in India.

[4] 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)

[5] Brown and Sharpe Inc. (ITA No.219 of 2014) (Del), Jebon Corporation India [2012] 206 Taxman 7 (Kar), Columbia Sportswear Company [2011] 337 ITR 407 (AAR), GE Energy Parts Inc. v. ADIT [2017] 184 TTJ 570 (Del)

[6] National Petroleum Company Construction v. DIT [2016] 383 ITR 648 (Del)

[7] Micoperi S.p.A. Milano v. DCIT [2002] 82 ITD 369 (Mum), P. No. 13 of 1995 [1997] 94 TAXMAN 171 (AAR)

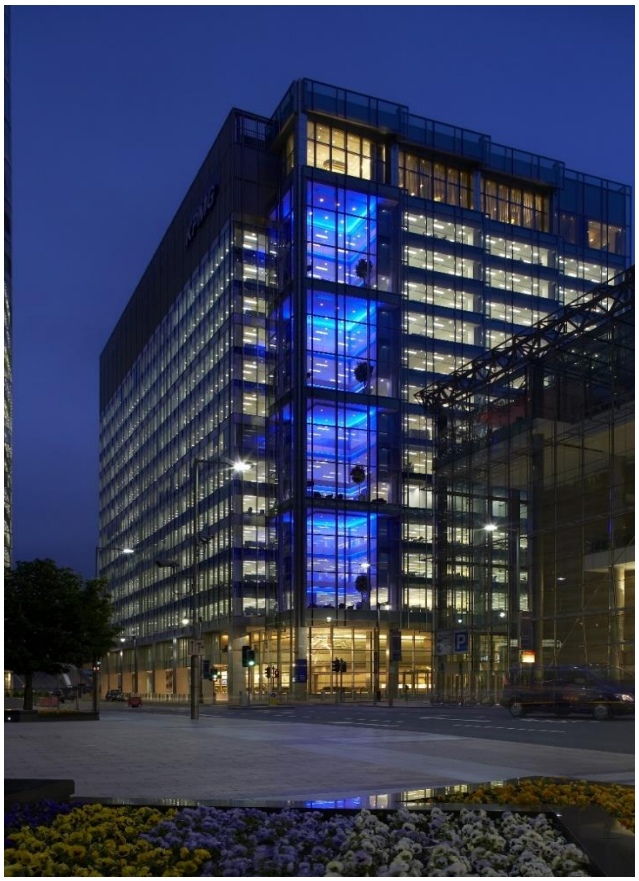
[8] National Petroleum Construction Company v. DIT [2016] 383 ITR 648 (Del), DIT v. Mitsui & Co Ltd [2017] 84 taxmann.com 3 (Del), BKI/HAM v. ACIT [2001] 70 TTJ 480 (Del)

[9] UOI v. U.A.E. Exchange Centre [2020] 116 taxmann.com 379 (SC)

In the decision of UAE Exchange Center, the Supreme Court dealt with constitution of a PE with respect to activities of an LO. In the present case, it has dealt with activities of PO. The Supreme Court held that the PO does not constitute a PE in India under Article 5(1) of the tax treaty in the absence of core business of the taxpayer being carried out through the said PO. Therefore, the PO would fall within Article 5(4)(e) of the tax treaty, because the office was solely an auxiliary office, meant to act as an LO.

It is important to note that Article 13 of the BEPS Multilateral Instrument (MLI), inter alia, provides two options i.e. 'Option A' and 'Option B' to deal with the artificial avoidance of PE through specific activity exemptions i.e. activities which are preparatory or auxiliary in nature. India has opted for 'Option A' which does not change the list of activities already mentioned for preparatory or auxiliary activities exemption under the tax treaty. However, it requires that all such activities (or combination of activities) must be preparatory or auxiliary in nature to qualify as exempt activities.

The Supreme Court decision may also help after the MLI changes in the tax treaties are effective, if it can be demonstrated that all the activities carried out in India through a fixed place are of preparatory or auxiliary in nature.



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