

## Indian subsidiary does not constitute a PE of a foreign company in India under the India-Saudi Arabia tax treaty

### Background

Recently, the Authority for Advance Rulings (AAR) in the case of Saudi Arabian Oil Company<sup>1</sup> (the applicant/foreign company) held that the Indian subsidiary of the applicant does not constitute a fixed place Permanent Establishment (PE) in India under Article 5(1) of India-Saudi Arabia tax treaty (tax treaty) since the applicant is not carrying on its main business from the premises of its subsidiary and the fixed place is not available to the foreign company at its disposal. The foreign company's services are in the nature of support services. Further, the activities of the Indian subsidiary are duly compensated on an arm's length basis in accordance with the transfer pricing regulations.

Since none of the services are rendered by an employee of the applicant to its customers in India, the applicant does not have a service PE in India. Further, the Indian subsidiary of the applicant does not constitute an agency PE in India since the Indian company does not have the authority of a binding nature to conclude contracts which are specifically prohibited by the service agreement. The AAR held that exclusions<sup>2</sup> provided under Article 5(4)<sup>3</sup> of the tax treaty are applicable only if the applicant has a PE within the meaning of Articles 5(1) to 5(3) of the tax treaty.

<sup>1</sup> Saudi Arabian Oil Company (AAR No. 25 of 2016) – Taxsutra.com

<sup>2</sup> Exemption for specific activities (e.g., storage, display or delivery of goods) and activities that are preparatory or auxiliary in nature.

<sup>3</sup> The term 'permanent establishment' shall be deemed not to include :

- (a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) 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;
- (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

### Facts of the case

- The applicant is a tax resident of Saudi Arabia and a fully integrated global petroleum and chemical enterprise. It is the world's largest crude oil exporter producing one in every eight barrels of world's oil supply. Presently, the applicant is making offshore crude oil sales to Indian refineries from outside India and payment is received by the applicant in a designated bank account outside India. It does not have any office in India.
- To expand its India operations and for having a long-term presence, the applicant has established a subsidiary (Aramco India) in India. Though the primary object of the subsidiary is to provide procurement support services, it would also create awareness about Aramco and Saudi Arabian crude oil amongst crude buyers and refineries in India. Aramco India provides certain support services in furtherance of the sales operations. Aramco India will be helping in strategic sourcing and registration of major Indian oil and gas equipment manufacturers and engineering procurement and construction contractors, performing engineering and inspection evaluations, and plant audits for identified manufacturers and suppliers.
- With regard to the negotiation of the material terms or conclusion of contracts with Indian customers as well as the signing of such contracts for and on behalf of the applicant, such activities will only be carried out by applicant's own employees based in Saudi Arabia.
- Aramco India started operations in India during Financial Year (FY) 2016-17, and in pursuance of the 'Service Agreement' dated 1 August 2016, it renders procurement, sourcing and logistic support and quality inspection support services to the applicant and other affiliates.

The applicant has suppressed the original service agreement and is seeking to split the 'Scope of Services' (Proposed Addendum) that the applicant wishes to seek from Aramco India.

- An application is filed before the AAR to seek an advance ruling. However, the tax department claimed that AAR application is not maintainable since there is no 'transaction' as provided in accordance with the AAR provisions.

### Issues before the AAR

- Whether application filed before the AAR is maintainable?
- Whether Indian subsidiary creates a PE for the applicant in India under Article 5 of the tax treaty?

### AAR ruling

#### **Maintainability of the application before the AAR**

- The purpose of introducing Chapter XIX-B<sup>4</sup> and setting up the AAR is to give a ruling in advance to remove uncertainty in the mind of an applicant and eliminate the possibility of a dispute regarding the tax issues surrounding a proposed or intended transaction, even before the transaction or a dispute occurs.
- On a perusal of the provisions under the Act<sup>5</sup> relating to the AAR mechanism, it indicates that not only a 'transaction' but also a 'proposed transaction' on which ruling has been sought would get covered. The provisions, the clarifications at the time of inserting the Chapter on AAR and subsequent clarifications in the Hand Book<sup>6</sup> are indicative of this position.
- The tax department contended that as per the earlier Ruling<sup>7</sup> the applicant already has a business presence in India, with similar services. However, due to insufficient details, the AAR could not give any finding on Section 9(1)(b) of the Act. While distinguishing the ruling relied on by the tax department, the AAR observed that in the present case, the 'Services Agreement' and the 'Proposed Addenda' were filed and duly considered before admitting the application.

<sup>4</sup> Chapter XIX-B - Advance Rulings

<sup>5</sup> 245N(a)(i) of the Act - Advance ruling means a determination by the AAR in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant.

Section 245S(1) of the Act - The advance ruling pronounced by the Authority under Section 245R shall be binding only –

(a) on the applicant who had sought it;

(b) in respect of the transaction in relation to which the ruling had been sought; and

(c) on the Principal Commissioner, Commissioner, and the income tax authorities to him, in respect of the applicant and the said transaction

<sup>6</sup> On AAR ruling

<sup>7</sup> Aramco Overseas Company, BV, In re [2010] 189 Taxman 214 (AAR)

Once this new subsidiary has come into existence, with a new set of agreements with the parent, the AAR is not concerned with any earlier branch office.

- In the present case, the agreements are on record, there are concrete and clearly outlined details of services, some of the activities have already commenced, and there is nothing fictional. In various cases<sup>8</sup> the AAR has entertained and admitted cases on a similar footing. The AAR referred to the decision of Andhra Pradesh High Court in the case Sanofi Pasteur<sup>9</sup> and observed that the maintainability of the application has already been upheld by the AAR<sup>10</sup> and that issue cannot be raised again.
- The powers of the AAR in dealing with the questions posed before it are contained in Rule 12 of the AAR (Procedure) Rules 1996. Thus, the AAR has not only the power but the duty to look at 'all aspects of the questions set forth' which would enable it to pronounce a ruling 'on the substance of the questions posed for its consideration'.
- Thus, where an application was allowed by the AAR under Section 245R(2) of the Act recording a finding that the application is not triggered by any of the three provisos<sup>11</sup> envisaged therein, the AAR found no reasons to revoke the application of the applicant and posted the same for hearing on merits. The AAR is not inclined to revisit its earlier order dated 16 August 2016 to admit the application. Therefore, contentions of the tax department as regards maintainability of the present application are not accepted.

#### **Fixed place PE**

- While referring to its earlier ruling in the case of AB Holdings Mauritius II<sup>12</sup> it is observed that the fact that the applicant has established a subsidiary does not automatically make the latter a PE of the applicant.

<sup>8</sup> Danfoss Industries Pvt. Ltd. [2004] 138 Taxman 280 (AAR), Cable & Wireless Networks India Private Limited [2009] 182 Taxman 76 (AAR), ABB Limited [2010] 189 Taxman 422 (AAR), and Areva T&D India Limited [2012] 346 ITR 456 (AAR)

<sup>9</sup> Sanofi Pasteur v. Department of Revenue [2013] 354 ITR 316 (AP)

<sup>10</sup> by its order dated 16 August 2016

<sup>11</sup> 1<sup>st</sup> proviso – The AAR shall not allow application where the question raised in the application (i) is already pending before any income-tax authority or Appellate Tribunal or any court (ii) involves determination of fair market value of any property (iii) relates to a transaction or issue which is designed *prima facie* for the avoidance of income-tax or in the case of applicant falling in Section 245N(b)(iia) of the Act

2<sup>nd</sup> proviso – No application shall be rejected by AAR unless an opportunity has been given to the applicant of being heard

3<sup>rd</sup> proviso – where the application is rejected, reasons for such rejection shall be given in the order

<sup>12</sup> AB Holdings Mauritius II (AAR/1129 of 2011, dated 8 November 2017)

- On a reference to Klaus Vogel Commentary on Double Taxation Conventions, it has been observed that unless the applicant proposes to carry out its main business from an establishment in India, or through its employees and personnel, or the Indian subsidiary acts as an agent of the holding company, it cannot automatically be concluded that Aramco India would constitute a PE of the applicant.
- Indian subsidiary has its own board of directors and is carrying out its activities in consonance with its objects specified in 'Services' under the services agreement and the 'Scope of Services' of the 'Proposed Addendum', respectively. These activities are carried out from its establishment in India. Aramco India is utilising its establishment for its own business in India and, from these premises, it is providing support services to the applicant, for which it gets duly remunerated.
- Services carried on by the applicant in the 'Proposed Addendum' is in the nature of support services only. It does not constitute the main business of the applicant which is production and sale of oil, and which is done from Saudi Arabia. As for the services rendered by Aramco India to the applicant from its premises, for which it will be compensated on arm's length basis, has no bearing on whether a fixed place PE exists or not.
- It has been held that the applicant cannot be said to be carrying on its main business from the premises of its subsidiary or even that such premises had been placed at its disposal for conducting its business. Therefore, the applicant cannot be said to have a fixed place PE in India under Article 5(1) of the tax treaty.
- Information from the internet or newspaper reports cannot be considered reliable. The role of the directors, wherever stationed, is only for Aramco India. It is providing services to the applicant, rather than for providing services to the customers of the applicant since it was set up to provide services to the applicant.
- Although directors may be appointed for perpetuity, the tax department itself states that they will be participating from outside India, i.e., the management and control would be outside India. This stand not only appears to be contradictory but also does not fit into the requirement that the employees or other personnel should be deputed to India by the applicant to render the services to the customers of the applicant in India, for more than the specified period.
- Follow up of orders, coordination, arranging shipments, building relationships, monitoring quality and performance of third party inspectors are support services, and in any case are neither supervisory services in connection with any building, construction, assembly or installation project, so as to form a Service PE under Article 5(3)(a) of the tax treaty nor are rendered through the applicant's employees or other personnel.
- The services such as market research and identifying new customers would be preparatory in nature. Services such as communication are only support services. Since none of the services are being rendered by the employees/personnel of the applicant to its customers in India, engaging in these services would not create a service PE. Accordingly, it has been held that Aramco India cannot be held to be a Service PE of the applicant within the meaning of Article 5(3) of the tax treaty.

### **Service PE**

- The tax department contended that non-resident director of Indian subsidiary is a high dignitary of Saudi Aramco group and has the power to control the activities of the Indian subsidiary. However, on a perusal of the information extracted by the tax department from the internet, the AAR observed that most of the appointments in high positions are of a period prior to the 'Service Agreement'. It has been observed that after the reorganisation, Aramco India was incorporated. No credence can be given to earlier entities. The role of directors/high officials/employees at that time or even if they are working side by side in other concerns of the group is not relevant, which is usual with the large MNCs.

### **Agency PE**

- On a reference to 'Proposed Addendum' clause, it indicates that the applicant has retained with itself the authority, regarding its main business, to finalise its marketing strategies, finalise terms of the contracts directly with the customers, and to accept or reject offers of customers. Thus, Aramco India is only to provide support services rather than act as an agent of the applicant.



- On a reference to the services to be rendered as per the terms of the agreements, Aramco India is completely prevented from doing any act that can render it to be termed as an agent of the applicant. Since the activities/transactions under the said Addendum are only proposed and yet to commence, the AAR cannot reach an adverse conclusion that the above limitations/preventive clauses/exclusions would not be adhered to. Accordingly, Aramco India cannot be termed as an Agency PE of the applicant.
- While negotiating could mean entering a contract, the words used in the agreement are 'engaging with' and it implies having discussions or being involved in. It does not indicate an authority of a binding nature to conclude contracts, as mentioned in Article 5(5)(a) of the tax treaty or authority to obtain orders, as in Article 5(5)(c) of the tax treaty, which are specifically prohibited by the services agreement, being independent contractors, referred to earlier.
- The words 'ensuring' compliance by Indian suppliers and 'controlling' only imply that Aramco India is expected to do its work diligently and with responsibility. It does not grant a legal right or authority to it to enforce the applicant's terms of the agreement with the supplier regarding their code of conduct. Ensuring compliance and controlling and inspecting quality are exercises prior or subsequent to the conclusion of a contract for procurement or supply.
- The support to be provided by Aramco India include allocations, claims, communication of customers' concerns, and maintaining business relationships. These activities do not indicate that any of the functions mentioned in Article 5(5) of the tax treaty are being provided by Aramco India. Aramco India is prevented from entering into any contract on behalf of the applicant as per Services Agreement and the Proposed Addendum.
- Accordingly, it has been held that the nature of business support/marketing support activities proposed to be undertaken by the Indian affiliate entity would not create a PE for the applicant in India under Article 5 of the tax treaty, where such activities of Aramco India are duly compensated on an arm's length basis in accordance with the Indian transfer pricing laws and regulations.

## Our comments

The issue of determination of a PE in India has been a matter of litigation before the Courts/Tribunal. The Supreme Court in the case of E-funds IT Solutions<sup>13</sup> had laid down certain guidelines for determination of a PE of a foreign company in India. It was observed that the principal test to ascertain whether an establishment has a fixed place in India is that such physically located premises have to be 'at the disposal' of the foreign company. No fixed place PE can be established if the main business and revenue earning activity of the foreign company are not carried on through a fixed place in India, which has been at the disposal of the foreign company. The mere fact that a 100 per cent subsidiary may be carrying on business in India does not mean that the holding company would have a PE in India.

However, the AAR in the case of Aramex International Logistics Private Limited<sup>14</sup> held that Indian subsidiary had a fixed place of business and branches in India and business of the applicant was being carried on by the Indian company i.e., obtaining an order, collecting articles and transporting them to a destination. Thus, the Indian subsidiary was a fixed place PE of the foreign company in India under Article 5(1) of the India-Singapore tax treaty. The Indian company secured orders in India wholly for the Aramex Group and had right to conclude contracts for the group for its express shipment business. Hence, the foreign company had an agency PE under Article 5(8) of the India-Singapore tax treaty.

## Exclusions from PE

- The exclusions provided under Article 5(4) of the tax treaty are applicable only if the applicant has a PE within the meaning of Articles 5(1) to 5(3) of the tax treaty at the first instance. Once it has been held that there is no fixed place, a service PE and agency PE under the tax treaty there is no requirement to examine the exceptions provided in Article 5(4) of the tax treaty, including preparatory or auxiliary services appearing at Article 5(4)(e) of the tax treaty.

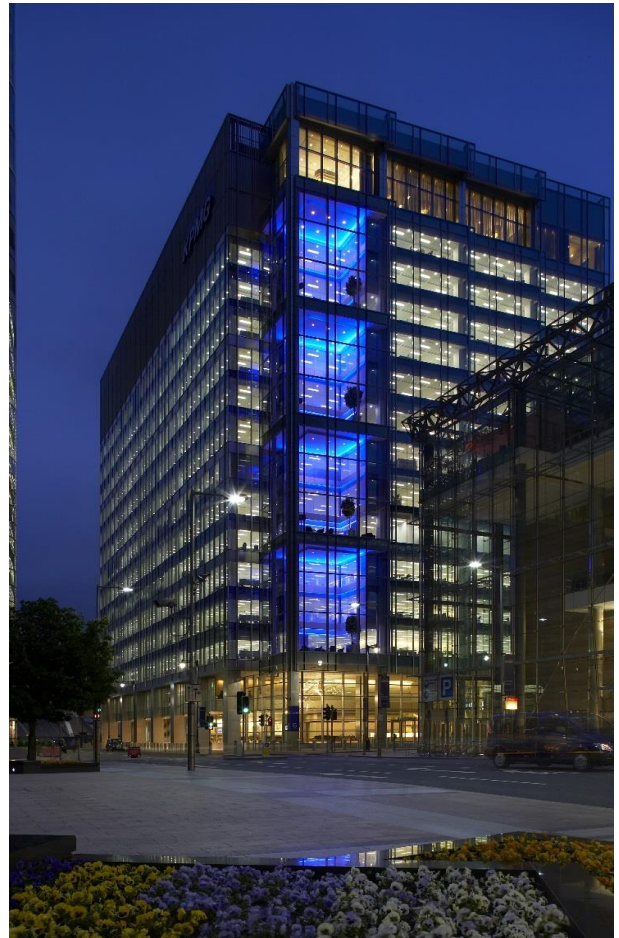
<sup>13</sup> ADIT v. e-Funds IT Solution Inc [2017] 399 ITR 34 (SC)

<sup>14</sup> Aramex International Logistics Private Limited (AAR No. 1061 of 2011, dated 7 June 2012)

In the present case, the AAR held that the Indian subsidiary of the applicant does not constitute a fixed place PE in India under the tax treaty since the applicant is not carrying on its main business from the premises of its subsidiary and the fixed place is not available to the foreign company at its disposal. Since none of the services are rendered by an employee of the applicant to its customers in India, the applicant does not have a service PE in India. The Indian subsidiary of the applicant does not constitute an agency PE in India since the Indian company does not have the authority of a binding nature to conclude contracts which are specifically prohibited by the service agreement.

It is important to note that where the foreign company, as well as its subsidiary, are operating simultaneously in India, operations of both the entities need to be analysed in detail to ascertain the possible PE exposure of the foreign company in India.

Even though the decision of the AAR is legally binding only on the parties involved in a particular case, the ruling would have persuasive value in similar matters before the Indian tax authorities and Courts.



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