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25 October 2019

Liaison Office of a Singapore entity held to constitute PE in India and profits to be attributed as per TNMM

Liaison Office carrying on activity other than preparatory and auxiliary services constitutes PE in India per DTAA between India and Singapore

Background and facts

- A Singapore Incorporated Company[1] (the taxpayer / the Company) which was a wholly owned subsidiary of a Japanese Company, had a Liaison Office (LO) in India since April 1988 for carrying on preparatory and auxiliary activities, including market research and liaison activities. The LO had offices in Delhi, Bangalore and Mumbai. In July 2007, the offices in Bangalore and Mumbai were closed and the LO was converted into a branch office in India.
- An income-tax survey under section 133A of the Income-tax Act, 1961 (the Act) was carried out at the premises of the branch Office of the taxpayer on 24 April 2008 and statements of the employees were recorded.
- Based on the tax survey, the Assessing Officer (AO) alleged that the LO was engaged in executing/negotiating contracts for the taxpayer in India and and was not merely undertaking preparatory and auxiliary activities and, therefore, the LO was Permanent Establishment (PE) of the taxpayer in India in terms of Article 5 of the India Singapore Double Taxation Avoidance Agreement (DTAA). Consequently, the AO initiated re-assessment proceedings for AYs 2002-03 to 2007-08 and computed total income of the assessee in the hands of the PE (LO) by applying the Global Profit Margin of the taxpayer, to the sales revenue made by the taxpayer in India and attributed 50 percent thereof to the PE in India aggregating to Rs 7.21 crores for all these years.
- In the first round of litigation before ITAT, the matter was remanded back to Dispute Resolution Panel (DRP) for passing a speaking order for the aggregate total income of Rs. 7.21 crores for the AYs 2002-03 to 2007-08.
- In the re-adjudication proceedings, the DRP framed its order on 27 March 2015 pursuant to the directions of the Tribunal and the final assessment order was passed by the Assessing Officer on 30 March 2015 framed u/s 143(3) r.w.s 144C(13)/254 of the Act, assessing the aggregate total income at Rs. 123.16 crores for all the years, by applying 16.5 percent as sale commission for the total sales value made to India, less the expenses of the LO in India.

Issue under consideration before the ITAT

- While adjudicating on the directions of the ITAT, had the DRP exceeded the directions of the ITAT?
- Whether while framing the final assessment on matter restored by the ITAT, can the AO put the taxpayer in a more worse position than it was before filing the appeal?
- Whether there was a PE of the taxpayer in India?

[1] Hitachi High Technologies Singapore Pte Ltd ITA Nos. 2683 to 2688/Del/2015 dated 17 September, 2019

- If there was a PE of the taxpayer, what was the profit amount that could be attributed to the PE?
- Whether the taxpayer was liable to pay interest under section 234B of the Act?

Decision of the ITAT

- The ITAT observed that if the taxpayer had not filed any appeal against the total assessed income of all the assessment years under consideration, the income would have been Rs. 7.21 crores only. However, after filing appeal and after re-adjudication on the matter restored by the ITAT, the total assessed income for all the years under consideration was increased to Rs. 123.16 crores.
- The ITAT held that "in all fairness, the entire proceedings should now be restricted to adjudication upon the assessed income for all the five years under consideration to the extent of Rs. 7.21 crores."
- The ITAT observed, based on documentary evidence during search/survey proceedings and key employee statements and email exchanges with tax consultant, that:
  - At least six employees were working in LO.
  - The employees were actively involved in ascertaining customer requirements, price negotiation, obtaining of purchase orders, following up on delivery of material and payments, etc.
  - There was clear relation between the business of the taxpayer and the activities in India, as business of the taxpayer was trading and activities of the LO are core activities for a trading business.
  - As per communication with a tax consultant of taxpayer, it was clear that he was advising the taxpayer on the probable tax litigation which may arise after survey operations, owing to substantial commercial activities carried out by LO.
- The ITAT observed that "as per India Singapore DTAA, 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" unlike DTAA with India-USA/Canada.
- Accordingly, the taxpayer was held to have a PE in India.
- ITAT also observed that the whether the taxpayer violated the conditions of RBI or FEMA is not relevant in determining the LO as a PE under the Income-tax Act.
- With regards to profit attribution to the LO (PE) in India, the ITAT held that:
  - The PE (taxpayer), though a distinct and a separate enterprise, is to be treated as an associated enterprise under Article 9 of the DTAA read with sections 92B and 92F of the Act.
  - The profits of the PE should be determined on the basis of what an independent enterprise under similar conditions would derive or is expected to derive on its own. The ITAT is of the view that based on the facts, LO is performing routine and limited functions and is operating in a risk immune environment. Accordingly, based on the intensity of its function, attribution made by the Revenue leading to operating margins in the range from 163 percent to 2357 percent is not only excessive but absurd and abnormal.
  - ITAT finally held that the allocation of profit to the PE should be done by applying Transaction Net Margin Method (TNMM) as being the most appropriate method.

- As regards to chargeability of interest under section 234B of the Act, the ITAT held that for the assessment year under consideration, no interest under section 234B can be levied on the taxpayer as it is a non-resident and for those years the non-resident was not required to pay advance tax as the obligation was on the payer to deduct the TDS before making the payment to a non-resident.

Comments:

- This decision has analysed the exclusionary article under the India-Singapore DTAA and held that "similar activities" used under article 5(7)(e) of DTAA is *ejusdem generis* to other terms used therein, which means that 'similar activities which have preparatory or auxiliary characters have to be read as business solely used for the purpose of advertising for the supply of information, for scientific research or for similar activities in contrast to the wordings in the DTAA between India – US/Canada.
- ITAT has distinguished SC judgment in case of E-Funds IT Solutions[2] and HC in case of UAE National Petroleum Construction Company[3] while concluding the existence of PE in India.
- Though the ITAT has not taken into consideration the recent Delhi HC in the case of GE Energy Parts Inc.[4] wherein it was held that LO of a US company carrying on core activity of marketing and selling highly sophisticated equipment has a PE in India, it is consistent in its view that LO will constitute PE in India based on activities carried out in India.
- Profit Attribution has been one of the most debated topics nationally and internationally. At an international level, the Organisation of Economic Cooperation and Development (OECD) issued its guidelines on authorised approach to profit attribution based on the transfer pricing principles. However, at the India level, the Central Board of Direct Taxes (CBDT) issued a public consultation document on 18 April 2019 on proposed changes to India's income-tax Rule 10 on the attribution of profits to a permanent establishment (PE) in India that deviates from transfer pricing principles However, as of now, the Public Consultation paper is only at the draft stage.

[2] (2014) 364 ITR 256
[3] (2016) 383 ITR 648
[4] (2019) 411 ITR 243

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