

Subsidiary as Permanent Establishment

Chapter 26

CA Natwar G. Thakrar, CA Harshal Bhuta

CA Natwar Thakrar, B.Com, CA specializes in FEMA, Transfer Pricing & International Taxation. He was Chairman of the International Tax Committee of the CTC from 2008 to 2010. He has co-authored publications titled "FEMA and Non- Resident Taxation", "Referencer on FEMA" & "Remittance Certificate U/s. 195- Practical Aspects" and is a regular contributor to regular FEMA updates in Income Tax Review—a monthly journal of the CTC.

CA Harshal Bhuta M.Com, ACA is currently working with M/s P. R. Bhuta & Co., Chartered Accountants. Areas of specialization include International Taxation, Transfer Pricing & FEMA. He is pursuing Advanced Diploma in International Taxation conducted by Chartered Institute of Taxation, United Kingdom. Presently Co-Convenor of Study Circle of International Fiscal Association (India Branch-Western Region Chapter). He has lead study group discussion/delivered lectures at various fora viz. Bombay Chartered Accountants Society, CPE Study circles of WIRC

Synopsis

<i>Particulars</i>	<i>Page No.</i>
1. Preface.....	710
1.1 Three Modes of conducting international business.....	710
1.2 Origin of Article 5(7) of the OECD Model Tax Convention on Income and Capital, 2010 ('OECD MC')	710
2. Analysis of Article 5(7) of the OECD MC.....	711
2.1 Background	711
2.2 Meaning of the term 'Control'	712
2.3 Significance of the phrase 'Of Itself'	712
2.4 OECD position on Companies forming part of Multinational Groups and Intra Group services	713
3. Position under the Indian Income-tax Act, 1961.....	715
4. Important Judgements	716
5. Typical Arrangements with Potential PE Exposure under Article 5(7)	738
5.1 Secondment / Deputation Arrangements	738
5.2 Captive Service Companies	740
5.3 Contract Manufacturing	743
5.4 Sub-Contracting Arrangements.....	743
6. Conclusion.....	745

1. Preface

1.1 *Three Modes of conducting international business*

1.1.1 Foreign enterprises doing business with other countries generally exercise one of the following three options -

- Supply goods or services directly to the source country
- Establish its own place of business in the source country (typically by way of a branch)
- Set up a subsidiary or joint venture company in the source country

1.1.2 This article deals with the tax implications of the third mode of conducting business i.e. conducting business in the source country through related companies, making the OECD Model Tax Convention on Income and Capital ('OECD MC') as a primary reference point and attempts to give a holistic picture of Article 5(7) of OECD MC.

1.2 *Origin of Article 5(7) of the OECD Model Tax Convention on Income and Capital, 2010 ('OECD MC')*

1.2.1 In the 1920's, the domestic tax laws of a few countries including Germany, Italy and Spain regarded a subsidiary as a permanent establishment of its parent for corporate tax purposes.¹ In fact, under German law until 1934, a subsidiary was automatically considered to be a PE.²

1.2.2 This was also reflected in the provisions of old Treaties between Austria, Hungary, Italy and several other countries. The Italy-France Tax Treaty of 1930 in fact stated, for instance, that a subsidiary should be regarded as a permanent establishment.

1.2.3 This position lasted until the late 1930's.³ The position, if allowed to continue, obviously would have resulted in a hindrance for cross-border trade and investments and therefore a need was felt for international consensus on protection to related companies from

1. Jean-Pierre Le Gall in a lecture on "Can a Subsidiary be the Permanent Establishment of its Foreign Parent?" at the eleventh lecture (2006) at David R. Tillinghast Lecture on International Taxation

2. German Branch Report on "Is there a Permanent Establishment" at IFA Congress, 2009

3. Jean-Pierre Le Gall at the eleventh lecture at David R. Tillinghast Lecture on International Taxation

their automatic taxation as a PE of its parent unless a PE is hidden behind the face of a subsidiary. The principle of treating a subsidiary as a distinct legal entity for taxation purposes thus found its way into Mexico (1943) and London (1946) models of the OECD.⁴ In due course, the principle codified in the OECD MC and now it appears as Article 5(7) of the OECD MC.

2. Analysis of Article 5(7) of the OECD MC:

2.1 Background

2.1.1 When an enterprise of a contracting state carries on business in another contracting state, the following two questions must be asked before the second state can levy tax on the profits of the enterprise: (1) whether or not the enterprise has a PE in this other state; and (2), if the answer to question (1) is affirmative, what are the profits on which the PE should pay tax. A PE, however, is not always easy to identify. This is particularly true where a PE is hidden behind a dependent operating company, i.e. if an operating company in addition to its own business also carries on the business of the parent company on which it is dependent.

2.1.2 But mere existence of a dependent company in other state itself shall not constitute itself a PE of the controlling company in that other state.

In this regard, Article 5(7) of the OECD MC states that:

“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.”

2.1.3 It follows from Article 5(7) that for the purpose of taxation, such a subsidiary constitutes an independent legal entity. Accordingly, both companies are subject to tax liability in the state in which they are resident or where their place of management is located. Mere factum of existence of a controlled subsidiary in another state does not automatically make itself a PE of the parent.

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

4. General Report on “Is there a Permanent Establishment” at IFA Congress, 2009

2.2 *Meaning of the term ‘Control’:*

2.2.1 ‘Control’ has not been defined at any place, either in the OECD MC Commentary on Article 5(7) or Commentary to Article 5(8) of UN Model Double Taxation Convention, 2011 or US Technical Explanation to Article 5(7) of US Model Income Tax Convention, 2006.

2.2.2 All DTAA entered into by India (as far as article on related companies is concerned) are based on Article 5(7) of the OECD MC except for few treaties such as India-UK DTAA and India-Egypt DTAA. Under India-UK DTAA, term ‘Control’ in relation to a company, has been defined to mean the ability to exercise control over the company’s affairs by means of the direct or indirect holding of the greater part of the issued share capital or voting power in the company, whereas under India-Egypt DTAA, specific reference has been given to a subsidiary rather than referring to ‘control over a company’.

2.2.3 Para 40 of the OECD MC Commentary on Article 5(7) specifically refers to subsidiary equating the notion of ‘control over a company’ with that of ‘owning more than half of a company’s shareholding’. Para 40 is reproduced below for ease of reference:

“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.”

2.3 *Significance of the phrase ‘Of Itself’:*

2.3.1 Article 5(7) of the OECD MC simply states that control of a subsidiary by the parent shall not ‘of itself’ create a PE. What meaning possibly the phrase ‘of itself’ can have in Article 5(7)? If a subsidiary is not a PE of its parent or vice versa ‘of itself’, what additional criteria are required to be satisfied in order for a related company to become a PE of the other?

2.3.2 Para 41 of the OECD MC Commentary on Article 5(7) explains it by stating that a parent company can have a PE in its subsidiary’s state of residence if the general requirements for a PE set out in Para 1 to 5 of Article 5 of the OECD MC are met.

2.3.3 Accordingly, under Article 5(1), any space or premises though belonging to the subsidiary but which is at the disposal of the parent and through which the parent company regularly carries on its business gives rise to a Fixed Place PE, subject of course to the provisions of Article 5(3) and (4) of the OECD MC. In addition, under Article 5(5) of the OECD MC, a subsidiary could constitute an Agency PE of its parent if the subsidiary has an authority to conclude contracts in the name of its parent and it habitually exercises this authority, unless such activities are limited to those referred to in Article 5(4) or the subsidiary is acting in the ordinary course of its business as an independent agent within the meaning of Article 5(6) of the OECD MC.

2.3.4 Para 41 of OECD MC Commentary on Article 5(7) reads as follows:

“41. A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 4, 5 and 6) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph 4.3). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.”

2.4 OECD position on Companies forming part of Multinational Groups and Intra Group services:

2.4.1 In light of the decision of Italian Supreme Court in the case of Phillip Morris⁵, the OECD in its revision to commentary on OECD MC in 2005, has clarified its position in Para 41.1 that for the purposes of determination of the existence of a PE, it is necessary to consider each company in a group separately, and not the group as a whole. It further modified Para 42 to affirm that when a company provides services to another company belonging to the same group

5. Case Number 7682

as part of its business through its own personnel and carried on in premises which are not those of the recipient, no PE shall be deemed to exist.

2.4.2 Para 41.1 as well as Para 42 of OECD MC Commentary on Article 5(7) are reproduced below for ease of reference:

“41.1 The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article (see paragraphs 32, 33 and 34). The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company’s own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.”

2.4.3 Italy made an observation to the aforesaid insertion to the commentary by stating that its jurisprudence is not to be ignored for interpretation of the cases falling in the above paragraphs.

This observation has been upheld in another decision of the Italian Supreme Court⁶. One will need to tread with caution & care while dealing with related company PE situations falling within the purview of India-Italy DTAA.

2.4.4 India, as a Non-OECD member has expressed its position with respect to the interpretation given in paragraph 42 and it is of the view that where a company (enterprise) resident of a State is a member of a multinational group and is engaged in manufacture or providing services for and on behalf of another company (enterprise) of the same group which is resident of the other State, then the first company may constitute a permanent establishment of the latter if other requirements of Article 5 are satisfied.

3. Position under the Indian Income-tax Act, 1961

3.1 In the erstwhile Circular No. 23 of 1969, while CBDT had illustrated that forming a local subsidiary company to sell the products of non-resident company would constitute 'business connection' under Income-tax Act, 1961; it had specifically provided that the mere existence of a 'business connection' arising out of the parent-subsidiary relationship or the fact that the parent company might have exercised control over the affairs of the subsidiary company would not give rise to an assessment.

3.2 Even the Supreme Court in the case of Vodafone International Holdings BV⁷ has upheld the principle that a subsidiary is a distinct legal person. While examining the question of the nature of "control" that a parent company has over its subsidiary, it held that it would not be the case that a parent company never has control over the subsidiary. It explained by way of an example wherein, in a proper case of "lifting of corporate veil", it would be proper to say that the parent company and the subsidiary form one entity. But barring such cases, the legal position of any company incorporated abroad would be that its powers, functions and responsibilities are governed by the law of its country of incorporation. A company is a separate legal person and the fact that all its shares are owned by one person or by the parent company would have nothing to do with its separate legal existence. The Supreme Court affirmed the well settled fact that for tax treaty purposes a subsidiary and its parent are totally separate and distinct taxpayers.

6. Judgment number 17206 of 28th July 2006

7. (2009) 221 CTR 617 (SC)

4. Important Judgements

4.1 Indian Case Laws: This paragraph provides insights into some of the important Indian judicial pronouncements in the context of Subsidiary PE.

4.1.1 *Morgan Stanley & Co.*⁸

4.1.1.1 Morgan Stanley & Co ('MSCo') was a non-resident company incorporated in USA providing financial advisory services, corporate lending and securities underwriting. The diverse activities of MSCo were undertaken by various divisions. One of the group companies was Morgan Stanley Advantage Services Private Limited ('MSAS') which was incorporated in India and was set up by MSCo to support the group member's front office and infrastructure unit functions in their global operations for providing support services, such as IT support, account reconciliation, research, etc. MSAS entered into a service agreement dated 14-4-2005 with MSCo, and under the said agreement, MSAS had undertaken to provide Morgan Stanley group, abovesaid support services. To enable MSAS to provide those services, it had been agreed between the parties that MSCo shall send staff to MSAS for stewardship activities and other similar activities and also on deputation in the employment of MSAS. The Morgan Stanley group had agreed to pay to MSAS, the actual sum of all costs together with an appropriate mark up mutually agreed between them. From an employment contract perspective, the staff would continue to be employed or engaged and their salaries and fees would be directly paid by MSCo. MSCo applied for an advance ruling on whether MSCo would be regarded as having a PE in India under Article 5(1) of India-USA DTAA on account of the services rendered by MSAS under the Services Agreement dated 14-4-2005 entered into by MSAS with MSCo and if so, the amount of income attributable to such PE.

4.1.1.2 AAR ruled as follows:

a) **Fixed Place PE:** AAR reviewed the agreement between MSCo and MSAS and highlighted certain important clauses on the basis of which it reached a conclusion that MSCo was in a position to exercise close control and supervision on the working of MSAS. Therefore in its opinion, there existed a 'fixed place' but it did not accept the contention that 'business of MSCo' was being rendered at the particular fixed place. Hence there was no Fixed Place PE in India.

8. (2007) 292 ITR 416 (SC)

b) **Agency PE:** Since no party had any authority to bind, to contract in the name of other or to create liability for any other party, in any other way or for any other purpose, AAR held that there did not exist any Agency PE.

c) **Service PE:** AAR held that even though the benefit of services of the staff deputed would enure to MSCo it would not be the same as working for MSCo singularly. Once employees are sent by the applicant on deputation for stewardship activities they would be actively involved in the key managerial activities of MSAS. AAR therefore did not distinguish between employees sent for stewardship activities and employees sent on deputation. It thus held that MSAS constituted Service PE of MSCo.

4.1.1.3 On further appeal against the AAR ruling, the Supreme Court held as follows:

a) **Fixed Place PE:** Supreme Court without further ado upheld the ruling of AAR with regard to constitution of 'fixed place' but it dealt in greater depth with the question of 'whether business of MSCo was being carried out' at that fixed place. On facts of the case, it held that back office functions proposed to be performed by MSAS in India were preparatory or auxiliary in nature for MSCo and therefore MSAS would not constitute a Fixed Place PE under Article 5(1) of India-USA DTAA as regards its back office operations.

b) **Agency PE:** Supreme Court observed that MSAS in India had no authority to enter into or conclude the contracts. The contracts would be entered in US. They would be concluded in US. The implementation of those contracts only to the extent of back office functions would be carried out in India, and therefore, MSAS did not constitute an Agency PE.

c) **Service PE:**

- **Stewardship activity:** Supreme Court examined the nature of Stewardship activities involved and held that MSCo was merely protecting its own interests in the competitive world by ensuring, the quality and confidentiality of MSAS services, it being the customer of MSAS. The stewards would not be involved in day to day management or in any specific services to be undertaken by MSAS. Therefore, stewardship activity did not fall within Article 5(2)(l) of India-USA DTAA and did not constitute a Service PE.
- **Deputation:** Supreme Court observed that a deputationist had a lien on his employment with MSCo. As long as the

lien remained with the MSCo the said company retained control over the deputationist's terms and employment. On completion of his tenure he was to be repatriated to his parent job. A deputationist lent his experience to MSAS in India as an employee of MSCo and in that sense there existed a Service PE (MSAS) under Article 5(2)(l) of India-USA DTAA.

4.1.1.4 Note: It is pertinent to note here that the examination of Fixed Place PE for MSCo in India was based on the nature of service arrangement between MSAS and MSCo rather than 'right to use test' as proposed by the OECD. In its examination, AAR noted that one of the clauses of agreement allowed persons authorised by the MSCo group unrestricted access to the business premises of the MSAS for certain purposes. Another relevant aspect to be taken note of is that AAR as well as Supreme Court held 'MSAS' as the Service PE of MSCo rather than 'employees of MSCo' as required under UN Model Double Taxation Convention.

4.1.2 Petition No. 8 of 1995, In re⁹

4.1.2.1 This ruling is one of the few initial decisions on Article 5(7) of the OECD MC in India.

4.1.2.2 In this case, the applicant-company was a trader in goods and commodities incorporated in Switzerland. Since it did not intend to have an office or place of business in India to trade with India, it proposed to incorporate a subsidiary company in India which would provide consultancy services from India to the applicant for use outside India, in terms of four draft agreements. It was stipulated that the consultant shall at all times act only on the instructions of the applicant and shall not have any authority to either accept order on behalf of the applicant or bind it in transactions.

4.1.2.3 Based on the service contracts, AAR observed that the scope of work in the proposed agreements included not only clerical and secretarial assistance but supply of information in respect of global tenders, by the subsidiary to the applicant and vice versa; signing and submitting of tenders on behalf of the applicant, although stated to be within the parameters fixed by the applicant; negotiating the terms of the tenders with the tendering authorities, again within the parameters laid down by the applicant; and follow-up of the tenders and finally signing the agreements.

9. (1997) 223 ITR 416 (AAR)

4.1.2.4 AAR remarked that even though it was true that a limitation had been placed on the role of the subsidiary by saying that it should act within the parameters prescribed by the applicant, nevertheless, such parameters had not been defined and, even acting within such parameters, the subsidiary would have to undertake such substantial and important commercial activities systematically and continuously for the applicant. On background of such facts, AAR held that the applicant would have a PE in India.

4.1.3 *Rolls Royce PLC*¹⁰

4.1.3.1 In this case, Rolls Royce PLC ('RRPLC'), a non-resident company incorporated in U.K., supplied aero-engines and spare parts manufactured by it to many Government organisations in India. RRPLC entered into an agreement with Rolls Royce India Limited ('RRIL') whereby RRIL was to render various services to RRPLC, viz., procure orders, organisation of event and conference in India, media relation and administration support. A survey conducted on RRIL further revealed that RRIL was not only RRPLC's 100 per cent subsidiary, but it also maintained a permanent office in India to undertake all such activities which were contained in the said agreement. Further, it was also found that no customers in India were directly to send orders to assessee in U.K. and such orders were required to be routed only through RRIL.

4.1.3.2 Assessing Officer as well as CIT(A) held RRIL to be the PE of RRPLC in India. On appeal to the Tribunal, it held as follows:

a) **Fixed Place PE u/a 5(1):** The Tribunal observed that RRPLC was to reimburse RRIL all the cost incurred by RRIL in towards the support services including but not limited to the salaries and expenses of employees, the cost of operating office premises and any payment to sub-contractors. RRIL was to receive service fees at 5.1 to 6 per cent of the reimbursed expenses. The employees of RRPLC visited India frequently and the premises of RRIL were being occupied and used during such visits. Further, the premises were also available to all the employees of RRPLC in respect of any business operations in India. It was also noticed that some of the personnel functioning from the premises of RRIL were in fact employees of RRPLC. It therefore came to the conclusion that the premises though in the name of RRIL were at the disposal and being occupied for the business operations of RRPLC in India. Thus, Tribunal concluded that RRPLC has a Fixed Place PE u/a 5(1) in India.

10. (2011) 339 ITR 147 (DELHI)

b) **Fixed Place PE u/a 5(2):** Having held that RRPLC had a Fixed Place PE in India under Article 5(1) of the India-UK DTAA, it further held that RRIL also constituted Fixed Place PE under Article 5(2)(f) of the India-UK DTAA (i.e. premises are also used for receiving and soliciting orders).

Whether preparatory/auxiliary in nature?: With respect to the question of activities being classified as preparatory/auxiliary in nature, after examining the relevant documents obtained during the course of survey, the Tribunal came to a conclusion that activity of the fixed place was not preparatory or auxiliary, but the core activities of marketing, negotiating & selling of the product. It was a virtual extension/projection of its customer facing the business unit, who had the responsibility to sell the products belonging to the group.

c) **Agency PE:** The Tribunal observed that it was a set practice that no customers in India would directly send orders to RRPLC in UK. Such orders were required to be routed only through RRIL and this was evident from the fact that apart from orders, even request for quotation/extension could not be communicated directly to RRPLC but were to be routed through the office of RRIL. It was not the case that the orders were firstly received by RRIL from the customers in India and only then communicated to RRPLC.

Thus, the Tribunal held that RRIL was an Agency PE of RRPLC as per Para 4(c) of Article 5 of India-UK DTAA (i.e. dependent agent habitually secured orders wholly for the enterprise itself).

4.1.3.3 The Delhi High Court has upheld the order of the Tribunal stating that its order is well reasoned.

4.1.4 *Motorola Inc.*¹¹

4.1.4.1 Motorola Inc ('MI'), incorporated in USA had entered into supply contracts for supply of GSM equipment to Indian cellular operators, whereas, Motorola India Limited ('MINL') its Indian subsidiary, had entered into installation contracts with Indian operators. Assessing Officer held that MI had a fixed place in the form of Indian company 'MINL' and had a PE in India. On appeal, Commissioner (Appeals) held that installation contract was inextricably linked with the supply contract in so much so that the tests carried out by the contractors were binding on the assessee and

11. (2005) 95 ITD 269 (Delhi)(SB)

they were to be carried out only by two persons who were in full knowledge of the work performed by either of them. Based on these facts, coupled with the fact that the supply agreement was preceded by network survey, planning and marketing, client discussions and was succeeded by monitoring of supplies, client discussions and control of accounts, receivables, the Commissioner (Appeals) held that the income of MI accrued and arose in India under sections 5 and 9 of the Income-tax Act. The Commissioner (Appeals) also held that MI had a fixed place permanent establishment in India in the form of office of the Indian company within the meaning of Article 5(1) of India- US DTAA.

4.1.4.2 On further appeal, the Delhi Tribunal Special Bench held as follows:

a) **Fixed Place PE:** Tribunal took note of the fact that there was no denial by MI that its employees had a right to enter the office of MINL in India either for the purpose of working for MINL or for the purpose of working for it and therefore, the business customers of MI in India could also look upon the office of MINL as a projection in India of MI. The fact that the entire expenses (including perquisites paid to employees sent by MI) incurred by MINL were being reimbursed on cost plus 5 per cent basis had in actuality strengthened the case that the employees did work only for MI in India. It therefore held that there was a projection of MI in India in the form of place of business of MINL, and, thus, there was a fixed place PE of the assessee in India under Article 5(1) of the India-US DTAA.

b) **Whether preparatory/auxiliary in nature?:** Dealing with the alternate contention that the activities carried out by MINL were preparatory or auxiliary in nature, the Tribunal observed that the activities described in the services agreement were basic operations to be carried out by MINL before the business actually started such as market survey, industry analysis, economy evaluation, furnishing of product information, ensuring distributorship and their warranty obligation, ensuring technical presentations to potential users, development of market opportunities, providing services and support information, procurement of raw materials for MI and accounting and finance services etc. Those activities could not be considered as activities in the course of carrying on business by MI in India, but they were anterior thereto. Further, MINL had to perform those activities only for a period of one year. Once the agreement came to an end, there was no obligation on the part of MINL to perform the above activities. In those circumstances, it held that the though

the office of MINL in India was a fixed place PE of MI in terms of Article 5(1), it could not be deemed to be so by virtue of Article 5(3) (e) since they were preparatory or auxiliary in nature considering the business of MI.

4.1.4.3 Note: Ericsson AB and Nokia Networks OY were also parties before the Delhi Tribunal Special Bench. Delhi Tribunal had held that subsidiaries of both companies constituted PE of respective parents in India. On further appeal to Delhi High Court by respective assesseees, in the case of Ericsson AB, Delhi High Court held that there was no PE in India of Ericsson AB whereas in the case of Nokia Networks OY, the Delhi High Court remanded the matter back to the Tribunal as the order of Tribunal was based on many factual errors.

4.1.5 Daimler Chrysler AG¹²

4.1.5.1 Daimler Chrysler AG ('DC') was a tax resident of Germany. It was one of the major players in automobile industry worldwide. Daimler Chrysler India Private Limited ('DCIL') was set-up as a joint venture with TELCO for manufacture/assembly and sale of cars in India. DC and DCIL had entered into a General Agency Agreement for distribution of Completely Built Up (CBU) cars manufactured by DC in India and Bhutan. During relevant assessment year, DC sold raw materials and parts/completely Knocked Down (CKD) kits to DCIL. It also made direct sales of CBU cars to Indian customers for which DCIL was a communication channel. Assessing Officer held that DC had a place of management, branch office, warehouse/sales outlet in India in the form of DCIL's premises and hence DCIL was a dependent agent of DC in India and, accordingly, DC had a PE in India and the profits from sale of CBU cars directly to Indian customers and parts/CKD kits to DCIL were attributable to the PE and, thus, were taxable in India.

4.1.5.2 On appeal, Commissioner (Appeals) held that DCIL did not constitute a PE of the assessee under Article 5(2) of India-Germany DTAA with regard to sale of CKD units, especially in light of clauses 1, 5 & 6 of the General Agency Agreement entered into between DC and DCIL. However, Commissioner (Appeals) held that DCIL was a dependent agent of DC in respect of sale of CBU cars directly to customers in India and constituted a PE in respect of such sales under Article 5(5) of the India-Germany DTAA and held that income from such sales which were attributable to the aforesaid PE would be taxable in India.

12. (2010) 39 SOT 418 (Mum)

4.1.5.3 On further appeal, Mumbai Tribunal held as follows:

- **Transaction of sale of parts/CKD by DC to DCIL:**

a) **Fixed Place PE u/a 5(1):** Tribunal reiterated the principle that mere existence of subsidiary does not by itself constitute the subsidiary company as a PE of the parent. The main condition for constitution of PE is carrying on of business in India, and as regards sale of parts/CKD no operations in respect of the manufacture and sale of parts was carried out by DC in India. Further, DC did not have a right to use DCILs premises. Further, DCIL did not constitute a place of management of DC in India, as the management of the DC's business was by the board of directors at Germany. The MD and ED actually came on deputation as employees of DCIL and worked under the directions and control of the board of DCIL. Hence DCIL did not constitute PE u/a 5(1) of India-Germany DTAA.

b) **Fixed Place PE u/a 5(2):** Tribunal agreed that as regards sale of parts/CKD, such sales were made by DC to DCIL on principal-to-principal basis and on sale, such parts/CKD became the property of DCIL. Hence, DCIL did not constitute sales outlet/warehouse of the assessee as stated u/a 5(2) of India-Germany DTAA.

- **Transaction of direct sales of CBU cars to Indian/Bhutan customers for which DCIL was a communication channel:**

a) **Agency PE:** Tribunal based on the following facts came to the conclusion that DCIL did not have authority to conclude any deal with the ultimate customer in India nor did it have any role to play in the sale or in any activity in making sale directly to the customers in India nor could it be considered as habitually procuring orders for DC in India:

- Even though the commission received by DCIL was for helping sale of the CBUs, it was obvious that its main activity was that of manufacture of cars. DCIL itself was manufacturing and selling the cars and procurement of orders for direct shipment of cars by DC would, in fact, be contrary to and against the interest of the DCIL in its manufacturing activity. Acting as communication conduit was not its main business and it was only collecting information and was merely rendering a very insignificant

auxiliary/preparatory service in the sale of CBU cars by DC to the Indian clients.

- If and when clients approached DCIL or its agents evidencing interest to buy CBUs from the assessee, DCIL passed on the communication on both sides and acted as a post-office between DC and ultimate customer in India/Bhutan;
- Negotiations of price, specifications, etc., were concluded by DC by itself and the sale to the customers was on principal-to-principal basis;
- The risk of diminishing value or damages to the cars was to the account of customer's right from the port of shipment at the manufacturing end and the cars were cleared through customs in India for and on behalf of the ultimate customers;
- The prices offered to the clients were as per the listed price notified by DC and so whether DCIL was involved or not the price charged to the customers would be the same.

On basis of the above facts and circumstances, Tribunal held that DCIL was not acting as a dependent agent of DC in India.

4.1.6 eFunds Corporation¹³

4.1.6.1 eFunds Corporation ('EFC'), was a company incorporated under the laws of United States and was tax resident of USA. It had a wholly owned subsidiary company eFunds International India (P.) Ltd ('EFI') operating in India. EFC had entered into various agreements with EFI during the periods under appeal by which EFI was rendering services outside India. EFI was providing service to EFC by way of providing: (a) call center services; (b) financial shared services and data entries; and (c) software development services and, for such services, EFI was being compensated by way of remuneration. Insofar as EFI was concerned, since it was an Indian company, all the revenues receivable under various agreements were subject to tax under the Indian tax laws, and had been offered for taxation in India. Insofar as EFC and other group company was concerned, since they did not have business in India; the amount of remuneration paid was not being claimed as a deduction in India. However, insofar as accounts maintained in the USA were

13. (2010) 42 SOT 165 (Delhi)

concerned, the amount of such remuneration paid was being regularly deducted as expenditure while computing its income in the USA.

4.1.6.2 EFC invoked Mutual Agreement Proceedings (MAP) in respect of Assessment year 2003-04. EFC was held to have a PE in India in accordance with the MAP resolution. Assessing Officer, taking into consideration the MAP order, invoked reassessment proceedings for all the years under Appeal (i.e. AY 2000-01 to 2005-06). Assessments for all these years under the appeal were completed by the Assessing Officer adopting the earlier line of action.

4.1.6.3 On appeal, the Tribunal observed that corporate office of EFI at Mumbai had an International Division which consisted of President's office and a Sales team. The president's office oversaw operations of EFC group entities globally and the sales team undertook marketing efforts for affiliates of EFC. The overall reporting of President's office was to EFC. The Tribunal referred to the contents of Form 10.K (405) dated 1-4-2002 in the case of EFC and further held that business of development and global deal carried out through the PE could not be considered to be preparatory and auxiliary as they were core income generating activities and business of EFI was inextricably linked to the business of EFC. The business model was also examined by the Tribunal whereby it remarked that EFC entered into contract with its clients for providing certain IT enabled services and then, the same contract was either assigned or sub-contracted to EFI for execution. Therefore, both EFC and EFI came under legal obligation to provide services to clients of EFC. From Function performed, Assets used and Risks assumed (FAR analysis) by EFC and EFI, it observed that it was clear that EFI did not have the requisite software and database needed for providing IT enabled services independently; therefore, to that extent they were made available by the assessee to EFI free of charges. Further, EFI did not bear any significant risk as ultimate responsibility lay with EFC. It was also noted that sales team of EFC undertook marketing efforts for its affiliates including EFI. It concurred with the view of the AO that EFI constituted sales outlet for EFC in India under Article 5(2)(i) of India-USA DTAA on the basis of disclosure made by EFC in its annual report. In view of the activities being carried out, the Tribunal held that EFC had a PE in India in terms of Article 5(1) and 5(2)(i) of India-USA DTAA.

4.1.6.4 **Note:** The decision does not throw much light on the factors considered by the Tribunal which were decisive for determining how the place of business was regarded as being at the disposal of

EFC. The decision of the tribunal seems to be influenced by the MAP proceedings for AY 2003-04 which are not made public to know the reasons for them in concluding existence of a PE.

4.1.7 EPCOS AG¹⁴

4.1.7.1 EPCOS AG ('EPCOS'), a German company, was engaged in the business of designing, manufacturing and marketing of passive electronic components. It had subsidiaries across the world including two subsidiaries in India, namely, Epcos India (P.) Ltd. ('EIPL') and Epcos Ferrites (P.) Ltd. ('EFPL'). EPCOS provided support services to EIPL and EFPL in the field of product marketing, sales and information technology from its centralised infrastructure in Germany. It furnished details stating that based on guidance of the EPCOS' product marketing team, activities relating to its decision on sale, production, dispatch cost computation and other relevant activities for effecting sales were carried out by the employees of EIPL and EFPL. Considering the details furnished by EPCOS, and taking into account e-mails and correspondence exchanged by EPCOS with its subsidiaries in India, the Assessing Officer held that it had a PE in India in the form of its subsidiaries, EIPL and EFPL. Commissioner (Appeals) negated the order of the AO.

4.1.7.2 On appeal to the Tribunal by revenue, Tribunal ruled that (a) business of EPCOS was not being carried out in India as required under Article 5(7) of India-Germany DTAA and (b) that EPCOS was merely providing support services to its subsidiaries in India and did not carry out any of their functions.

4.1.7.3 Tribunal considered the following facts while arriving at this conclusion:

- It was not the case that the taxpayer company was supposed to handle entire marketing function or entire information technology function and a part of this work was delegated by EPCOS to the employees of the subsidiary;
- The payment which was made to EPCOS was only for the services rendered by EPCOS - either directly or through the intervention of a third party and that no part of this business was carried out in India in as much as there was no billing raised by the assessee in connection with any services rendered in India;

14. (2009) 28 SOT 412 (Pune)

- Though some employees of the Indian subsidiaries worked under the guidance of EPCOS, but work was done for the business of the Indian subsidiaries and not for EPCOS. While the business of EPCOS was rendering certain types of services to its Indian subsidiary, the business of the Indian company was to manufacture and sell its products. What was done by the employees of the Indian subsidiaries was running business of the Indian subsidiaries which included marketing of its products - with or without the guidance of the foreign parent company, and ensuring a smooth functioning of the business by ensuring an effective information technology support service. Just because employees of the Indian subsidiaries were also engaged in marketing activities and information technology support activities, it would not mean that these employees were doing business of the foreign principal, unless the work so done by these employees entitles the foreign parent company to rewards of the work so done.
- What was being done by the Indian subsidiaries under the guidance and supervision of the assessee was business of the Indian subsidiaries, and that aspect of the matter, by no stretch of logic, was relevant for deciding whether or not the assessee had a PE in India.

4.1.7.4 Tribunal therefore held that merely because the Indian subsidiary conducted its business in India with the help and guidance it has received from EPCOS, it did not follow that EPCOS such help and guidance would be deemed to have a PE in the form of its Indian subsidiaries.

4.1.8 *Aramex International Logistics (P.) Ltd.*¹⁵

4.1.8.1 Aramex International Logistics (P.) Ltd. ('AIL'), a company incorporated in Singapore and a part of Aramex group of companies was engaged in the business of door-to-door express shipments by air and land and performing related transport services. AIL entered into an agreement with Aramex India Pvt. Ltd. ('AIPL'), a subsidiary of Aramex Bermuda Limited (Group Company) to look after movement of packages within India, both inbound and outbound. The agreement provided for the AIL being responsible for transportation of packages throughout the world except India and AIPL being responsible to transport packages in India. According

15. (2012) 348 ITR 159 (AAR- New Delhi)

to AIL, the contract was entered into by the parties on principal to principal basis. AIL conducted its international express business on its own account outside India and AIPL conducted its international business on its own account in India. Neither AIL nor AIPL were liable to each other for negligence, misrepresentation or otherwise for loss of profits or revenues in business, anticipated savings and so on. AIPL was not otherwise to act on behalf of AIL. AIPL could not legally bind AIL. AIL had no officer, equipment, employee or agent in India and no operations were carried out by it in India. It charged fees to AIPL in connection with invoicing and payment functions performed by it for AIPL. On these facts, it sought for an advance ruling on questions as to (1) whether payment on account of activities conducted outside India in connection with international express business and fees paid by AIPL to it would be chargeable to tax in India; (2) whether there exists PE of it in India as per DTAA between Singapore and India.

4.1.8.2 AAR held AIPL to be a PE of Aramex Group on the basis of the following reasoning:

- **Subsidiary as a PE:** AAR observed that AIPL obtained orders, collected articles, transported them to a specified destination so as to be taken over by the group and then delivered the same to the addressees in various countries through its entities in those countries. It therefore held that without AIPL the Aramex group could not complete its business or fulfill its obligations to its clients or customers around the world. The Aramex group could have done this through any entity in India by entering into necessary agreement in this behalf. AAR also put forward the proposition that since the business was not through an agent, but through a wholly owned subsidiary created for this purpose, it was possible to postulate that the subsidiary entity would be a PE of the group. Even though AIPL could have an independent existence as a subsidiary, the authority over it of the principal, vertical or persuasive, was not in doubt. It concluded that it was really a case of a group carrying on its business in India or that part of the business relatable to India through a fully owned subsidiary involving all its business activities and therefore the PE of Aramex group in India was clearly the location of its subsidiary in India.
- **Agency PE:** AAR observed that AIPL secured orders in India wholly for the Aramex group. It also had the right

and in fact concluded contracts for the Aramex group for its express shipment business and therefore, it also constituted Agency PE of the group.

4.1.8.3 Note: It is to be noted here that AAR did not examine and comment on satisfaction of pre-requisites of Article 5(1) for AIPL to constitute a Fixed Place PE. Further, the application of Para 42 of OECD MC Commentary on Article 5 is also unclear.

4.1.9 eBay International AG¹⁶

4.1.9.1 eBay International AG ('eBay Intl'), a Swiss company, operated India specific websites providing online platform for purchase and sale of goods/services to the users in India. It filed NIL return of income but stated by way of a note that it had entered into a Marketing Support Agreement with both eBay India ('eBay I') and eBay Motors ('eBay M') (both eBay group companies) in connection with its India specific websites. It earned Rs. 4.94 crores from its websites in India but claimed that the revenue was not taxable under Article 7 of the Indo-Swiss DTAA since it did not have a PE in India as per Article 5 of the treaty.

4.1.9.2 The Assessing Officer, however, held that eBay Intl had DAPes in India in the form of eBay I and eBay M under the DTAA. The CIT(A) upheld the findings of the AO in remand proceedings that eBay Intl had PE in India within the meaning of Articles 5(5) and 5(6) and accordingly held that the revenue earned by it was taxable in India under Article 7.

4.1.9.3 On further appeal, the Tribunal held as follows:

- **Fixed Place PE u/a 5(2):** The contention of the revenue u/a 5(2) related to constitution of 'place of management' in the form of eBay I and eBay M. The revenue argued that all the costs incurred by eBay I in the nature of rent, traveling expenses, marketing expenses etc., were reimbursed by the eBay Intl with 8% mark-up and thus in effect meant that the premises for which rent was paid by eBay India etc., belonged to eBay Intl and all other expenses, though apparently incurred by eBay I, were, in reality, incurred by eBay Intl. Therefore, they constituted a 'place of management' of eBay Intl.

The Tribunal, on this count, observed that a 'place of management' ordinarily refers to a place where overall

16. (2012) 25 taxmann.com 500 (Mum)

managerial decisions of the enterprise are taken. On facts of the case, it observed that eBay I and eBay M were not taking any managerial decision. They simply rendered marketing services to eBay Intl. All business decisions and deals were settled through eBay Intl's websites. eBay I and eBay M had no role to play either in the maintenance or the operation of the websites. Also, they had absolutely no say in the matter of entering into online business agreements between the sellers and the assessee or finalisation of transactions between the buyers and sellers resulting into accrual of eBay Intl's revenue. Therefore it could not be said that eBay I and eBay M formed 'place of management' of eBay Intl's overall business in India.

- **DAPE:** The Tribunal acknowledged the fact that eBay I and eBay M were providing their services exclusively to eBay Intl and that they had no other source of income except that from eBay Intl in lieu of the provision of service. It thus agreed that they definitely had become Dependent Agents of eBay Intl.

The next question for the Tribunal to examine, however, was whether or not these two Dependent Agents constituted PE of eBay Intl under Article 5(5) of DTAA.

It observed that Clause (ii) of Article 5(5) referring to the dependent agent habitually maintaining a stock of goods or merchandise for or on behalf of an enterprise did not to have any application in the case since there was no requirement on the part of eBay I or eBay M to maintain any stock of goods or merchandise on behalf of the sellers. Further, Clause (iii) relating to a dependent agent manufacturing or processing the goods or merchandise in a particular State for an enterprise was also not applicable since eBay M was not required to manufacture or process the goods or merchandise on behalf of eBay Intl.

Lastly under Clause (i) of Article 5(5), after examining whether eBay I and eBay M did or habitually exercise an authority to negotiate and enter into contracts for or on behalf of eBay Intl, Tribunal held that by performing the activities as narrated in the agreement, eBay I had at no stage negotiated or entered into contract for or on behalf of eBay Intl.

Tribunal therefore held that both eBay I and eBay M, albeit were Dependent Agents under para 6 of Article 5, since they did not perform any of the functions enumerated in clauses (i) to (iii) of para 5 of Article 5, they were held not to be 'Dependent agent PE' of eBay Intl.

4.2 *International Case Laws:* Three important / controversial foreign court judgments in the context of Subsidiary as PE are discussed in brief in this section.

4.2.1 *Phillip Morris*¹⁷

4.2.1.1 This case related to the activities of an Italian company belonging to the Phillip Morris Group, whose main business consisted of production and distribution of filters for cigarettes in Italy and abroad.

4.2.1.2 Besides, the Italian company performed services for the benefit of other non-resident group companies with no consideration. In substance, the activities of the Italian company consisted of (a) the supervision of the relationships between the non-resident group companies and the Italian Tobacco Administration, including supervision of the performance of the obligations under the agreements in force between the non-resident companies and the Italian Tobacco Administration for the production and distribution of Phillip Morris cigarettes; (b) promotional activities for the distribution of Phillip Morris cigarettes in duty free areas, embassies and other exempted resale.

4.2.1.3 With reference to the activities of the Italian company and to relationships between the group companies, the Supreme Court observed that:

- **PE of the Group as a whole:** Regardless of the relationships between the Italian company and each single non-resident group company, the Italian company was acting in Italy for the benefit of the whole group. In other words, the legal and contractual relationships between the various group companies with reference to the activities performed in Italy should not be analysed separately, but should rather be considered as a whole. Indeed, in the opinion of the Court, the group companies were all subject to a unitary strategy aimed at the maximization of profits in Italy for all the non-resident companies involved and it would

17. Case number 7682 - Italian Supreme Court

have been misleading to consider each fragment of such a strategy separately. In substance, the Supreme Court considered the group a unitary subject for the purposes of identifying the existence of a PE in Italy. The Court supported this argument with the wording of paragraph 24 of the commentary to Article 5 of the OECD model, stating that a national structure could act as management office of the group with international ramifications (in the view of the Court the national structure exercised “supervisory and coordinating functions for all the departments of the enterprise located within the region concerned”);

- **Substance over Form:** The OECD commentary on the identification of the elements of a PE gave relevance to the substance rather than to the mere legal form of the transactions;
- **Place of Management as PE:** The Italian company was actually subject to control by the non-resident group companies and subject to the group directives, in such a way that it was to be considered as a management structure of the non-resident companies, regardless of its legal and formal independence;
- **Not auxiliary activities:** The activities performed by the Italian company for the benefit of the non-resident group companies did not have an auxiliary nature, but rather were essential for the profitability of the non-resident group companies. The Court observed on this point that as paragraph 25 of the commentary to Article 5 of the OECD model clarifies that “after-sales organisation” might represent a PE, in the same way the Italian company’s activities should be regarded as forming an essential part of the business of the group. Moreover, the performance of such activities required use of notable human and financial resources by the Italian company;
- **Participation in negotiations of contract:** Representatives of the Italian company holding offices also in other non-resident group companies used to participate in various phases of negotiation and conclusion of the agreements between the non-resident group companies and the Italian Tobacco Administration. This circumstance was interpreted by the Court as a fictitious split-up of business responsibilities - actually in the hands of the Italian

company in the view of the Court - and legal authority to conclude the agreements, which was in the hands of the non-resident group companies;

- **Not an Independent agent:** The Italian company was not acting in the ordinary course of its business when providing services to the non-resident companies, which were not included in its statutory business purpose, and were performed without any formal mandate by the non-resident group companies.

4.2.1.4 On the basis of such arguments, the Supreme Court affirmed the following principles:

- a company having its seat in Italy may be deemed to be a multiple PE of foreign companies belonging to the same group and pursuing a common business strategy. In such instances, the assessment of whether the activities performed in Italy have an auxiliary character shall be made in the light of such a common business strategy of the whole group;
- the participation of officers or representatives of an Italian company in phases of the negotiation or conclusion of contracts also with no power of representation, formally executed by other non-resident companies, should be considered as an authority to conclude contracts in the name of a foreign company for the purposes of assessing the existence of an agency PE in Italy;
- control and supervision over the performance of a contract between a resident subject and a non-resident subject should not in principle be considered as an auxiliary activity for the purposes of Article 5(4) of the OECD model and of the corresponding article of the relevant DTC;
- a national structure carrying on management of the business transactions for the benefit of a non-resident company should be deemed to constitute a PE in Italy of the non-resident company, even though solely one area of business of the non-resident company was managed by the national structure;
- assessment regarding the existence of the elements of a PE in Italy, including that of dependence and that of the authority to conclude contracts, should be made on the basis of the substance rather than exclusively on the basis of the mere legal form of the business transactions.

4.2.1.5 **Note:** The Italian Supreme Court considered the group a unitary subject for the purposes of identifying the existence of a PE in Italy. As discussed earlier at Para number 2.7, OECD revised its commentary with reference to Para 41, 42 and 33 on Article 5. OECD gave its official interpretation in 2005 amendment to the MC for companies forming part of multinational groups and intra group services rendered by them while examining applicability of Article 5(7) in such cases in the backdrop of Phillip Morris case. Italy made an observation to the aforesaid insertion to the commentary by stating that its jurisprudence is not to be ignored for interpretation of the cases falling in the above paragraphs.

4.2.2 *Société Zimmer Limited*¹⁸

4.2.2.1 The taxpayer, Zimmer Ltd, a UK resident, which sold its orthopedic products in France until 1995 through a French distributor, Zimmer SAS, entered in to commissionaire agreement with the French distributor Zimmer SAS to commercialise the taxpayer's products with effect from 27 March 1995. Under the commissionaire agreement, Zimmer SAS could accept orders, present estimates and documents within the framework of tender offers and conclude sales contracts for the account of the taxpayer without prior approval. In addition, Zimmer SAS could negotiate prices, grant discounts and payment facilities to existing or new clients without the prior approval of the taxpayer.

4.2.2.2 The French tax administration assessed the taxpayer to French corporate tax for the years 1995 and 1996 on the ground that it had a PE in France.

4.2.2.3 On appeal, the Administrative Court of Appeal took the view that the fact that Zimmer SAS acted in its own name as a result of the commissionaire agreement and thereby could not conclude contracts in the name of the taxpayer did not have any impact on its capacity to engage the taxpayer in commercial relationships related to the taxpayer's activities. In addition, the Administrative Court of Appeal observed that Zimmer SAS was subject to guidelines from the taxpayer or was under its control with respect to the modalities of sales or advertisements. The risks linked to the sales contracts were borne by the taxpayer and Zimmer SAS acted exclusively for the account of the taxpayer. In conclusion, the Administrative Court of Appeal of Paris determined that Zimmer SAS could not be regarded as an independent agent within the meaning of Article

18. Nos. 304715 and 308525 - French Supreme Administrative Court

4(5) of the treaty. Accordingly, the Administrative Court of Appeal dismissed the appeal of the taxpayer and concluded that Zimmer SAS constituted a PE of the taxpayer in France and was taxable in France.

4.2.2.4 On further appeal, the Supreme Administrative Court commenced its decision by quoting the relevant treaty provision, namely Article 4(4) of the treaty as follows:

“A person acting in a Contracting State on behalf of an enterprise of the other Contracting State – other than an agent of an independent status to whom paragraph 5 applies – shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.”

The Court observed that, in principle, a commissionaire did not fall within the scope of this provision, as Article 4(4) of the treaty requires that contracts being concluded “in the name of” the foreign enterprise, whilst a commissionaire acts “in its own name” and does not create a direct contractual relationship between the principal (the taxpayer) and the third-party customers (the French clientele). In this respect, the Court referred to Art. L 132-1 of the French Commercial Code which provides that “a commissionaire is someone who acts in his own name or under a business name but for the account of his principal”. Stated otherwise, a commissionaire does not entail a direct representation, which is a prerequisite to constitute a PE for the principal. In view of the Court, an exception to this rule could only be made, and, therefore, a PE could be deemed to be present, if it could be substantiated (by way of either the terms of the contract or any other element of the inquiry) that the principal was *de facto* personally bound by the contracts concluded by the commissionaire. This would imply that the parties have characterised the contract erroneously as a commissionaire arrangement, whilst the facts and circumstances indicated that the (alleged) commissionaire was *de facto* an agent directly binding the principal.

4.2.2.5 In its conclusion, the Supreme Administrative Court observed that although (1) Zimmer SAS sold products exclusively for the taxpayer, which was also the only activity of Zimmer SAS; (2) the taxpayer bore the costs, and, therefore, also the risks of the commercialisation of these products; and (3) the taxpayer largely determined the sales conditions, there was no implication that the contracts concluded by Zimmer SAS gave rise to a direct legal

relationship between the taxpayer and the third-party customers. It also stated that this conclusion would remain valid, even if the commissionaire were controlled by the principal. Hence, the Supreme Administrative Court held that the decision of the Administrative Court of Appeal of Paris was erroneous and had to be quashed.

4.2.3 *Dell Products*¹⁹

4.2.3.1 In this case, the taxpayer, an Irish-resident company through commissionaire arrangement sold its computers to large customers in Norway through Dell AS, a Norwegian company which acted as the commissionaire for the taxpayer. Both, the tax payer and Dell AS, Norway were indirect subsidiaries of the US multinational, Dell Computer Corporation.

4.2.3.2 Under Sec. 2-3 of the Norwegian Tax Act, a non-resident entity is liable to tax in Norway if it conducts any kind of business in Norway, provided that the activity is performed and/or managed from Norway. The taxpayer claimed that it was not liable to tax in Norway as it did not have a PE in Norway under Article 7(1) of the tax treaty between Ireland & Norway. However, the tax authorities took the view that Dell AS constituted a PE under Article 5(5) of the treaty and therefore was taxable in Norway. The case was brought before the Oslo District Court which held that the taxpayer did have a PE in Norway since Dell AS was the taxpayer's dependent agent within the meaning of Article 5(5) of the treaty and hence was taxable in Norway.

4.2.3.3 On appeal, the Borgarting Court of Appeal took the view that Dell AS in reality bound the taxpayer on following grounds:

- The use of the Dell trademark provided an impression that Dell Group as a whole was behind Dell AS and the customers of Dell AS was related to the Dell trademark rather than to Dell AS exclusively.
- The customers were not made aware that Dell AS was a commissionaire. The customers were only aware that they were engaged in a transaction with Dell Group as a whole.
- It was clearly unlikely that any violations of the standard terms or other orders/instructions from the appellant would result in the taxpayer refusing to fulfill contracts with customers of Dell AS. The taxpayer had not submitted a

19. Case No. 2011/755 -Norway Supreme Court

single example of its refusing to fulfill an agreement with a customer which had been entered into by Dell AS.

- The most important function of the taxpayer in the sales activities in Norway was being the principal in a commissionaire relationship, while the major value driver of the sales activities of Dell products in Norway was the sales function performed by the taxpayer.

4.2.3.4 Based on functional-realistic approach, despite the existence of the commissionaire agreement and the Commission Act, the Court of Appeal observed that Dell AS in reality bound the taxpayer considering that all sales were made under the Dell trademark and on standard terms and conditions, the taxpayer accepted without review all of the sales made by Dell AS, and that the taxpayer would not refuse to deliver goods to the ultimate customers even if Dell AS exceeded its authority.

4.2.3.5 The Court of Appeal then observed that Dell AS was not an independent agent as it acted exclusively for the taxpayer. It sold computers on terms established by the taxpayer, the taxpayer and Dell AS shared some of the directors and management, the taxpayer had full access to the premises of Dell AS and its financial information, and all of Dell AS's business was conducted under the Dell trademark. Accordingly, the Court of Appeal upheld the decision of the Oslo District Court that the taxpayer had a PE in Norway and dismissed the taxpayer's appeal.

4.2.3.6 On further appeal, the Supreme Court quashed the decision. The Court started with the literal interpretation of the treaty and concluded that the commissionaire must enter into a legally binding agreement in the name of the principal. Since, OECD Commentary to Article 5(5) did not provide any specific guidelines on the issue; the Supreme Court gave relevance case law from a third country by referring to the Zimmer case, where the French Supreme Court had ruled in a similar case that a commissionaire structure did not create a PE for the principal. The Supreme Court observed that if the argument put forth by the tax authorities (i.e. that functional realistic approach on a case by case basis should be undertaken to determine whether the commissionaire binds the principal) were accepted, it would be very difficult to apply Article 5(5) in practice. Hence, the Supreme Court held that the taxpayer did not have a PE in Norway.

4.2.3.7 **Note:** Both the respective Supreme Courts have held that in absence of legal right to bind principal, Dependent Agent does not constitute PE. Further, both the decisions of Société Zimmer Ltd and

Dell Products concern commissionaire arrangements prevalent in civil law jurisdictions. Under common law, any actions carried out by an agent are considered as having been performed for the principal and binding the principal in the same way as actions carried out by themselves. This is the case, regardless of whether the contract is written in the name of the principal or in the name of the agent. Whereas, under civil law, there is a separation of the relationship between the principal and its agent on the one hand and that of between the agent and the third party (including a customer) on the other. Thus civil law countries do not necessarily see the presence of a non-resident principal in the actions of the resident agent.

5. Typical Arrangements with Potential PE Exposure under Article 5(7)

There are certain typical arrangements prevalent between parent and subsidiaries as encountered in their normal course of business. The same have been initially described and subsequently, an attempt has been made to analyse the potential PE exposure under Article 5(7) for such typical arrangements and the precautions to be taken while entering into such types of arrangements keeping in view the various judicial pronouncements and relevant material available on the subject.

5.1 *Secondment / Deputation Arrangements*

5.1.1 Within a multinational group, it is relatively frequent for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract.²⁰

5.1.2 In general, secondment/deputation arrangements with subsidiaries could be broadly classified into two categories: (a) where the employment, direction, control of the personnel as well as risk arising out of work performed by the personnel remains with foreign parent and (b) where economic employment rests with the subsidiary. The analysis described in paragraph 8.13 to 8.15 of the OECD MC Commentary on Article 15 will be relevant for the purposes of distinguishing cases where business of the other

20. Issue No. 7 of Public Discussion Draft on Proposed Changes to OECD MC Commentary on Article 5 dated 12th October 2011

company is performed from other cases where employees of a foreign enterprise perform that enterprise's own business activities.

5.1.3 Secondment/deputation arrangements could give rise to Fixed Place PE exposure as well as Service PE exposure (only in cases where foreign parent is located in a country with which it has signed DTAA containing Service PE provision).

5.1.4 *Fixed Place PE:*

5.1.4.1 The basic requirement of the Fixed Place is that the *business of an enterprise* is wholly or partly *carried on* through the fixed place of the business in the other contracting state. Therefore, in cases where the economic employment of the personnel seconded/deputed lies with the subsidiary and the role of foreign parent is limited to provision of employees to the subsidiary, then the possibility of constitution of a Fixed Place PE in such type of situations is very remote. The Supreme Court of India in the case of *Carborandum Co.*²¹ way back in 1977 held that since services of making available foreign personnel to the Indian company was rendered outside the taxable territory of India, there could not arise any business connection in such situations under the Income Tax Act, 1922. Even Prof. Klaus Vogel²² has stated that if the parent company makes personnel available to the subsidiary for remuneration, then the activity of this 'hired labour' is to be attributed to the subsidiary and does not constitute a permanent establishment of the parent doing the hiring-out.

5.1.4.2 Whereas, in cases where economic employment remains with the foreign parent and the employees perform business of the parent as well from the premise of the subsidiary, it becomes imperative to examine whether the premise of the subsidiary is at the disposal of the foreign parent. This "right to use" test in the context of parent-subsidiary relationship has been further elaborated by way of an illustration in Para 4.3 of the OECD MC Commentary on Article 5 wherein the premises of subsidiary constitute a Fixed Place PE for the parent when employees of parent who, for a long period of time, are allowed to use an office in the headquarters of its subsidiary in order to ensure that subsidiary complies with its obligations under the contracts concluded with the parent. Issue No. 2 of Public Discussion Draft on Proposed Changes to OECD MC Commentary on Article 5 dated 12th October 2011 seeks to further clarify this

21. 108 ITR 335

22. Refer "Klaus Vogel on Double Taxation", Third Edition- Para 192a, Page 353

aspect by stating that apart from situations wherein the enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities, even in cases where such enterprise performs business activities on a continuous and regular basis, rather than having intermittent or incidental presence, during an extended period of time at a location that belongs to another enterprise or that is used by a number of enterprises could constitute that location as a Fixed Place PE of the enterprise.

5.1.4.3 Therefore care needs to be taken when Indian subsidiary provides office space to seconded/deputed employees of the parent carrying on business of the parent company as well from such premises such that particular office space is not reserved for such employees and also to limit the amount of time spent by employees of the parent at the premises of the Indian subsidiary, not only on an individual trip basis but also on a continuous basis if the trips are recurrent.

5.1.5 *Service PE*

5.1.5.1 Service PE could arise only in cases where economic employment remains with the parent and the parent renders services through its employees to its AEs, provided the services are rendered for specified time duration as stipulated under respective DTAAAs. In most DTAAAs entered into by India containing the Service PE provision, even if 'other personnel' (other than employees) over whom the enterprise would be having a control are seconded/deputed to the subsidiary, it could still be considered as such personnel constituting a Service PE for the parent.

5.2 *Captive Service Companies:*

In today's offshoring scenario, more and more MNCs are setting up subsidiaries in India for the benefit of cost savings through relocating their operations into India.

5.2.1 *Intra-Group Services:*

5.2.1.1 In such cases, where certain operations of the parent are outsourced to the subsidiary, it may be contended that, subject to satisfaction of other conditions of Article 5(1), the business of the parent as outsourced is carried on by the employees of the subsidiary at its premises rather than its own and hence the premises of the subsidiary constitutes a Fixed Place PE for the parent. It may be appropriate here to refer to Para 42 of the OECD

MC Commentary on Article 5 which clarifies that a company that is a member of a multinational group providing services to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel would not constitute PE even though the company's own activities at a given location may provide an economic benefit to the business of such other company since it would not amount to the business of such other company being carried on through the location of the company providing the services.

5.2.1.2 Supreme Court of India in the case of Morgan Stanley²³ has acknowledged that rendering of back-office operation services to the parent and other group companies which may be usefully utilised by them in running their business did not amount to carrying on their business through the fixed place of business of the subsidiary. The court explained this by giving an example of an Indian subsidiary of a foreign automobile manufacturing company engaged in design, research work, preparation of software and supplying the same to the foreign company which may, after due study, utilize the same, it could not be said in such a situation that the business of manufacturing automobiles is carried on through the Indian subsidiary.

5.2.2 *Whether preparatory or auxiliary in nature?*

5.2.2.1 In most offshoring cases, only non-core functions are outsourced and hence such operations carried on from the subsidiary's premises would be classified as preparatory/auxiliary in nature. However, that may not be the case in certain situations (eg: outsourcing of front office operations). Therefore, it becomes important to carefully examine whether the activities of the subsidiary forms an essential and significant part of the activity of the parent as a whole so as to constitute its core business.

5.2.3 *Cost Plus arrangements:*

5.2.3.1 Another issue which is typical to offshoring situations is remunerating the subsidiary on cost plus basis. It may be contended that due to existence of such arrangements, subject to satisfaction of other conditions of Article 5(1), the premises of the subsidiary are at the disposal of the parent or that the employees of the parent seconded to the subsidiary are conducting the business of the parent.

23. (2007) 292 ITR 416 (SC)

Such line of reasoning has been put forward by the revenue in few cases such as Rolls Royce Plc²⁴, Motorola Inc.²⁵, eBay International AG²⁶ though in such cases the decisions were rendered only after examining the presence/absence of satisfaction of other conditions of Article 5(1). Therefore, proper arrangement of the affairs coupled with robust documentation is warranted in such cases to negate such line of reasoning.

5.2.4 Common directors:

5.2.4.1 It is not uncommon to find common directors on the board of the parent and the subsidiary especially in case of newly incorporated subsidiaries where directors are appointed in non-executive capacity. Care should be taken in such cases to ensure that business of the parent is not carried on from the premises of the subsidiary with certain degree of regularity when the directors attend to the business of the subsidiary.

5.2.5 Whether stewardship activity would amount to a Service PE?

5.2.5.1 In order to ensure that best practices are being followed by the captive subsidiary in the provision of services, the parent company frequently sends its employees to the subsidiary to ensure compliance with the standards set by it for the subsidiary. In such situations, a question could arise whether such stewardship activity would be considered as a provision of service by the parent to the subsidiary?

5.2.5.2 A similar question was raised before the Supreme Court of India in the case of Morgan Stanley Co. (supra) wherein after considering the scope of stewardship activities, the Supreme Court arrived at the conclusion that such activity involving monitoring operations of the subsidiary was primarily undertaken to protect its own interest as a customer and therefore it could not be said that the parent company was providing any services to its subsidiary so as to constitute a Service PE.

5.2.5.3 Apart from the aforementioned Supreme Court decision, one could also refer to Chapter VII (Special considerations for Intra Group Services) of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 ('OECD TP

24. (2011) 339 ITR 147 (Delhi)

25. (2005) 95 ITD 269 (Delhi)(SB)

26. (2012) 25 taxmann.com 500 (Mum)

Guidelines') for further analysis. Although the nomenclature used by the Supreme Court to describe such activities was 'Stewardship activities', Chapter VII of OECD TP Guidelines refers to them as 'Shareholder activities' rather than 'Stewardship activities'. As per Chapter VII of the OECD TP Guidelines, such activities do not justify a charge to the recipient company i.e. subsidiary in this case since such activity is performed solely because of its ownership interest in its subsidiary, i.e. in its capacity as shareholder. Taking cue from the aforesaid, it could be argued under identical facts that there is no provision of services and therefore there is a remote possibility for existence of a Service PE.

5.3 Contract Manufacturing

5.3.1 In many industries, rather than outsourcing parts of its business, a company could outsource its entire business process (eg: production/manufacturing/processing) to another company due to advantage of cost savings amongst others. In contract manufacturing, the manufacturing process is the proprietary property of the entity hiring the contract manufacturer and the contract manufacturer has to undertake the process as per the specifications and raw materials provided by such entity.

5.3.2 In the case of parent appointing its subsidiary as a contract manufacturer, can the premises (eg: factory) of the subsidiary constitute a Fixed Place PE of the parent?

5.3.3 The pre-requisites of Article 5(1) would have to be examined in this case too. Under these arrangements, factory owned and used exclusively by an independent subsidiary cannot be said to be at the disposal of the parent that will receive manufactured goods merely because these goods will be used in the business of the parent²⁷. An independent subsidiary carries on its own business of manufacturing products for the parent as it would have done under similar market conditions for any other company that did not form part of the same business group. Therefore, under such circumstances, the factory of the contract manufacturer (i.e. subsidiary) should not become a Fixed Place PE for the parent.

5.4 Sub-Contracting Arrangements

5.4.1 Often the parent company bids for the contract as a whole and then sub-contracts a part of the contract to its subsidiary

27. Issue No. 2 of Public Discussion Draft on Proposed Changes to OECD MC Commentary on Article 5 dated 12th October 2011

(incidentally incorporated for performance of part of the contract). An important question which arises in such situations is whether the subsidiary becomes the Agent PE of the parent.

5.4.2 Para 38.1 of the OECD MC Commentary on Article 5 states that in relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. Prof. Klaus Vogel²⁸ has observed that the independence of the subsidiary under company law also remains authoritative for tax purposes if it subcontracts entirely or partially to associated enterprises or it acquires the means required for the contract's execution from associated enterprises. But in cases of subcontracts, if the parent assumes the economic risk of the contract's fulfilment in relation to the main customer, the parent company and the subsidiary would in fact have established a company of which they are partners. This will lead to a permanent establishment for the partners if the general preconditions are fulfilled.

5.4.3 Further, in the landmark judgment in the case of Visakhapatnam Port Trust²⁹, the High Court while examining Agency PE referred to certain decisions dealing with the relationship between a contractor and a sub-contractor. The first one was *Lakshminarayan Ram Gopal & Son Ltd. vs. Govt. of Hyderabad*³⁰, wherein the Supreme Court pointed out the distinction between an agent, a servant and an independent contractor quoting the following passage from Halsbury's Laws of England—Hailsham edn., Vol. I, page 193, article 345 as follows: "An agent is to be distinguished on the one hand from a servant, and on the other from an independent contractor. A servant acts under the direct control and supervision of his master, and is bound to conform to all reasonable orders given to him in the course of his work; an independent contractor, on the other hand, is entirely independent of any control or interference and merely undertakes to produce a specified result, employing his own means to produce that result. An agent, though bound to exercise his authority in accordance with all lawful instructions which may be given to him from time to time by his principal, is not subject in its exercise to the direct control or supervision of the principal.

28. Refer "Klaus Vogel on Double Taxation", Third Edition- Para 192a, Page 353

29. (1983) 144 ITR 146 (AP)

30. (1954) 25 ITR 449

...” (p. 456). The other decisions were *Pritchtt & Gold & Electrical Power Storage Co. Ltd. vs. Currie*³¹ and *Mahomed Shafi vs. Fazal Din*³² wherein it was held that the relationship between a contractor and his sub-contractor is similar to that between one principal and another.

5.4.4 Irrespective of whether the subsidiary is considered to act as an independent contractor or as an agent, for it to become an Agent PE of its parent under Article 5(5) of the OECD MC, it needs to have an authority to conclude contract in the name of its parent and habitually exercise it too. This principle has been reiterated in several judgements including *Daimler Chrysler AG*³³ and *eBay International AG*³⁴. Negotiation of contracts by a subsidiary is a relevant though not a conclusive factor in determining whether the subsidiary has an authority to conclude contracts in the name of the parent.

5.4.5 India, however, has made its position clear on the OECD MC with respect to this aspect stating that the mere fact that a person has attended or participated in negotiations in a State between an enterprise and a client, can in certain circumstances, be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. Further, India has also placed the view that a person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts.

6. Conclusion

The traditional understanding of the concept developed in the wake of World War II has once again come under serious challenges in the new era where tax authorities have been recharacterizing subsidiaries as branch in cases of excessive dependence on the parent. Consequently, we are faced with emerging issues. This trend, though, is disappointing and could probably dampen international cooperation, in the ultimate analysis, proper substance must hold the sway. In view of the broad propositions emerging from the above discussion of various judicial pronouncements and the statutory provisions, the reader would be well advised to minutely study and analyse the relevant contracts / agreements and all the relevant facts of the matter on hand and apply appropriate legal propositions discussed in the article.

31. [1916] 2 Ch. D. 515

32. AIR 1930 Lahore 1062

33. (2010) 39 SOT 418 (Mum)

34. (2012) 25 taxmann.com 500 (Mum)