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Tax Flash News

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Provision of marketing support services does not create permanent establishment unless the prescribed conditions are fulfilled

Executive summary

In the case *of Zscaler Inc*[1] , the Delhi Bench of Income-tax Appellate Tribunal (the Tribunal) held that the Indian subsidiary providing marketing support services shall not constitute a Dependent Agent Permanent Establishment (DAPE) of the taxpayer under the India-USA tax treaty (treaty).

The Revenue failed to establish that there was an element of agency between the taxpayer and the Indian subsidiary as defined under the Indian Contract Act, 1862 or the Indian subsidiary had authority to conclude the contract, or was securing orders, on behalf of the taxpayer.

Facts of the case

The taxpayer, a tax resident of the USA, was engaged in providing software-based solutions.

[1] *Zscaler Inc*. v. *DCIT* (ITA No. 3376/ DEL/ 2023; ITA No. 928/ DEL/ 2025)

In India, its sales were routed through local resellers/ distributors. The Indian customers executed click-through End-User Subscription Agreements (EUSAs) directly with the taxpayer to access its services.

The taxpayer's Indian subsidiary (Zscaler India) *inter alia* provided marketing support services such as the product marketing, undertaking product demos, identification of potential customer leads and providing relevant information to the taxpayer on customer preferences/ expectations.

The taxpayer remunerated Zscaler India on an arm's length basis, following a cost-plus mark-up model.

The taxpayer classified the software receipts from India as business profits, not chargeable to tax in India in the absence of Permanent Establishment (PE) in India under the treaty. The taxpayer also took the position that such receipts are not chargeable to tax as royalty[2].

Additionally, the taxpayer claimed exemption from tax on the software receipts under the Income-tax Act (the Act)[3] as it has already paid Equalisation Levy (EL) thereon in India.

The Revenue, however, argued that that Zscaler India constituted DAPE of the taxpayer in India under the treaty[4] and attributed 25 percent profits to the alleged PE. Further, the Revenue alleged that as the taxpayer has a PE in India, it is outside the scope of the EL and thus, is not eligible for exemption under the Act.

Relevant provisions

As per Article 5(4) of the treaty, DAPE is established in India if a dependent agent in India - (i) has and habitually exercises authority to conclude contracts on behalf of the foreign enterprise; (ii) has no authority but habitually maintains stock of goods or merchandise on behalf of the foreign enterprise; or (iii) habitually secures orders on behalf of the foreign enterprise.

Section 165A of the Finance Act, 2016 imposes EL on the amount of consideration received or receivable by a non-resident e-commerce operator from e-commerce supply or services. However, if the e-commerce operator has a PE in India and such e-commerce supply or services is effectively connected with such PE, EL shall not be charged.

[2] *Engineering Analysis Centre of Excellence (P.) Ltd*. v. *CIT* [2021] 125 taxmann.com 42 (SC).
[3] Section 10(50)
[4] Article 5(4)

Section 10(50) of the Act provides that income which is subject to EL in India shall be exempt from tax in India, provided such income is not taxable as Royalty under the Act, read with the applicable treaty.

Taxpayer's contentions

Zscaler India did not constitute DAPE of the taxpayer in India as it operated on a principal-to-principal basis.

Software receipts fall squarely within the scope of EL and as the EL liability was fully discharged, the income is exempt from tax under the Act.

Even if PE is alleged, Zscaler India had been remunerated at arm's length and, therefore, no further income was attributable to the alleged PE in view of *Morgan Stanley* ruling[5].

Attribution of 25 percent profits to the alleged PE was arbitrary. The Revenue failed to appreciate the fact the taxpayer had reported losses from global operations and accordingly, no attribution of profits can be made.

Revenue's contentions

Zscaler India constitutes DAPE of the taxpayer in India as it provides sales/ marketing support to the taxpayer for securing of orders for selling/ licensing of Zscaler software products to Indian resellers/ distributors.

Zscaler India is earning its entire income from the taxpayer, thus, being economically dependent on the latter.

Zscaler India failed to produce any evidence such as email record, travel itinerary etc. to satisfy that it was the taxpayer who was directly involved with the contract negotiation and conclusion. The Revenue also placed reliance on the decisions in the case of *Daikin*[6] and *Rolls-Royce*[7] to emphasise "substance over form."

In the instant case, PE has been established by treating Zscaler India as DAPE, hence, the taxpayer does not fall within the ambit of EL provisions.

[5] *DIT* v. *Morgan Stanley & Co*. [2007] 292 ITR 416 (SC)

[6] *Daikin Industries Ltd.* v. *ACIT* [2018] 65 ITR(T) 693 (Delhi Tribunal)
[7] *Rolls Royce Singapore (P.) Ltd.* v. *ADIT* [2012] 347 ITR 192 (Delhi)

Tribunal's decision

The Tribunal decided the matter in favour of the taxpayer and held that Zscaler India did not constitute DAPE of the taxpayer in India[8] as none of the DAPE conditions under the treaty were satisfied[9]. Key observations of the Tribunal include:

The taxpayer and Zscaler India transacted on a principal-to-principal basis and there was no element of agency as defined under the Indian Contract Act, 1862.

No clause existed in the agreements whereby Zscaler India was given the authority to conclude contracts relating to provision of software-based solutions on behalf of the taxpayer in India

There were no records to show that Zscaler India was making any expenditure for maintaining any stock of the taxpayer for being consigned to any Indian customer out of obligation under the Reseller agreements.

The Revenue is unable to demonstrate involvement, if any, of Zscaler India in procuring any orders on behalf of the taxpayer.

Resellers, not Zscaler India, executed purchase orders with customers and EUSAs were directly with the taxpayer.

Burden to prove that the taxpayer has a PE in India lies initially on the Revenue[10]. In the instant case, the Revenue failed to bring on record any specific clause(s) under the relevant agreements or any other material to establish principal-agent relationship between the taxpayer and Zscaler India.

Our comments

The determination of a PE requires a detailed factual analysis and careful application of the conditions specified in the relevant tax treaty. The burden of proof lies with the Revenue to establish that the taxpayer has a PE in India. In the absence of strong and conclusive evidence to support such a position, the Tribunal and the Courts have consistently rejected the Revenue's claims.

[8] Based on perusal of the Reseller Agreement (between taxpayer and resellers/ distributors) and Service Agreement (between the taxpayer and Zscaler India),

[9] *Bharti Cellular Ltd*. v. *ACIT* [2024] 462 ITR 247 (SC); *Progress Rail Locomotive Inc*. v. *DCIT* [2024] 466 ITR 76 (Delhi); *SFDC Ireland Ltd.* v. *CIT* [2025] 171 taxmann.com 731(Delhi)

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

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