Subsidiary as a Permanent Establishment

The taxation of Permanent Establishments (PE) is one of the most important concepts in International Taxation. The potential exposure to a PE is a major concern amongst corporate houses. PE determination is highly fact-sensitive and subjective and it cannot be assumed that any entity by virtue of being a subsidiary of a non-resident holding/parent company could be classified as a PE of the same. The onus to prove that the assessee has a PE rests with the Revenue. Unless it is established that the assessee has a PE in India, the AO should not ideally proceed to determine the profits attributable to such PE. The author has referred some recent decisions in this write-up, where a subsidiary is being determined as a PE.

(Contributed by Committee on International Taxation, of ICAI. Comments can be sent on citax@icai.in)

Introduction

The taxation of Permanent Establishments (PE) is one of the most important concepts in International taxation. The potential exposure to a PE is a major concern amongst the corporate houses. Business process outsourcing, cross-border travel of employees, and various other transactions between associated enterprises is an inherent part

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of the globalised corporate set-up and the imbuing 'Multinational 'culture. This trend has also flared up the litigation around PE.

Whether or not a foreign company has a PE in India, is function of several factors like carrying on of business in India through:

- a fixed place
- a dependent agent
- Employees/other personnel visiting India, *etc.*

The aforesaid is determined, having regard to the relevant tax treaty in consideration. A holding–subsidiary set up, is a most conventional multinational structure. In a number of cases, an Indian subsidiary of a foreign company has been alleged to be a PE. Is subsidiary also a type of PE? Or, in other words, does having a subsidiary in India by itself leads to a PE in India?

As we go along in this article, we will explore the aforesaid questions and discuss some of the recent important decisions that throw light on this issue.

Subsidiary as a PE

In the 1920s, the domestic tax laws of a few countries including Germany, Italy and Spain regarded subsidiary as a Permanent Establishment of its parent. In fact, under the German law until 1934, a subsidiary was automatically considered as a PE[1].

However, with the increase in globalisation and to meet the need of the hour, the default PE taxation of a subsidiary was withdrawn. **Attention is invited to Article 5(7) of the OECD Model convention** which reads as under:

> *"The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."*

Article 5(7) of the OECD Model Convention is identical to Article 5(8) of UN Model Double Taxation Convention, 2011 and Article 5(7) of US Model Income Tax Convention, 2006.

The Article as reproduced above, is clarificatory. It clarifies that a company is not deemed to have a PE in the other contracting state, merely because, it controls, or is controlled by the other. A subsidiary can become a PE of the holding or the controlling company, if it satisfies the postulates and requirements of other paragraphs of the Article 5 notwithstanding and negating the protection provided under paragraph 6 of Article 5 which recognises the legal independence of the two entities.

While the term control has not been specifically defined in this context, Paragraph 40 of the OECD Model Convention Commentary refers to the term "subsidiary" while discussing this Article. It reads as under:

> *"40. It is generally accepted that the **existence of a subsidiary company** does not, of itself, constitute that **subsidiary company** a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, **such a subsidiary company** constitutes an independent legal entity. Even the fact that the trade or business carried on by the **subsidiary company** is managed by the parent company does not constitute the **subsidiary company** a permanent establishment of the parent company".*
>
> (Emphasis supplied)

Thus, a subsidiary is generally construed as an independent legal entity and unless the other conditions in relation to existence of a PE are not fulfilled (like fixed place PE, agency PE, service PE *etc.*), a subsidiary by itself shall not be regarded as a PE.

Thus, a subsidiary in a way, unlike a branch or a project office, is a guarded structure, for carrying on business in India. Having a subsidiary does not by itself constitute a PE. In other words, a subsidiary is not a type of PE, but can be regarded as a PE if other applicable conditions are fulfilled.

It may be noted that the identification of a PE is not generally easy in circumstances where the PE maybe concealed behind a dependent operating

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[1] Source–International Taxation–A compendium by CTC Mar 2013-Third Edition

company carrying on other company's business in guise of an independent legal entity. As per the jurisprudence on the issue, the technical basis for PE determination involving subsidiary companies hovers around the "disposal test", "agency test", "place of management test", or a combination thereof.

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Recent Indian Jurisprudence

In the context of deliberating on the issue of subsidiary being determined as a PE of the non-resident holding company, the Author has referred to some recent decisions which may be worthwhile to note.

Note: Though numerous issues have been deliberated by the courts in the rulings discussed in this article, we have restricted our discussion to the part of the ruling which deals with the aspect of subsidiary being construed as a PE.

A. Delhi High Court- E Funds Corporation & E Funds IT Solutions[2]

Facts of the Case

- E Funds Corporation and E Funds IT Solutions Group Inc. (taxpayers) are companies incorporated in USA and E Funds India is a wholly owned subsidiary of the taxpayers.
- The subsidiary performed back office operations in respect of ATM management services, electronic payments, decision support services *etc.*
- Income Tax Appellate Tribunal (ITAT) determined the subsidiary as a PE, since all the activities in India were carried out by the subsidiary and had not been remunerated on arm's length basis.

Issue before the High Court

- Whether the Indian subsidiary would be deemed as a PE of the taxpayer in India and how much could be attributed and taxed in the hands of the taxpayer?

High Court Ruling

- **Subsidiary as a PE:-** The Delhi HC opined that the subsidiary company constitutes an independent legal entity and the holding or the subsidiary company by themselves would not become a PE of each other. A subsidiary can become a PE of the holding/controlling company only if it satisfies the requirements stipulated in article 5 of the treaty.
- **Fixed Place PE: -** The fact that the subsidiary company was carrying on core activities as performed by the foreign taxpayer does not create a fixed place PE. Also there was no material to hold that the business of the taxpayers was carried out wholly or partly through a fixed premises and that the taxpayers used any premises belonging to the subsidiary.
- **Service PE-** The High Court observed that employees of E-fund India were their employees, *i.e.*, employees of the Indian subsidiary and not employees of the taxpayers. Though the employees of the taxpayer were deputed to the Indian subsidiary, the control and supervision over the employees rested with E fund India. Therefore Service PE did not exist in India.
- **Agency PE-** Subsidiary by itself cannot be construed to be a dependent agent PE of the Principal unless the conditions stipulated in Article 5(4) and (5)[3] are satisfied. Since transactions between the taxpayers and the Indian subsidiary were taxed on an arm's length principle and therefore requirements of article 5(5) are not satisfied and hence, there was no agency PE in India.

Comments

- This is a welcome ruling of the Delhi High Court laying down exhaustive principles in relation to determination of a PE, which have been internationally accepted by OECD as well as several benches of the Income Tax Appellate Tribunal. The High Court has taken a well-considered view clarifying concepts surrounding the issue of PE. The High Court has gone ahead to spell out various factors which in its opinion have no bearing on determination of PE and also reiterated that merely because a foreign company has a subsidiary in India would not create a permanent establishment.

[2] DIT vs E Funds IT Solutions (2014) 42 taxmann 50(Delhi)
[3] Article 5(4) & 5(5) of the India-USA DTAA stipulate criterion for classification of dependent agent PE

B. ITAT Delhi -Nortel Networks India International Inc.[4]

Facts of the Case

- M/s Nortel Group is a leading supplier of hardware and software products for GSM cellular radio telephone systems.
- The taxpayer, Nortel Networks India International Inc., a group concern of Nortel Group is a company incorporated in USA.
- The Nortel India (Indian subsidiary) installed the hardware supplied by the taxpayer and pre-negotiated the contracts.
- The Indian subsidiary of the Nortel group entered into an agreement with Reliance Infocom for supply of hardware and immediately after it's signing, the contract was assigned to the taxpayer.

Issue before the Tribunal

- Whether the taxpayer constitutes a Permanent establishment in terms of Article 5 of the DTAA between India and the USA?

Tribunal's Observations & Ruling

- The contract awarded was an indivisible contract involving supply, installation, testing, commissioning etc.
- M/s Nortel India undertook the responsibility for negotiating and securing the contracts as also the contract for installation and commissioning. The Tribunal agreed that the taxpayer executed the said work through Nortel India.
- Tribunal observed that the taxpayer is merely a shadow company of Nortel Group.
- All the facilities and services available to the Nortel Group were made available to the taxpayer. The installation works was executed as also the negotiation of the contracts was done by the Indian subsidiary.
- Nortel India was determined the subsidiary as a Fixed PE and Dependent Agent PE.

While the Revenue Authorities in India, in several cases, have been promiscuously leveling PE allegations, notwithstanding the independent subsidiary, whether the subsidiary is in fact a PE of the foreign enterprise is a question which is dependent on facts of each particular case.

- The Tribunal held that *"the activities carried out by the PE are the core activities of the assessee resulting in generation of income to the assessee and they cannot be considered to be preparatory and auxiliary and therefore, the contention of the assessee that it do not have PE in India is rejected."*

Comments

- Based on the facts of the case, the Delhi Tribunal held that, under the DTAA, the taxpayer had a fixed place PE as well as dependent agent PE by virtue of activities carried on by the Indian subsidiary. The ruling indicates the possible existence of a PE exposure while executing a turnkey contract (which are indivisible) which involves supply of equipment as well as provision of installation and commissioning services.

C. Mumbai Tribunal-Lubrizol Corporation USA

Facts of the Case[5]

- Lubrizol Corporation USA(assessee)engaged in manufacturing and sales of chemicals and lubricants, had a subsidiary[Lubrizol India Pvt. Ltd. (LIPL)]in India with 50% stake held by the assessee and balance 50% stake held by Indian Oil Corporation.
- The subsidiary is engaged not only in manufacture of products developed by the assessee but also in the marketing of products manufactured by the assessee.
- AO observed that the subsidiary maintained stock of various products, it was involved in procurement of order, had complete rights and liabilities in respect of marketing and sales activities on behalf of the assessee and was a virtual projection of the assessee in India. In view of the above factors, the AO held that assessee has a PE in India and the income is taxable in terms of Article 5(1), 5(2) and 5(4) of the India-USA DTAA.

Issue before the Tribunal

- Whether the Indian subsidiary would be deemed to be a PE in terms of India-USA DTAA?

Tribunal's Observation/Ruling

- The Tribunal in the case of the assessee for AY 2006-07 observed that LIPL was carrying

[4] Nortel Networks India International Inc. vs. DDIT (ITA Nos 1119,1120 & 1121 of 2010) dtd 13/06/2014
[5] Lubrizol Corporation USA vs. ADIT [2013] 33 taxman 424 (Mumbai-Trib)

The mode and manner in which functions are carried out by the subsidiary, the precision with which the documentation is done would, go a long way in determining /fighting a PE situation.

on independent manufacturing activities, own marketing network of sales, the commission received from the assessee constituted only a small portion of the total sales. Neither did LIPL had any authority to conclude contracts on assessee's behalf nor had any right to use LIPL premises. Also, LIPL did not had any authority to negotiate the terms of the contract and the authority to make final decision making authority rested with the assessee. The above mentioned facts are similar to the facts of the present case. In view of the above facts, the Tribunal held that the assessee does not have a PE in India.

- The Tribunal while holding non-existence of PE for AY 2006-07 relied on the decision of Daimler Chrysler[6] wherein it was held that *"there should be some definite activity of the PE to which profits can be attributed and merely acting for a non-resident principal would not by itself render an agent to be considered as PE for the purpose of allocating profits taxable in the hands of the principal....."*
- The Tribunal in the present case (following the decision of the co-ordinate bench of the Tribunal in the assessee's own case) held that the assessee did not have a PE in India in terms of Article 5(1), 5(2), 5(4) and 5(5) of the Indo-US Treaty.

Comments

- On factual analysis of the case, the Mumbai Tribunal primarily placing reliance on the decision of the Tribunal in its own case for AY 2006-07 and in absence of any other distinctive feature brought on record by the Revenue, held that the subsidiary of the assessee shall not be determined as a PE. Enormous reliance was also placed on the decision of the Mumbai Tribunal in case of Daimler Chrysler *(supra),* wherein it has been held that mere existence of a subsidiary does not by itself constitute the subsidiary as a PE of the parent company and it is imperative for the subsidiary to carry on business in India for constitution of a PE. On various occasions it has been held essentially that, subsidiary cannot be recorded as a PE if the subsidiary has its own independent business operations. However if the functions of the subsidiary are not independent of the business of the parent company, there could be a reasonable belief that PE exists.

In the light of the above judgments, it is evident that such arrangements often raise peculiar tax issues under the applicable Double Taxation Avoidance Agreements as well as the Indian Tax Laws. It can be thus concluded that PE determination is highly fact sensitive and subjective and it cannot be assumed that any entity by virtue of being a subsidiary of a non-resident holding/parent company could be classified as a PE of the same.

Onus to prove existence of PE

It may be pertinent to note that there are numerous factors associated with determination of PE and also PE determination is fact intensive exercise. It has also been held in various judgments[7] that the onus to prove that a PE exists rests with the Revenue. There should be some evidence or justification from the Revenue to substantiate the existence of a PE.

In the case of Sofema SA[8] the Tribunal observed that in the absence of any evidence on record with regard to commercial activity having been done by the assessee company in India, its liasion office cannot be considered to be permanent establishment. The order passed by the Tribunal has been confirmed by the jurisdictional Delhi High Court and moreover, the SLP filed by Revenue was dismissed by the Apex Court. The Apex Court observed that:

> *".... In the present case, there is a concurrent finding that Sofema SA, respondent herein is not a PE under the DTAA. However we find that this finding has been given on the basis that there is no evidence or justification forthcoming from the side of the Department to show that the respondent is a PE. On that account alone we do not wish to interfere in this matter."*

[6] DDIT vs. Daimler Chrysler A.G. [2010] 39 SOT 418 (Mum)
[7] Daikin Industries Ltd ITA No 3005/Del/2011; Meta One Corporation ITA No 5377/Del/2011
[8] Sofema SA ITA No 3900/Del/2002of 2006, affirmed by Delhi HC *vide* ITA No 1764/2006

The controversy that persists is whether the AO possesses sufficient material to demonstrate that the assessee has a PE in India. It is reiterated that the onus to prove that the assessee has a PE rests with the Revenue. Unless it is established that the assessee has a PE in India, the AO should not ideally proceed to determine the profits attributable to such PE.

Conclusion

While the Revenue Authorities in India, in several cases, have been promiscuously leveling PE allegations, notwithstanding the independent subsidiary, whether the subsidiary is in fact a PE of the foreign enterprise is a question which is dependent on facts of each particular case. While the Delhi High Court in the case of E Funds (*supra*) has elaborately considered all facets of possible PE determination and held that a subsidiary would not be classified as a PE, the Tribunal in the case of Nortel (*supra*) on the basis of facts of the case, has classified the subsidiary as a PE of the taxpayers. It appears from the reading of the judgment in the case of Nortel (order pronounced on 13th June'14) that the Delhi High Court's decision in case of E Funds (order pronounced on 5th Feb'14) has not been brought to the attention of the Hon'ble ITAT Bench.

As stated in earlier paragraphs, since subsidiary is not as such a type of PE, there are no unique features associated with subsidiary being reckoned as a PE. The mode and manner in which functions are carried out by the subsidiary, the precision with which the documentation is done would, go a long way in determining/fighting a PE situation. Nonetheless the following factors can be generally categorised as associated risks for classifying the subsidiary as a PE:

- Non-resident holding Companies employees regularly using the Indian subsidiary's facilities.

Since the subsidiary has always been classified as an independent and distinct legal entity for the purpose of taxation, there cannot be any thumb rule for classification of the subsidiary as a PE of the holding company unless factual analysis proves to be contrary.

- Indian subsidiary habitually exercises authority to conclude contracts on behalf of the non-resident holding company.
- Employees seconded from the non-resident holding company perform activities to promote/assist the business of the holding company, working under the control of and is compensated by the holding company.
- Non-seconded employees of the holding company perform services both for the non-resident holding company as well as the Indian subsidiary.

In sight of the above factors and the Indian jurisprudence, it is critically important to have continued diligence on permanent establishment front. A detailed risk matrix is essential to determine the possible risk areas. The good practices that may be followed to mitigate the risks could be in the form of having consistent supporting documentation, not retaining lien over the employment by the parent company, clear definition of roles and responsibilities *etc*. It is reiterated that factual matrix should be reviewed regularly in view of the judgments of the Courts as it can help in mitigating the risk to PE exposure as well as taking corrective action in a timely manner.

Since the subsidiary has always been classified as an independent and distinct legal entity for the purpose of taxation, there cannot be any thumb rule for classification of the subsidiary as a PE of the holding company unless factual analysis proves to be contrary. It would be interesting to see in times to come as to how this issue would be dealt in by the higher courts. ■