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Tax Flash News

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Indian subsidiary installing the equipment supplied by the parent under separate contract does not constitute permanent establishment

Executive summary

The tax implications of offshore supply have been contentious. In a situation where the Indian subsidiary handles onshore installation, Revenue Authorities claim that the subsidiary acts as an extension of the foreign company, thereby establishing a Permanent Establishment (PE). Consequently, they attribute a portion of profits from the offshore supply to that PE.

In the case of *Nokia Network OY*[1], the High Court has reaffirmed the Tribunal decision that the Indian subsidiary did not constitute the PE of the taxpayer as it was found to be pursuing an independent line of business with Indian customers, and it did not have the authority to conclude any contract of supply of equipment on behalf of the taxpayer which binds the taxpayer.

The High Court also reaffirmed that the PE must be established based on empirical evidence and objective standards as outlined in the treaty rather than fluctuating perceptions, impressions and mutable beliefs.

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[1] *CIT* v. *Nokia Network OY* (ITA No. 785/2019), Source: Taxsutra

Facts of the case

The taxpayer, a tax resident of Finland, was engaged in manufacturing and trading of the telecommunication hardware and software.

The taxpayer entered into contracts for supplying GSM equipment to Indian telecom operators and also entered into the contract for the installation.

Earlier, the taxpayer had established a Liaison Office (LO) in India, followed by the incorporation of a wholly owned subsidiary in India (the Indian subsidiary).

After the incorporation of the Indian subsidiary, the existing installation contracts were assigned to it and thereafter all installation activities were carried out by the Indian subsidiary under separate agreements with Indian telecom operators.

The tax officer concluded[2] that the LO constituted a Fixed Place PE and that the Indian company was a Dependent Agent PE (DAPE) as per the India-Finland tax treaty (the treaty). Accordingly, a portion of the taxpayer's global income was attributed to India. The Commissioner of Income-tax (Appeals) upheld this view, stating that the taxpayer's business presence in India through the Indian subsidiary was significant enough to establish a PE.

The matter was referred to the Special Bench of the Income-tax Appellate Tribunal (Tribunal), which ruled that the LO did not constitute a PE and that as the equipment sale took place outside India, no income derived therefrom was accruing in India. However, the Special Bench also held that the Indian company would constitute a PE. Notwithstanding the absence of direct evidence establishing control of the Indian subsidiary by the taxpayer, perception of the former as a projection of the parent entity would suffice.

The taxpayer as well as Revenue challenged this decision before the High Court, which held that the LO did not constitute a PE in the absence of any adverse factual finding. The High Court relying on the Supreme Court decision in *Hyundai Heavy Industries*[3] held that even in composite contract, the offshore supply should be segregated, and the revenue's argument of clubbing offshore supply and installation contract was not permissible. The question of the Indian company being PE was remitted back to the Tribunal in the light of certain factual errors.

[2] There were multiple years and appeals involved in this case

[3] *CIT* v. *Hyundai Heavy Industries* [2007] 291 ITR 482 (SC)

The Tribunal re-examined the case and the majority members of the Tribunal ruled that the Indian company did not constitute a PE, as it operated independently under separate contracts and had no authority to conclude contracts on behalf of the taxpayer.

The Revenue appealed against the Tribunal order before the High Court, leading to the present judgment.

Tribunal's decision

Majority decision

Fixed Place PE

The Revenue could not bring any evidence that any physical place was made available which can be said to be at the disposal of the taxpayer for carrying out its off-shore supply contract in India.

The Fixed Place PE does not get established merely by providing telephone, fax and car facility to employees of taxpayer visiting India. The activities carried out by such employees were preparatory and auxiliary in nature.

The Indian company entered into installation contract directly with the customer (although guarantee was given by the taxpayer), the income from which was offered to tax in its hands. The installation activity performed by the Indian subsidiary under the independent contract cannot be reckoned to constitute a PE.

Regarding Revenue's argument on virtual projection, the Tribunal noted that the concept of virtual projection originates from a fixed place. Virtual projection alone does not imply that a PE can be inferred without a fixed place. In this particular case, since there is no established fixed place, virtual projection alone cannot be considered a factor in the creation of a PE.

Dependent Agent PE

The defining feature of DAPE is the authorisation to act on behalf of another party to conclude contracts. In this case, there was no evidence indicating that the Indian subsidiary had negotiated or finalised any equipment supply contracts on behalf of the taxpayer that would legally bind the taxpayer.

The title of the goods supplied was directly passed on to the customers and the Indian subsidiary neither undertook any negotiation process nor assisted in delivery of goods.

Regarding the Revenue's claim that the taxpayer guaranteed Indian customers that the installation contracts would be executed by the Indian subsidiary, it was noted that this guarantee was not relevant to determining DAPE. Such a claim might be pertinent in the context of a composite contract, which is not present in this situation.

Minority decision

The dissenting member rejected the taxpayer’s plea against the existence of PE. The member was of the view that when a subsidiary company was merely an alter ego, or virtual projection of its parent company, in the sense that it had no significant activities of its own or on behalf of persons other than the non-resident parent company, it must be treated as a PE of the parent company in India.

High Court decision

The High Court upheld the Tribunal's ruling that Indian company did not constitute a PE of the taxpayer in India.

The ‘virtual projection’ and ‘functional integration’ argument advanced by the Revenue was deemed insufficient to establish a PE under the treaty. The PE must be established based on empirical evidence and objective standards as outlined in the treaty.

The Indian subsidiary was found to be pursuing an independent line of business with Indian telecom operators, and it did not have the authority to conclude any contract of supply of equipment on behalf of the taxpayer which binds the taxpayer.

The Indian subsidiary's onshore activities were disconnected from the taxpayer's offshore contracts, which were conducted on a Free on Board (FOB) basis from Finland.

The High Court referred to judicial precedents including *Formula One World Championship*[4] case and *E-Funds*[5], which emphasize the importance of factual evidence over perceptions in determining PE status. The minority decision to bypass these precedents was not accepted.

A parent or holding company is naturally expected to have an interest in the operations of its overseas subsidiary. This reflects its right to oversee,

[4] *Formula One World Championship Ltd.* v. *CIT* [2017] 394 ITR 80 (SC)

[5] *ADIT* v. *E-Funds IT Solution Inc*. [2017] 399 ITR 34 (SC)

supervise, and protect shareholder interests. However, exercising these powers does not strip the subsidiary of its independent economic existence.

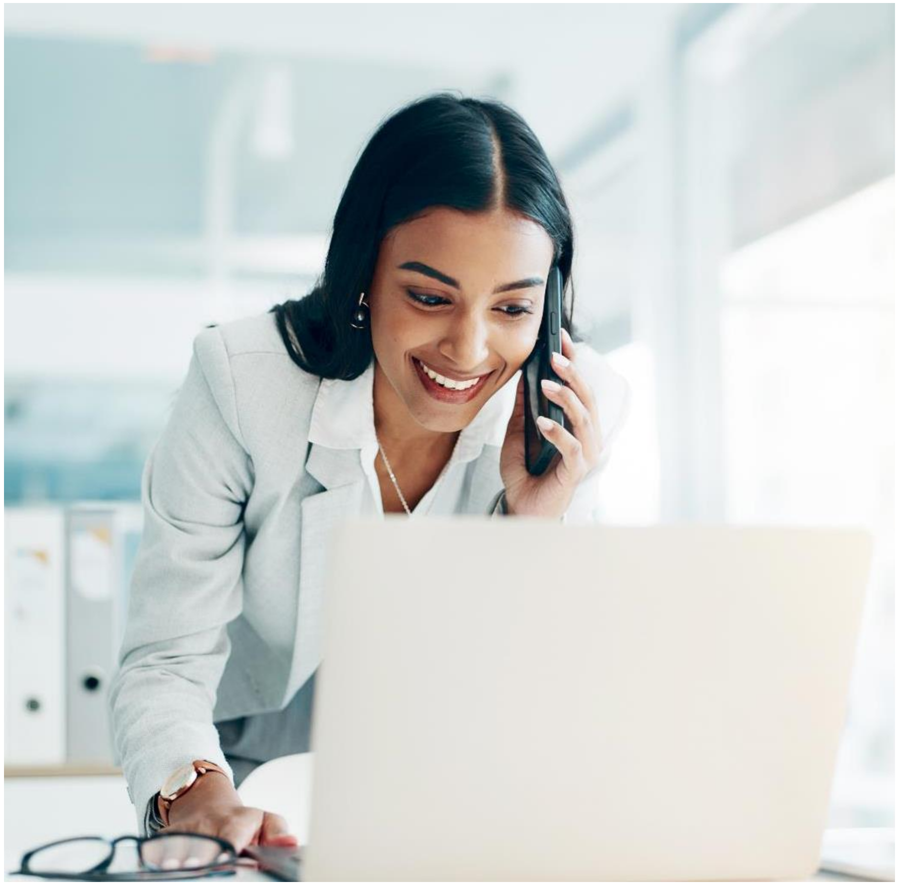
It was crucial for the Revenue to demonstrate that the Indian company was an enterprise through which the taxpayer was conducting its own business, and that the former was merely an extension of the latter.

The fact that the taxpayer provided assurances for a nascent venture in its early stages is insufficient to conclude that it constituted a PE. These assurances should not be interpreted as evidence of the taxpayer using the Indian subsidiary as a vehicle for its own business operations.

Our comments

The Delhi High Court has reaffirmed the internationally recognised principles for establishing a PE, which rely on tangible evidence and objective criteria outlined in the relevant tax treaty.

Additionally, the High Court has reiterated that a subsidiary is considered independent in its operations unless proven otherwise with concrete evidence.



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