Regulating the Liaison Offices' Periphery.....

The Liaison Office (hereinafter referred to as 'LO') generally acts as a communication channel between the overseas parent entity and its present or prospective connects/clients in India. The LO can also be set up to establish business contacts or gather market intelligence to promote the products or services of the overseas parent entity. Considering the limited scope of activities that can be undertaken by LOs and especially the prohibitions and restrictions cast upon them, of not being allowed to earn income in India, it is a common understanding that LOs are not subject to taxation in India. However in the recent times, Revenue Authorities are trying to examine whether the LOs are performing activities which are beyond the scope of permitted activities and whether the same could constitute a business connection/Permanent Establishment (PE) of the overseas parent entity in India?

(Contributed by the Committee on International Taxation. Comments can be sent at citax@icai.in)

Establishment Of Liaison Office

Entities which are incorporated outside India can establish a Liaison Office in India with prior approval of the Reserve Bank of India (hereinafter referred to as 'RBI'). A 'Liaison Office' as the term suggests can only undertake the liaison work, *i.e.* it can act as a channel of communication between the head office abroad and the parties in India.

1 Source : Master Circular No 7/ 2014-15 on Establishment of Liaison/Branch/Project Offices in India by Foreign entities dated 1st July 2014

RBI, before according approval to the application made by an entity, for establishment of a Liaison Office in India, ensures that the following criterions are fulfilled:-

a) a profit making track record during the immediately preceding three financial years in the home country, and
b) total net worth of not less than $ 50,000 or its equivalent.

Compliance to Foreign Exchange Management Act (FEMA), guidelines issued from time to time and RBI Policy requires that an LO shall not carry out any activity other than the ones for which approval has been granted by RBI. The LO is also not allowed to undertake any business activity in India and cannot earn any income in India.

The following are activities that can be undertaken by a Liaison Office in India in terms of the Master Circular issued by the Reserve Bank of India (RBI). This circular also imposes some restrictions which are also listed here below :-

Within The Arena Of RBI Permission

Any foreign entity desirous of opening LO in India is required to obtain prior approval from the RBI and is required to mandatorily carry out only those activities for which permission has been granted by the RBI. Usually, the approval is granted for a period of three years which can be further renewed on expiry. An annual Activity Certificate duly certified by a Chartered Accountant has to be presented at the Regional Office of the RBI, verifying that the Liaison Office is engaged in only those activities which are permitted by the RBI. Adequate measures have been provided by way of stringent reporting requirements both, under the Income-tax Act as well as FEMA. With the objective of seeking regular information from non-residents regarding the activities of their liaison offices in India, the Finance Act, 2011 has inserted Section 285 which requires a non-resident, having a liaison office in India set up in accordance with the guidelines issued by the RBI, to furnish an annual statement in Form 49C within sixty days from the end of the financial year.

However, can violation of the conditions (activities of the LO) imposed by the RBI conclude that the LO constitutes PE of the foreign entity in India? The views emanating from some of the judgments are being highlighted in the subsequent paragraphs of this article.

ITAT Delhi in case of *Metal One Corporation*[2] while concluding that the LO of the assessee did not constitute PE in India held that *" it can be concluded that the presumption which can validly be raised in this case that India office does not constitute a PE as no violation was noticed by the RBI. This presumption has not been rebutted by the Assessing Officer by bringing any positive material to show that any substantive business activity was carried on by the assessee in India."*

In contrast to the above, the Karnataka High Court in the case of *Jebon Corporation*[3] held that *"Once the material on record clearly establishes that the liaison office is undertaking an activity of trading and therefore entering into business contracts, fixing price for sale of goods and merely because, the officials of any liaison office are not signing any written contract would not absolve them from liability..... But merely because no action is initiated by RBI till today would not render the findings recorded by the authorities under the Income Tax Act as erroneous or illegal."*(emphasis supplied)

On the one hand, ITAT Delhi in case of *Metal One (supra)* has clearly held that since no violation was noticed by RBI, existence of PE as such cannot be construed. On the other hand, the Karnataka HC in the case of *Jebon (supra)* observed that mere non-enquiry by the RBI on whether the activities of the LO were confined only to liaison work would not invalidate the findings of the authorities.

"Compliance to Foreign Exchange Management Act (FEMA), guidelines issued from time to time and RBI Policy requires that an LO shall not carry out any activity other than the ones for which approval has been granted by RBI. The LO is also not allowed to undertake any business activity in India and cannot earn any income in India."

[2] *Metal One Corpn. vs. DDIT [2012] 22 taxman 77 (Delhi ITAT)*
[3] *Jebon Corporation India vs. CIT [2012] 19 taxmann 119 (Kar HC)*

"An annual Activity Certificate duly certified by a Chartered Accountant has to be presented at the Regional Office of the RBI, verifying that the Liaison Office is engaged in only those activities which are permitted by the RBI. Adequate measures have been provided by way of stringent reporting requirements both, under the Income-tax Act as well as FEMA."

RBI being the Central authority having control over the existence and continuance of LO in India, is well informed about the activities carried on by the LO by way of furnishing the audited financial statements, annual activity certificate, returns *etc.* In instances where the LO carries out activities beyond the permissible boundary and any violation observed by the RBI, it may lead to withdrawal of permission granted to the LO for carrying out activities in India.

In view of the aforesaid facts and the judicial pronouncements discussed in the preceding paragraphs, it is suggested that a comprehensive analysis of facts of the case, nature of activities performed by LO and compliances undertaken with RBI should be examined at regular intervals to ensure that the assessee is compliant to various regulations.

Trigger For Taxability Of A Liaison Office

Since the LO is refrained from carrying out any activity or earning any income in India, ordinarily it should not constitute any taxable presence in India. However, the Income Tax Laws do not provide any specific shield to the LO from being excluded from the tax net. Generally, the taxability of the LO triggers if the LO has business connection in India or PE of the foreign entity is established in form of LO in India. A brief insight to the relevant provisions of the Income Tax Act as well as Double Taxation Avoidance Agreement (DTAA) which impact the taxability of LO is given in subsequent paragraphs.

As per Section 9 of the Income-tax Act, all incomes accruing or arising directly or indirectly, through or from any business connection[4] in India, shall be deemed to accrue in India. However explanation to Section 9(1) limits the quantum of taxable income deemed to have been accrued or arisen in India to such part of income as could be reasonably attributed to the operations carried out in India. It may also be noted that any income arising from activities which are confined to the purchase of goods in India for the purpose of export shall not be deemed to accrue or arise in India.

The taxability or otherwise of an LO under the terms of DTAA shall be governed by Article 5 and Article 7. Article 7 of the DTAA categorically states that profits of an enterprise of a contracting state shall be taxable only in that state, unless the enterprise carries on business, in the other state, through a Permanent Establishment (PE). A functional and factual analysis of each of the activities undertaken by the entity shall certainly aid in deciding whether a PE is constituted or not. Nonetheless, the fixed place of business carrying out preparatory or auxiliary activities is generally excluded from the definition of PE in most of India's tax treaties.

As per the provisions enunciated by the law, LO may undertake preparatory and auxiliary activities in India and fall outside the purview of being taxed in India. However, it is a matter of debate as to what constitutes preparatory and auxiliary activities that the LO can undertake in India?

Preparatory And Auxilliary Services-Exclusionary Clause

The term 'preparatory' and 'auxiliary' have not been defined in the model treaties. At times, it is quite difficult to determine as to what constitute preparatory or auxiliary activities as distinct from activities which are not. In order to determine the existence or otherwise of a PE, a factual and functional analysis of the activities of the establishments (LO, Subsidiary, BO, PO etc.) needs to be undertaken. Generally, if the activity of the establishment forms an indispensable and significant part of the activity and are identical with the general purpose and object of the parent entity, then such activities may not be construed as preparatory or auxiliary in character.

While there is no clear explanation as to which activity is preparatory or auxiliary in character, Paragraph 24 of the OECD Model Convention Commentary has analysed clause 5(3)(e) as under :

"It is often difficult to distinguish between

"The Income Tax Laws do not provide any specific shield to the LO from being excluded from the tax net. Generally the taxability of the LO triggers if the LO has business connection in India or PE of the foreign entity is established in form of LO in India."

[4] *The expression business connection was not defined earlier in the Act until Explanation 2 which was inserted by Finance Act 2003, w.e.f. 1-4-2004, clearly stipulated the activities specified in clauses (a) to (c) within the domain of 'business connection'. The term 'business connection' is defined in Explanation 2 to Section 9(1) of the Income Tax Act, 1961.*

"Delhi ITAT in the case of *Amadeus Global*[1] held that it is difficult to distinguish between the activities which are 'preparatory or auxiliary' character and those which are not. Since part of the function was operated in India which directly contributed to the earning of revenue, the activities shall in no way be 'preparatory or auxiliary' in character."

activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole."(emphasis supplied)

In the following cases, it has been held that the activities constituted to be preparatory and auxiliary in character and therefore did not establish existence of a PE:-

a) Carrying out of back office operations by the Indian subsidiary for the US parent does not result in formation of PE for the US parent company since the back office functions carried out by the Indian company falls under Article 5(3)(e) which are preparatory or auxiliary in character.[5]
b) Activities carried on were within the scope of the liaison office and no trading activity was being carried therefore there was no PE in India.[6]
c) Basic operations, industry analysis, economic evaluation, market survey, furnishing information, technical presentation to prospective customers, development of market opportunities, *etc.* were held to be preparatory and auxiliary in nature.[7]

Whereas in the following cases, it has been held that the activities carried out were not preparatory or auxiliary in nature and established existence of a PE in some form or the other:

a) Operations carried out in India cannot be regarded as preparatory or auxiliary functions because they were essential and significant part of the activity of the enterprise as a whole.[8]
b) The branch was doing R&D work for the taxpayer and the same was being done exclusively which was the core business of the taxpayer. This important facet of the Indian branch's work was not of preparatory or auxiliary nature within the ambit of Article 5(3) (e) of the tax treaty. Accordingly, the Indian branch cannot be excluded from being a PE.[9]
c) Delhi ITAT in the case of *Amadeus Global*[10] held that it is difficult to distinguish between the activities which are 'preparatory or auxiliary' character and those which are not. Since part of the function was operated in India which directly contributed to the earning of revenue, the activities shall in no way be 'preparatory or auxiliary' in character.

The issue of determination of whether an LO constitutes a PE or not, shall have to be examined based on facts and circumstances of each case and it cannot be presumed that a liaison office will always be excluded from the purview of Article 5. The ensuing paragraphs of the article have made reference to some important judicial pronouncements which may be worthwhile to note in the context of taxability of a liaison office in India.

Analysis Of Judicial Precedence

A.TESCO INTERNATIONAL SOURCING LTD's case[11]

Facts: - The activities carried on by the assessee included the following:

a) Identification of vendors in India
b) Communication of the design and specification requirements to the vendor
c) Receiving prototype from the vendor
d) Quality check for products before production
e) Tracking the production and delivery

Ruling: - ITAT held that the activities undertaken by the LO *viz.* liaisoning between the manufacturer and vendor, giving opinion on reasonability of prices, monitoring the progress and quality of products, *etc.* are activities of LO prior to purchase of good by the parent company. Explanation 1(b) to Section 9(1) (i)[12] is clearly applicable to the assessee's case and, thus, no income was derived by the assessee in India through its operations as LO in India.

B. JEBON CORPN. INDIA's case[13]

[5] *DIT vs. Morgan Stanley and Co. Inc. [2007] 292 ITR 416 (SC)*
[6] *IAC vs. Mitsui & Co. Ltd. [1991] 39 ITD 59 (Del)(SB)*
[7] Motorola Inc, 95 ITD 263 (Del)(SB)
[8] Rolls Royce Plc, 19 SOT 42 (Del)
[9] Consulting Engineer Corporation vs. JDIT (ITA No 1597,1598,1275,1172/Del/2009)
[10] Amadeus Global Travel Distribution S.A. vs. DCIT [2011] 11 taxman 153 (Delhi)
[11] Tesco International Sourcing Ltd vs. DDIT [2014] 41 Taxman 241
[12] Expl 1(b) to Section 9(1)(i)- "in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to purchase of goods in India for the purpose of export "

Facts: - The activities carried on by the assessee included the following:

a) Procuring purchase orders
b) Identifying the prospective customers and negotiating with the buyers.
c) Forwarding the purchase order to the Head Office
d) Following up with the customers for payments

Ruling: - The Karnataka HC affirming the order of the ITAT, observed that the activities carried on by the LO were not confined only to liaison work but were actually carrying on commercial activities. It was held that merely because the buyers place orders directly with the HO and make payments directly and the HO directly dispatches goods to the buyers would not be sufficient to hold that the work done by the LO is only liaison and it does not constitute a PE. Merely because no action is initiated by RBI till today would not render the findings recorded by the authorities as erroneous or illegal.

C. UAE EXCHANGE CENTRE's case[14]

Facts: - The brief facts of the case are mentioned hereunder:

a) Assessee entered into contracts with NRI remitters for transmitting funds to beneficiaries in India. The contracts were executed in UAE.
b) Funds were either remitted through telegraphic transfer or by involving the LOs which drew cheques on banks in India and dispatched the same to beneficiaries in India.
c) The assessee charged one-time commission from the NRI remitters in UAE.
d) AAR held that the activities of LO contributed directly or indirectly to the earning of income and therefore such income is deemed to accrue or arise from the business connections in India.

Ruling: - Delhi HC observed that every aspect of the transaction was concluded in UAE and the commission was also earned in UAE. Since the activities of LO were only supportive of transaction carried on in the UAE, it did not contribute to the earning of profits or gains. It was also observed that activity of the LO (*viz.* to download information from the servers in UAE and issue cheques drawn on banks in India and dispatch to Indian beneficiaries) was in aid or support of the main activity and therefore would fall within the exclusionary clause of Article 5(3)(e).[15]

D. BROWN AND SHARP's case[16]

Facts: - The brief facts of the case are mentioned hereunder:

1. Employees appointed by LO were entitled to sales incentive to the extent of 25% of their annual remuneration.
2. The activities carried on by the assessee (LO) included the following :
   a) Explaining the products to buyers in India
   b) Furnishing intimation in accordance with the requirements of the buyers
   c) Discussion of commercial issues pertaining to the contract through the technical representative, after which an order was placed by the buyer directly.

Ruling:- The High Court held that the disclosures which were made by the taxpayer before the AO clearly indicate that the activities of the liaison office were not confined only to being a channel of communication between the head office in the US and prospective buyers in India. Also, the nature of the incentive plan would indicate that the purpose of the LO in India was not merely to advertise the products of the taxpayer or to act as a link of communication between the taxpayer and a prospective buyer. The LO was involved in activities which traversed the actual marketing of the products of the taxpayer in India because it was on the basis of the orders generated that an incentive was envisaged for the employees.

E. K T Corporation's case [17]

Facts: - The activities carried out by the LO included the following:

a) Holding seminars and conferences
b) Receiving trade enquiries from the customers
c) Advertising about technology used to answer queries

"The sole criterion which would determine the taxability or otherwise is the nature of activities carried out by the LO and whether they are in conformity with the permissions granted by the RBI."

[13] Jebon Corporation India vs. CIT [2012] 19 taxmann 119 (Kar)
[14] U.A.E. Exchange Centre Ltd vs. UOI [2009] 183 taxman 495 (Delhi)
[15] ".....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."
[16] Brown and Sharp Inc vs. CIT [2014] 51 taxman 327 (All)
[17] [2009] 181 taxman 94 (AAR-New Delhi)

d) Collecting feedback from the prospective customers

e) Preparation of reports dealing with India's market scenario

Ruling: - The Authority for Advance Ruling held that the activities of the LO were covered within the exclusionary clauses (e) and (f) of Article 5(4) of DTAA[18] . Further it held that if the activities of LO are enlarged beyond the parameters fixed by RBI or department has evidence against the veracity of the applicant's version of facts; it shall be open for the department to take appropriate steps under the law.

Conclusion

Uncertainty in taxability of LO coupled with the cumbersome reporting requirements under respective statutes may possess challenges for the foreign entities having LO/planning to establish LO in India. The sole criterion which would determine the taxability or otherwise is the nature of activities carried out by the LO and whether they are in conformity with the permissions granted by the RBI.

The permitted activities of an LO are amenable to wide connotations and diverse interpretations. In view of the different interpretations as indicated in the preceding paragraphs, foreign entities planning to establish LO in India may consider obtaining an advance ruling to determine whether or not the activities to be conducted by the LO could attract any tax liability or create a PE for them in India.

Though there have been quite a few judicial precedents in favour of the proposition that LO is not liable to tax in India, nonetheless the taxability of the LO still continues to be a litigative issue. The regulations have been clearly defined to limit a liaison office's activity within RBI guidelines. It would be imperative for the foreign entities to have regular review of its activities and keep proper documentation in place to demonstrate the purpose of activities undertaken by the LO. ■

[18] Article 5(4) of the Treaty between India and Korea:(e) maintenance of a fixed place business solely for the purpose of advertising, the supply of information, scientific research, or any other activity if it has a preparatory or auxiliary character in the trade or business of the enterprise(f) maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of preparatory or auxiliary character.