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Tax Flash News

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Mere existence of a subsidiary does not result in a permanent establishment; the prescribed conditions need to be tested vis-à-vis actual facts

Executive summary

The determination as to whether or not a foreign company has a permanent establishment (PE) in India has been a complex and facts-driven exercise.

In a situation where the foreign company has a subsidiary in India, the Revenue has been arguing that the foreign company is carrying on its business in India through the subsidiary and has a PE in India.

The Delhi High Court in the case of *Progress Rail Locomotive Inc.*[1] reiterated the well-accepted principle that mere existence of a subsidiary in India would not itself amount to an assumption of a PE having come into existence. To constitute a PE, the conditions prescribed under the applicable treaty need to be satisfied in the light of the actual facts.

The Delhi High Court considered these conditions vis-à-vis the facts of the instant case and held that the taxpayer did not have a PE in India.

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[1] *Progress Rail Locomotive Inc*. v. *DCIT* [W.P. (C) 12405/2019] - Source: Taxsutra

Facts of the case

The taxpayer, a resident of the USA, is a manufacturer and supplier of railway related equipment.

It supplied the equipment to the Indian Railway.

The taxpayer had a wholly owned subsidiary in India which had a manufacturing unit in India.

The subsidiary also provided back office and technical support services to the taxpayer and was remunerated on a cost-plus basis for these services.

The Revenue issued a reassessment notice to the taxpayer alleging that the taxpayer had a PE in India and the income attributable to the PE is taxable in India.

Relevant provisions of the treaty

The term PE is defined to mean a fixed place of business through which the business of a non-resident enterprise is carried on (Fixed place PE)[2]. Such place of business should be at the disposal of the enterprise.

The business activities carried out through that place should be the core business of the enterprise, and not merely preparatory and auxiliary activities.

The term PE also includes furnishing of services through employees or other personnel (Service PE)[3].

The enterprise shall be deemed to have a PE in India if a dependent agent habitually exercises authority to conclude contracts on behalf of the principal (enterprise) or habitually secures orders wholly or almost wholly for the enterprise (Agency PE)[4].

The mere existence of a wholly owned subsidiary in India would not itself amount to an assumption of non-resident having a PE in India.

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[2] Article 5(1) of the India-USA treaty

[3] Article 5(2)(l) of the treaty

[4] Article 5(4) of the treaty

Revenue's contentions

Fixed place PE

The senior officials of the taxpayer visited India during the year under consideration. The premises of the subsidiary was at the complete disposal of the taxpayer and used for carrying out sales activities in India. The taxpayer had a virtual projection in India in the form of its subsidiary.

Many key officers of the subsidiary report directly to the taxpayer. Two out of four board members of the subsidiary were foreign nationals and represented the taxpayer in the top level management. The performance appraisal of the subsidiary's employees was done by the taxpayer.

The subsidiary was providing marketing support, engineering support, and also assistance in bid submission, inventory management, transportation and shipping, to the taxpayer.

Relying on a statement of an employee of the Indian subsidiary, the Revenue alleged that the employee was providing post tender/ post agreement services such as obtaining purchase orders, delivery of goods, information relating to the supplies made to the Indian Railways.

The employees of the subsidiary were not only working for India specific designs but also a part of the global team of the taxpayer in designing of the components for the global tenders.

It was assisting the taxpayer in its core business activities and thus, the activities performed by the subsidiary were not 'auxiliary' or 'preparatory' in nature.

Service PE

The taxpayer's employees visited India to overview subsidiary's operations, devise plans for India, diversify business and formulate the future business strategies.

The taxpayer was furnishing services through its employees for the benefit of the subsidiary and thus had a service PE in India.

Agency PE

The subsidiary was authorised to take all decisions pertaining to tenders, pricing etc. on behalf of the taxpayer.

The subsidiary was fixing the price of goods sold by the taxpayer to the Indian Railways.

The subsidiary was not doing similar activities for any other Indian or foreign entity.

The seal of the taxpayer was found at the place of subsidiary, and while signing the statement to the Revenue, the employee of the subsidiary was affixing such seal.

The subsidiary had the authority to conclude contract on behalf of the taxpayer and constituted an agency PE.

High Court's decision

Fixed place PE

The Revenue could not prove that any part of the Indian premises was under the exclusive or significant control or disposal of the taxpayer for its business activities.

The concept of virtual projection is concerned with a functional integration between the two units and would mean that an establishment has been used for carrying out the principal business activities of the taxpayer.

The taxpayer's principal activity was manufacturing and supplying railway related products and that activity was not undertaken at the subsidiary's premises.

The fact that the products manufactured by the Indian subsidiary were distinct from those manufactured by the taxpayer and were supplied to various arms of the Indian Railways dispels any assumption of the taxpayer conducting its business activities from the subsidiary's premises.

Merely because the submission of tenders was aided by a collaborative exercise between the taxpayer's and the subsidiary's employees would not meet the test of 'virtual projection' or the subsidiary being viewed as an 'alter ego'.

A subsidiary would become a 'alter ego' if it is found that it had no independent business activity to undertake or is working only to subserve the business interests of the taxpayer. In the instant case, the subsidiary was undertaking business activities independently and in its own right. The subsidiary was not created solely for the purposes of undertaking activities and discharging functions concerned with the core business activity of the taxpayer.

The mere fact that the parent company placed representatives on the board of the subsidiary, would not mean that a PE had come into existence.

The reporting to the foreign personnel was essentially to ensure compliance with the global best practices of the group companies. The performance evaluation of the employees of the Indian subsidiary was undertaken by the functional heads present in India who, in turn, were evaluated by the Indian managing director and HR department of the Indian subsidiary, though based on the feedback received from the foreign manager as well. This suggested that the administrative control of the employees of the subsidiary was in the hands of the management situated in India.

There was no evidence that the inputs received from the Indian design team was with respect of products supplied to Indian Railways. The engagement of Indian personnel in connection with the global tenders that were proposed to be submitted would also fall within the ambit of preparatory or auxiliary activities and not in the furtherance of the core activities of the taxpayer.

As the Indian company was a wholly owned subsidiary of the taxpayer, there was some degree of collaboration and exchange of information, but that alone would not result into a PE.

The subsidiary's activities are in the nature of collecting information, co-ordination, etc. which were preparatory or auxiliary in nature.

Most of the functions discharged by the subsidiary were subjected to the transfer pricing assessment where it was accepted that such functions were mere back-office operations.

Service PE

The Revenue's reliance on the India visits of the taxpayer's employees, their interaction with employees of the Indian subsidiary and discussion on subjects of mutual concern did not mean that the services were provided by the taxpayer to the subsidiary and thus, was not sufficient to establish a service PE.

The periodic visits of the taxpayer's employees to India at best be recognised as a right of the holding company to oversee India operations and exercise broad managerial oversight. Such visits are principally to share best practices, experiences and problem solving.

Agency PE

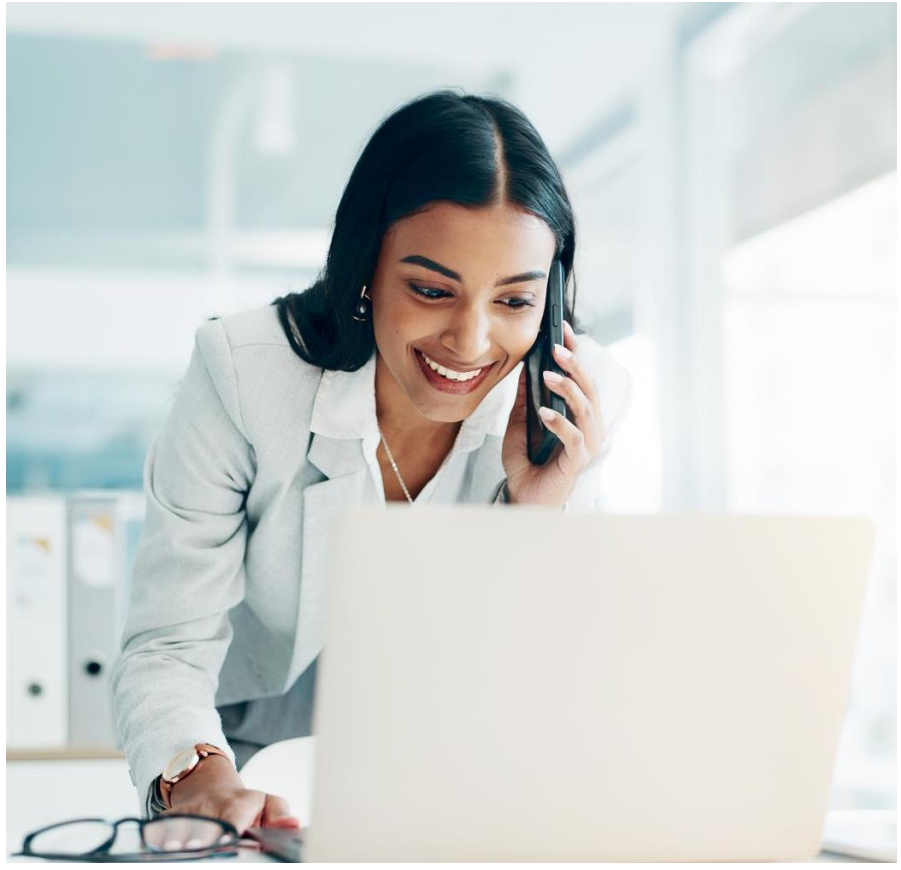
The Revenue could not prove that the subsidiary entered into contracts for and on behalf of the taxpayer with the Indian Railways.

Mere discovery of the seal of the taxpayer at the place of the subsidiary did not mean that the condition relating to authority to conclude contract was satisfied. There was no material to prove that the seal was affixed on any contract or agreement to which the taxpayer was a party.

The subsidiary had independent transactions with Indian Railways. It was not a mere an extension of the taxpayer that was established to secure orders and that too wholly or almost wholly for the taxpayer.

The tax officer's opinion on the issue of PE is perverse and untenable. It is unsustainable even if that opinion were to be tested on a *prima facie* basis.

The High Court quashed the reassessment notice.



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