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HOT SPOT

Permanent Establishment – Analysis of Recent Rulings

A. Introduction

The development of telecommunications and the internet has created new channels to do business globally in a seamless manner, and in many circumstances eliminating physical presence. This evolution of new business models, pose challenges to the tax authorities in taxing profits emanating from such business, while applying the traditional concept of determining whether a trade or business has presence in a country, through a permanent establishment (PE).

The below article analyses the recent rulings of Authority for Advance Rulings, New Delhi (AAR) in the case of MasterCard Asia Pacific Pte Ltd, In re.[1], and Delhi Income-tax Appellate Tribunal (Special Bench) (ITAT SB) in the case of Nokia Networks OY[2], in relation to the determination of a PE in India.

B. MasterCard Asia Pacific Pte. Ltd., In Re.

The AAR ruling in the case of MasterCard Asia Pacific Pte Ltd, In re., deals with the issue of determination of a PE in India, as regards the use of a global network and infrastructure, to process card payment transactions of customers in India and other connected issues.

1. Facts of the case

MasterCard Asia Pacific Pte Limited (the Applicant), being one of the leading global payment solution providers is engaged in facilitating financial institutions, businesses, merchants, cardholders and governments worldwide, to use electronic forms of payment.

The Applicant charges its customers: transaction processing fees relating to authorization, clearing and settlement of transactions and other ancillary charges as per the terms of Master License Agreements. The transaction processing activity consists of electronic processing of payments between banks of merchants (acquirer bank) and banks of cardholders (issuer bank) through the use of MasterCard Worldwide Network (the MasterCard Network).

1 [AAR No. 1573 of 2014] / [2018] 94 taxmann.com 195 (AAR - New Delhi)

2 [ITA Nos. 1963 & 1964/Del/2001] / [2018] 94 taxmann.com 111 (Delhi - Trib.) (SB)

The Applicant provides a customer with a MasterCard Interface Processor (MIP) that connects to the MasterCard Network and processing centers placed in India and outside India. An MIP is about the size of a standard personal computer and is placed at the customers' locations in India. The Applicant is able to facilitate the authorization, clearing and settlement of payment transactions through the network and processing centers.

The Applicant has a subsidiary in India, namely MasterCard India Services Private Limited (MISPL), in which it owns 99% of the shareholding.

2. Issues

The major issues that arose before the AAR were, whether the Applicant has a PE in India under Article 5 of the India-Singapore Double Taxation Avoidance Agreement (DTAA) and whether the fees received by the Applicant from the Indian customers comprising of transaction processing fees and other ancillary fees would be chargeable to tax in India as royalty or fees for technical services (FTS) as per Article 12 of the DTAA.

3. Ruling of the AAR

a) The AAR after hearing both the parties agreed with the revenue's contentions and held that various digital and connected equipments located in India can create a PE in India. Furthermore, to create a PE, the AAR held that the fixed place does not mean that the equipment should be fixed to the ground. It further held that the transaction processing activities constituted important functions performed by MIPs. For this reason, the AAR held that MIPs created a fixed place PE of the Applicant in India.

b) The AAR observed that the activity of transmission of information between various banks in India and uploading of raw data and receipt of final data using application software are performed in India through Bank of India (the entity which carried out work for the Applicant, in relation to settlement, etc. in India) and therefore, the clearance and settlement of the transactions also happen in India.

The AAR principally observed, that even if significant activities are happening outside India; there can still be a PE in India, if significant activities are also happening in India. Relying on the earlier rulings in case of Amadeus Global Travel Distribution SA[3] and Galileo International Inc.[4], the AAR held that **the MasterCard Network** that consists of transmission tower, leased lines, fiber optic cable, nodes and internet, etc., also passed the tests of fixed place and permanency and creates a fixed place PE of the Applicant in India.

c) The AAR also observed that since the employees of Bank of India (BOI) carried out their functions in accordance with the instructions given by the Applicant, such employees were under the control and supervision of the Applicant, and hence the space occupied by them in the premises of BOI was effectively at the disposal of the Applicant. Hence, the AAR held that **Bank of India** also constituted a **fixed place PE** of the Applicant in India.

d) The AAR further observed that there were some functions and risk related to transaction processing which were earlier carried out by MasterCard International Incorporated (MCI or AE of the Applicant) in India and are still carried out by MISPL (as MISPL had taken over everything), but not shown in the functional, assets and risk analysis of MISPL. Hence, the AAR held that the **subsidiary company (MISPL)** also creates a **PE** of the Applicant in India.

e) The AAR further held that the services performed by visiting employees of MasterCard, such as taking customer feedback, providing information about new

3 Amadeus Global Travel Distribution SA vs. DCIT [2008] 113 TTJ 767 (ITAT Delhi)

4 Galileo International Inc. vs. DCIT [2008] 19 SOT 257 (Delhi)

products, and monitoring the efficiency of operations were an integral part of the transaction processing services provided by the MasterCard Asia Pacific to the Indian customers. The AAR stated that such services could not constitute stewardship activities. Accordingly, the AAR held that a **service PE** of the Applicant was constituted in India through such employees.

f) The AAR observed that MISPL habitually secured orders for the Applicant in India. The AAR also observed that all agreements entered into with Indian customers after the incorporation of MISPL were in fact routed through MISPL. According to AAR, this showed that MISPL was habitually securing orders for the Applicant, thereby resulting in the constitution of a **dependent agent PE** of the Applicant in India.

g) The AAR held that the licensing of various IPs in the form of brand/ trade name/ mark, etc. are not incidental to the activity of transaction processing and the payment made by various customer banks in India to the Applicant was also for the use of these IPs and hence, the same is royalty. The AAR also held that the same is effectively connected with various types of PEs, as discussed above. Thus, it would get taxed with the profits attributable to the PE under Article 7 of the DTAA and not under Article 12 of the DTAA.

The AAR also held that payments for the use of equipment (MIPs), or payments for use of a secret process (workings of the MIPs), or payments for use of software (application software of MasterCard Asia Pacific used for accessing the MasterCard network) would amount to royalty payments, but however, would be taxable as business profits under Article 7 for being effectively connected with a PE of the Applicant in India.

h) The AAR relied on the FAR of the Applicant and MISPL to conclude that the remuneration paid by the Applicant to MISPL was not at arm's length. Further, relying on the decision of the Hon'ble Supreme Court in Morgan Stanley[5], the AAR concluded that there would be a need to attribute further profits. On this basis, the AAR observed that the tax authorities may consider a further attribution of profits to MISPL.

C. Nokia Networks OY

Further, the Delhi ITAT SB in the case of Nokia Networks OY, deals with the issue of determination of a PE in India, when the non-resident carries out signing, networking, planning and negotiation of offshore supply contracts in India. It also debated the proposition set out by the revenue authorities as regards the concept of virtual projection.

1. Facts of the case:

Nokia Networks OY (Nokia Finland or the assessee) is a company incorporated under the laws of Finland and is engaged in the manufacturing of advanced telecommunication systems and equipment (GSM equipment) which are used in fixed and mobile phone networks; and trading of telecommunication of hardware and software.

The GSM equipment manufactured in Finland was sold to Indian telecommunication operators from outside India on a principal-to-principal basis under independent buyer-seller arrangements as well as certain contracts for installation were entered through the Liaison Office. Nokia Finland incorporated an Indian subsidiary, Nokia India Pvt. Ltd. (NIPL) in May 1995. The installation activities after such incorporation, were carried out by NIPL under its independent contracts with the Indian telecommunication operators.

The assessee claimed that there existed no business connection as well as no PE in India and hence, it was not liable to tax in India. The Assessing Officer (AO) however, did not agree and completed the

5 DIT(IT) vs. Morgan Stanley & Co. Inc (292 ITR 416) (SC)

assessment holding both the Liaison Office and NIPL as constituting a PE of the assessee. The AO relied heavily on the fact that the assessee had provided guarantee for the services rendered by NIPL to the customers of NIPL. The AO also relied on the fact that the contracts for offshore supply of equipment were signed in India.

2. Decision of the Delhi ITAT (SB) (majority view)

a) Fixed Place PE under Article 5(1) of the India-Finland DTAA (DTAA)

The ITAT stated that, for establishing a fixed place PE, as referred to in Article 5(1) of the DTAA, one of the crucial terms used is *'fixed place of business through which the business of an enterprise is wholly or partly carried on'*. The word 'through' assumes a great significance, because it enlarges the scope of a fixed place in as much as, where no fixed premises may belong to an enterprise but even if a particular space is made available at its disposal then such place is reckoned to be place of business under this paragraph.

The ITAT referred to the judgement of the Hon'ble Supreme Court (SC) in the case of Formula One[6], wherein it was held that the place of business will qualify, ***only if the place is at the disposal of the enterprise.*** The term ***'at the disposal'*** of the enterprise means when the enterprise has the right to use the said place and the control thereupon.

The ITAT noted that there was no evidence brought out on record to show that the premises of NIPL were at the disposal of the assessee. The ITAT observed that though administrative services namely telephone/ fax/ conveyance services were provided by NIPL, there was no place of business which was provided by NIPL 'at the disposal' of the assessee for carrying out its business wholly or partly in India. It was nowhere brought out by the AO that, any kind of physically located premise or a particular location was made available to the assessee.

The ITAT observed that providing telephone/ fax/ conveyance services could not be equated with fixed place and thus, concluded that providing such kind of administrative support services will not result in the determination of a fixed place PE.

The ITAT also observed that mere signing of the offshore supply contracts in India, planning and negotiation or networking before the actual supply of goods, are preliminary activities (i.e. preparatory and auxiliary) and therefore, would fall under the exclusion provided under Article 5(4) of the DTAA and thus would not constitute a PE of the assessee in India.

The ITAT specifically held that in case of offshore supply of goods, what is of importance is that the sale has taken place outside India and once this fact is established, the activities of negotiation, signing are preparatory and auxiliary in nature, thus such activities would not lead to the determination of a PE.

b) Agency PE under Article 5(5) of the DTAA

The tests to be satisfied For Dependent Agent PE (DAPE), as laid down by the ITAT are:

- Commercial activities of the agent for the enterprise are subject to instruction or comprehensive control
- The agent does not bear entrepreneurial risk

The ITAT noted that NIPL neither had any authority to conclude contracts for supply, nor any of the orders were booked by NIPL which were binding upon the assessee. The ITAT observed that managing or providing guarantee by assessee does not yield any income to the assessee, albeit to NIPL, which is already taxed in India.

c) Virtual Projection

The main argument of the AO was that the entire identity of the assessee and NIPL got blurred, and that NIPL was practically a ***'virtual projection'*** of the assessee in India and thus constituted PE relying

6 Formula One World Championship Ltd. vs. CIT [394 ITR 80 (SC)]

on the decision of Vishakhapatnam Port Trust[7], on the grounds that:

- NIPL carried out installation activities for the contract of supply entered by the assessee,
- NIPL carried out marketing and technical support services for the equipment installed by the assessee.

The ITAT held that the concept of virtual projection does not mean that even without a fixed place, virtual projection itself will lead to an inference of a PE. If on facts there is no establishment of a fixed place and disposal test is not satisfied, then virtual projection itself cannot be held to be a factor for creation of a PE. Thus, the ITAT held that the concept of virtual projection brought in by the AO would not lead to any kind of establishment of PE.

d) Business Connection

The ITAT observed that in the present case, the goods were manufactured outside India and even the sale had taken place outside India. Thus, the ITAT held that there existed no business connection of the assessee in India. The ITAT also relied on the decision of the Hon'ble High Court in the case of Nortel Network[8], wherein it was clearly concluded that equipments supplied overseas cannot be taxed under the Act.

D. Conclusion

Traditionally, the concept of a PE required some physical presence in the country seeking to impose tax. Today, however, technology is changing the way companies conduct business. It is no longer necessary to have a physical presence in a country in order to sell products or services in that country. Thus, the integral question is whether the mere use of computer equipment (e.g., a computer server, network, etc.) located in a country, fulfills the essential requirements for determination of a PE. In the days to come, this is going to be of critical importance to both governments and businesses.

The AAR ruling on MasterCard (*supra*) once again brings to fore the disconnect with the traditional understanding of the concept of a PE and trying to fit that understanding to the technological innovation of carrying on business in the source country, through revolutionary methods of information technology and communication via digital means.

Technological advancement by way of artificial intelligence, etc. will no longer require human intervention for interaction with the customer. This methodology of conducting business may lead to difficulty with the question in tax law, of determining whether a non-resident has a PE in the source country and the ability of the government to tax the profits in the source country.

Further, the decision of the ITAT Special Bench in the case of Nokia Networks OY (supra) brings out the important principle that for determination of a PE in India, as regards the transaction of sale of offshore equipment, what is important is where the sale of the offshore equipment takes place. If the supply of equipment is outside India, the transaction cannot be taxed in India.

Another important facet considered by the ITAT is the concept of 'virtual projection' as espoused in the judgment of Vishakhapatnam Port Trust (supra). The ITAT ruled that virtual projection should not be seen de hors the determination of a PE in India. Thus, the concept of virtual projection has to be seen alongwith the other facts of the case, which would determine whether the non-resident has a PE in India under the relevant DTAA.

The above judgements clearly brings out that the determination of a PE is a fact based exercise and thus regard should be given to the facts and circumstances of each case, before deciding the existence of a PE. Detailed documentation demonstrating the correct economic substance of the transactions, would help the taxpayers to mitigate the risk of PE exposure.

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7 CIT vs. Vishakhapatnam Port Trust [(1983) 144 ITR 146 (SC)]

8 Nortel Network India International v. DIT [(2016) 386 ITR 353 (Del)]