

Permanent Establishment- Recent Controversies

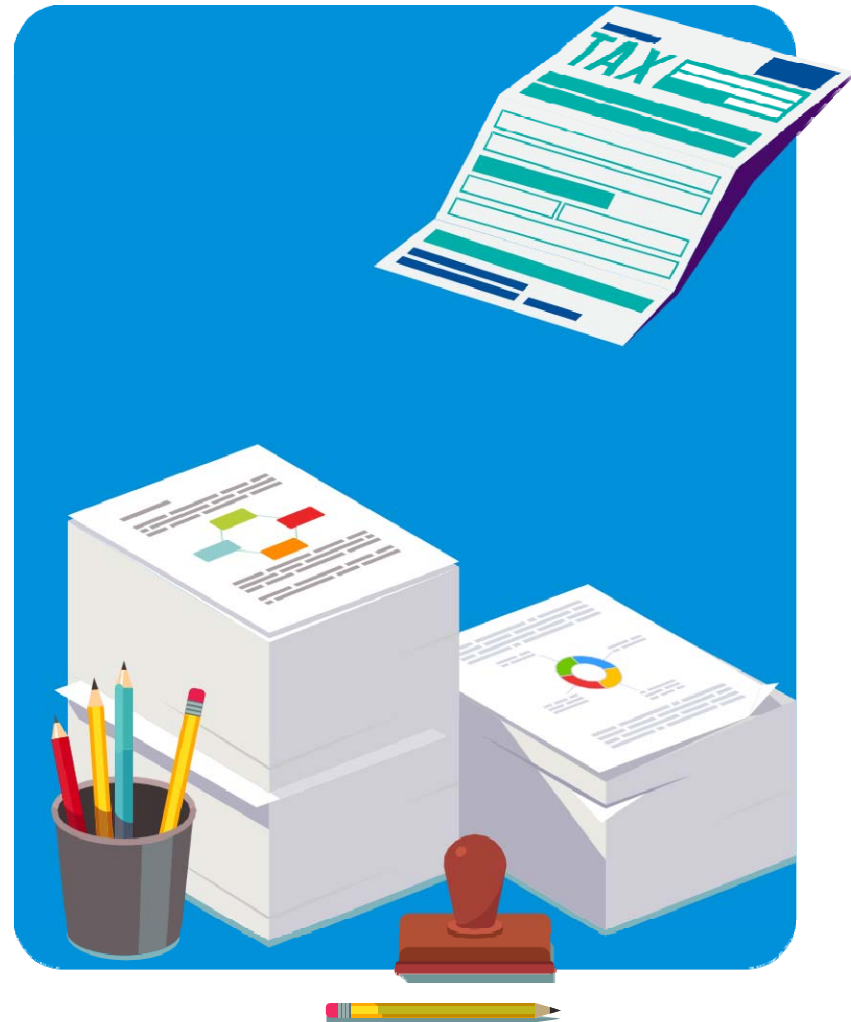
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15 December 2018



Recent Trends in International Taxation

- Global alignment on transparency and exchange of information
- Initiatives such as BEPS and MLI
- Changing business landscape – calibration of concepts relating to international tax
- Changes to domestic tax law to bring in the concept of significant economic presence and agency PE



PE - Recent Controversies

MasterCard Asia Pacific
Pte. Ltd.

- Digital equipment and network constituted PE

Nokia Networks OY

- Constitution of "indirect PE"

FRS Hotel Group
(Luxembourg)

- Hotel management services constituted PE

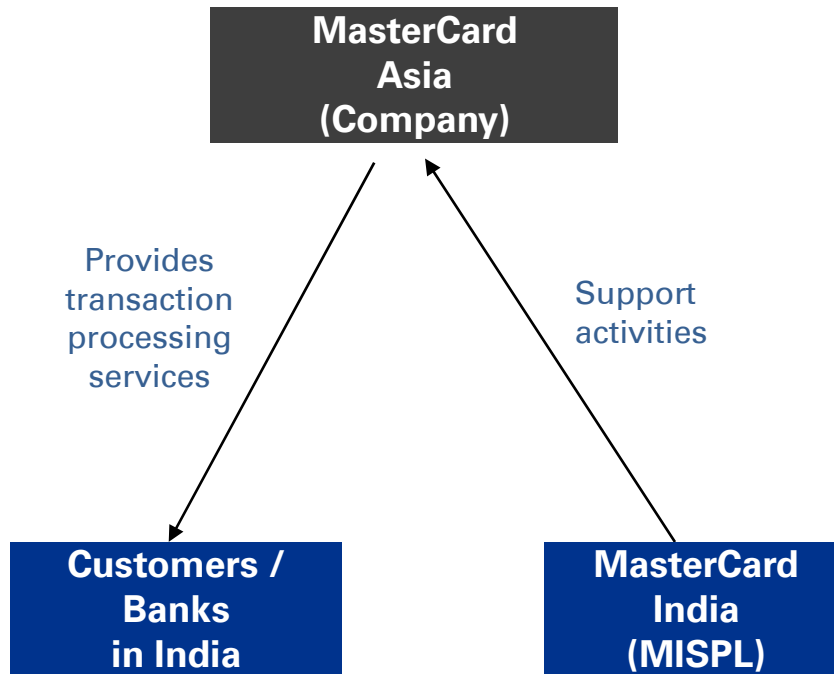
SeaBird Exploration FZ
LLC

- Service contract for 113 days constituted Fixed Place PE

AAR Ruling -
MasterCard Asia Pacific Pte. Ltd.
(406 ITR 43)

Decision by AAR in case of MasterCard Asia Pacific

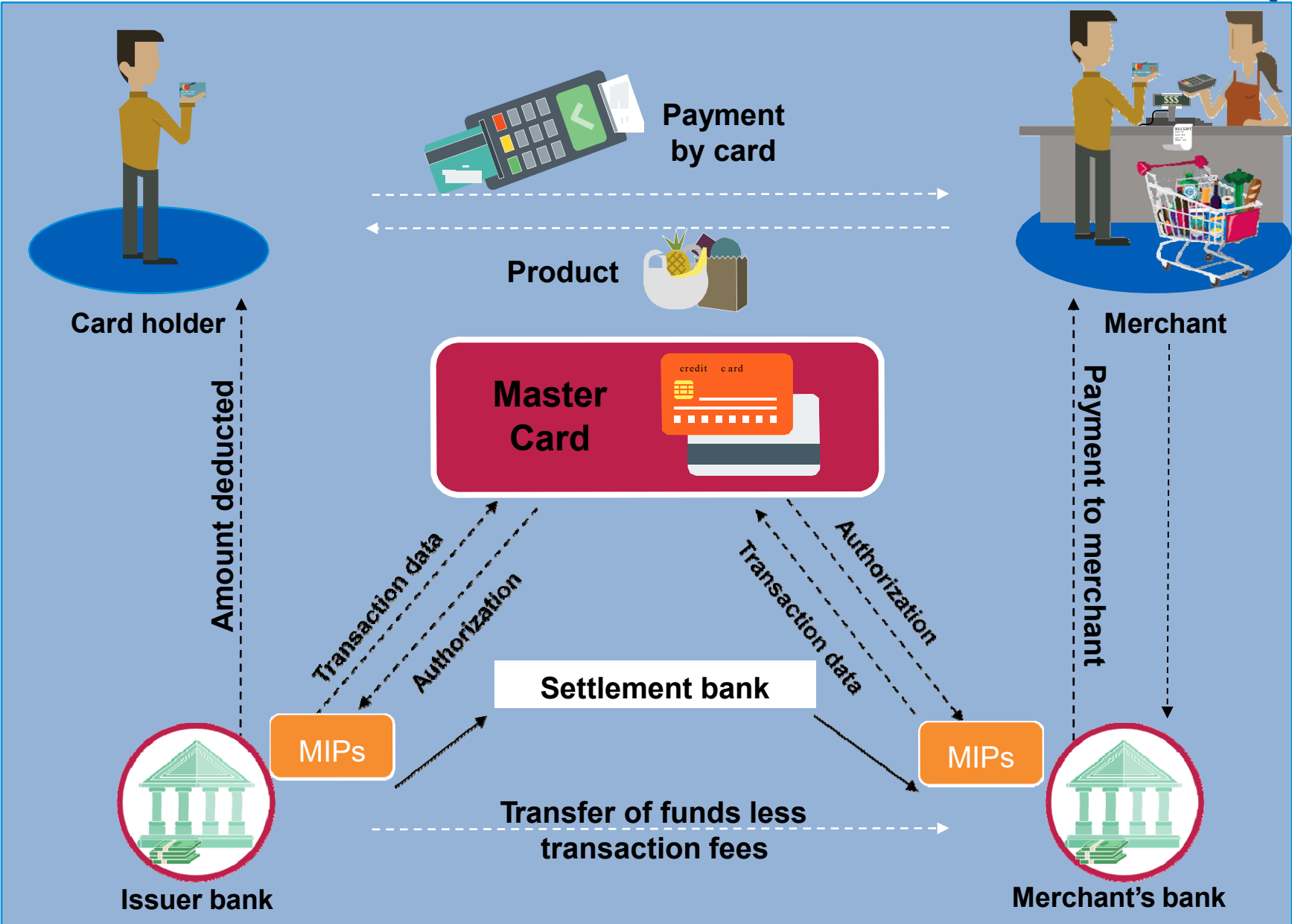
Background



- MasterCard Asia engaged in the business of transaction processing and payment related services
- Services provided to Indian customers under Master License Agreement through the use of MasterCard worldwide network
- MasterCard Interface Processor's (MIPs) that connects the MasterCard's Network and Processing Centers are installed at customer location in India
- MIPs are owned and maintained by MasterCard India
- Company charges transaction processing fees relating to transaction clearing and settlement of transactions
- MasterCard India charges support services fee to the Company



Transaction Process



Fixed Place PE - MIP

Test laid down in SC judgment¹ followed:

Permanency	Fixed Place	Disposal
<ul style="list-style-type: none">• MIPs are on the site of customer banks throughout the year	<ul style="list-style-type: none">• An automatic equipment can create PE²• It is not necessary that the equipment should be fixed to the ground³	<ul style="list-style-type: none">• Ownership of asset is immaterial³• Responsibility of maintenance & up-gradation with applicant

Activities undertaken by MIP not in nature of preparatory or auxiliary⁴ in character

- MIP is involved in facilitating authorization
- Issuing bank does the authorization and applicant facilitates in doing that work
- TP study of the Indian subsidiary

Facts distinguished from ruling of Australian Taxation Office and Delhi High Court⁵

¹ *Formula One World Championship Limited (394 ITR 80) (SC)*

² *Swiss Server Case referred in Formula One World Championship Limited*

³ *OECD commentary on Article 5 of Model Tax Convention*

⁴ *E-Funds IT Solutions Inc. (399 ITR 34) (SC)*

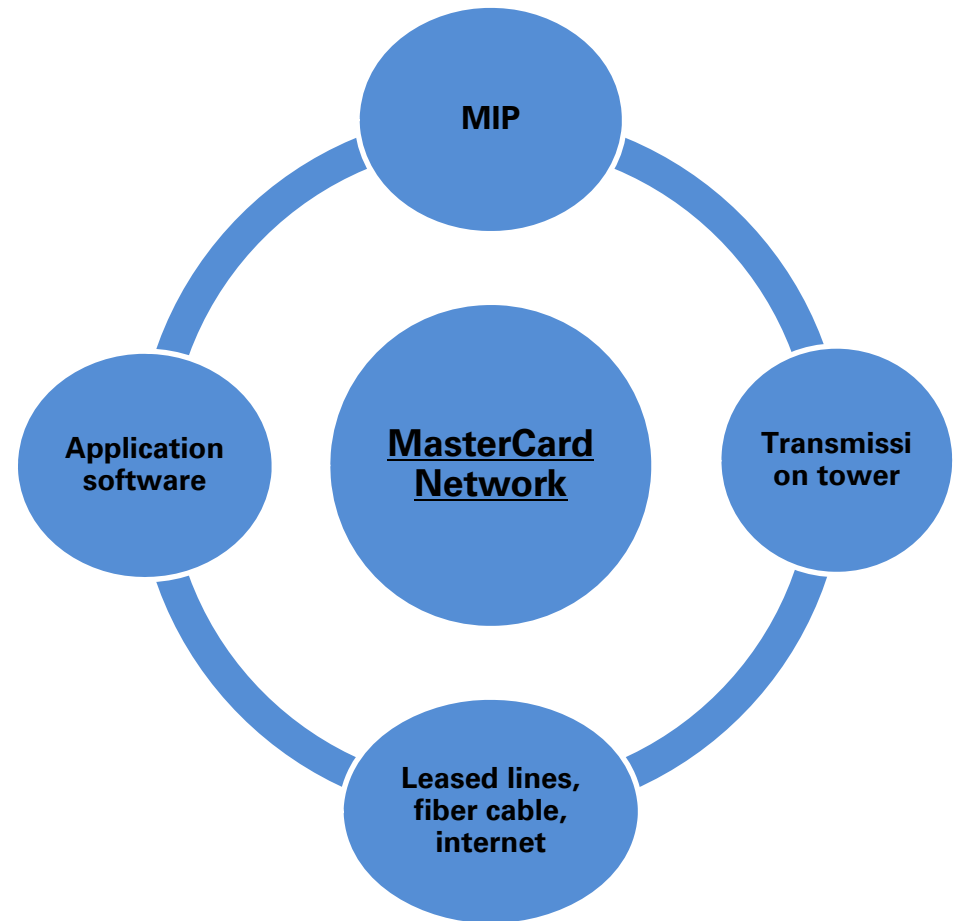
⁵ *UAE Exchange Center Limited (313 ITR 94)(Delhi HC)*

Fixed Place PE – MasterCard Network

- Transmission towers, leased lines, fiber optic cable, modems, internet become network
- Clearance & settlement happens in India as banks are aware of position
- Reliance placed on Delhi ITAT judgements⁶ – CRS system
- No human intervention is necessary to establish PE
- Functions performed by network of transmission in India for third party not preparatory or auxiliary⁷

Fixed place PE test satisfied:

- ✓ **Permanency**
- ✓ **Fixed place**
- ✓ **Disposal**



⁶Amadeus Global Travel Distribution SA. (113 TTJ 767)(ITAT Delhi) 767 and Galileo International Inc. (19 SOT 257) (ITAT Delhi)

⁷ Klaus Vogel Commentary

Fixed Place PE

Subsidiary PE

- MC US had a liaison office ('LO') in India, and it (through its overseas AE) owned MIPs
- Prior to MC India, MC US entered into licensing agreement with various Indian customers
- For ten years prior to Dec 2014, income from transaction processing service in India at full 100% attribution at global net profit rate was disclosed
- Taxability determined by MAP

From Dec 2014

- The LO was shut down and the work, employees transferred to MC India
- TP report depicts MC India doing only support activities
- Certain functions and risks related to transaction processing which were earlier carried out by MC US in India and are still carried out by MC India but not shown in the FAR of the MC India
- Transaction processing work carried in India not reflected in the FAR

Bank of India

Dedicated team in BOI to carry out the settlement activity

Rejects Applicant's stand that in settlement, significant activity of sorting and collating is done by Applicant outside India

Significant activity in settlement is movement of fund by passing debit and credit entry which is done by BOI in India

Service and Agency PE

Other PE exposure

Agency PE

- MC India is legally and economically dependent on the MC Singapore
- It gets instructions and remuneration from the Applicant
- Article 5(8) discussed:
 - Clause (a) not applicable as the subsidiary does not habitually conclude contracts
 - Clause (c) applied as the subsidiary habitually secures orders⁸

Service PE

Employees of the Applicant

- “Services” in India such as interaction with clients, meeting with clients for feedback, to check if the process is working alright
- Threshold of 90 days per Article 5(6)
- Reliance placed on the Supreme Court decision⁴ to hold first test for creating service PE is satisfied
- Distinguishes Morgan Stanley ruling on steward activities⁹

Employees of Bank of India

Does not create a service PE

⁸Rolls Royce Plc (19 SOT 42) (Delhi ITAT)

⁹Morgan Stanley (292 ITR 416) (SC)

Royalty and FTS

Brand name/ trademark/ logo

- License fee paid by MC Singapore to MC US for Intellectual Property
- Huge amount incurred on brand promotion and no amount charged from customers
- Distinction made from Supreme court decision¹ where it was held that payment of brand/trademark is incidental in nature

Use of Equipment

- MIP's de-facto owned by the MC Singapore
- One time fee paid for MIP installation
- No requirement of equipment control should be with the user

Process royalty

- The process is 'secret' with patents granted on technology
- Contention that banks pay for the 'services' and not for 'intangibles' rejected
- The equipment and the process are in India
- Technology is not licensed to customer banks is irrelevant

Application software

- Reliance placed on AAR ruling¹⁰ - Use of software inside MIP and application software held royalty

Fee for Technical Services ('FTS')

Transaction processing Services – Applicant is providing a standard facility and not technical services to cardholder

Other services held as FTS however not taxable as no '*Make available*' clause in the tax treaty

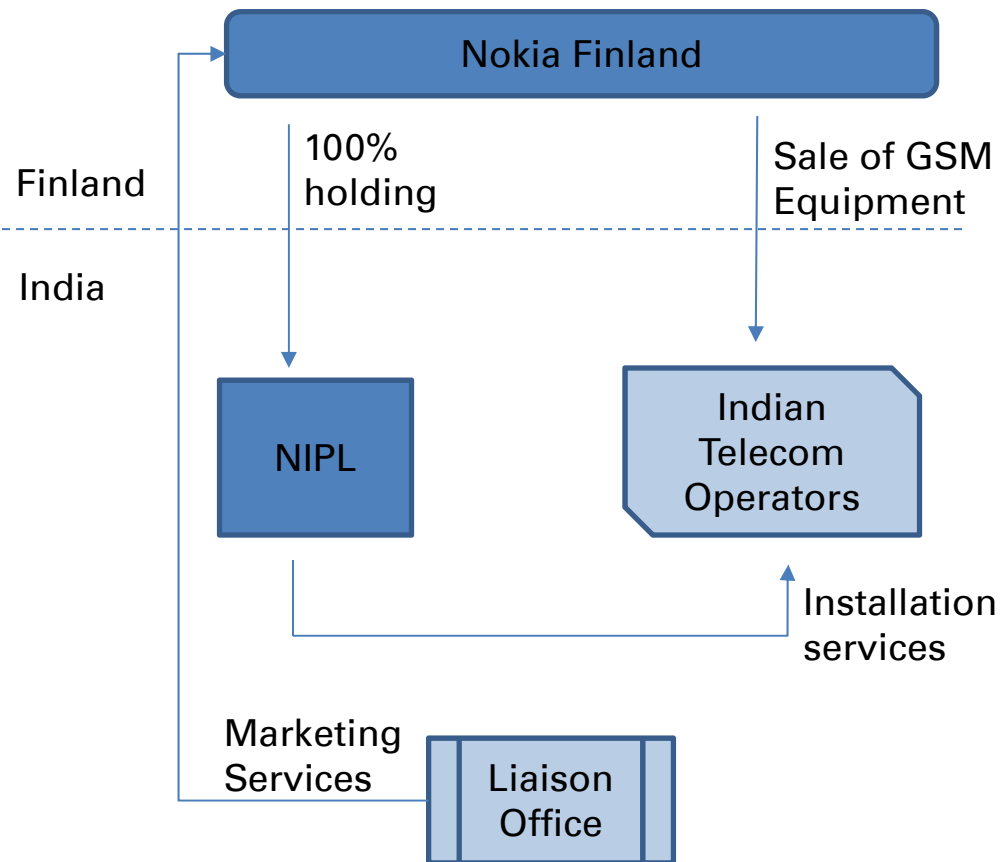
¹⁰*SkillSoft Ireland Limited (AAR no 985 of 2010)*

Points to Consider

- Admission to “buy peace of mind” not appreciated
- FAR analysis & 3CEB – need to be careful on activities as impacts attribution
- Automatic equipment without human intervention – more issues on the cards for businesses run on digital / e-commerce platforms
- Department getting aggressive – need to be ahead on principles

ITAT SB (Del)-
Nokia Networks OY
[65 ITR(Trib) 23]

Decision by Special Bench of ITAT in case of Nokia Networks OY



Background

- Nokia Finland ('Appellant') is engaged in the business of manufacturing of GSM equipment used in fixed and mobile phone networks and trading
- Nokia Finland directly sold equipment manufactured by it outside India to customers in India
- Nokia India entered into an agreement towards installation and other connected activity with customers of Nokia Finland
- Marketing support agreement between Nokia India and Nokia Finland



Matter remanded by High Court for adjudication on certain matters including PE/ Business Connection in India

Observations on Permanent Establishment

Majority Members' view

Reference to the decision of Supreme Court in case of Formula One

No fixed place PE/ Service PE created in India

Subsidiary was an independent entity whose income was subject to tax in India on an arm's length basis

No part of offshore supply was carried out in India

Administrative support without physical place being made available to the overseas employees would not trigger a PE

Mere signing, planning, negotiation or networking before supply of goods are preliminary activities

NIPL is not negotiating or concluding contracts on behalf of the foreign company and is acting on a principal to principal basis

Argument of virtual projection cannot be looked at without having regard to provisions of Article 5



No business connection/ PE triggered in India

Key Points for Discussion (Majority view)



Approach followed

- **'Look-at'** approach followed
- Respect of the **legal structure**
- Judicial hierarchy/ **discipline** followed
- **Strict interpretation** of tests for determination of PEs



Fixed Place PE

- Networking planning, negotiation and signing of contracts held as **preparatory and auxiliary**
- Far reaching consequences



Virtual presence

- **Splitting up of transactions** - supply of equipment different from installation activity
- Assumption of transactions being **at arm's length**

Observations on Permanent Establishment

Dissenting Member View

Role of employees considered

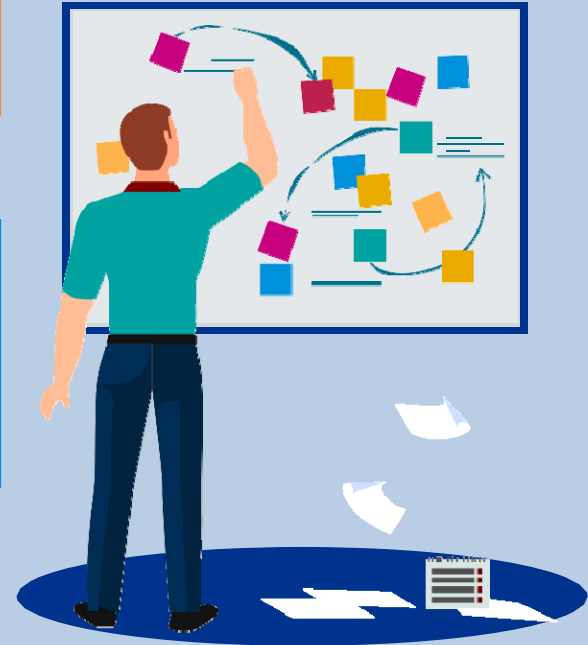
NIPL's work was interdependent and interconnected with the Appellant

Work of the foreign enterprise is carried out through NIPL

NIPL creates a business connection and PE in India

Critical marketing and support function performed by PE is not adequately compensated

Attribution of 35% of profits to the India PE



Key Points for Discussion (Minority view)



Approach

- **'Look-through'** approach: Can corporate veil be lifted so easily?
- **Economic basis** given precedence
- Similar to BEPS **Action Plan 7**



Fixed Place PE

- New concepts of PE: **direct v indirect**
- New dimensions to **disposal test**: View against the tide?




Virtual projection

- Is the argument on interdependence and interconnection of operations stretched?
- Performance guarantee and non-dilution of stake trigger a PE?

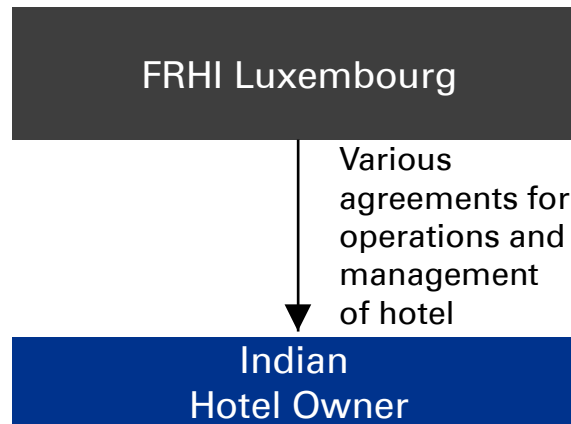
Shifting from legal principles to an economic basis could increase litigation ?

Key Takeaways

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- Test of Formula One applied in the context of business activity
 - Necessary to look at arrangement holistically
 - a) Virtual projection of the foreign company
 - b) Presence of personnel and role in the overall activity
 - c) Ownership of asset/ premises not critical if other tests satisfied
 - Role of the Indian Subsidiary/ affiliates – activities of affiliates seen as a unified transaction
 - Documentation – importance of FAR of the Indian subsidiary

AAR Ruling -
FRS Hotel Group (Lux)
(404 ITR 676)

Decision by AAR in case of FRS Hotel Group (Luxembourg)



Background

- FRS Hotel Group (FRHI) Luxembourg entered into centralized services agreement for provision of global reservation services and other services in different phase of hotel development and operation
- Question raised on taxability as fees for technical services/ royalty

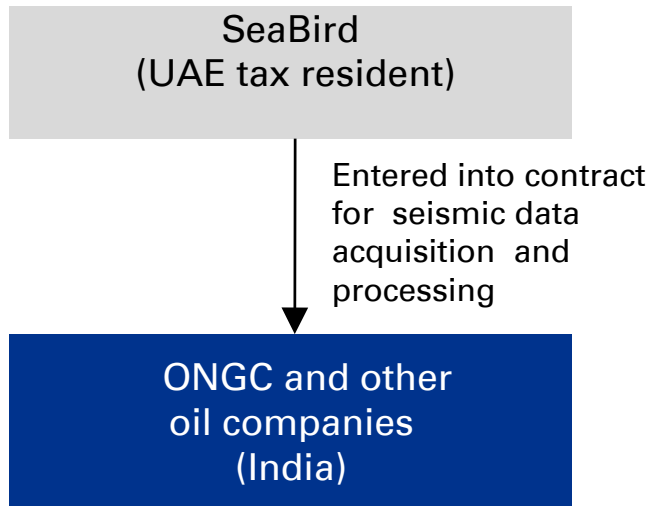
Observations and ruling by AAR

- Took note of four additional agreements covering hotel management, hotel license, hotel advisory and technical services agreement
- Referred to the test laid down in Formula One that: a) the hotel in India was a fixed place b) the hotel was at the disposal of FRHI c) the business of FRHI was being carried out from this fixed place
- Hence, existence of PE confirmed



AAR Ruling -
SeaBird Exploration FZ LLC
(403 ITR 82)

Decision by AAR in case of SeaBird Exploration FZ LLC



Background

- Sea Bird Exploration FZ LLC's (Sea Bird) core business activity is 4C-3D seismic data acquisition and processing
- Sea Bird entered into contract with ONGC and other customers for 4C-3D seismic data acquisition, processing and interpretation in Mumbai high field

Observations and ruling by AAR

Service PE

Services not provided by employee/ personnel but primarily through vessels and equipment. Hence Article 5(2)(i) not relevant

Fixed Place PE

Article 5(1) is applicable and a fixed place PE is created

It is immaterial that period of operation in case of applicant is 113 days since a PE need not be permanent or for all times [Formula One decision referred]

What next?

Bringing Clarity for Business



Need for corporates to respond proactively to evolving PE-related concepts

Thank you

The information contained herein is of general nature and is not intended to address the circumstances of any particular individual or entity. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.