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TAX FLASH NEWS

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Liaison Office of a Singapore based company constitutes a PE in India under the India-Singapore tax treaty

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal), in case of Hitachi High Technologies Singapore Pte Ltd[1] (the taxpayer) held that the Liaison Office (LO) of the taxpayer constituted a Permanent Establishment (PE) in India under the India-Singapore tax treaty (tax treaty). The Tribunal observed that the taxpayer's LO in India is actively involved in ascertaining customer requirements, price negotiation, obtaining of purchase orders, following up on delivery of material and payments. These activities cannot be considered as having preparatory or auxiliary character. The LO was directly participating in the core activities of the trading business of the taxpayer.

With respect to the attribution of profits, the Tribunal held that the LO was performing routine and limited functions and was operating in a risk immune environment, and therefore, the allocation of profit should be done by applying Transactional Net Margin Method (TNMM) as most appropriate method. The taxpayer was directed to furnish necessary details and the Assessing Officer (AO) was directed to recompute the attribution of profit to PE by applying TNMM method.

Facts of the case

The taxpayer, a Singapore based company, is a wholly owned subsidiary of a Japanese based company. The taxpayer is engaged in trading operations across various countries and also carries out sourcing and trading operations in respect of various products and equipments. In August 1988, the taxpayer had established a LO in India for rendering preparatory and auxiliary services, including market research and liaison activities. Further, branches of the LO were set up in Delhi, Bangalore and Mumbai. However, subsequently the branches of LO at Bangalore and Mumbai were closed. In July 2007, the taxpayer's group company had established a Branch Office (BO) in India.

During Financial Year 2008-09, a survey operation[2] under Section 133A of the Income-tax Act, 1961 (the Act) was carried out at the premises of the BO and statements of the employees were recorded. On the basis of the statements of the employees, the AO initiated reassessment proceedings under Section 147 of the Act for assessment years 2002-03 to 2007-08. The AO observed that LO was engaged in executing/negotiating contracts for the taxpayer in India and was not merely undertaking preparatory and auxiliary activities. Therefore, LO constituted a PE of the taxpayer in India in terms of Article 5 of the tax treaty. Accordingly, the income of the taxpayer was computed in the hands of the PE (i.e. LO) by applying the global profit margin of the taxpayer to the sales made in India and attributed 50 per cent thereof to the PE in India. The Dispute Resolution Panel (DRP) upheld the order of the AO.

Tribunal's decision

Admissibility of statement recorded in survey proceedings

The decisions relied on by the taxpayer on the question of the admissibility of statements recorded at the time of survey proceedings were misplaced. In the case of S. Khader Khan[3], the High Court held that solely on the basis of statements given by one of the partners of the firm, the income was not assessable as lawful income of the taxpayer. In that case, statement was given by a partner who was new to the management and was incapable of answering the enquiries made. However, in the present case, statements of key employees relied upon by the tax department were well supported by documentary evidences in the form of emails which prompted the tax department to take a stand that the office of taxpayer in India was engaged in marketing,

[1] Hitachi High Technologies Singapore Pte Ltd v. DCIT (ITA Nos. 2683 to 2688/Del/2015) – Taxsutra.com

[2] During the survey operation, statements of the employees were recorded and certain documents were found, mostly email exchanges, between the representatives at LO, tax consultants with employees of the taxpayer

[3] CIT v. S. Khader Khan Son [2008] 300 ITR 157 (Mad) which was affirmed by the Supreme Court in CIT v. S. Khader Khan Son [2013] 352 ITR 480 (SC)

sales promotion and market research. Moreover, in the present case, the income has not been determined on the basis of any banal declaration by any witness but after analysing in detail the activities of the PE in India since its inception.

Permanent Establishment

There was no dispute in relation to the activities of the office in India which were 'advertisement and marketing, sales promotion, market research and administration'. The Tribunal observed that the activities carried out by the LO unquestionably occupy time, attention and labour. The taxpayer indeed carried on business in India. The Tribunal observed that the concept of 'business connection' was dealt by the Supreme Court in the case of R.D. Aggarwal[4]. Relying on the said decision, it was observed that the LO in India had atleast six employees engaged in advertisement and marketing, sales promotion, market research and administration activities in India and therefore, there was a clear relation between the business of the taxpayer and the activities in India. Business of the taxpayer was trading and activities of the LO were core activities for a trading business.

The taxpayer emphasised that since the activities of the LO was of preparatory/auxiliary character, the same falls into the exclusionary Article 5(7)(e) of the tax treaty. The taxpayer emphasised on the words 'or for similar activities which have preparatory or auxiliary character' of the Article 5(7)(e). However, the Tribunal observed that in India-Singapore tax treaty, preparatory or auxiliary character, as used in para 7 of Article 5 is *ejusdem generis*[5] to the other terms used therein which means that 'similar activities which have preparatory or auxiliary character' has to be read as solely used for the purpose of advertising, for the supply of information, for scientific research or for similar activities. The Tribunal observed that the general words 'similar activities' should be read with specific words 'advertising, for the supply of information, for scientific research'. Article 5 of the tax treaty restricts the nature of preparatory or auxiliary activities which can be excluded to determine existence of PE.

In contrast, formulation in India-USA/Canada tax treaty, the words 'Other Activities' have been mentioned which have to be read as 'Besides advertisement, supply of information and scientific research'. This indicates that India-Singapore tax treaty is restrictive in nature than the exclusionary article of India-USA/Canada tax treaty. As per India-Singapore tax treaty, unless fixed place of business (LO in the case of the taxpayer) was being used only for the purpose of advertisement, for supply of information, for scientific research or for similar activities which have preparatory or auxiliary character, it could not have been excluded from the definition of PE.

In the present case the employees were engaged into marketing, sales promotion and market research activities which are 'sine qua non' for a trading business. The LO was actively involved in ascertaining customer requirements, price negotiation, obtaining of purchase orders, following up on delivery of material and payments. None of these activities can be termed as having preparatory or auxiliary character keeping in mind that LO was functioning since 1988. The LO was directly participating in core activities of the trading business of the taxpayer. The only activity in which the LO was not involved was preparing of invoices and receiving payments. The decisions[6] relied on by the taxpayer was distinguishable on facts of the present case. Accordingly, the Tribunal held that the LO constituted a PE of the taxpayer in India.

Profit attribution

The Tribunal observed that even if the orders were placed directly with the head office of the taxpayer, any profit arising from such transactions to be taxed in India to the extent any part was played by the PE of the taxpayer in India. As per Article 7(2) of the tax treaty, the PE, though a distinct and a separate enterprise, was to be treated as an associated enterprise under Article 9 of the tax treaty read with Sections 92B and 92F of the Act. Therefore, the transactions of the PE to be carried out at arm's length.

The Tribunal observed that to boost sales in India, the taxpayer entered into arrangements with agents in India for specific marketing and promotion and one of such agent was ForeVision. As per terms of the agency agreement, the agents were responsible for marketing including advertisements, exhibition participation and necessary sales co-ordination activity, follow up assistance services in respect of the PO & letters of credit from customers, etc. It was not in dispute that ForeVision was also doing business with other companies. It is equally true that the lower authorities had not done any FAR analysis of ForeVision qua the taxpayer's PE (LO).

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[4] CIT v. R.D. Aggarwal and Co. [1965] 56 ITR 20 (SC)
[5] Of the same kind or nature
[6] E-Funds IT Solution [2014] 42 taxmann.com 50 (Del), UAE National Petroleum Construction Company [2016] 66 taxmann.com 16 (Del)

The Tribunal agreed with taxpayer's contention that the LO was performing routine and limited functions and was operating in a risk immune environment and considering the intensity of functions, attribution made by the tax department was not only excessive but absurd and abnormal. The profits of the PE should be determined on the basis of what an independent enterprise under similar circumstances might be expected to derive on its own. The Tribunal relied on the decision of Morgan Stanley[7] and observed that, looking to the business profile of ForeVision and in the absence of complete details, the same was not a good comparable. Considering that the LO was performing routine and limited functions and was operating in a risk immune environment, the allocation of profit should be done by applying TNMM as most appropriate method. The taxpayer was directed to furnish necessary details and the AO was directed to recompute the attribution of profit to PE by applying TNMM as most appropriate method. Further, sales through ForeVision and sales to Videocon should not be considered for the purposes of attribution of profits.

Our comments

The issue with respect to LO constituting PE in India has been a matter of debate before Courts/Tribunal.

In some of the cases[8], the courts/Tribunal have 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 RBI. On the other hand, in few cases[9], the courts/Tribunal have held that LO constitutes fixed place PE in India because it was carrying on certain commercial activities which were core activities of the taxpayer.

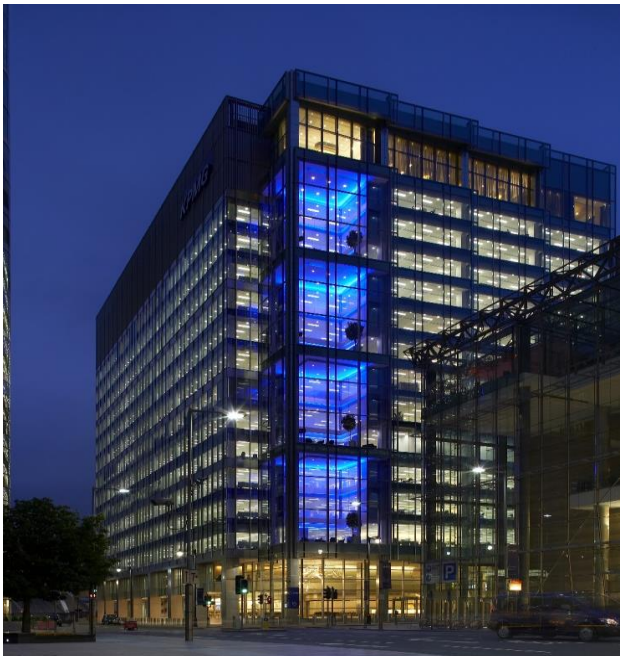
The Tribunal in the present case, on the basis of LO's activities in India, held that the LO constituted a PE in India. The Tribunal observed that the India-Singapore tax treaty is restrictive in nature as compared to the India-US/Canada tax treaty. The India-Singapore tax treaty restricts the nature of preparatory or auxiliary activities which can be excluded to determine existence of PE.

Whether LO constitutes a PE or not is based on the facts and circumstances of each case. It cannot be presumed that LO will not constitute a PE merely because the RBI has given permission for its set-up in India. To determine the taxability of LO in India, it is relevant to examine whether LO is carrying out an important part of the business activity of the foreign company or it is merely carrying out preparatory and auxiliary activities.

It is important to note that Article 13 of the Multilateral Instrument (MLI) [Base Erosion and Profit Shifting (BEPS)] deals with the artificial avoidance of PE through specific activity exemptions i.e. activities which are preparatory or auxiliary in nature. It provides two options i.e. Option A which does not change the list of activities already negotiated between the countries. It ensures that all such activities (or combinations of activities) must be of a preparatory or auxiliary nature in order to qualify as exempt activities and Option B which provides that any activity already existing in the tax treaty which is not specifically required to be of a preparatory or auxiliary nature may continue to fall within the specific activity exemptions. All activities (or combinations of activities) not already mentioned in the existing tax treaty must be of a preparatory or auxiliary nature to qualify under the specific activity exemption.

Further Article 13(4) of the MLI tackles the issue of multinational enterprises splitting up their business activities or altering their structures in order to take the benefit of the specific activity exemptions.

While India has chosen Option A, Singapore has chosen Option B and also given its reservation with respect Article 13(4) of the MLI. Therefore, the provisions of Article 13 of the MLI (dealing with the artificial avoidance of PE through specific activity exemptions) will not impact Article 5(7) (dealing with the preparatory and auxiliary activity exemption) of the India-Singapore tax treaty.



[7] DCIT v. Morgan Stanley & Co. [2007] 162 Taxman 165 (SC)
[8] 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)
[9] 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), UAE Exchange Centre, In re [2004] 139 Taxman 82 (AAR), GE Energy Parts Inc. v. ADIT [2017] 184 TTJ 570 (Del)

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