Case studies based on recent landmark rulings on International taxation

WIRC

CA. Vispi T. Patel

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Contents

- Brief Background
  - Scope of Total Income
  - Concept of Business Connection- Section 9 (1) of the Income Tax Act
  - Income Deemed to Accrue or arise in India
- Principles of Profit Attribution to a Permanent Establishment and relevance of Arm's Length Standard
- Case Study based on important / recent Case laws
  - Morgan Stanley & Co.
  - Tiger Global International II Holdings, In re
    - Sufficiency of TRC
  - Daikin Industries Ltd. v. ACIT
    - Other important Rulings on Profit Attribution
  - UOI v. U.A.E. Exchange Centre
- COVID-19 and its impact

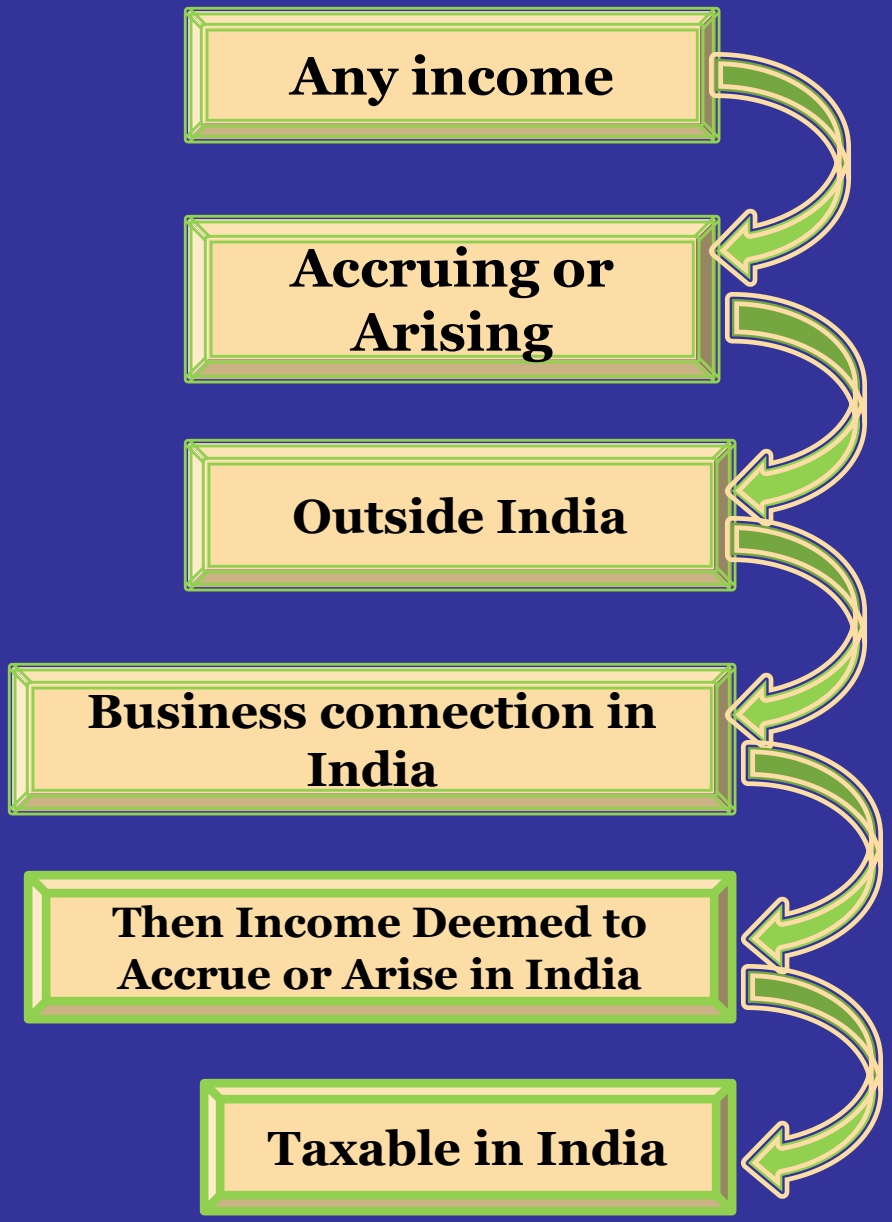
Brief Background

Scope of Total Income - Non-Resident

- Section 5(2) provides the scope of taxable income of the non-resident. Brief background on profit attribution to the PE

- The scope has been defined to include income from whatever sources which:
  - Is received or is deemed to be received in India.
  - Accrues or arises in India
  - *Is deemed to accrue or arise to him in India*

Concept of Business connection



Incomes deemed to accrue or arise in India / Business Connection

- Section 9 provides the incomes which are deemed to accrue or arise in India

- The business income of the non-resident which is deemed to accrue or arise in India and hence is taxable in India is all those incomes accruing or arising, whether directly or indirectly, through or from *any business connection* in India.

- Thus, the existence of the business connection is the *sine qua non* for taxing the business profits of the non-resident

Incomes deemed to accrue or arise in India / business connection.....

- If there be a business connection in India, the whole of the profit accruing or arising from the business connection is not deemed to accrue or arise in India. It is only that portion of the profit which can reasonably be attributed to the operations of the business carried out in India, which is liable to income tax

- ... CBDT Circular No. 23 dt. July 27, 1969

Principles of Profit Attribution to a Permanent Establishment and relevance of Arm's Length Standard

The concept of Permanent Establishment (PE)

- Section 90 of the Income-tax Act, 1961 provides for the concept of Permanent Establishment (PE). It enables the non-resident to not pay any tax on its income earned from a source country if it does not have a PE in the source country, even when it has a business connection in India

- Article 7 of the DTAA mandates the existence of a PE, apart from the business connection, so as to giving taxing rights to the source country in respect of the income attributable to he source country

- Article 5 has defined PE basically to mean *"a fixed place of business through which the business of an enterprise is wholly or partly carried on"*

Business profit under Article 7

- Article 7(2) further states that:
  - *in case there is a PE of the non-resident enterprise in the source state, then the profits attributable to the PE would be the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's length with the non resident enterprise of which it is a permanent establishment …*
- Thus, the profits attributable to the PE have to be at ALP as per the DTAA
- Further Rule 10 of the Income-tax Rules, 1962, also provides for the computation methodology to be adopted for determining the profit attributable to the PE in India

Judicial Thinking on Attribution of Profits

" In the absence of some statutory or other fixed formula, any finding on the question of proportion involves some element of guesswork. The endeavor can only be to be approximate and there cannot in the very nature of things be great precision and exactness in the matter."

...Hukumchand Mills Ltd (103 ITR 548) (SC)

Attribution of profits.... Guesswork?

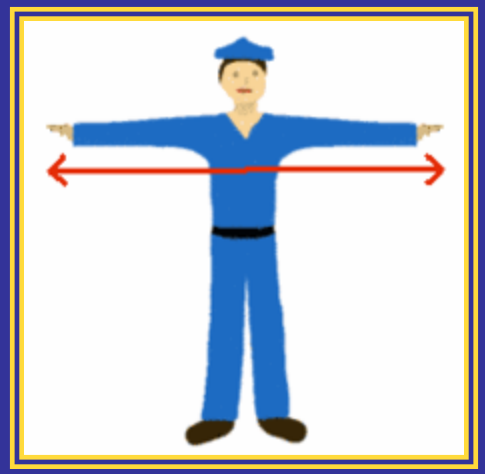
Profit Attribution to PE –key points

- Key takeaways for attribution of Profit to the PE:
  - Computation or presumptive method can be followed to compute taxable income
  - Under Computation Method only profits attributable to PE taxable in source country
  - Books of account maintained by PE to be considered to work out actual income attributable to PE
  - In the absence of books or rejection thereof Rule 10 can be applied (Results should be in line with Article 7)
  - Tax rate applied as applicable to foreign companies

The Arm's Length Standard (ALS)

- The History and underlying policy rationale of the ALS can be traced to the PE principle of treating the PE as a fictionally separate and distinct entity for attributing profits

- This ALS is the central feature of the Transfer Pricing Regulations (TPR) world over



The Arm's Length Standard .....

- Economic Rationale - FAR Analysis
- The Principle of FAR Analysis
- Analysis of Business Purpose is to:
- Understand the method of remunerating the business activities
- Comparable Analysis
- Benchmarking
- Same Analysis can be used to attribute profits to a PE
- Report on profit attribution by OECD

Methodology to attribute profits to PE on an Arm's Length basis

FACTUAL & FUNCTIONAL ANALYSIS

To determine the Functions, assets and risks and economic relevant conditions under which the PE acted (Book entries are not determinative of F & F Analysis actually it is other way round, and that the BE should have consistent flow from the F &F Analysis)

Determination of the Transactions of the PE and the mother enterprise based on comparability analysis of the TPR by Analogy?

Comparison of dealings between the PE and the Mother Enterprise With that of Independent Enterprises?

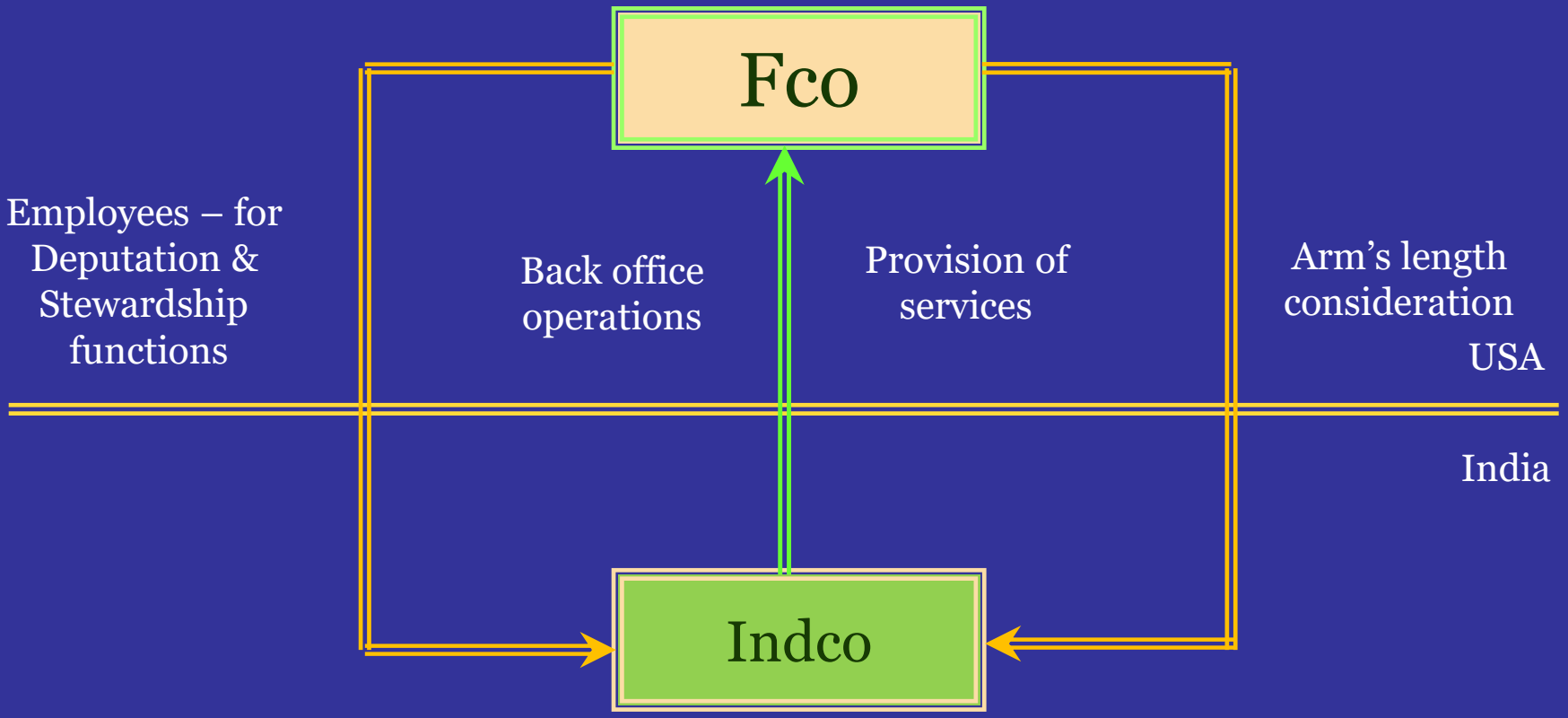
Determination of an Arm's Length return to the PE

Case Study – Morgan Stanley & Co.

Supreme Court (SC)

(292 ITR 416)

Important Decision - Morgan Stanley & Co. – Supreme Court (292 ITR 416)



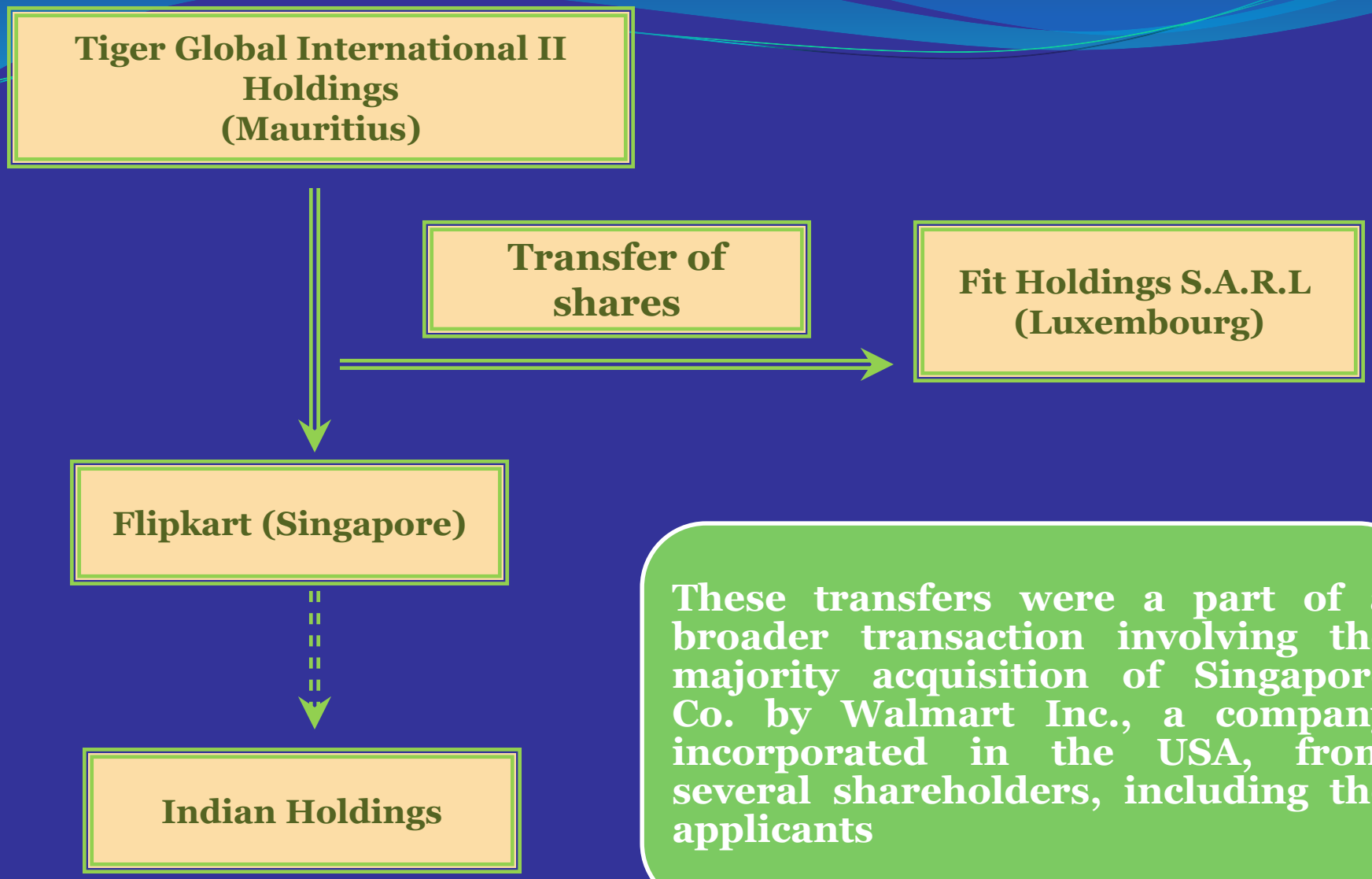
- Held, Foreign company (Fco) was not carrying out any business in India. The Indian Company (Indco) was rendering back-office operations in India and such functions were considered as preparatory and auxiliary in nature within the meaning of India US Treaty. Hence, no Fixed place of business was constituted under Article 5(1) of the treaty

Morgan Stanley & Co.

- The SC analyzed the facts of the case and held that the assessee did not have a fixed place PE and Dependent Agent PE in India.
- However the SC also held that the assessee had Service PE in India as per Article 5(2)(l) of the India-USA DTAA, though only on the account of the services to be performed by the deputationists deployed by the assessee and not on account of stewardship activities.
- On the aspect of profit attribution, the SC importantly also held that :
  - *"...Insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE"* ***This principle is considered to be the cornerstone for all the cases where profit attribution to the PE is required to be carried out***

Tiger Global International II Holdings, *In re*

AAR Ruling


Tiger Global International II Holdings (Mauritius)
Transfer of shares
Fit Holdings S.A.R.L (Luxembourg)
Flipkart (Singapore)
Indian Holdings
These transfers were a part of a broader transaction involving the majority acquisition of Singapore Co. by Walmart Inc., a company incorporated in the USA, from several shareholders, including the applicants

Tiger Global International II Holdings, *In re*
AUTHORITY FOR ADVANCE RULINGS, NEW DELHI

- Facts of the case :

- The Applicants are private company limited by shares incorporated under the laws of Mauritius
- They were set up with the primary objective of undertaking investment activities with the intention of earning long term capital appreciation and investment income.
- The applicants held shares of Flipkart Private Limited, a private company limited by shares incorporated under the laws of Singapore (for short "Singapore. Co").
- Singapore Co, in turn, had invested in multiple companies in India and the value of the shares of Singapore Co was derived substantially from assets located in India.

Facts of the case : Continued...

- Facts of the case :
- Applicants sold shares of Flipkart to Luxembourg based company as a part of acquisition of Flipkart by Walmart Inc. The Applicants have filed application u/s 197 seeking lower withholding certificate from tax authorities at Nil rate.
- The application was passed by tax authorities with higher rate on ground that the capital gains exemption under India-Mauritius DTAA was not available to the applicants as Mauritius entities are just a 'see through entity' and thus, not eligible for treaty benefit.

Important dates

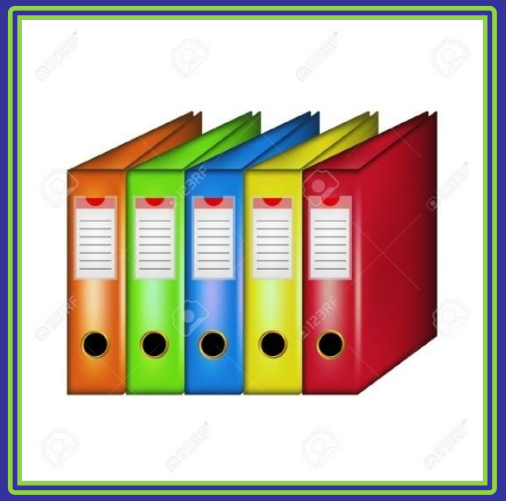
Particulars	Date
Date on which lower withholding application filed	02.08.2018
Date on which order u/s 197 passed	17.08.2018
Date of transaction	18.08.2018
Date of filing application to AAR	19.08.2019

Issues Addressed

- Whether the application for advance ruling can be admitted by the Authority u/s 245R of the Act?
- Whether determination of Fair Market Value (FMV) is involved?
- Whether the application for advance ruling relates to a transaction designed *prima facie* for avoidance of income tax?
- Whether the transaction of transfer of shares chargeable to tax in India as per India-Mauritius DTAA?

Held- Admission of application u/s 245R

"The provisions of the Act do not provide a bar that an applicant can't approach this Authority after the matter has been examined in the proceeding u/s 195 or u/s 197 of the Act. The bar is only in respect of *pending proceeding* and as already discussed earlier there was no pending proceeding on the date of filing of present applications"



Held : Determination of FMV

"The exercise of valuation of shares (if at all necessary) and the computation of capital gains has to be undertaken by the assessing officer only when the issue of taxability of capital gain on sale of shares is decided in the favour of the revenue."

We do not find any involvement of determination of Fair Market Value of any property (shares) in the question raised in the application.

Principle contentions of the Applicant with respect to Treaty benefits

- A claim for treaty eligibility does not tantamount to tax avoidance
- It is a settled principle that a treaty is to be interpreted in good faith.
- A mere fact of obtaining a TRC to avail the treaty benefits does not make it a colourable device for tax avoidance (Vodafone SC)
- No artifice or device employed and, therefore, there was no question of any tax avoidance

Held : Transaction designed prima facie for avoidance of tax

- The contention of the applicants that the transaction involved in the present application was sale of shares simpliciter undertaken between two unrelated independent parties which cannot be considered as being designed for avoidance of taxis *too simplistic to be accepted*
- No FDI made in India, therefore no question of participation in investment
- The immediate investment destination was in Singapore and not in India.

Held : Transaction designed prima facie for avoidance of tax

- No strategic foreign direct investment in India
- No business operation in India or generation of any taxable revenue in India
- The actual control and management of the applicants was not in Mauritius but in USA with Mr. Charles P. Coleman, the beneficial owner of the entire group structure.
- In the absence of any direct investment in India one can only conclude that the arrangement was a pre-ordained transaction which was created for tax avoidance purpose and to claim benefit under the India - Mauritius DTAA

Held : Transaction designed prima facie for avoidance of tax

- Since one US based person was the beneficial owner of entire group structure, the applicant companies were only a 'see-through entity' to avail benefits of India-Mauritius DTAA
- Even though tax residency is established, no other investment apart from shares of Flipkart have been made
- The fact remains that what the applicants had transferred was shares of Singapore Company and not that of an Indian company
- The AAR held that *"The objective of India-Mauritius DTAA was to allow exemption of capital gains on transfer of shares of Indian company only and any such exemption on transfer of shares of the company not resident in India, was never intended by the legislator"*

Another recent case where Treaty benefits denied under India-Mauritius DTAA

- In a similar case, ***Bid Services Division (Mauritius) Ltd., In re*** **([2020] 114 taxmann.com 434 (AAR - Mumbai),** which was a part of a consortium entered into a JV to undertake the development and maintenance of Mumbai Int'l Airport Ltd.
- The Mumbai Bench of AAR concluded that the entity served as a mere conduit for routing funds for South Africa based holding companies, thus denying treaty benefits
- Ruled that the applicant is not entitled to benefit under article 13(4) of Indo-Mauritius DTAA in regard to gains arising from the transaction of sale of shares

Contrary decisions in favour of Mauritian entities

- It will be unfair to not bring out some of the recent judgments wherein the benefit of India Mauritius Tax Treaty was granted to the entity

  - **CIT v. JSH (Mauritius) Ltd.** - Shares held in Tata Industries Ltd. were transferred. The AAR held that the taxpayer is entitled to tax treaty benefits

  - **AB Holdings – Mauritius II** – Transfer of shares to AB Singapore. AAR held that it would not like to interfere with the benefits available to the applicant as investments made were not for the purpose of tax avoidance.

Sufficiency of TRC

- Can DTAA benefit be denied merely due to non-furnishing of TRC u/s 90(4) of the IT Act particularly if the circumstantial evidence demonstrates that the assessee is eligible for DTAA benefits?

- While in the case of **AB Holdings – Mauritius II,** the AAR agreed that the applicant possessed a valid TRC and was not a *mere fly-by-night operator,* in the closely connected case of **AB Mauritius**, even though the applicant possessed a valid TRC, it was denied treaty benefits by the AAR

- In the case of Skaps Industries India Pvt Ltd., It was held that :
  - An eligible assessee cannot be declined the Treaty benefits if it is unable to furnish TRC but production of such TRC by itself may not be sufficient

Some Recent Rulings that addressed the issue of sufficiency of TRC

Skaps Industries Pvt. Ltd. [2018] 94 taxmnann.com 448 (Ahmedabad – Trib.),	**Sreenivasa Reddy Cheemalamarri [TS-158-ITAT-2020(HYD)]**	**SERCO BPO Pvt. Ltd. [Civil Writ Petition No.11037 of 2014 (O&M)]**
The provision of section 90(4) cannot override the provision of the DTAA and accordingly if the condition prescribed under the relevant DTAA are fulfilled, then the assessee cannot be denied benefits of the DTAA.	If the assessee with circumstantial evidences demonstrates that he is a resident of the other state, the provision of section 90(4) ought to be relaxed and accordingly the claim of the assessee should not be rejected merely on the ground of non-furnishing of TRC.	Tax Residency certificate issued by a foreign state can be considered as valid for the purpose of determining taxability of companies incorporated and engaged in the said state

Sufficiency of TRC

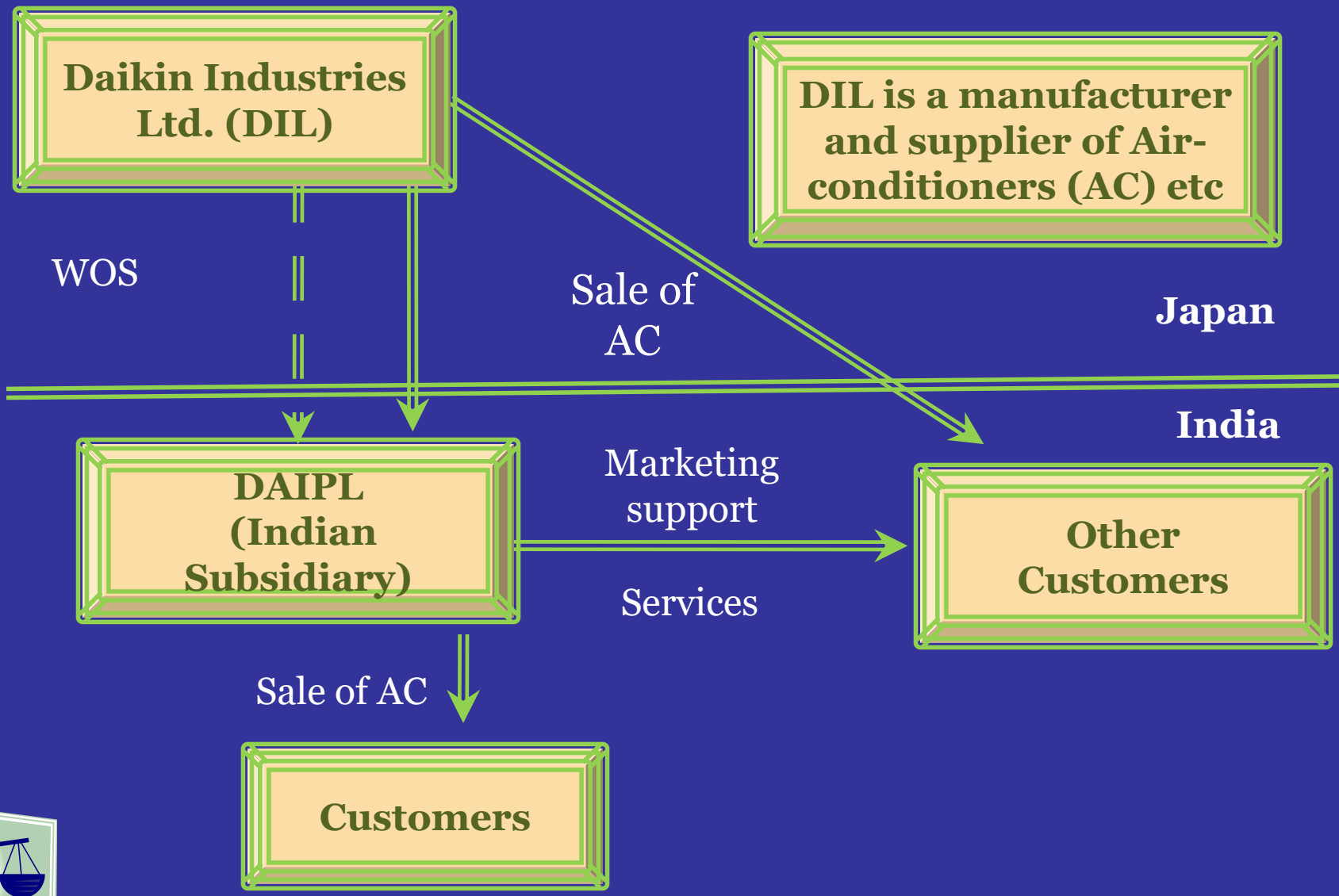
- The CBDT had issued Circular No. 789 in April 2000, which clarified that a certificate of residence issued by the Mauritian authorities will constitute sufficient evidence of residence, as well as beneficial ownership for the purpose of applying the treaty provisions

- The Supreme Court in the case of Vodafone had laid down that the tax authorities may invoke the substance over form principle to deny the benefits of a tax treaty *only after* it is established that a transaction is a sham or is designed for tax avoidance

Case Study – Daikin Industries Ltd. Delhi ITAT

[2018] 94 taxmann.com 299 (Delhi - Trib.)

Daikin Industries Ltd. v. ACIT [[2018] 94 taxmann.com 299 (Delhi - Trib.)]



Facts And Issues -Agency PE

Facts :

- DIL engaged in development, manufacture, assembly and supply of air-conditioners (AC) & refrigeration equipment
- It sold ACs to DAIPL (WOS) as well as to other third party customers in India. In addition, DIL also made direct sales to third parties in India.
- DAIPL provided various market support services and other services, forwarding customer's requests and received remuneration for its services at 10% commission from DIL
- AO held DAIPL to be Dependent Agent PE (DAPE) of DIL in India & also attributed some portion of income to DAPE in India
- Issues :
- Could DAIPL be regarded as the DAPE of DIL in India as per India-Japan tax treaty and consequently , could profits be attributed to it ?

DIL's Contentions

- The assessee contended that DAIPL was merely acting as a communication channel and its role was limited to quotations, forwarding customer's requests and giving marketing support services

- Certain employees of taxpayer regularly visited India to carry out certain activities like negotiation and finalisation of prices

Revenue's contention

- Price charged by taxpayer for goods sold directly to customers in India was higher than price charged to DAIPL
- Employees deployed in India rendered consultancy services for which DAIPL was charged separately by taxpayer
- Emails pertaining to sales transactions with customers were routed through DAIPL and not directly through taxpayer

HELD – Delhi Tribunal

- DAIPL incurred huge marketing expenditure while distributing products in India
- Based on emails exchanged between DIL and DAIPL, it was observed that DAIPL was involved in all essential activities involved in a sale transaction
- Mere signing of contracts by taxpayer outside India does not imply that related activities were performed by taxpayer
- Therefore, Tribunal held that DAIPL to be a DAPE – as it was habitually exercising authority to conclude contracts in India

Daikin Industries Ltd. (ITAT)

- <u>Profit Attribution methodology adopted by the AO:</u>
- The AO first reduced the commission paid to DAIPL (approx. 10%) from the amount of direct sales (INR 45.40 crores) by DIL to end-customers in India and determined net sale value at INR 40.86 crores;
- He then applied 79.58% (the sale price to DAIPL is 79.85% of the sale price to direct customers less commission.) and computed the price had the sales made directly to customers were instead sold to DAIPL.
- As a result, in the aforesaid case, the sale value would have been INR 32.63 crore, resulting in additional sale value earned by the DIL computed at INR 8.23 crore (40.86 – 32.63)
- The AO then allowed a expenses deduction at 5% of the sales value from the differential amount of Rs.8.23 crores and finally determined the profit attributable to the PE at INR 5.96 Crores

Daikin Industries Ltd. (ITAT)

- Observations, Analysis and Decision of ITAT :
  - The ITAT confirmed the findings of the AO and held that DAIPL was a DAPE of DIL
  - The assessee contended that even if it be considered that DIL had a PE in India by way of DAIPL, the same would be subsumed in the commission payment made by DIL to DIAPL, and hence there was no need for further attribution relying on the SC decision of ***Morgan Stanley & Co.(supra)***
  - The ITAT however distinguished the SC ruling saying that the SC decision itself had also carved out an exception to the aforesaid general rule by laying down that :

"The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered."

Daikin Industries Ltd. (ITAT)

- Observations, Analysis and Decision of ITAT :
  - The ITAT further observed that the agreement between DAIPL and DIPL stipulated commission payment for only 2 functions:
    - to forward the customers' request of procuring products from DIL to DIL
    - to forward DIL's quotation and contractual proposal to the customers
  - However, as per the factual matrix presented by DIL as well as the AO, DIAPL was performing various additional functions related to:
    - negotiating and finalizing the price and concluding the contracts in India
  - The consideration for these functions was not remunerated to the PE, and hence the principles of *Morgan Stanley & Co (SC) (supra)* could not be applied and hence further attribution of profits was required

Daikin Industries Ltd. (ITAT)

- Observations, Analysis and Decision of ITAT :
  - However, the ITAT observed that the AO's methodology of determining the profits attributable to the PE suffered from several infirmities.
  - The ITAT also mentioned that the AO's method which was based on sales value was logically incorrect.
  - The ITAT held that the correct methodology would be to first find out the profit which would have been earned by the DIL in India from the direct sale to end customers and then reduce it with the amount which has already suffered taxation in the hands of its subsidiary, DAIPL, by way of commission
  - In line with the above approach, the ITAT first determined the total net profit earned by DIL from direct sales to end-customers and then secondly work out that part of total profit computed as per the first sub-step, which relates to the operations carried out in India.

Daikin Industries Ltd. (ITAT)

- Observations, Analysis and Decision of ITAT :
  - The ITAT relied on Rule 10 of the Income-tax Rules, 1962 as well as the net profit rate given in sections 44BB and 44BBB and having regard to the facts and circumstances of the case held that the net profit relatable to the direct sales to customers in India, as per the first sub-step, would be 10% of the amount of sales
  - Further, the ITAT also placed reliance on various case laws like *Rolls Royce PLC, ZTE Corporation as well GE Energy Parts Inc.,* for the determination of the profits attributable to the PE
  - The ITAT emphasised that attribution of profits to the PE is a fact based exercise and as such there can be no hard and fast rule of determining the rate of profit attributable to marketing activities carried out in India
  - Considering the whole gamut of the facts and circumstances prevailing in the instant case, we estimate 30% of the above total profit @ 10% of the sales, as attributable to the operations carried out by the PE in India

Daikin Industries Ltd. (ITAT)

- Observations, Analysis and Decision of ITAT :
  - The ITAT finally held that considering the facts and circumstances of the instant case, 30% of the aforesaid total profit @ 10% of the sales, would be attributable to the operations carried out by the PE in India
  - Accordingly the ITAT determined an income of INR 1.36 crores as attributable to the marketing activities carried out in India
  - Further, the ITAT also directed that the net commission amount already paid would be deducted from the aforesaid amount and only the net remaining amount after deducting the commission would be considered as income of the PE and chargeable to tax in India
  - Since details of income offered by DAIPL were not available on record, the ITAT remanded the matter back to the AO with a direction to recompute the attributable profits based on the methodology prescribed above

Few other important Rulings on Attribution of profits to the PE

- Voith Paper GmbH vs. Deputy Director of Income Tax, Circle-2(2), New Delhi
  [2020] 116 taxmann.com 127 (Delhi - Trib.)

- GE Nuovo Pignone SPA vs. Deputy Commissioner of Income Tax, (International Taxation) Circle 1(3)(1), New Delhi
  [2019] 101 taxmann.com 402 (Delhi - Trib.)

- PJSC Stroytransgaz vs. Deputy Director of Income Tax, Circle 2(2), New Delhi
  [2019] 106 taxmann.com 114 (Delhi - Trib.)

- Director of Income-tax, Circle- 3 (2) International Taxation, New Delhi vs. Corning SAS
  [2018] 100 taxmann.com 385 (Delhi - Trib.)

- Deputy Director of Income-tax, International Taxation, Circle- 2 (1), New Delhi vs. Nipro Asia Pte Ltd.
  [2017] 79 taxmann.com 154 (Delhi - Trib.)

Few other important Rulings on Attribution of profits to the PE

- Arrow Electronics India Ltd. v. Addl. DIT
  [IT Appeal Nos. 209 & 210 (Bang.) of 2001]

- Shanghai Electric Group Co. Ltd. vs. Deputy Commissioner of Income-tax, Circle-3(1)(2), International Taxation, New Delhi
  [2017] 84 taxmann.com 44 (Delhi - Trib.)

- Convergys Customer Management Group Inc. vs. Assistant Director of Income-tax (International Taxation), Circle-1(1), New Delhi
  [2013] 34 taxmann.com 24 (Delhi - Trib.)

- Linmark International (Hong Kong) Ltd. vs. Deputy Director of Income-tax , Circle 3(1), International Taxation, New Delhi
  [2011] 10 taxmann.com 184 (Delhi)

UOI v. U.A.E. Exchange Center

[2020] 116 taxmann.com 379 (SC)

UOI v. U.A.E. Exchange Center [2020] 116 taxmann.com 379 (SC)

Facts and Issue :

- The assessee, a tax resident of UAE, was engaged in provision of remittance services for transferring funds from UAE to beneficiaries in India

- The assessee opened four Liaison Offices (LO) in India The expenses were met out of the funds received from its Head Office in UAE

- No fees/commission charged by LO for the services to be rendered in India

- The assessee entered into contracts with customers in UAE for provision of remittance services and received one-time fees

.....UOI v. U.A.E. Exchange Center

a) By telegraphic transfer through bank channels; or

b) On request of the customer, the assessee dispatched instruments/drafts/cheques through its LO to beneficiaries in India (While remaining connected to the server)

- The assessee had been filing its returns of income, since the assessment year 1998-99 until 2003-04, showing NIL income, as according to the assessee, no income had accrued or deemed to have accrued to it in India.

- Further, the assessee filed an application before the AAR for determining, whether the activity in the second mode of transfer would result in a taxable presence of the assessee in India.

Issues Addressed

Whether the activity of dispatching cheques/drafts to beneficiaries, by a Liaison Office (LO) in India, as per the instruction of its Head Office, could be regarded as activities of 'preparatory or auxiliary' in nature as per Article 5(3)(e) of the India-UAE DTAA, and thus the LO would not be considered as a PE of the UAE entity in India?

CONTENTION OF THE ASSESSEE

- The assessee contended that the activities undertaken by the LO, such as printing instrument/drafts and dispatching the same through courier to beneficiaries in India, are only supportive and auxiliary in nature to the main work undertaken by the assessee in UAE

- Accordingly, the assessee contended that the activities would not constitute a PE in India in view of Article 5(3)(e) of the DTAA in as much as the activities are in the nature of preparatory or auxiliary character.

CONTENTION OF THE REVENUE

- The Revenue contented that the LO assists the assessee to extend its volume of business in India and the services rendered by the LO is connected to the main services rendered by the assessee in UAE.

- Accordingly, some portion of the fees/commission charged by the assessee pertains to the services rendered by the LO in India and hence shall be deemed to accrue or arise in India.

DECISION OF AAR

- The AAR held that activities undertaken by the LO would constitute a taxable presence in India by observing without the service of the LO the assessee would not be able to render the remittance services to its customer in UAE. Further, the AAR also observed that the commission which the assessee receives for remitting the amount covers not only the business activities carried on in UAE but also the activity undertaken by the LO.

- The AAR further held that, the activities undertaken by the LO constitute a main function of the business of the assessee and hence cannot be termed as preparatory or auxiliary in nature.

DECISION OF HIGH COURT

- The HC reversed the decision of the AAR, by relying on the decision of the Supreme Court in case of Morgan Stanley & Co. [2007] 162 Taxman 165 (SC), and held that the activities undertaken by the LO are auxiliary in nature since it support/aids the execution of the main activity undertaken by the assessee in UAE and hence the LO would not be considered as a PE of the assessee in India.

DECISION OF SUPREME COURT

- The SC placed reliance on the approval given by the RBI for establishing the LO in India and observed that the LO was not allowed to enter into any contrast with any person in India nor the LO was allowed to charge any fees/commission in respect of the services rendered in India.

- The SC referred Black's Law and Oxford Dictionaries to interpret the expression 'preparatory' and 'auxiliary' and observed that the expression 'preparatory' has been defined as '*Material used in preparing the ultimate form of an agreement or statute*' and the expression 'auxiliary' has been defined as '*aiding or supporting or subsidiary or supplementary*'.

- The SC observed that Article 5(3) of the DTAA, opens with a non-obstacle clause, which indicate that notwithstanding the fact that a PE is constituted under Article 5(1) or 5(2), if the nature of activities carried by the assesssee fall within the purview of article 5(3), it would be deemed that the assessee does not have a PE in the contracting state.

DECISION OF SUPREME COURT (……continued)

- The SC observed that the RBI had given permission to the assessee to open a LO for conducting activities such as responding to enquiries from correspondent banks, reconciliation of bank accounts, act as a communication centre, printing INR drafts etc.

- The above conditions imply that the LO would not be able to undertake any commercial activities (such as charging fees/commission for its services or entering into commercial contracts) and hence the activities carried by the LO are in nature of preparatory or auxiliary character.

- Accordingly the SC upheld the order of the HC and held that the LO was not allowed to undertake any commercial activities and hence the activities were preparatory or auxiliary in nature, which did not result in constitution of a PE of the assessee in India and thereby not liable to tax in India.

Key Takeaways from the Jurisprudence

Key takeaways.....

- Key takeaways from the Jurisprudence:
  - In Morgan Stanley & Co (supra), the SC held that the assessee had a PE in India. However since the transactions of the assessee were already at ALP, no further attribution of profits to the PE was required and hence there was NIL addition to income
  - In the case of Galileo International Inc. [2009] 180 Taxman 357 (Delhi), the ITAT and subsequently the Delhi HC also held that the assessee had a PE in India. However, the profits attributable to the PE were determined as 15% of the revenue generated from the bookings made in India. The revenue generated from the bookings made in India was USD 3 and 15% of the same came to USD 0.45.

Key takeaways.....

- However the assessee was already paying its AE USD 1 and hence even though there was attribution, it was subsumed in the consideration and hence NIL addition to income

- In the case of Daikin Industries Ltd, the ITAT held that the remuneration paid by the assessee to the PE did not provide compensation for all the functions performed by the PE, and hence further attribution of profit to the PE as well as addition to the computation of income of the PE was sustained

Key takeaways.....

- Key takeaways from the Jurisprudence:
  - Thus, as business models continuously evolve as a result of technology and the digital world, and become more and more dynamic as well as complex, a corresponding change as well as care also needs to be taken to shore up the documentation of the company so that the same is in line with the actual conduct of the business.
  - Effective and transparent documentation maintained by the company would be the first line of defence as well as the best defence strategy to safeguard against any punitive action of the Tax department

COVID-19 and its Impact

OECD analysis of Tax Treaties and the impact of COVID-19

- The unprecedented situation is raising many tax issues
- As a result, the OECD had issued guidance addressing various issues including :

  - Concerns related to Creation of PE
  - Concerns related to the residence status of a company
  - Concerns related to cross border workers

COVID-19 and its impact

- The OECD released an analysis on the impact of COVID-19 in April 2020
- This report addresses the various concerns including Agency PE, residential status of employees
- It addresses concerns for employees or individuals who may be unprecedently stranded in country different from their residence
- Eg. If an individual employee is working from home could give rise to an DAPE?

→ The Report states that it is necessary to evaluate whether the activities of the employee leads to habitual conclusion of contracts on behalf of the enterprise under Article 5 of the OECD

COVID-19 and its impact

- The report clarified that an employee's or agent's activity in a State is unlikely to be regarded as 'habitual' if he/she is only working from home for a short period due to a force majeure and/or government directives impacting normal routine.

→ Further, Para 98 of the 2017 OECD Commentary on Article 5 explains that the presence which an enterprise maintains in a country should be more than merely transitory for an enterprise to be regarded as maintaining a PE in that state under Article 5

Possible issues that may lead to litigation in future

- Double residence of an entity-In such cases, tax treaties provide tie breaker rules ensuring that the entity is resident in only one of the states
- Unplanned tax implications due to the pandemic
- Residential status of individual- The CBDT issued a clarification in May 2020 for individuals who got stranded in India

Thank You