

Evolving PE concept in light of global developments | PE rulings

16 November 2018

Agenda

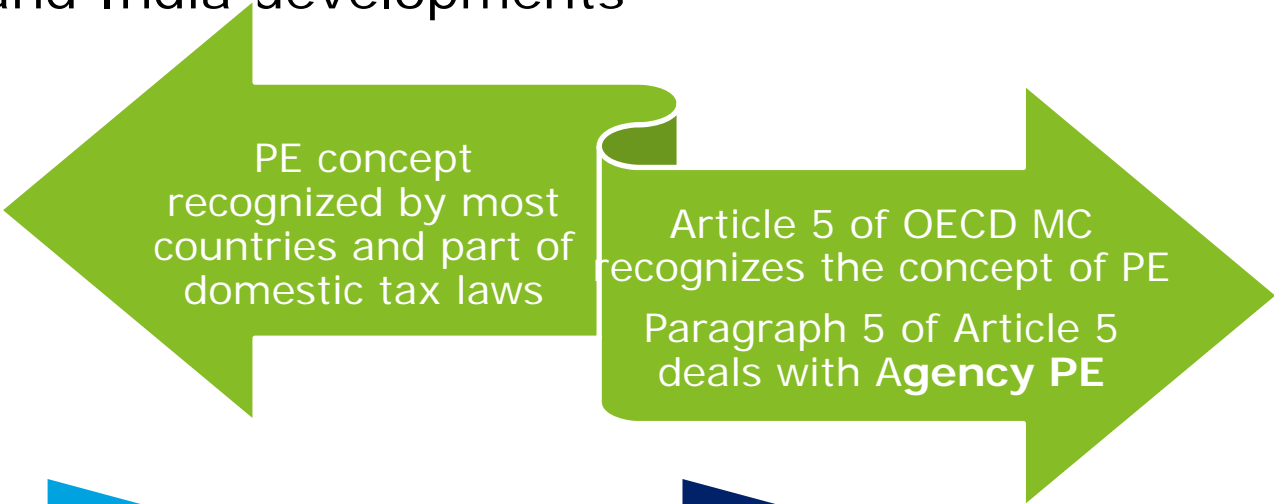
- PE – Global developments and changes in Indian law
- PE - Key Indian PE Rulings
- PE – Mastercard AAR ruling
- PE – Nokia SB ruling
- PE – FRS Hotels AAR ruling

PE – global developments

PE – Recent Global and India developments

Existing law →

Recent developments ↓



BEPS Action Plan 7 recommends changes to PE definition

BEPS recommendations have been included in Article 12 of **Multilateral Convention to Implement Tax Treaty Related Measures** ("MLI"); India is also a signatory

+

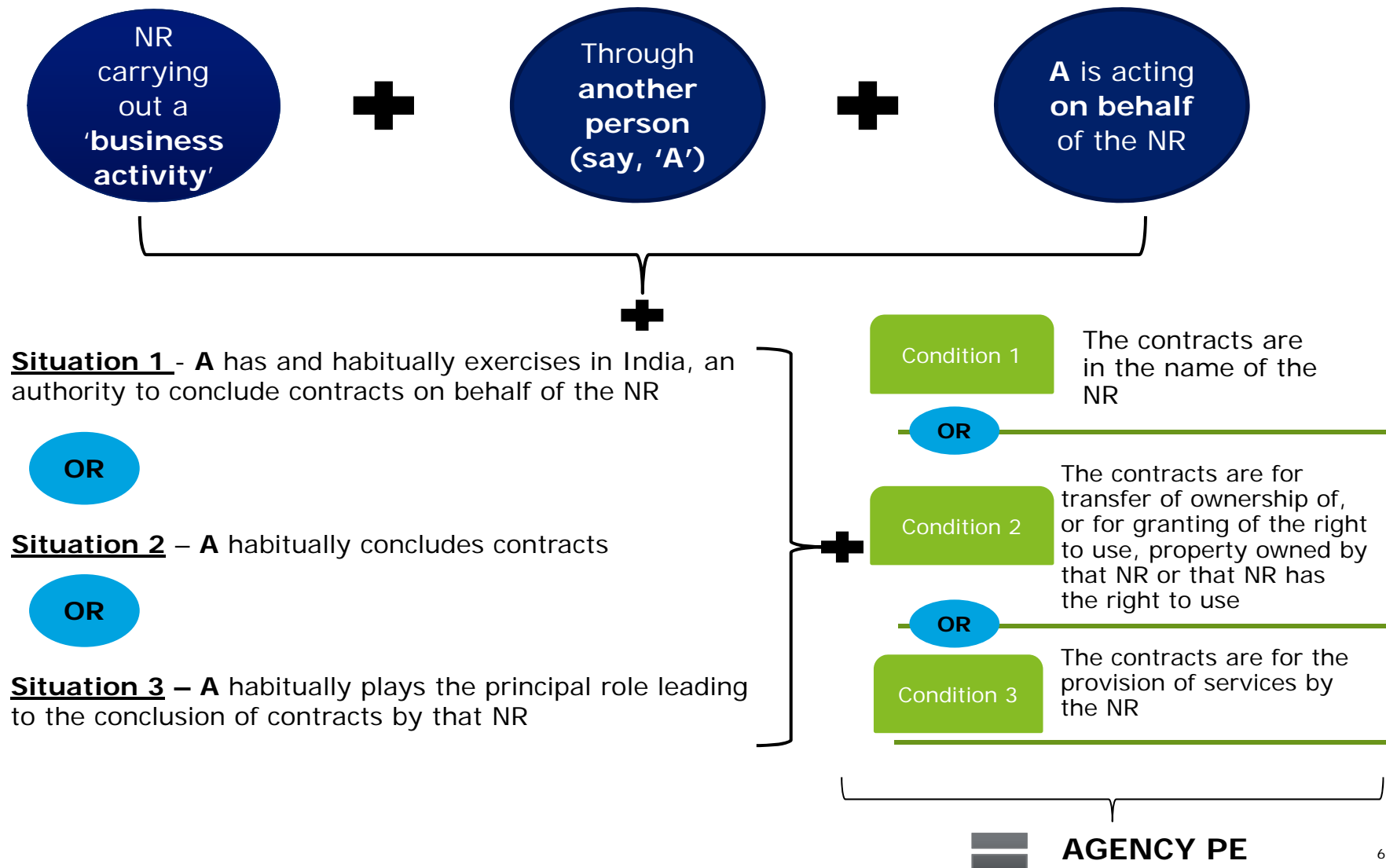
OECD 2017 MC & UN 2017 MC released

Budget 2018 amendments - India amends definition of "Business Connection" under domestic tax law (Explanation 2 to section 9(1)(i) of the Income-tax Act, 1961 ("IT Act")); conceptually similar to BEPS changes, however with some modifications

Changes under the India Budget 2018

India Budget 2018

Scope of 'Agency PE' in "Business Connection" widened



India Budget 2018

Scope of 'Agency PE' in "Business Connection" widened (contd..)

A business connection **shall not include** any business activity carried out through a broker, general commission agent or any other agent **having an independent status**, if such broker, general commission agent or any other agent having an independent status is **acting in the ordinary course of his business**

However, where such broker, general commission agent or any other agent **works mainly or wholly –**

- On behalf of a NR ("principal NR"); or
- On behalf of such NR and other NRs which are controlled by the principal NR or have a controlling interest in the principal NR or are subject to the same common control as the principal NR,

he shall not be deemed to be a broker, general commission agent or an agent **of an independent status**

India Budget 2018

“Business connection” to include “significant economic presence” - Section 9(1)(i) - Rationale for the change

- As per existing DTAA's, business profit of an enterprise is taxable in the residence country unless there is a PE in the source country
- Nexus rule based on physical presence used as against regular economic connection to determine existence of a PE
- New business models of operating remotely through digital medium have emerged with the advancement in information and communication technology in the last few decades
 - Non-resident enterprises interact with customers in another country without having any physical presence in that country
 - Results in avoidance of taxation in the source country
- Right of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded
- OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy
 - Several options discussed to tackle the direct tax challenges arising in digital businesses
 - One such option is “significant economic presence”
 - The scope of existing provisions of section 9(1)(i) restrictive - essentially provides for physical presence based nexus rule
- ‘Business connection’ under section 9 is amended to introduce the concept of “significant economic presence”

India Budget 2018

“Business connection” to include “significant economic presence” - Section 9(1)(i) - Proposed amendment

- New explanation [Explanation 2A] to section 9(1)(i) of the Act to clarify that the significant economic presence of a non-resident shall constitute “business connection” in India
- “Significant economic presence” defined to mean –
 - transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India provided the revenue therefrom exceeds monetary threshold as may be prescribed; or
 - systematic and continuous soliciting of business activities or engaging in interaction with users (exceeding the number as may be prescribed) in India through digital means
- Whether or not the non-resident has a residence or place of business in India or renders services in India not relevant
- Attribution principles will be applied
- Amendments consequent to recommendations under BEPS Action Plan 1 on addressing tax challenges of the digital economy

Key considerations

Threshold of “revenue” and “users” to be decided after consultation with stakeholders

India to re-negotiate existing DTAA's for inclusion of the new nexus rule

Cross border business profits to continue to be taxed as per existing DTAA rules till the DTAA's are modified

Non-DTAA jurisdictions to be impacted by the proposed amendment

Key differences –

**PE definition under amended IT Act
vis-à-vis OECD/ UN Model
Convention**

Key differences – OECD/UN Vs IT Act

SI No	Parameters	OECD/ UN model	IT Act
1	Modifications to the terms of the contract by the NR	Agency PE exists if Agent plays a principal role leading to the conclusion of contracts and the contracts are "routinely concluded without material modification by the enterprise"	<p>The phrase "routinely concluded without material modification by the enterprise" is absent in Explanation 2(a) to Section 9(1)(i) of the IT Act</p> <p>Impact – Scope of Agency PE under IT Act is wider; even material modifications to contract by principal outside India will result in Agency PE</p>
2	Sourcing activities of the agent on behalf of the NR (if preparatory or auxiliary in nature)	Exemption for "preparatory or auxiliary" activities of Agent, hence sourcing could come under the exemption if it is "preparatory or auxiliary"	<p>IT Act does not recognize an exception for preparatory or auxiliary activities.</p> <p>Also, pre-amended Explanation 2(a) excluded from its ambit business activities of a person carried out on behalf of the NR which were limited to purchase of goods or merchandise</p> <p>No such exemption is given under the amended Explanation 2(a) to Section 9(1)(i)</p> <p>However, Explanation 1(b) provides an exemption to the extent that there would be no PE in India through or from operations which are confined to the purchase of goods in India for the purpose of export</p> <p>Impact – (i) Preparatory/auxiliary activities will still result in Agency PE (ii) No exemption for sourcing activities for onward supply to Indian businesses</p>

Key differences – OECD/UN Vs IT Act

SI No	Parameters	OECD/ UN model	IT Act
3	Other preparatory and auxiliary activities	Exemption in respect of activities falling under the definition of “preparatory or auxiliary” activities	<p>No exemption provided under the IT Act in respect of any preparatory or auxiliary activities although the Memorandum to the Finance Bill 2018 refers to such clauses being present in the DTAAs</p> <p><u>Impact</u> – Agent’s activities may still come under PE even if it is preparatory or auxiliary</p>
4	Insurance business	An enterprise carrying on insurance business shall, except in regard to re-insurance, be deemed to have a PE in a country if it collects premiums in that country or insures risks situated therein through a person	No such reference under the IT Act in respect of the insurance business

PE – No exemptions and some exclusions

PE – No exemptions



Agency PE of a NR may be constituted even if -

- The agent does not have a place of business in India
- The agent is a NR
- There is more than one agent
- Some of the agents are of independent status for the purposes of first Proviso to Explanation 2 to Section 9(1)(i) of the IT Act
- The person acting on behalf of the foreign enterprise is a partner, director or employee of the foreign enterprise

While there may be a PE, chances of profit attribution to PE are low



Agency PE includes the following contracts -

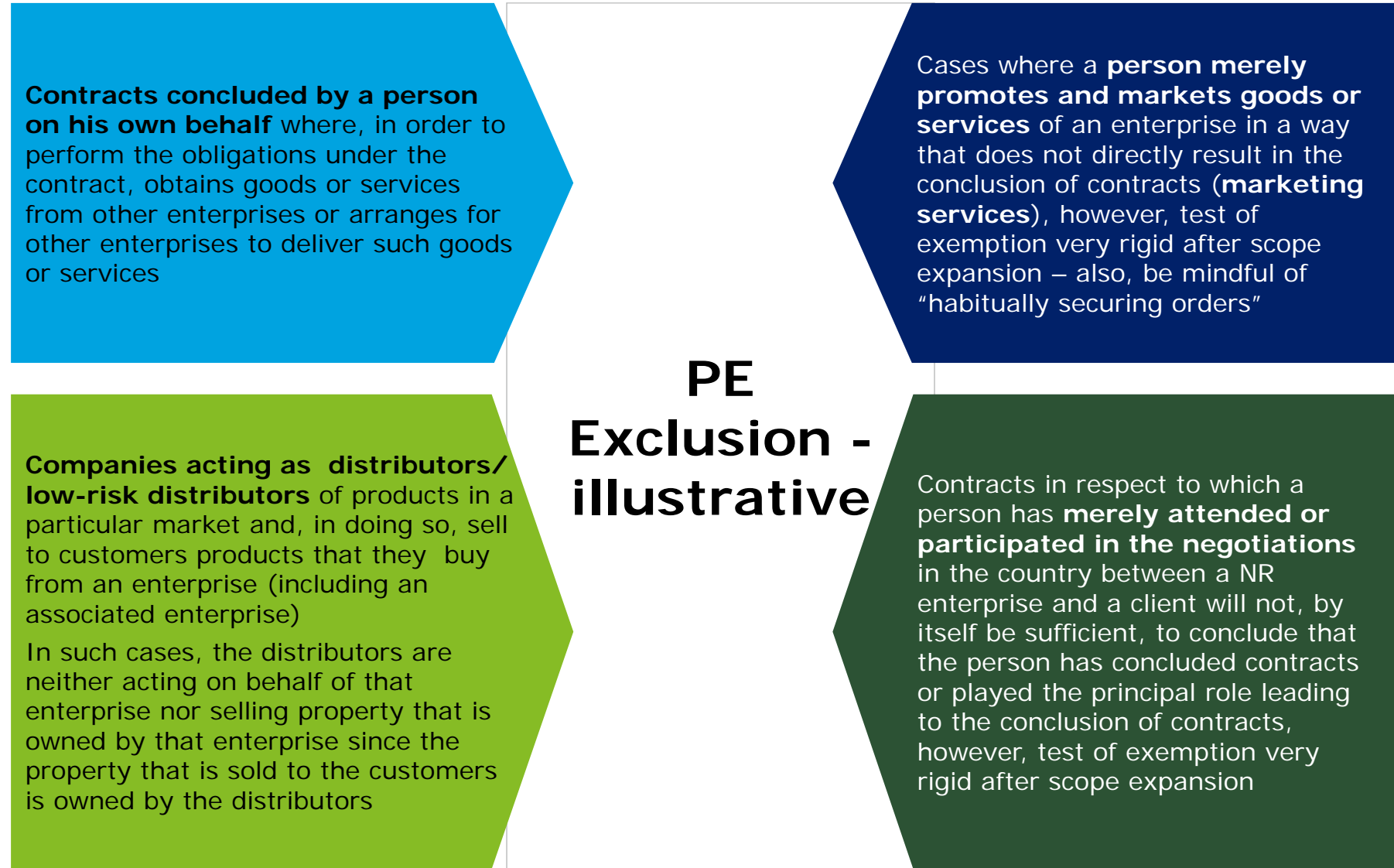
- Contract signed outside India although acceptance, by Agent (under expanded scope), of an offer to enter into a contract made by a third party occurs in India
- Contracts where all elements and details are negotiated by a person in a way binding on the enterprise although the contract is signed by another person outside that country



Contracts for provision of services and/ or transfer of ownership or grant of right to use property includes -

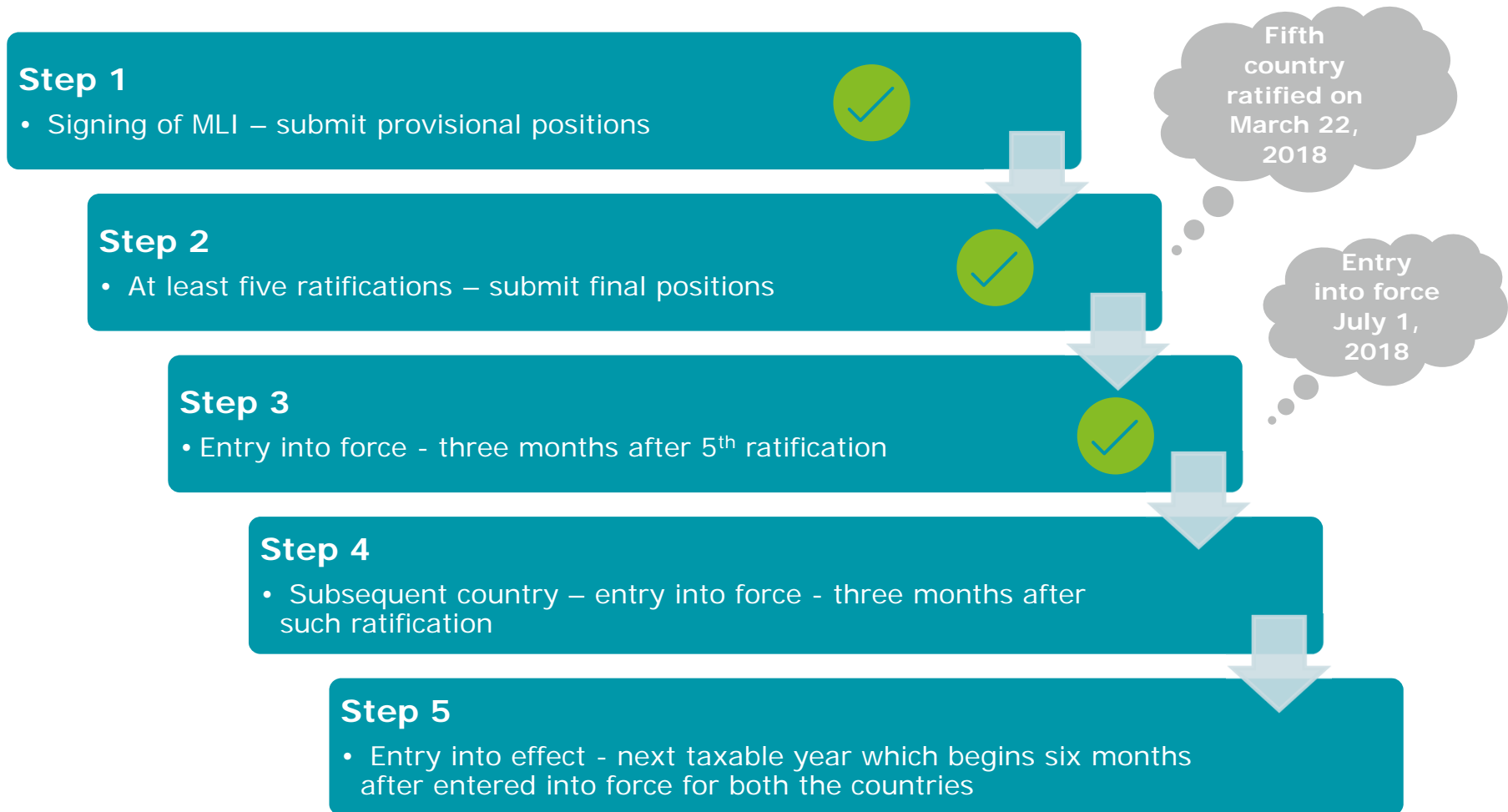
- Agency PE not restricted to goods -
- Contracts concluded by Agent on behalf of the NR for **the provision of services** by such NR outside the country
 - Contracts where an Agent acting on behalf of a NR sells property that the NR will **subsequently produce/ procure** before delivering it directly to the customers
 - “property” covers any type of tangible or intangible property (hence, **royalty income** derived by NR principal also covered)

PE – Some exclusions



PE changes owing to Multilateral Instruments (MLI)

MLI – progress till date



- BEPS changes on PE are part of the MLI , to which India and many countries are signatories
- India's DTAA's with most countries likely to be amended soon as a result of the MLI

MLI - Article 12 – Changes to Agency PE

- Article 12(1) of MLI reflects BEPS changes on Agency PE (similar to OECD/UN revised MC)
- India has adopted 12(3)(a) of MLI – therefore, Article 12(1) of MLI shall apply **in place** of Agency PE clauses in the existing
- Applicable **only** when all DTAA partners of India have agreed to apply Article 12(1) of the MLI, else existing Agency PE article in the DTAA will continue to apply
- Illustrative position of India's DTAA's on MLI for Agency PE -

Country	USA	France	UK	Denmark
Position	<u>Has not signed MLI</u>	12(3)(a)	Not opted	Not opted
Impact	Existing DTAA will continue	MLI will replace DTAA	Existing DTAA will continue	Existing DTAA will continue

Country	Singapore	Japan	Netherlands	Germany
Position	Not opted	12(3)(a)	12(3)(a)	Has not included India Treaty
Impact	Existing DTAA will continue	MLI will replace DTAA	MLI will replace DTAA	Existing DTAA will continue

MLI - Article 13 – exemption for ‘preparatory/auxiliary activities’

- Article 13 of MLI reflects BEPS changes on PE exemption for ‘preparatory/auxiliary activities’
- Two options are provided – (A) Activities specifically listed as not to constitute PE whether they are ‘preparatory/auxiliary’ in nature or no will hereafter be deemed to constitute PE, **unless they are ‘preparatory/auxiliary’ in nature** (B) Activities specifically listed as not to constitute PE whether they are ‘preparatory/auxiliary’ in nature or no will continued to get PE exemption
- India has chosen Option A for all covered tax agreements
- In case of mismatch in Options selected by DTAA partner countries, the MLI clause will not apply and the respective countries will have to mutually discuss and agree; until then existing DTAA continues
- Illustrative position of India’s DTAA on MLI for ‘preparatory/auxiliary’ activities -

Country	USA	France	UK	Denmark
Position	<u>Has not signed MLI</u>	Option B - Mismatch	Mismatch	Not opted
Impact	Existing DTAA will continue	Countries to agree	Countries to agree	Existing DTAA will continue

Country	Singapore	Japan	Netherlands	Germany
Position	Not opted	12(3)(a)	Option A	Has not included India Treaty
Impact	Existing DTAA will continue	MLI will replace DTAA	MLI will replace DTAA	Existing DTAA will continue

PE - recent Indian rulings

Key Indian rulings

Name	Country	Key principles	Key takeaways
Formula One (SC)	UK	<ul style="list-style-type: none"> • Fixed place PE 'Permanence test' - Nature of business has to be examined along with duration of activity for determining existence of PE. Activities involving short-term duration may also constitute PE - the six months threshold for the purpose of application of Article 5(1) cannot be taken for granted • Substance over form - It is important to understand the substance of the arrangement between parties; to determine who is carrying on what business and the place of business is at whose disposal • Actual control - Indian entity though operating independently but on the direction pre-defined by the NR may lead to PE • Attribution - Only that portion of the income of the NR which is attributable to the said PE would be treated as business income of NR 	<ul style="list-style-type: none"> • General concept of Fixed Place PE approved by SC • Short-term activities can also constitute PE
E-Funds (SC)	USA	<p>Fixed Place PE</p> <ul style="list-style-type: none"> • Mere having access to a place in India for the purpose of business not sufficient for creation of a fixed place PE – the NR should have right to use the place or have control thereupon • Close association between the entities or interactions/cross-transactions between them or dependence of India Co on foreign parent/group company is not an appropriate test to determine the existence of a fixed place PE • Indian entity rendering support services which enable a foreign affiliate to render services to its clients abroad would not create fixed place PE of the foreign affiliate in India <p>Service PE</p> <ul style="list-style-type: none"> • Service PE primary condition - services should have been furnished within India • To constitute Service PE, it is important to evaluate the nature of services rendered by seconded employees as well as their reporting obligation 	<ul style="list-style-type: none"> • Principles from Formula One ruling applied • Service PE principles also clarified • No attribution if transactions are at ALP

Key Indian rulings

Name	Country	Key principles	Key takeaways
Master Card (AAR)	Singapore	<ul style="list-style-type: none"> • Equipment as PE – Equipment (Mastercard Interface Processor) placed at customer’s (bank) site in India, along with other network infrastructure creates fixed place PE for Singapore based company • Subsidiary as PE – Notes that Indian subsidiary was formed as a transition from Liaison Office (LO); disregards FAR analysis of the subsidiary, as not adequately capturing the actual FAR. Subsidiary almost an extension of the overseas parent • Activities not ‘Preparatory & Auxiliary’ – After extensive analysis of the activities in India compared to the overall business of the NR, holds that activities in India are substantial in nature and entitled for the preparatory/auxiliary exemption • Service PE – NR’s employees visiting India for long durations creates service PE • Dependent Agent PE – Subsidiary ‘secures orders’ for NR parent and hence subsidiary is also dependent agent PE • Service charges akin to brand royalty – Rejects argument that NR receives only service charges from Indian banks and holds that the banks are effectively paying for the logos displayed on the credit/debit cards issued; such royalty income is effectively connected with the PE • Attribution – Rejects reliance on Morgan Stanley (SC) to say that the since the subsidiary’s FAR is not appropriately captured, ALP argument cannot absolve from PE attribution 	<ul style="list-style-type: none"> • Significant impact for card agencies; also relevant for other NR companies, with automated equipment at India customer sites • Exposure in cases where LO is converted to subsidiary and caution to be exercised • In-depth analysis of the business by AAR • Extensive reliance on SC’s Formula One and E-Funds rulings • Extensive investigation and attention to detail by Revenue; seeking information from customers in India, cross verifying statements made in the AAR application with Indian subsidiary’s TP reports • Reference to prospective MLI amendments

Key Indian rulings

Name	Country	Key principles	Key takeaways
FRS Hotel Group (AAR)	Luxembourg	<ul style="list-style-type: none"> • AAR has powers to give ruling on all aspects of the question on which ruling is sought – Rejects, NR company’s argument that ruling was sought for only taxation of global reservation fees as royalty/FTS (under centralized services agreement); holds that AAR is duty bound as per AAR Rules to deal with all aspects of the question raised. Justifies that AAR is entitled to go into PE question • Fixed place PE – AAR notes that the NR company is engaged right from the construction/development of the hotel to the operating, running, marketing and sales activities of the hotel. Also, given the extensive presence of NR’s personnel at the hotel site, holds that the hotel is at the disposal of the NR company; taking all agreements (hotel management, centralized services, hotel license, hotel advisory and technical services) into cumulative consideration, holds that fixed place PE is fully satisfied. 	<ul style="list-style-type: none"> • Significant impact for foreign hotel chains operating/managing hotels in India, by lending their brand name • Extensive reliance on SC’s Formula One and E-Funds rulings
Nokia (ITAT – SB)	Finland	<ul style="list-style-type: none"> • Fixed place PE – No fixed place PE, test of disposal not satisfied. Administrative support provided to employees of NR by subsidiary in India like office support, cars, telephones, etc cannot lead to fixed place PE • Preparatory & Auxiliary – Activities such as signing contract (for offshore equipment supply), network planning and negotiation are in the nature of ‘preparatory & auxiliary’ activities, entitled for PE exemption • Subsidiary as virtual projection of NR – Virtual projection by itself cannot amount to PE unless the PE parameters in Article 5 stand satisfied (<i>however contrary view in the dissenting judgment by one of the judges, who holds Indian subsidiary’s virtual projection (alter ego) as creating PE for NR</i>) • Service PE – No Service PE clause in the DTAA at the relevant point in time, hence no Service PE 	<ul style="list-style-type: none"> • Extensive reliance on SC’s Formula One and E-Funds rulings • While ruling in favour of NR, dissenting judgment (minority view) has made significant observations on the Indian subsidiary being a virtual projection of the NR (alter ego) and hence the PE being formed

Other key Indian rulings

Name	Country	Key principles	Key takeaways
Production Resource Group, In Re (AAR)	Belgium	<ul style="list-style-type: none"> • A 'lockable' space for storing tools and equipment implies access to and control over space. Considering nature of business, such a place cannot be considered merely for storage but for carrying business itself • Subcontracting some of the activities by a foreign entity is an extension of the foreign entity on Indian soil • The foreign entity taking a comprehensive insurance of its equipment deployed on the Indian project is indicative of the foreign entity having a fixed place of business in India • The length of presence has to be tied to the nature and requirements of the business under consideration 	<ul style="list-style-type: none"> • A "lockable" storage space may create a fixed place PE depending on the nature of business • Imperative to analyze all the arrangements and contracts relating to Indian projects to evaluate PE exposure
ABB FZ – LLC (ITAT)	UAE	<ul style="list-style-type: none"> • For Service PE, physical presence of employees is not required • Article 5(2) is independent of Article 5(1) 	<ul style="list-style-type: none"> • Ruling in line with India's position on OECD Commentary
Shanghai Electric Group Co. Ltd (ITAT)	China	<ul style="list-style-type: none"> • Substance of contracts and intention of parties to be considered to evaluate whether supply and services are linked • Satisfaction of conditions provided in Article 5(2) will create PE irrespective of whether general conditions of Article 5(1) cover such a situation or not • Any income in respect of services rendered to an Indian project, similar to the services rendered by the PE, is also to be taxed in India, irrespective of the fact whether such services are rendered in India or outside India, through the PE or directly by the general enterprise 	<ul style="list-style-type: none"> • Arrangements involving offshore supply and onshore services may need a relook depending on the language of the respective treaty

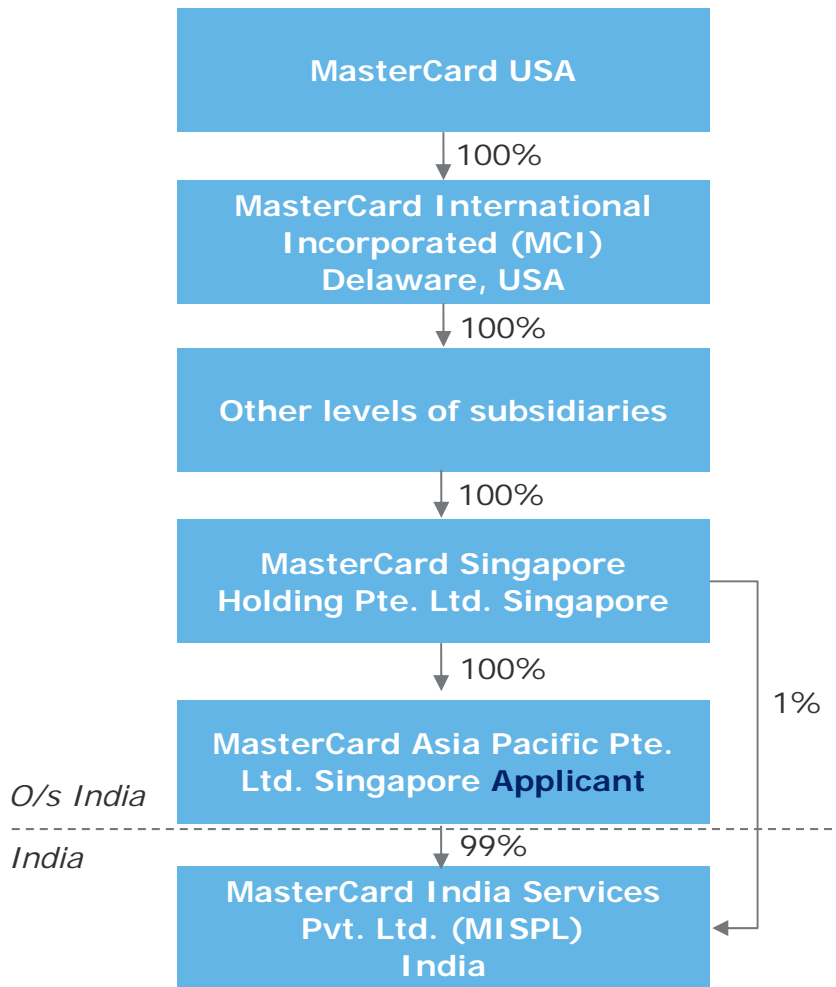
Mastercard AAR ruling

**MasterCard Asia Pacific Pte.
Ltd., In re. [2018] 94
taxmann.com 195 (AAR - New
Delhi)**

PE through multiple factors
including system and network

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)

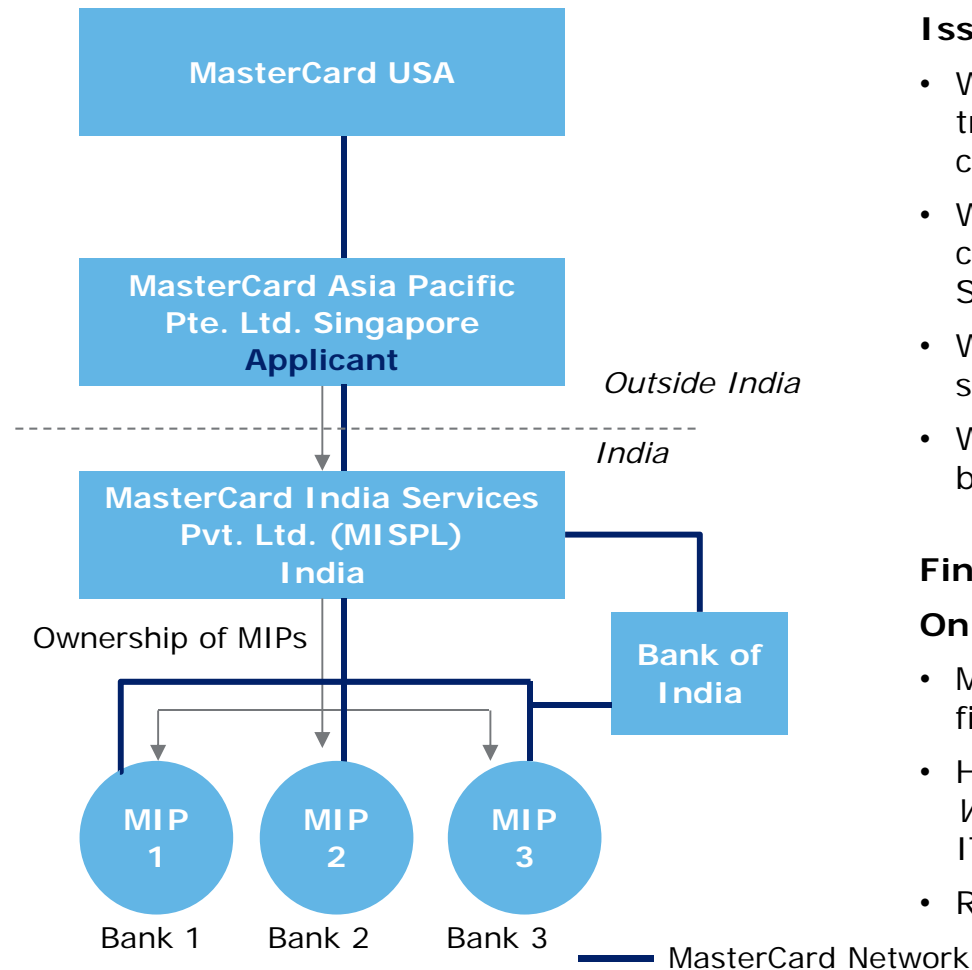


Facts

- Applicant is a group company of MasterCard, one of the leading global payment solution providers through electronic mode
- Applicant is the regional headquarter for Asia-Pacific region
- Applicant enters into Master License Agreements (MLA) with various customers in the Asia-Pacific region, including India. These customers are mainly banks and other financial institutions.
- The main business of the applicant consists of authorization, clearance and settlement of transactions between its customers for which it charges a fee
- It also receives other fees in the form of assessment fees for building and maintaining a processing network, fees for setting up of clearing and settlement process, warning bulletin fees for listing invalid or fraudulent accounts, account and transaction enhancement services, fees for holograms and publication.

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



Issues

- Whether the applicant has a PE in India for transaction related to services provided to customer banks in India?
- Whether fees received by the applicant from customer banks is royalty under the India-Singapore treaty?
- Whether ALP remuneration to alleged PE would suffice for PE profit attribution?
- Whether any withholding tax liability arises because of the above?

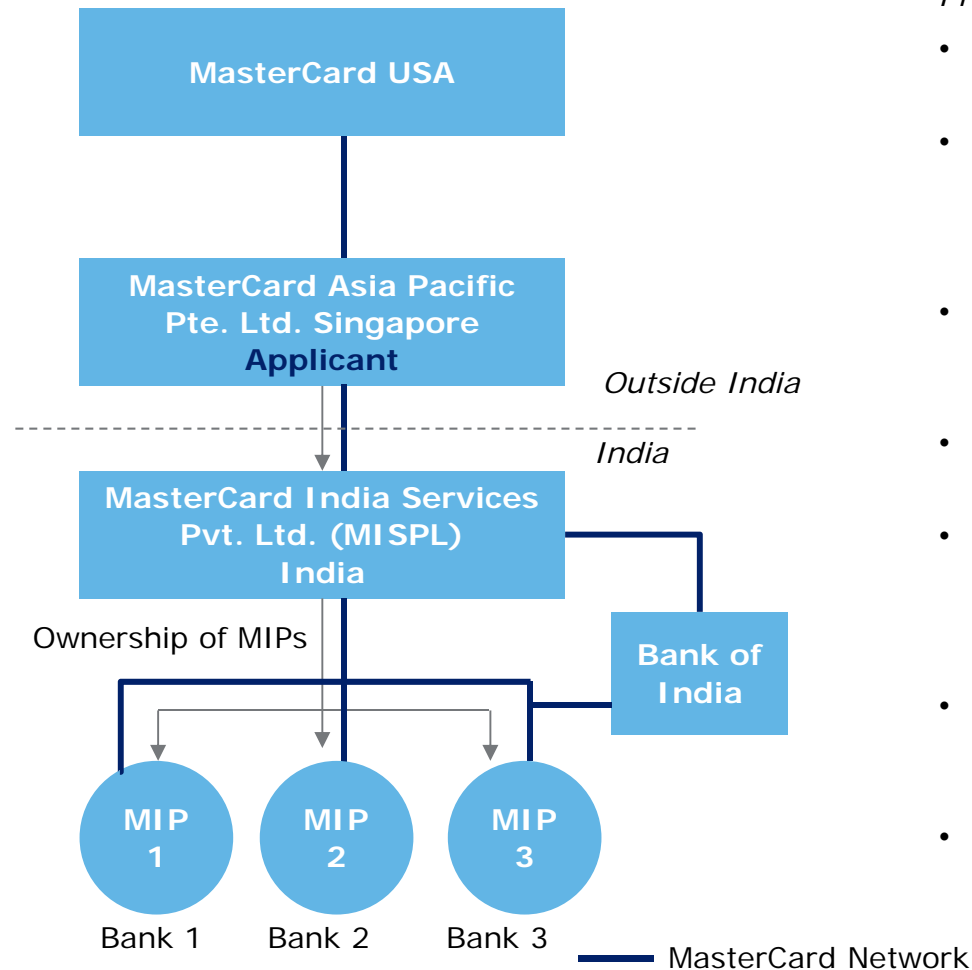
Findings

On PE

- Main tests for PE determination – permanency, fixed place and disposal
- Heavy reliance on SC judgement in *Formula One World Championship Ltd. v. CIT(IT)* [2017] 394 ITR 80 (SC)
- Reference to OECD Commentary

MasterCard Asia Pacific Pte. Ltd., In re.

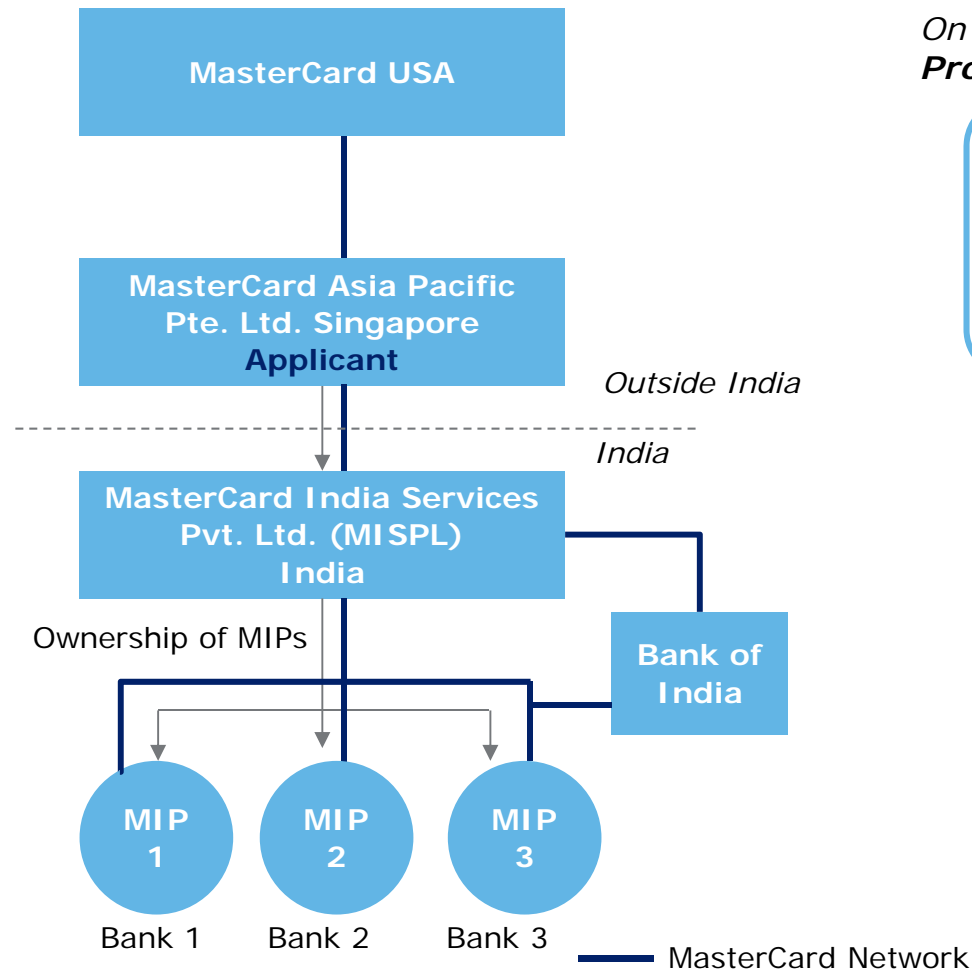
[2018] 94 taxmann.com 195 (AAR - New Delhi)



On fixed place PE through MasterCard Interface Processors (MIPs) – Authorization activity

- MIPs constitute a fixed place since there is no condition of attachment to ground
- Permanency test is also satisfied since MIPs were on premises of the customer banks throughout the year. Even otherwise, permanence just means for the duration of the business and not forever.
- Nature of activities performed by MIPs (authorization) is significant and cannot be categorised as preparatory or auxiliary.
- Legal ownership of MIPs (which was with MISPL) is not necessary for PE creation.
- The MIPs are controlled by the applicant through agreement with customer banks. There is no agreement between MISPL and the customer banks
- All risk mitigation functions are performed by the applicant and all decisions with respect to MIPs are taken by it (like repairs, upgradation).
- The software inside MIPs is also admitted to be owned by the applicant and is upgraded by third parties on behalf of the applicant.

MasterCard Asia Pacific Pte. Ltd., In re.
 [2018] 94 taxmann.com 195 (AAR - New Delhi)



On fixed place PE through **MasterCard Interface Processors (MIPs)** – Authorization activity

“... all costs of MIP maintenance and upgradation ultimately get charged to the Applicant...”

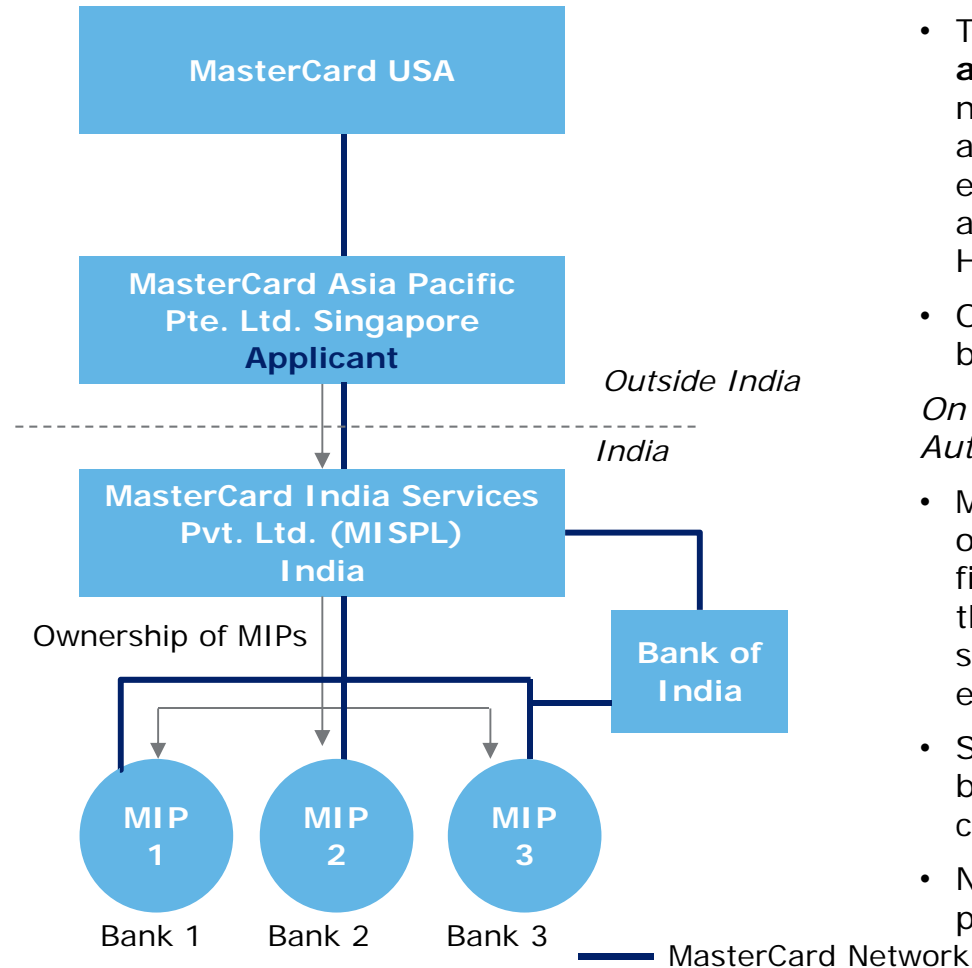
“The Applicant's argument of the cost of MIPs being fractional to the cost of infrastructure that is outside India, is of no significance. ...”

“... MIPs are at disposal of the Applicant as the Applicant is charging fee for cost of its installation.”

“... this function (authorization) performed by MIP, which is part of transaction processing, is the function of the Applicant and not the function of MISPL (which is only performing support functions).”

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



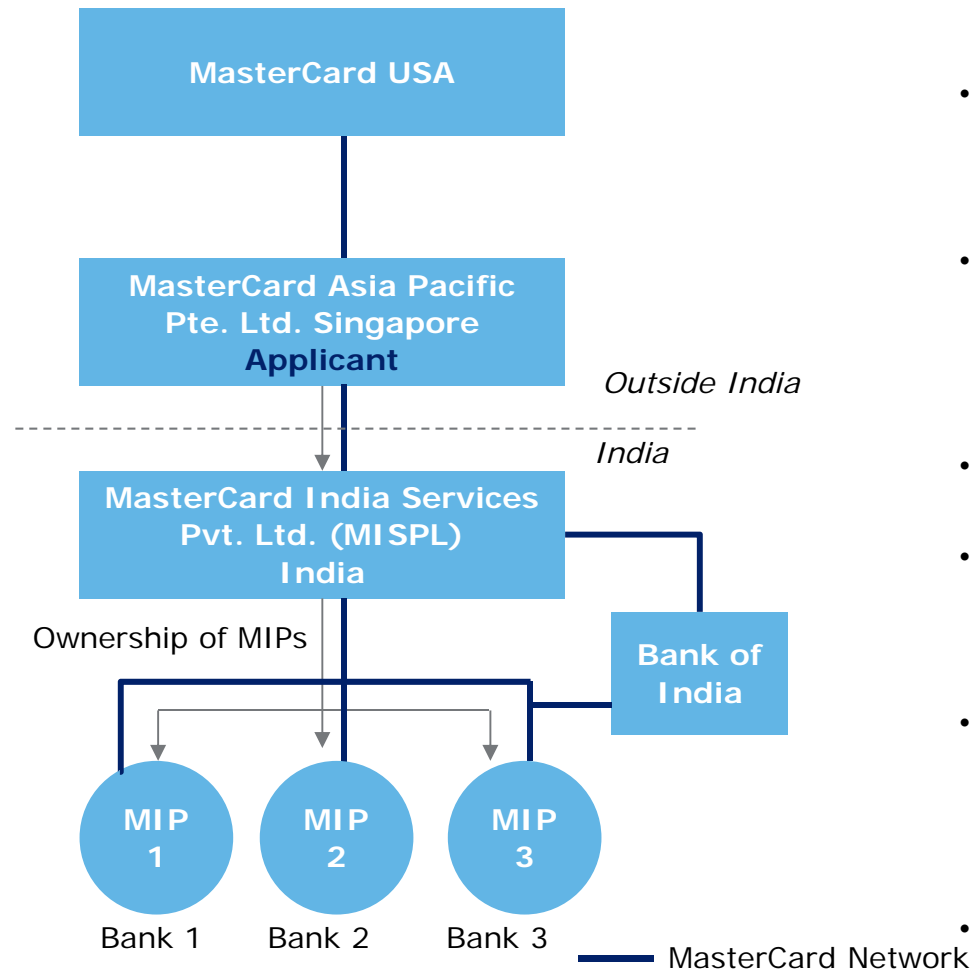
- Being "at the disposal of" would mean right to use and having control over that place/equipment. This is with the applicant
- Transaction processing has three stages: **authorization**, clearing and settlement. It is not necessary that PE will be created only if the MIPs are involved in all three stages. Involvement in even one stage (without it being preparatory or auxiliary) can create PE, provided it is significant. Hence, MIPs create PE of applicant.
- On facts, MIPs are not at the disposal of customer banks in whose premises they are located.

*On fixed place PE through **MasterCard network** – Authorization, clearance and settlement activity*

- MasterCard Network in India consists of MIPs owned by MISPL, transmission tower, leased lines, fiber optic cable, nodes and internet- owned by third party service provider, and application software - Master Connect and Master Card File express, owned by the applicant.
- Since the network is involved in all three stages of business, it is important to examine whether it creates a PE.
- Network passes the test of permanence and fixed place.

MasterCard Asia Pacific Pte. Ltd., In re.

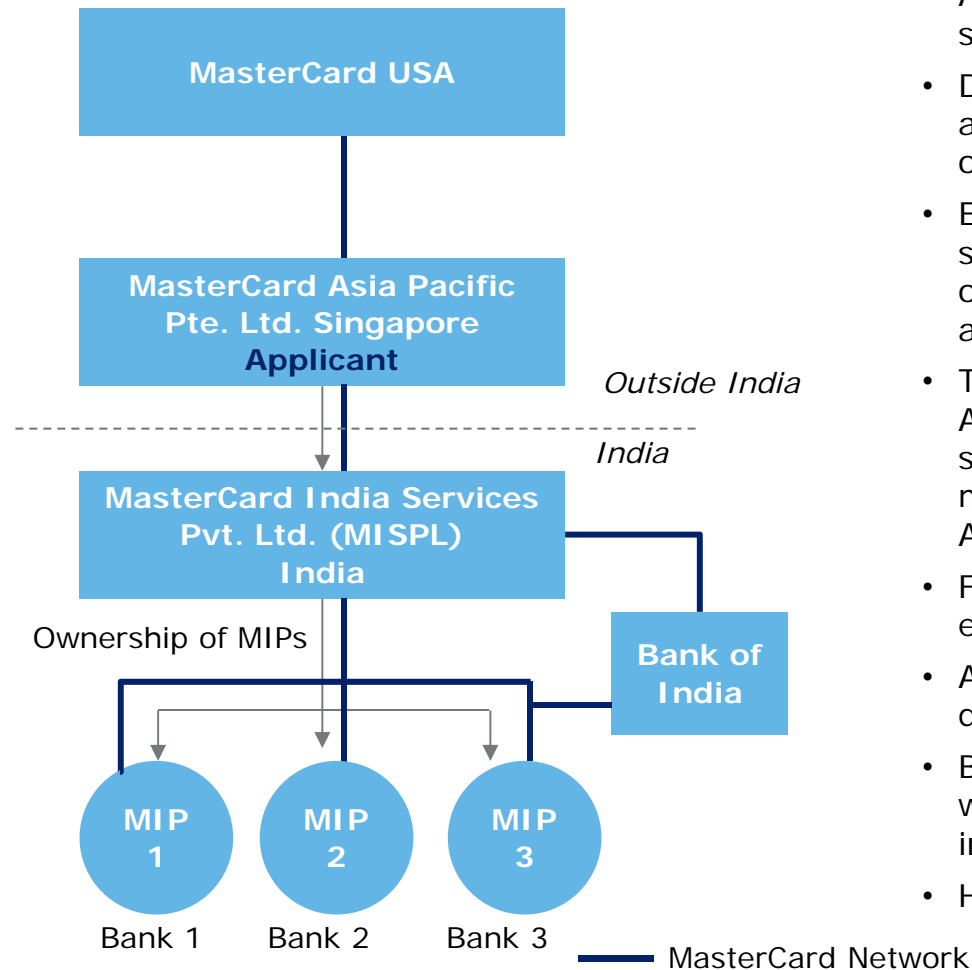
[2018] 94 taxmann.com 195 (AAR - New Delhi)



- It also passes the test of disposal since it is admitted in the TP report of MISPL that one MasterCard group entity in US is responsible for management and maintenance of MasterCard worldwide network remotely from the USA.
- Application software - Master Connect and Master Card File express are owned by the Applicant and controlled by them and are therefore at the disposal of the Applicant.
- The part of network provided by third party service provider in India is also at the disposal of the Applicant. It was admitted that the network in India is secured by MasterCard to prevent fraud and to enhance security.
- **Thus, MasterCard network in India is at the disposal of the Applicant.**
- Functions of all components of the network have to be examined together to determine whether the activities performed by the network are preparatory or auxiliary.
- MIPs, part of the network, on their own also perform significant activities. Hence, when combined with remaining parts of the network, the scope of activity cannot be said to be preparatory or auxiliary.
- Hence, MasterCard network in India creates a PE.

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)

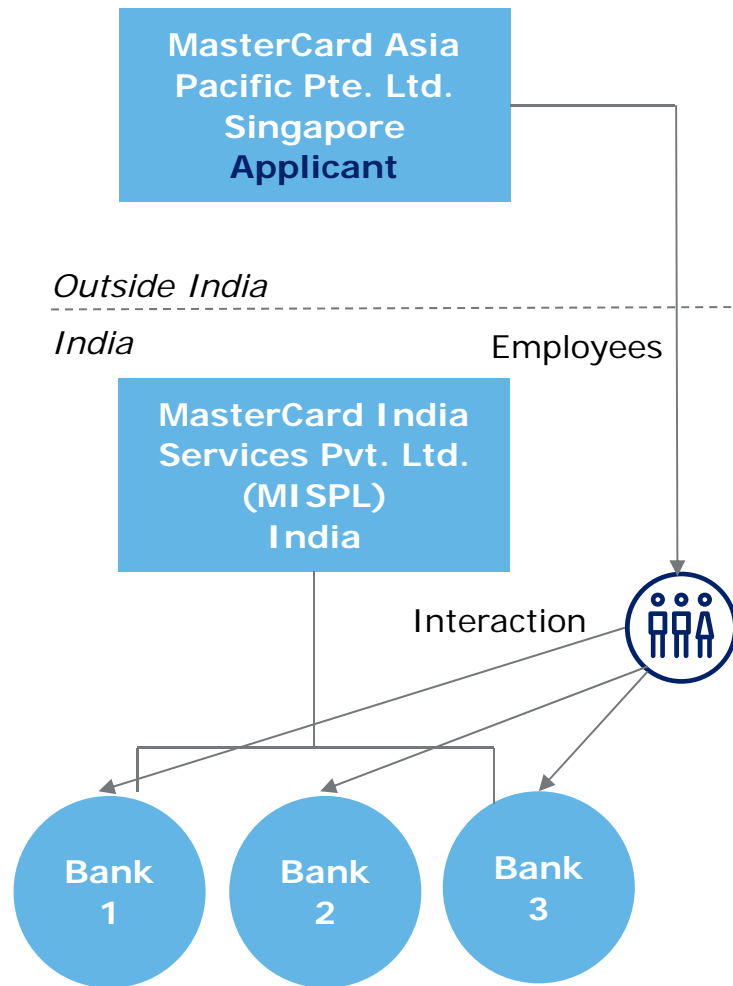


*On fixed place PE through **Bank of India (BoI) premises** – Settlement activity*

- Applicant's important business activity of settlement is carried on at the premises of BoI.
- Dedicated team of BoI employees performs this activity and the responsibility for any errors is that of the applicant.
- Employees of BoI are under control and supervision of the applicant and the space occupied by them in BoI is at the disposal of the applicant.
- The fact that BOI is acting as an agent of the Applicant and under its instruction and supervision, and has a space at its disposal, it means that the space is at the disposal of the Applicant.
- For constituting PE, the space may not be exclusively used by the non-resident enterprise.
- Amount of remuneration paid to BoI cannot determine the significance of the work.
- BoI was not a dependent agent. Nevertheless, it was an agent of the applicant, though independent.
- Hence, BoI premises create applicant's PE in India.

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



*On fixed place PE through **Indian subsidiary MISPL** - Transaction procession activity*

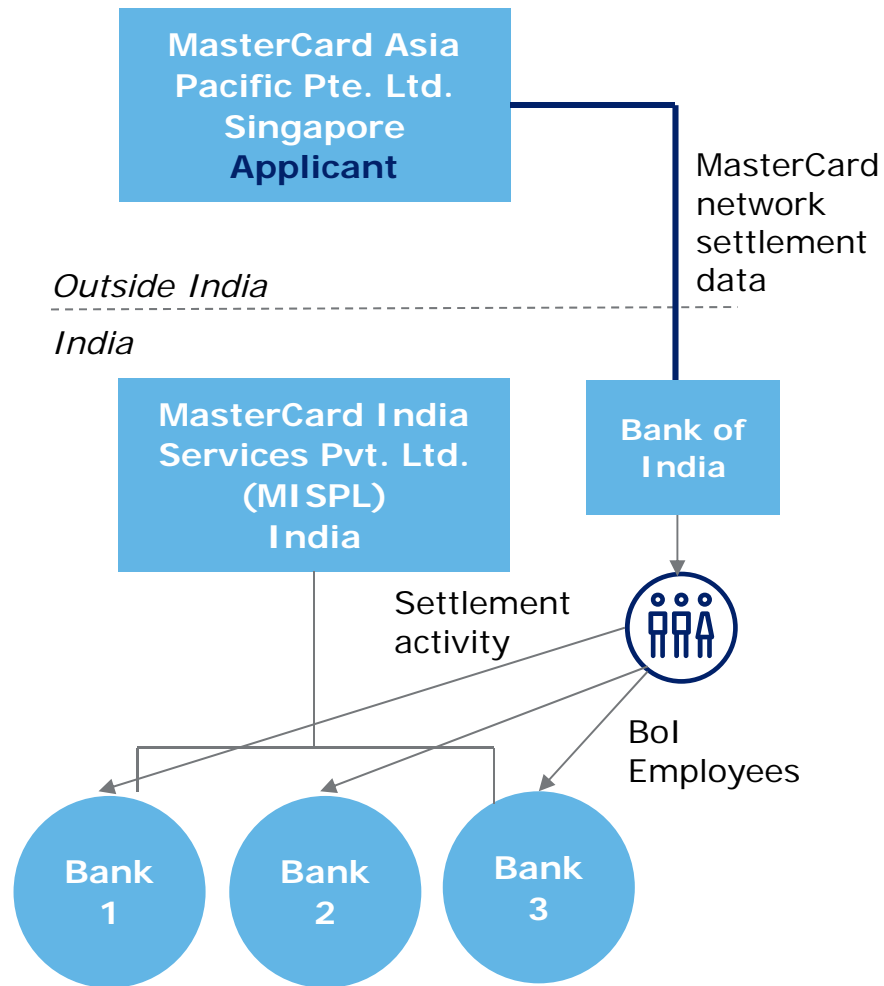
- Transaction processing activity was earlier shown to be carried out by the LO of MCI in India. Post group restructuring, the same activity was only shown as a support services in MISPL's FAR report.
- Some functions relating to transaction processing, which were earlier carried on by the LO and continued to be carried on by MISPL were not shown in MISPL's report.
- MISPL is carrying on work of the applicant and to that extent facility, service, personnel and premise of MISPL are at the disposal of the Applicant as these are not reflected in the FAR of MISPL.
- Hence, the subsidiary constitutes PE of the applicant in India.

*On service PE through applicant's **visiting employees** – Transaction procession activity*

- 90-day test under the treaty is met
- Employee activities like interaction with clients, taking feedback from them, informing them about new products are an integral, monitoring operation efficiency, part of applicant's services rendered to clients and are **not steward activities**.

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



*On service PE through **BoI employees** – Settlement activity*

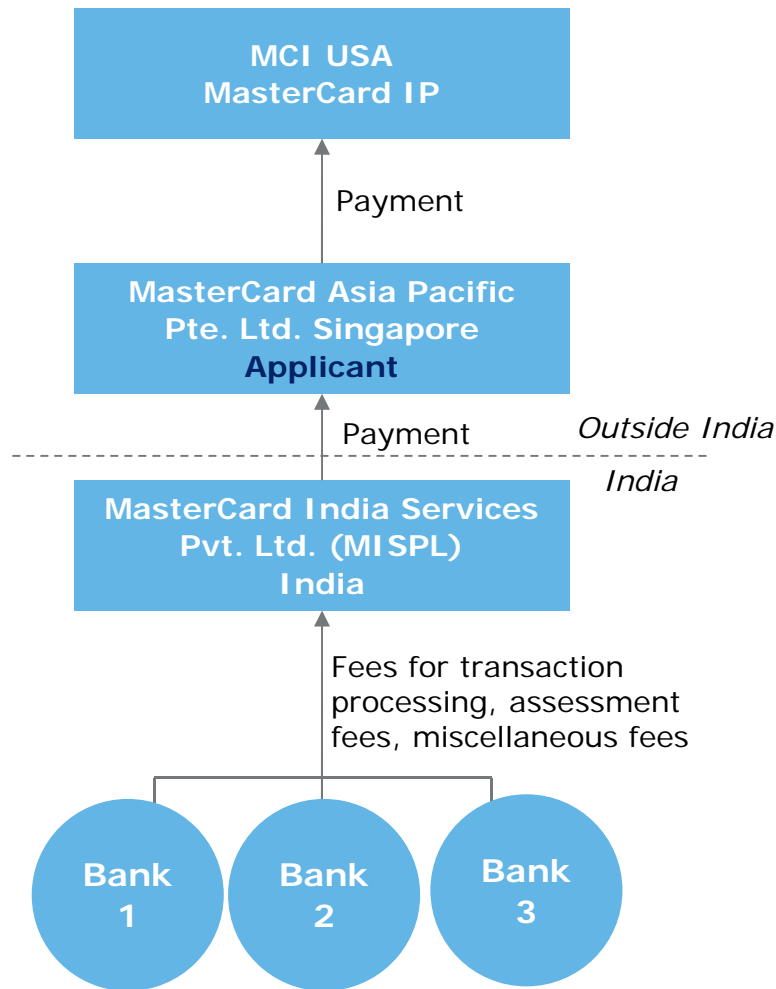
- These employees render services to the applicant on behalf of the bank.
- They receive salary for this work from the bank and are not employees or other personnel engaged by applicant.
- Hence, no PE through them.

On agency PE through MISPL

- No habitual conclusion of contracts by MISPL on behalf of applicant
- On facts, AAR concluded that MISPL habitually secured orders for the applicant which was a criterion for PE creation in the India-Singapore tax treaty.
- Some activities done by MISPL for securing orders - providing proposals prepared by applicant to Indian banks, transmission of counter proposals and changes to proposals between applicant and customers in India, acceptance of order/ agreement from customer for applicant.
- Hence, applicant had agency PE through MISPL

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



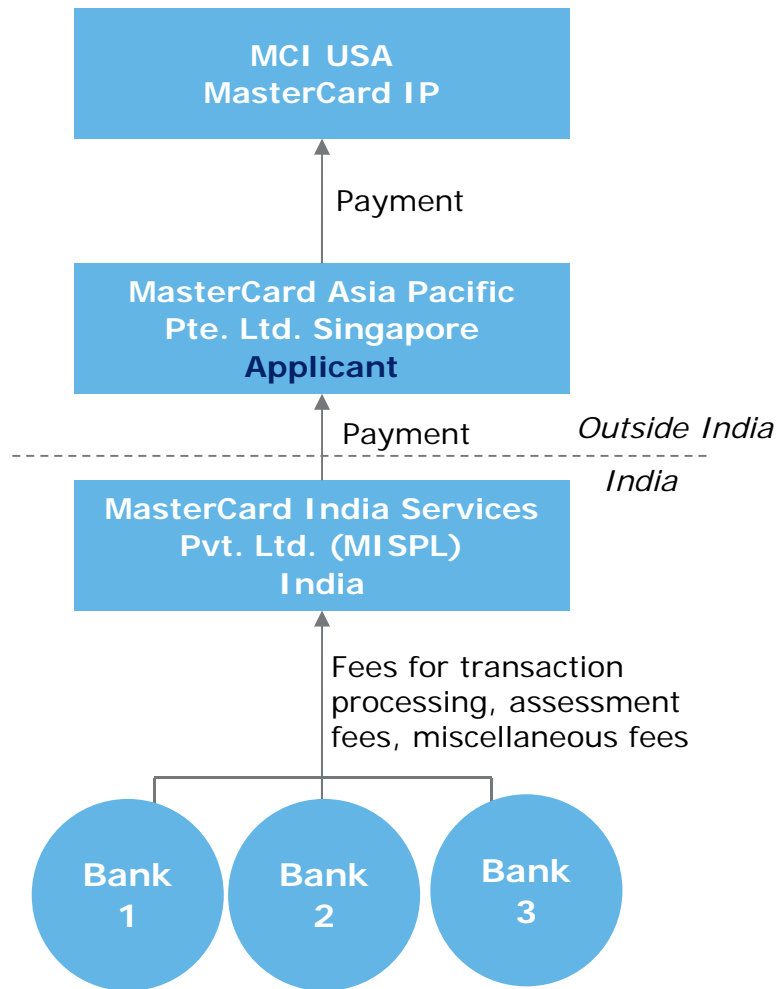
Royalty

Whether fees paid by customer banks is royalty under the India-Singapore tax treaty?

- Use of MasterCard logo on cards of customer banks was not incidental.
- For the banks, it helped in building a trust factor in customers and increase sales which in turn would profit the applicant by way of increased transactions.
- Huge advertisement expenses also incurred for promotion in India.
- This established that use of brand MasterCard was not incidental.
- Royalty also paid by applicant to MCI US who was the owner of IP.
- Hence, payment in question was royalty. Being effectively connected to the PE in India, was taxable under Article 7 of the treaty and not Article 12.

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)



On equipment, process and software royalty for MIPs and MasterCard network

- MIPs are not legally transferred to MISPL and hence, ownership continues with the applicant
- Control – domestic law reference to Explanation 5 to section 9(1)(vi). Control need not be with applicant.
- Held to be equipment royalty
- Patents sought for various types of transaction processing in India.
- Patented process are not known to public and hence secret process, payment for which constitutes royalty.
- It is not necessary that this secret technology is licensed to customer banks. It is sufficient if secret process is used, as the definition of royalty in India- Singapore DTAA classifies use of secret process as royalty.
- The use of software inside MIP, and cards in the application software are essential part of the transaction without which no transaction can be completed.
- Hence, it is software royalty as well

MasterCard Asia Pacific Pte. Ltd., In re.

[2018] 94 taxmann.com 195 (AAR - New Delhi)

Transfer pricing – PE profit attribution

- In the case of a fixed place PE, if TP analysis does not adequately reflect the functions performed and the risks assumed by the nonresident enterprise, there would be a need to attribute further profits [Reiterated in recent SC judgement in Honda Motor Co. Ltd. v. ADIT [2018] 301 CTR 601 (SC)]
- Even in case of a dependent agent PE in this case, there is need for further attribution since all the functions/risks are not reflected in the FAR of MISPL.

Others

On group restructuring being a colourable device

- Revenue contended that there was no business purpose for reorganization. Operations of applicant in India remained same post reorganization from LO to subsidiary but income offered to tax reduced from 50% of Indian revenue to 2.5%. Hence, there was suppression of income and reorganization was only done to reduce tax liability.
- On facts, there were commercial reasons for the restructuring. Hence, it was not a colorable device.
- It is not for the Revenue to take business decisions for the applicant. They can only be taken by the business itself keeping its business interests in mind, in terms of profitability, efficiency and expediency.
- Unless a reorganization serves no other purpose except bypassing tax laws, no adverse inference can be drawn by the Revenue.

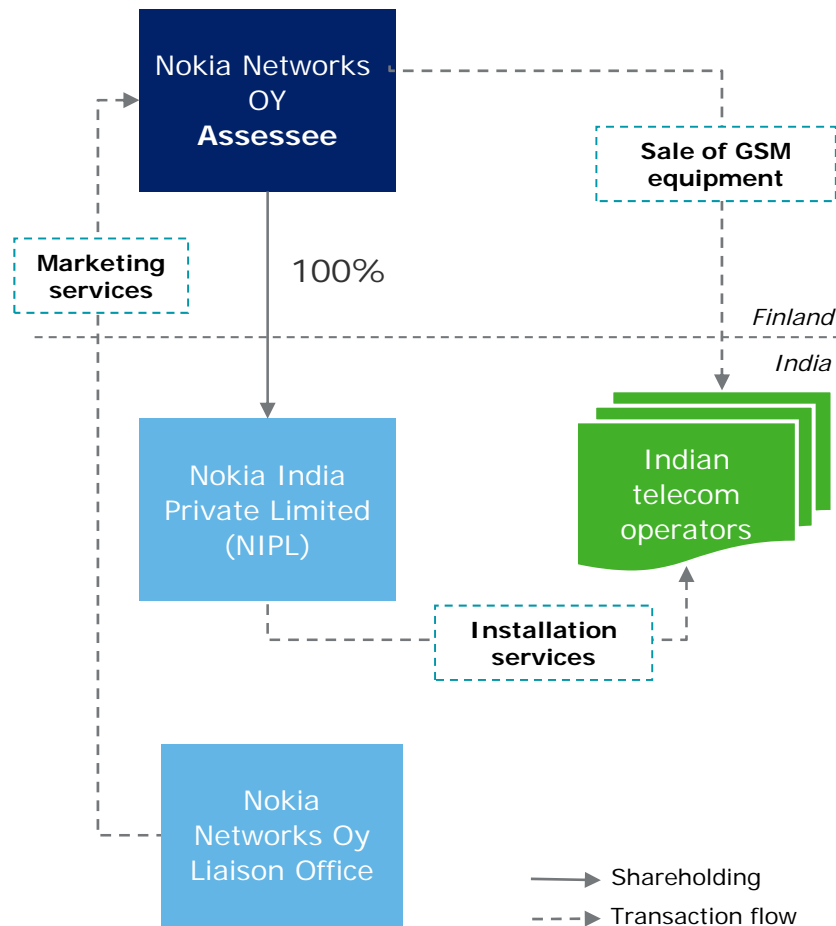
On whether fees paid to applicant is FTS

- Transaction processing service has to be seen from the perspective of the ultimate user who is the bank's customer. For that customer, it is a standard facility and hence, not FTS.
- Other services like warning bulletin fees for listing invalid or fraudulent accounts, account and transaction enhancement services, etc. are not standard but in absence of make available (requirement of treaty) they cannot be taxed as FTS

Nokia Networks OY v. JCIT
[2018] 94 taxmann.com 111
(Delhi - Trib.) (SB)
Subsidiary PE

Nokia Networks OY v. JCIT

[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)

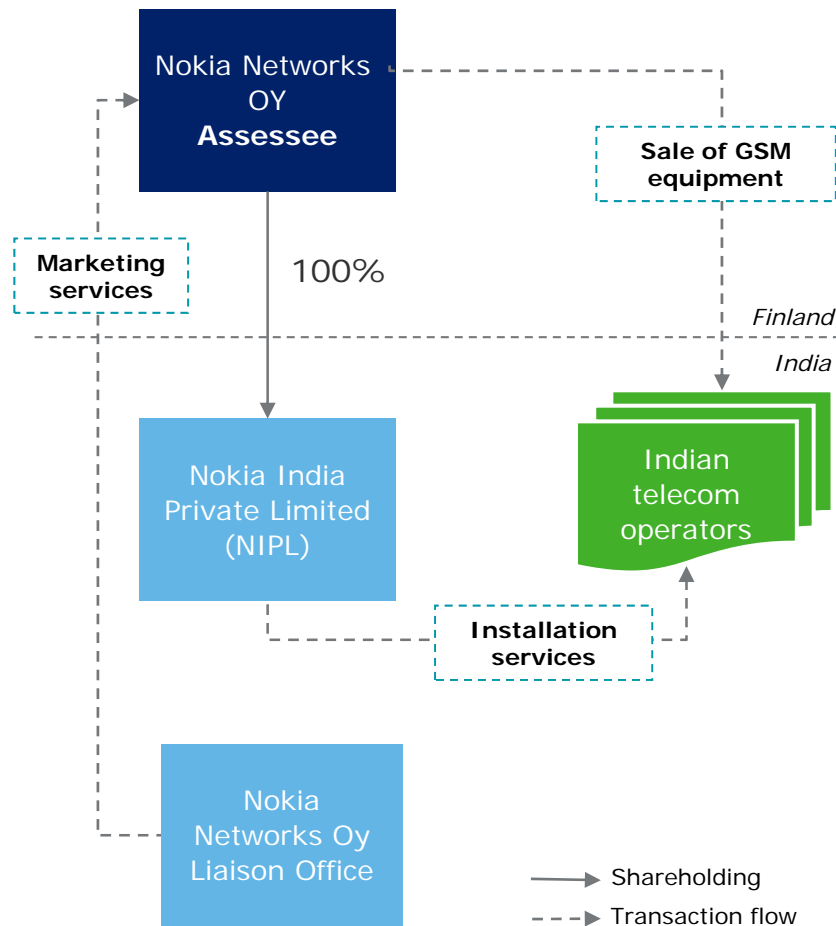


Facts

- AY 1997-98 and 1998-99
- Nokia Networks OY (Nokia), tax resident of Finland, is engaged in manufacture of advanced telecommunication systems and equipment (GSM equipment) used in fixed and mobile phone networks
- In 1993, Nokia established a liaison office (LO) in India to carry out advertising activity
- Nokia sold equipment manufactured in Finland, to Indian telecom operators, on a principal-to-principal basis and also entered into installation contracts
- Subsidiary Nokia India Pvt. Ltd. (NIPL) was established in 1995. Thereafter, installation activities (including existing contracts) were carried out by NIPL
- Undertaking was given by Nokia to the customers on the performance of NIPL and that ownership of NIPL will not fall below 51% without the consent of customers in the event of non-performance by NIPL
- Employees of the assessee company were seconded to I Co for installation contract of I Co, and their salaries were paid by the assessee.

Nokia Networks OY v. JCIT

[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)



Issues

- Whether the subsidiary of Nokia would constitute business connection or PE in India
- If yes, can there be any attribution of profits on account of signing, network planning and negotiation of offshore supply contracts in India, and if yes, what is the extent and basis thereof

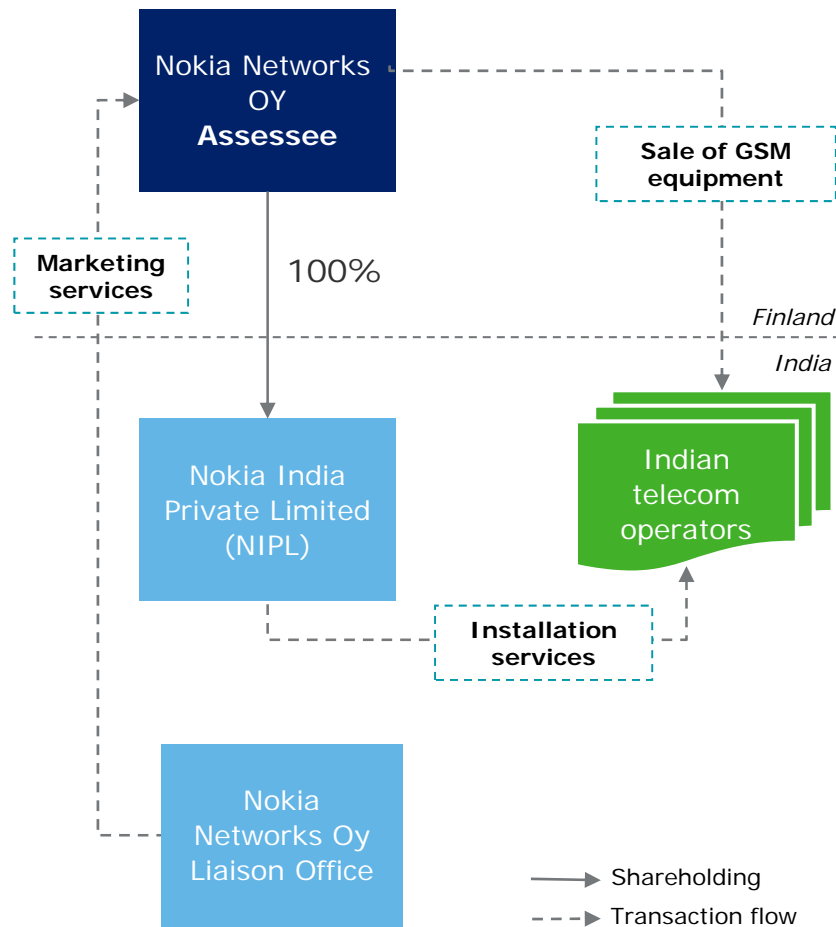
Findings – Majority view

On fixed place PE

- No categorical findings by lower authorities that Fixed Place PE exists qua Indian subsidiary NIPL
- Disposal test is paramount – Formula One (SC)
- Fixed place PE does not get established by making reference to provision of telephone, fax and car facility to visiting employees
- After incorporation of NIPL, Nokia has not carried out any activity other than offshore supply and any activity performed by NIPL under independent contract cannot constitute a PE.
- NIPL entered into installation contract directly with customers (although guarantee was given by Nokia), the income from which was offered to tax in its hands

Nokia Networks OY v. JCIT

[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)



- Activities carried out by employees of Nokia travelling to India i.e. network planning, negotiation and signing of contracts are preparatory and auxiliary in nature.
- The concept of “virtual projection” flows from a fixed place.
- Such concept is not relevant alone and has to be seen in relation to fixed place or any other concept of PE.
- In the present case, as there is no establishment of a fixed place, the virtual projection itself cannot be held to be a factor for creation of PE

On subsidiary constituting PE

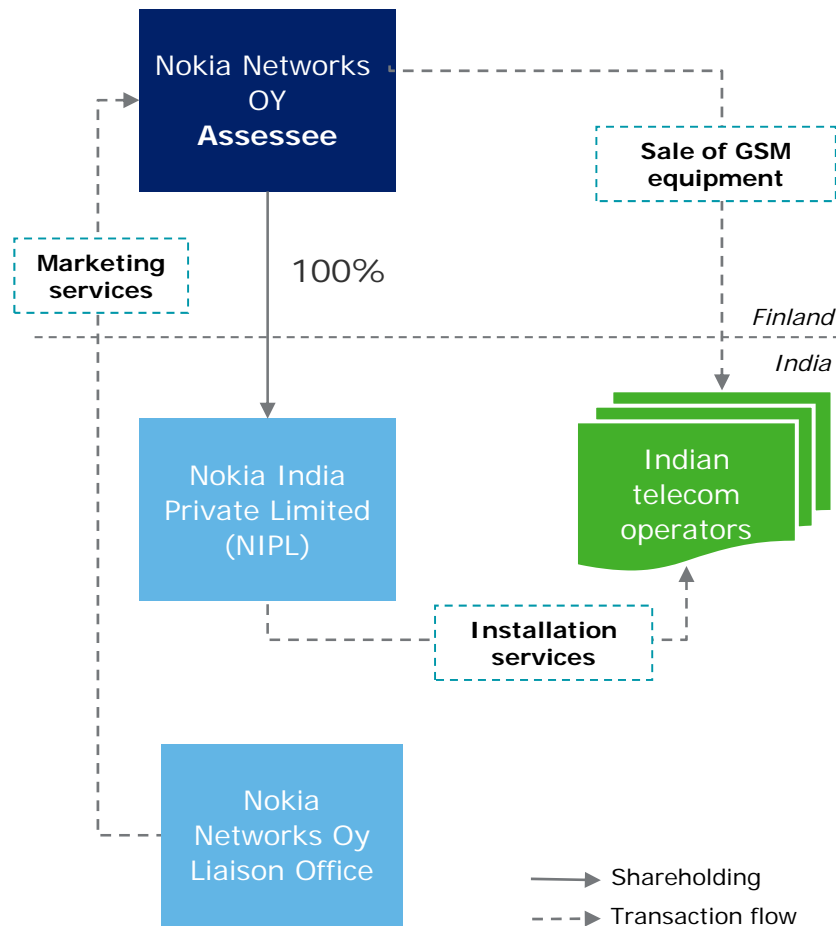
- Subsidiary cannot be reckoned to constitute PE, merely because it is controlled by Nokia
- Guarantee does not yield income to the assessee.

On Agency PE

- Qualified character of agency PE is authorization to act on behalf of somebody so as to conclude the contracts
- There is no material on record that NIPL has negotiated or concluded any contract of supply of equipment on behalf of Nokia which binds Nokia

Nokia Networks OY v. JCIT

[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)



- The marketing support agreement is an independent agreement between Nokia and NIPL, for which NIPL is remunerated at arm's length; and activities of this agreement do not relate to supply of equipment.
- Thus, the question of NIPL exercising any authority to conclude contracts on behalf of Nokia does not arise

On Service PE

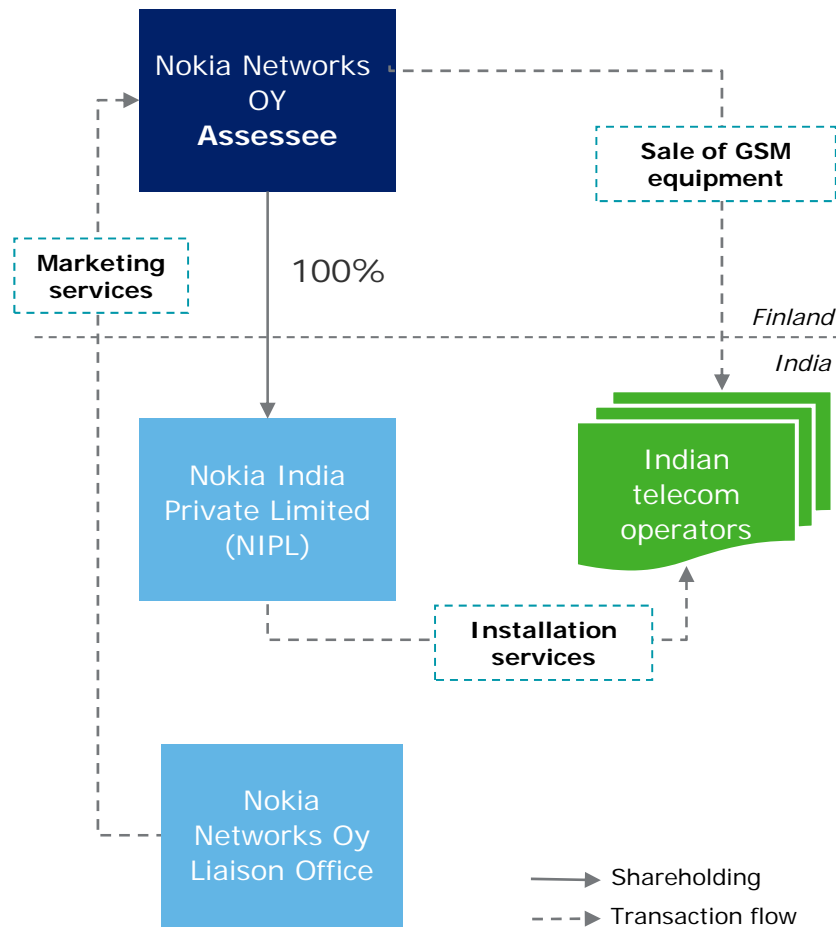
- No service PE clause in India-Finland treaty for the concerned assessment year

On business connection

- Once PE question answered under treaty, examination of business connection under the Act is academic.
- In the context of LO, High Court had decided that it did not create a business connection or PE of Nokia in India. Also, supply of offshore equipment, which had been done outside India was held to be not taxable in India.
- Even in a composite contract, supply is to be segregated from installation.
- Possession till final acceptance does not result in taxability.
- These principles would mutatis mutandis apply to NIPL as there is no material change in the facts

Nokia Networks OY v. JCIT

[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)



Findings - Dissenting member view

- When a subsidiary company is merely an alter ego, or virtual projection of its parent company, in the sense that it has no significant activities of its own or on behalf of persons other than the non-resident parent company, it must be treated as a PE of the parent company in India
- Marginal relief granted by reducing quantum of profits attributable to the PE

Nokia Networks OY v. JCIT

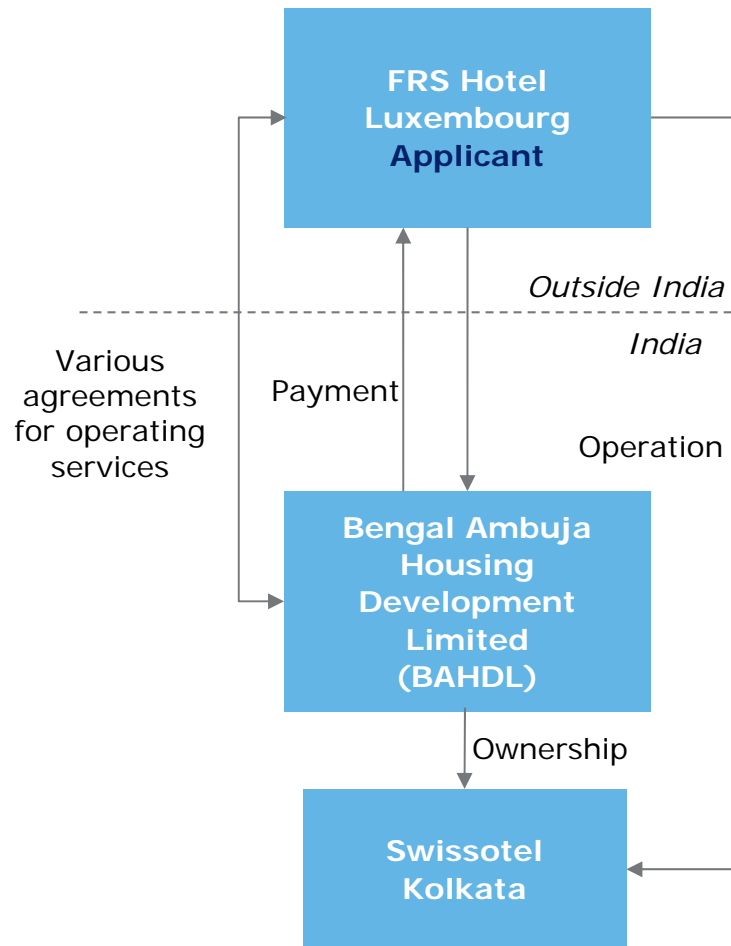
[2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)

Features of 'alter ego' conclusion

- For all the contracts signed by I Co with the third parties for installation, the equipment / machines were sold by the parent F Co
- Agreement between the I Co and third parties provided that I Co had significant experience in installation work, though I Co is recently incorporated
- Key employees of I Co were all employees of the F Co seconded to India.
- Performance guarantee given by F Co to the customers of I Co (i.e. those entities to whom F Co had sold machines / equipment) to the effect that I Co will do the desired installation work correctly
- Assurance given by F Co to the customers of I Co that F Co will not dilute its stake below 51% without prior consent of customers
- In absence of guarantee related to installation, the transaction for sale of complex equipment may not happen.
- No consideration given by I Co to F Co for the performance guarantee given by the F Co. This was not commercially justifiable as there was no remuneration for the function and risk undertaken by the F Co
- Control of operations of I Co by F Co
- Any notice sent by the I Co's client to I Co was also required to be sent by such client to the F Co.
- F Co was required to compensate I Co at cost plus 5% and the contract between the two provided for quarterly billing. Invoices were not raised regularly. The delay in raising invoice meant that return on the cost incurred by I Co was not at arm's length and did not even cover the time value of the cost incurred by I Co.
- Installation services rendered to the Indian customers by I Co resulted in huge losses for I Co – F Co artificially allocated lesser amount of the total consideration for the activities to be performed by I Co
- Incorporation of I Co. was a device to artificially block creation of a PE
- No consideration charged for support services
- OECD approach on whether subsidiary is a PE is not binding. Disposal test not applicable.
- "Indirect PE"

FRS Hotel Group (Lux) S.a.r.l.
In re [2018] 94 taxmann.com
23 (AAR - New Delhi)
PE of operator

FRS Hotel Group (Lux) S.a.r.l. *In re* [2018] 94 taxmann.com 23 (AAR - New Delhi)



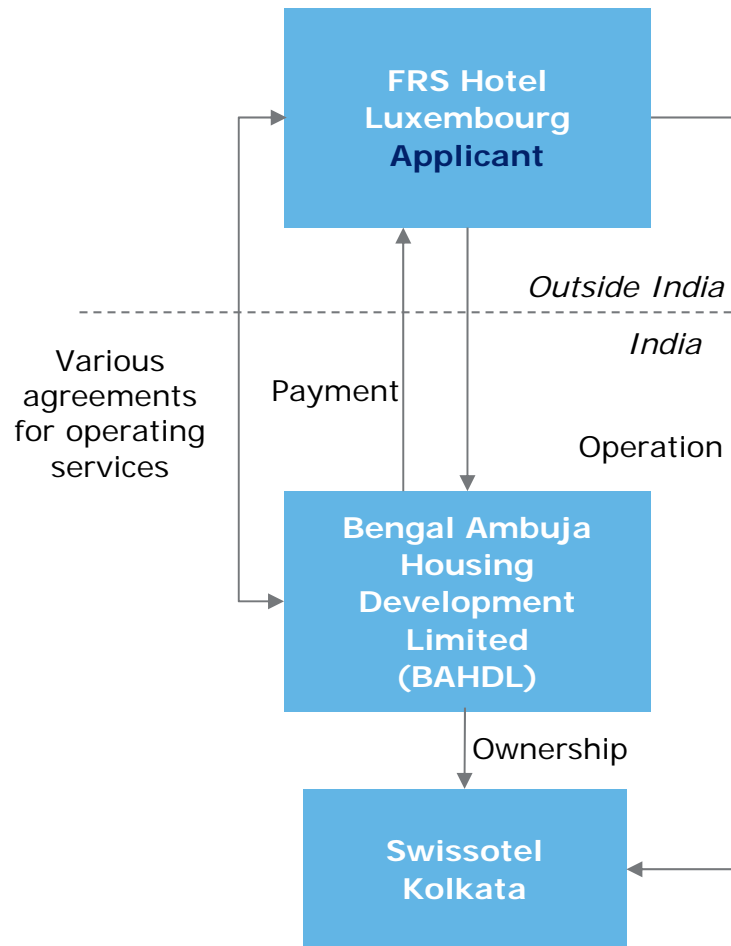
Facts

- Applicant was a part of FRS Hotel group and principal operator of the group outside North America
- It provides services in connection with hotel management, including all services that are necessary for hotel operation.
- BAHDL, owner of Swissotel, enters into various agreements with the applicant for services relating to different phases of hotel development and operation of Swissotel.
- The main agreement is the Centralized Services Agreement (CSA)
- Some examples of services provided by applicant include facilitation of reservation/booking of rooms, global sales & marketing, finance support, human resources support, operations support, advisory services in connection with capital improvements, including refurbishing, maintenance, etc.

Issue

- Whether payment made by BAHDL constitutes FTS or Royalty under the provisions of the Income-tax Act, 1961, read with the India-Luxembourg tax treaty

FRS Hotel Group (Lux) S.a.r.l. *In re* [2018] 94 taxmann.com 23 (AAR - New Delhi)



Findings

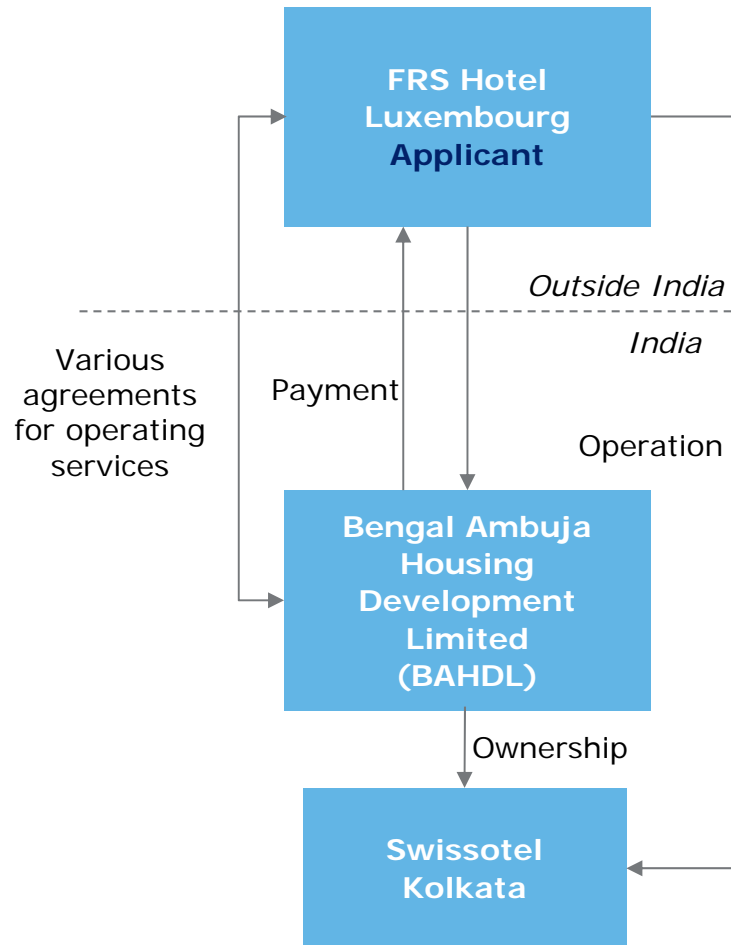
On whether AAR can decide on a question not directly raised by the applicant

- In deciding on an issue, all business aspects need to be looked at. Hence, determination of existence of a PE was important in this case.
- Reliance on Rule 12 of Authority for Advance Rulings (Procedure) Rules, 1996

On whether applicant had a PE in India through Swissotel

- The AAR studied relevant clauses of all agreements in detail
- Three important conditions for existence of a PE – fixed place, disposal and non-resident carrying on business through such fixed place.
- Swissotel is a fixed place
- Swissotel is at the disposal of applicant. Applicant is to oversee the construction and design of hotel to ensure that it is compliant with its brand standards.
- Applicant and its employees had right to access all parts of the hotel at all times as considered necessary.

FRS Hotel Group (Lux) S.a.r.l. *In re* [2018] 94 taxmann.com 23 (AAR - New Delhi)



Findings (contd...)

- On facts, the entire operation and management function of Swissotel was with the applicant, including core functions like booking and sales and marketing
- BAHDL has undertaken that it will not interfere in the applicant's exercise of the exclusive authority over such operation and management.
- These agreements were for 10 years, and could be further extended.
- Owner BAHDL was barred from even contacting any of the hotel staff directly, with few exceptions.
- Thus, applicant was carrying on its entire business from the premises of Swissotel.
- Hence, it had a fixed place PE in India
- The relationship with BAHDL was on principal-to-principal basis and hence, applicant was not a dependent agent of BAHDL
- Since there was a PE, determination of whether the payment for all these services was royalty or FTS was irrelevant

Question & Answer

The views expressed in this presentation are that of the presenter in his individual capacity.