



Tax alert: Liaison office role not limited to preparatory or auxiliary work, constitutes PE in India

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The Delhi Bench of the Income-tax Appellate Tribunal, based on the facts of the case, has held that the activities of the liaison office (LO) carried out in India constitutes permanent establishment (PE) of the taxpayer in India in terms of Article 5(1) of the India-Germany tax treaty.

In a nutshell



The LO not only procures orders, but also works out the cost components and margin of the books to be reprinted in Export Processing Zone (EPZ) and sends for acceptance of the Head Office (HO).



The LO has a major say with regard to not only the titles to be reprinted in India, but their pricing also.



The activities undertaken by the LO were not merely preparatory or auxiliary character of a communication channel between the clients in India and HO.



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Background:

- The taxpayer¹, a non-resident corporate entity incorporated in and a tax resident of Germany, is engaged in the business of publishing scientific, technical, medical books and journals. The business activities carried out by the taxpayer in India were as follows:
 - Journal subscription;
 - Direct import of books in India;
 - Sale of books printed at export processing zone (EPZ) in India.
- The taxpayer got an approval from Reserve Bank of India (RBI) in the year 1997 to open a Liaison Office (LO) in India. The LO was opened to carry out solely liaising activity or to act as a communication channel between the head office (HO) and clients in India.
- Further, the taxpayer set up a subsidiary in India (I Co) in March 2002.
- For the Financial Years (FYs) 1998-99 to 2000-01, corresponding to Assessment Years (AYs) 1999-2000 to 2001-02, the taxpayer did not file any return of income. A survey was conducted at the premises of the LO, wherein certain documents were impounded containing communication between the LO and HO, and statements from certain officers/persons working in the LO were also recorded. Based on the information gathered, the Assessing Officer (AO) recorded reason to believe that income chargeable to tax has escaped assessment in the relevant AYs and accordingly, issued notice under section 148 of the Income-tax Act, 1961 (ITA) [relating to issue of notice where income has escaped assessment].
- In response to the aforesaid notice, the taxpayer furnished returns of income declaring nil income. It was the case of the taxpayer that:
 - The income earned from sale of books/journals in India could not be made taxable in India, as such income was in the nature of business income and in absence of Permanent Establishment (PE), not taxable in India.
 - The LO could not be treated as PE, as it had not carried on any commercial activity in India.
- However, the AO held that the LO was involved in activities, which were something more than mere preparatory and auxiliary services and thus, the LO constituted a PE of the taxpayer in India. Further, the AO attributed 15% of the total sales as income of the LO.
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings the matter reached before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extract of Article 5 of the India-Germany tax treaty

“(1) For the purposes of this Agreement, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on...

... (4) Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include...

...(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character ;”

Decision of the ITAT:

The ITAT noted that the issue arising for consideration was whether the LO of the taxpayer in India could be

¹ ITA Nos. 643 to 645/Del/2005 & 3660/Del/2009 (Delhi ITAT)

treated as PE in terms of Article 5 of the India-Germany tax treaty. In this regard, the ITAT noted/observed the following:

Sale of books printed at export processing zone (EPZ) in India

- Based on the statement recorded from two employees, with reference to the printing activities carried on in India in EPZ, the following was noted:
 - Employees working at LO identified a title for reprinting and mass circulation. Once the title identification was done, the distributors were contacted by the LO to determine their readiness to purchase the said titles.
 - Once the distributor showed readiness to procure the identified titles, the LO obtained the price, on which they were willing to buy the titles and number of prints they wanted. After completion of this exercise, the LO contacted the HO to find out the cost component in terms of royalty payable and e-file costs.
 - Thereafter, the printing quotes were taken from the printer by the LO. Once, the LO procured the cost components, the number of confirmed orders and the selling rates, the net price and gross margin were determined by the LO and the quote was sent to the HO for acceptance. After acceptance of the quote by the HO, printing order was placed with the concerned EPZ. In very rare instances, some queries were raised by the HO, otherwise, in 90 to 95% of cases, the quotes sent by the LO were accepted by the HO.
 - Further, the LO had visited various institutions during the year and met the scientists and academicians to inform them about the existing new products of the company to enable them to procure the required products through distributor companies in India. The LO provided market research information and market feedback to HO for pricing of the products.
- Thus, so far as the reprinting of low-priced editions of EPZ in India was concerned, the activities of the LO were much more than mere preparatory and auxiliary character. The LO not only procured orders, but also worked out the cost components and margin of the books to be reprinted in EPZ and send for acceptance of the HO. In majority of cases, almost 90 to 95%, the price and margin fixed by the LO in respect of specific titles to be published/reprinted at the EPZ were accepted by the HO. Thus, the LO had a major say with regard to not only the titles to be reprinted in India, but their pricing also.
- Though, the LO may not be involved in direct sales of products, the activities of the LO with regard to printing of books at EPZ were of much wider magnitude than mere preparatory and auxiliary character.
- Therefore, the LO constituted a PE in terms of Article 5(1) read with Article 5(2) of the India-Germany tax treaty, in relation to reprinting of books at EPZ. The exceptions provided under Article 5(4) of the tax treaty were not applicable as the activities undertaken by the LO were not merely limited to preparatory or auxiliary character of a communication channel between the clients in India and HO.

Sale of journals and books printed abroad

- The PE had no role to play in sale of journals and books printed abroad, as these were direct transactions between the taxpayer and subscribers/buyers in India without any intervention of the LO.

Attribution of income

- No part of the income derived by the taxpayer from sale of journals and books imported to India could be attributed to the PE.
- The attribution of income to PE should only be with reference to the books printed at EPZ and sold to distributors/customers. Thus, the profit rate of 11%, at which the Indian subsidiary (i.e., I Co) was remunerated, was taken as a yardstick to determine the quantum of profit attributable to PE. Out of that, 80% was attributable as income of the PE as major role was played by the PE with regard to EPZ sales. Also, while computing the income of the PE, the taxpayer's claim of expenses incurred towards making sales in India and

other deductions such as depreciation, head office expenses, turnover discounts etc. was to be considered.

In view of the above, the ITAT partly allowed the taxpayer's appeal.

Comments:

Evaluation of existence of a PE in a country is a fact-based exercise.

This ruling, based on an analysis of the activities carried out by the LO, has held the following:

- The LO not only procures orders, but also works out the cost components and margin of the books to be reprinted in EPZ and sends for acceptance of the HO.
- The LO has a major say with regard to not only the titles to be reprinted in India, but their pricing also.
- The activities undertaken by the LO were not merely preparatory or auxiliary character of a communication channel between the clients in India and HO.

Thus, the LO constituted a PE of the taxpayer in India in terms of Article 5(1) of the India-Germany tax treaty in relation to reprinting of books at EPZ. Having held that the activities of the LO constituted a PE in India, the ITAT has also held that:

- No part of the income derived by the taxpayer from sale of journals and books imported to India could be attributed to the PE.
- The attribution of income to PE should only be with reference to the books printed at EPZ and sold to distributors/customers.
- While computing the income of the PE, the taxpayer's claim of expenses incurred towards making sales in India and other deductions such as depreciation, head office expenses, turnover discounts etc. is to be considered.

We have provided below links to tax alerts of earlier rulings in connection with the issue of constitution of LO as a PE in India:

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-whether-activities-of-a-liaison-office-constitute-a-permanent-establishment-noexp.pdf>

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-activities-carried-out-by-project-office-does-not-constitute-a-permanent-establishment-noexp.pdf>

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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