PERMANENT ESTABLISHMENT ISSUES IN INDIAN OUTSOURCING TRANSACTIONS

Ravishankar Raghavan*

ABSTRACT

India has emerged as one of the leading destinations for outsourcing of operations by multinational companies in recent years. One principal source for the low costs is the tax reductions available due to Double Taxation Avoidance Agreements between India and the parent country of the company. The author in this essay discusses the concept of “permanent establishment” (PE), a very important aspect of tax liability governed by such agreements. Providing a useful introduction to the workings of these agreements, the author moves to discuss the two primary kinds of PE’s, engaging with pertinent case law on the issues involved therein. In light of the increased attempts of taxation authorities to use this “permanent establishment” concept to widen the tax net, the essay assumes great importance and practical value.

I. INTRODUCTION

* Principal (Tax Group), Majmudar & Co., India.
Permanent Establishment Issues in Indian Outsourcing Transactions

into arrangements with Indian third-party service providers or set up subsidiaries in India. Payroll processing, healthcare services, engineering services, call centre services, HR-related services, accounting services, and head office support services are some of the examples of outsourced operations.

Tax treaties of specific countries are negotiated on the basis of the Organisation for Economic Co-operation and Development [Hereinafter, “OECD”] model, the United Nations model, and the United States model. Tax regimes are confined to specific countries, although multinational enterprises have a global reach. Each jurisdiction enacts its own country-specific tax rules. India is no exception to the above arrangement. Hence, while computing the tax treatment of a non-resident in India, the provisions of the Agreement for Avoidance of Double Taxation [Hereinafter, “DTAA”] between India and the country of which the non-resident is a tax resident are considered. As per the provisions of the Income Tax Act, 1961 [Hereinafter, “the Act”], the taxability of non-residents is governed either by the Act or the DTAA, whichever is more favourable.

The Act deals with the concept of a business connection between a resident and a non-resident. Where there is an intimate and real relationship between the two on a continued basis, the non-resident becomes liable for tax in India in respect of income earned, pertaining to a business connection, that is deemed to accrue in India. For a non-resident, only that income is subject to tax in India that, inter alia, accrues or arises, or is deemed to accrue or arise, in India. In this regard, any income accruing or arising, directly or indirectly, through or from a ‘business connection’ in India to a non-resident, is deemed to accrue or arise in India and hence, such income is taxable in India. The term ‘business connection’ is very wide and what constitutes the same has been the subject matter of judicial scrutiny in a large number of cases. Business connection may take several forms: it may include carrying on a part of the main business, or activity incidental to the main business of the non-resident through an agent, or a relation between the business of the non-resident and the activity in India, which facilitates or assists the carrying on of that business.

§ 9 of the Act, which deals with business connection, stands superseded where the non-resident is residing in a country with which India has entered into a DTAA. Under such an agreement, business profits are taxable under Art. 7, provided such

profits are attributable to the permanent establishment [Hereinafter, “PE”] defined by Art. 5 of the DTAA. Art. 5 of the DTAA will apply where an enterprise carries on a business, whether wholly or partly, through a fixed place of business.

The issue that arises from such outsourcing of business is the attribution of income to a PE. This has become a subject of debate over the recent years. The PE concept as it is understood in international tax law provides the basic threshold limit beyond which a multinational enterprise can be taxed in the source jurisdiction of the business activity.

The concept of a PE is not alien to the Indian tax system. Generally, under Art. 7 of the tax treaties (dealing with taxation of business profits), a contracting State (such as India) cannot tax the profits of an enterprise of the other contracting State (such as the US), unless the enterprise carries on its business in India through a PE situated therein. There are circumstances in which a foreign customer can be deemed to have a PE in India, in which case certain attributable profits of such customer will be taxable in India. Therefore, from a non-resident company’s perspective, the structuring of the outsourcing contract, the examination of the PE exposure and the adoption of measures to mitigate risk become very critical.

Let us understand the concept of a PE in a typical outsourcing arrangement by way of an illustration. A foreign enterprise (say “XYZ Inc.”) contracts out some of its business functions to its Indian subsidiary (say “XYZ India”). In the course of the outsourcing arrangement, XYZ Inc. undertakes the following:

1. preliminary quality control of XYZ India’s deliverables; and
2. training of XYZ India’s personnel by employees of XYZ Inc. to maintain quality and standards.

Further, XYZ Inc. allows XYZ India to use its hardware, systems or software to perform services and transmit data in a secure manner. On an as-needed basis, XYZ Inc. and its employees have access to XYZ India’s premises for inspection purposes, to the extent required by XYZ Inc. to comply with its obligations under the agreement. Moreover, in certain circumstances, XYZ India also provides the representatives of XYZ Inc. office space, furniture, cabinets etc., to the extent required.

XYZ India employs a dedicated pool of personnel at a level set by XYZ Inc., to provide the services. XYZ India also follows the HR policy of XYZ Inc.
Permanent Establishment Issues in Indian Outsourcing Transactions

However, XYZ Inc. retains authority and supervision over XYZ Inc.'s business-related decisions, including business rules and strategic direction, among others, which are relevant for the delivery of services.

Based on this fact summary, can XYZ Inc. be reckoned as having a “Fixed Place PE” in India; or can it be reckoned as having a “Service PE” due to the activities of its employees?

II. WHAT IS A FIXED PLACE PE?

Generally, the PE of the foreign enterprise in India is a fixed place through which the business of a foreign enterprise is wholly or partly carried on. A fixed place PE can arise due to the activities of the non-resident's Indian subsidiary or due to the existence of the foreign enterprise's employees in India. For a foreign enterprise to be reckoned as having a fixed place PE in India, it should satisfy the following three conditions:

1. existence of a “place of business”;
2. “right to use” the place of business; and
3. carrying out the business “through” that place.

In this context, it must be noted that significant Indian jurisprudence on this issue has emanated, by placing reliance on the OECD Model Commentary. As per the Commentary on Art. 5 of the Model Tax Convention [Hereinafter, “OECD MC”], a “place of business” covers any premises used for carrying on the business of the foreign enterprise, whether or not used exclusively for that purpose. Further, the OECD MC clarifies that the premises need not be owned or even rented by the foreign enterprise, provided they are at the disposal of such enterprise. The commentary of OECD on Art. 5 also states that there must be a fixed place of business, which takes in not only fixed premises but also machinery or equipment. The expression “a fixed place” indicates a certain degree of permanence. It is necessary that the business of the enterprise be carried on through a fixed place. ¶ 2 of Art. 5 of the DTAA is an inclusive provision that takes in various places and services enumerated in clauses (a) to (l). A number of places are specified in clauses (a) to (k), whereas clause (l) postulates the provision of services by an enterprise within a contracting State, through employees or other personnel.

The OECD MC gives certain examples to illustrate what is meant by premises at the disposal of an enterprise. One such example refers to the employee of a company (“A”) being allowed to use an office in the headquarters of another
company ("B") in order to ensure that B complies with its contractual obligations with A. In this regard, the OECD MC states that B’s office will constitute A’s PE, provided that it is at A’s (or its employees’) disposal for a sufficiently long period of time so as to constitute a "fixed" place of business, and the activities are not in the nature of preparatory or auxiliary activities.  

Therefore, in principle, the OECD MC concludes that a place of business is at the disposal of an enterprise if it has some right to use the premises for the purposes of its business and not solely for the purposes of the project undertaken on behalf of the enterprise.  

From an Indian tax jurisprudence perspective, the Andhra Pradesh High Court, while interpreting a similar clause in the DTAA between India and Germany, has held that a PE postulates the existence of a substantial element of an enduring or permanent nature of a foreign enterprise, which can be attributed to a fixed place of business in India. It should, by its character, amount to a virtual projection of the foreign enterprise in India.  

In an important case, another aspect of a Fixed Place PE was discussed. The employees of Motorola, Inc. rendered certain services from the office of Motorola’s Indian subsidiary. The salary of these employees was borne by Motorola, Inc. However, the perquisites were borne by the Indian subsidiary. Further, the employees also performed certain services for the Indian subsidiary. The Income Tax Appellate Tribunal [Hereinafter, “the Tribunal”] ruled that these employees worked for Motorola, Inc., in India. They used the office of the Indian subsidiary to carry on Motorola, Inc.’s work, and thus, there was a projection of Motorola in India in the Indian subsidiary’s office. It was held that the Indian subsidiary was a fixed place of business of Motorola. However, it was ultimately held that the Indian subsidiary’s activities were preparatory or auxiliary in nature, and therefore, Motorola, Inc. did not have a Fixed Place PE in India. In this case, Nokia was also a party, and it had a wholly owned subsidiary in India. Nokia’s Indian subsidiary was engaged in supporting Nokia’s main activities. The Tribunal held that Nokia had a PE in India as the Indian subsidiary’s nature of activities was much more than just preparatory or auxiliary. However, Ericsson, which was the third party in this

5 Commissioner of Income Tax v. Vishakhapatnam Port Trust, (1983) 144 ITR 146 (AP) [Andhra Pradesh High Court].
6 Motorola, Inc. v. Deputy Commissioner of Income Tax, (2005) 96 TTJ 1 (ITAT) [Delhi Income Tax Appellate Tribunal].
case, was held not to have a PE in India because, although Ericsson's employees performed certain services using the office of Ericsson's Indian subsidiary, they in fact had no right to enter the Indian subsidiary's office to carry on Ericsson's activities. Therefore, the Tribunal concluded that Ericsson had no PE in India through its Indian subsidiary.

In the case of eFunds Corporation [Hereinafter, “eFunds USA”], eFunds USA had an Indian subsidiary that provided certain 'back office' services to it. The Indian subsidiary bore limited risks, had little-to-no assets, and relied on eFunds USA for performing the services. The most significant issue before the Tribunal was regarding the existence of eFunds USA's permanent establishment in India. The tax authorities, on the basis of the Group Annual Report, held that the facilities of eFunds India were at the disposal of eFunds USA and that it was eFunds USA's business that was carried out in India. Therefore, the income earned in connection with such services rendered in India should be considered as derived, and hence taxable, in India. On the other hand, eFunds USA contended that the premises of eFunds India were never at the disposal of eFunds USA. Further, the sales outlet whose presence was stated in the Group Annual Report was of eFunds India, and not of eFunds USA, and therefore, such premises should not constitute a PE for eFunds USA in India. Further, it was contended that only back office operations were being carried on in India, and these operations were preparatory and auxiliary in nature and therefore, not the core business activity of eFunds USA. Here, the Tribunal ruled that the Indian subsidiary was not an independent contractor, but a "partner in business" owing to which it was deemed to be eFund USA’s PE in India. The facilities of eFunds India were at the disposal of eFunds USA. eFunds USA and eFunds India were viewed as partners in business as they were under a legal obligation to provide services to eFund's clients under the same contract, and as eFunds India did not bear any significant risk as the ultimate responsibility vis-à-vis the eventual client was with eFunds USA. The Tribunal's observation was based on the Form 10K filed by eFunds USA according to which its activities in India were not preparatory or auxiliary; rather, they were core income generating and thus this contention of eFunds USA was also rejected.

In the case of Rolls Royce PLC v. Director of Income Tax, the Delhi Income Tax Appellate Tribunal considered the taxation of a multinational enterprise selling its products in India. Rolls Royce PLC, a UK-resident company, was engaged in

---

7 eFunds Corp. v. Assistant Director of Income Tax, 2010-TII-165-ITAT-DEL-INTL [Delhi Income Tax Appellate Tribunal].

8 Rolls Royce PLC v. Deputy Director of Income Tax, (2007) 19 SOT 42 (Del.) [Delhi Income Tax Appellate Tribunal] [Hereinafter, “Rolls Royce Plc.”].
the business of supplying airplane engines to Indian customers. Rolls Royce PLC's India office provided it with marketing support services and was compensated on a cost-plus basis for its services. The Delhi tribunal held that Rolls Royce PLC had a fixed place of business in India as its employees visited India frequently and the Rolls Royce India premises were used and occupied during such visits. The Delhi tribunal held that Rolls Royce PLC also had an agency PE since the activities of the India office resulted in it soliciting orders wholly and exclusively on behalf of Rolls Royce PLC.

In another case dealing with the creation and existence of a PE and income attribution in the context of a business using digital and Internet technology, in Galileo International Inc. v. Deputy Commissioner of Income Tax, the Delhi tribunal again ruled in favour of a fixed place of business. Galileo, a US company, owned a computer reservation system [Hereinafter, “CRS”] located in the US. This system was accessed by unrelated travel agents in India using hardware, software and connectivity provided by Galileo. Galileo appointed an unrelated distributor in India that was responsible for initiating relationships and signing subscriber agreements with these travel agents in India. Although the distributor was remunerated by Galileo, the travel agents were paid directly by the airlines for successful bookings. The Delhi Tribunal ruled that Galileo had a fixed place of business in India as the CRS extended to India through telecom networks, and that Galileo carried on business in India through computers installed on travel agents’ premises in India.

Based on the OECD MC and Indian rulings, it is possible that XYZ India may be considered to be a place of business of XYZ Inc., if a part of XYZ Inc.'s business (core income generating activities) is carried on at XYZ India’s premises. Additionally, if XYZ Inc. (or its secondees) has an exclusive uninterrupted right to use XYZ India’s premises, there can be Fixed Place PE exposure.

III. WHAT MEASURES CAN BE TAKEN TO MITIGATE A FIXED PLACE PE?

To the extent possible, XYZ India should be an independent contractor providing services to XYZ Inc. on an arm’s-length basis under the Agreement. Additionally, XYZ India should have the sole right to supervise, manage, control, direct, procure, perform, or cause to be performed, all necessary work, duties

or obligations as per the terms of the agreement. In no event should XYZ Inc. control XYZ India’s business or its internal management. XYZ Inc. can, however, undertake stewardship activities (limited to quality control activities, and briefing and providing preliminary training to personnel involved in delivering the services).

Additionally, most DTAs do not consider a fixed place to be a PE of a foreign enterprise if the place is maintained solely for activities that have a preparatory or auxiliary character. As per the United States DTAA, a fixed place maintained solely for the purpose of advertising, for the supply of information, for scientific research or for other activities that have a preparatory or auxiliary character for the enterprise will not be considered as the PE of the American enterprise. However, the United States DTAA does not define the terms ‘preparatory’ or ‘auxiliary’ activities. Since most DTAs do not define the term, it becomes difficult to distinguish activities that have a preparatory or auxiliary character from those that do not.

The decisive criterion is whether the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

The Supreme Court of India has held that an Indian enterprise performing ‘back office’ functions supporting the front office, such as fixed income and equity research, IT-enabled services such as data processing, support center and technical services, and reconciliation of accounts, for an American enterprise, would be carrying on activities that can regarded as preparatory or auxiliary, and hence, the same would not result in a Fixed Place PE for the American enterprise in India.

The Tribunal has also held in Rolls Royce Plc. that it is often difficult to distinguish between the main activities of an enterprise and those activities that have a preparatory or auxiliary character. The Tribunal has pointed out that each case has to be examined on its own merits. The essential and significant activities, within the framework of the business purpose of the enterprise, constitute the core business activities, and the business operations in the nature of the core business activities invariably constitute a PE.

10 Art. 5 (3) (e), United States Double Taxation Avoidance Agreement.
11 Supra. note 5, at 102.
13 Rolls Royce Plc.
In another case, the Delhi High Court has held that the term ‘auxiliary’ connotes activities that can be described as "aiding or supporting", or "subsidiary" to, the main business. The case involved a United Arab Emirates (Hereinafter, “UAE”) company that was engaged in the business of remitting money from the UAE to India under instructions from expatriate Indians residing in the UAE. Once a customer gave an order for a remittance in the UAE, the company’s liaison offices in India would download the details, arrange for the banker’s drafts, and deliver them to the beneficiary. The Delhi High Court stressed that any activity that aids or supports the main activity should be reckoned as auxiliary to the main business. In this matter, the Court held that the activities of the Indian liaison offices were only aiding and supporting the principal business activity being carried out in the UAE.

However, this exemption is not available if the Indian enterprise performs activities that are considered to be core income generating activities of the foreign enterprise.

IV. What is a Service PE?

Generally, if an American company (a) deputes employees or other personnel to India, and such personnel stay in India for more than ninety days within a twelve month period and render services other than ‘included services’, or (b) renders the above services for an ‘associated enterprise’, then it is regarded as having a PE in India.

Additionally, two enterprises are cumulatively referred to as associated enterprises when (i) one enterprise participates, directly or indirectly, in the management, control or capital of the other enterprise, or (ii) the same persons participate, directly or indirectly, in the management, control, or capital of both enterprises, and the commercial or financial relations between the enterprises are not being conducted at arm’s-length.

In addition, ‘included services’ mean the rendering of technical or consultancy services (including through the provision of the services of technical or other personnel) where such services (i) are ancillary or subsidiary to the application or enjoyment of: (a) various intellectual property rights such as patents, copyrights,

15 UAE Exchange Centre v. Union of India, (2009) 223 CTR (Del) 250 [Delhi High Court].
16 Art. 5 (2) (I), United States Double Taxation Avoidance Agreement.
17 Art. 9, United States Double Taxation Avoidance Agreement.
Permanent Establishment Issues in Indian Outsourcing Transactions

trademarks etc. (b) design or model, plan, secret process, information concerning industrial, commercial or scientific experience etc. (c) any industrial, commercial or scientific equipment, or make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.\textsuperscript{18}

However, the following services are excluded from the purview of included services: (i) services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property (ii) services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic (iii) teaching in or by educational institutions (iv) services for the personal use of the individual or individuals making the payments or (v) professional services (as defined in Art. 14 of the United States DTAA) provided by an employee to any individual or firm of individuals (other than a company).\textsuperscript{19}

Therefore, based on the above provisions, a foreign enterprise can be deemed to have a Service PE in India if it deputes employees or other personnel to India, and such personnel stay in India for more than the period specified in the DTAA to render services other than included services, as defined in the DTAA. In the abovementioned transaction, XYZ Inc. is deputing its employees to India for carrying out various activities such as training, developing and supervising the work performed by the Indian employees.

The concept of stewardship as an exception to the creation of a Service PE was first discussed by India’s Authority for Advance Rulings [Hereinafter, “AAR”] in the \textit{Morgan Stanley} case,\textsuperscript{20} which was reviewed by the Supreme Court on appeal.\textsuperscript{21} Here, Morgan Stanley Incorporated [Hereinafter, “MS Inc.”] was obliged to depute various employees to its Indian subsidiary, Morgan Stanley Advantage Services [Hereinafter, “MSAS”], who could be classified into:

1. deputationists performing managerial functions for MSAS; and
2. employees performing stewardship functions, i.e., monitoring the progress of the work being performed by MSAS for MS Inc.

\textsuperscript{18} Art. 12 (4), United States Double Taxation Avoidance Agreement.
\textsuperscript{19} Art. 12 (5), United States Double Taxation Avoidance Agreement.
\textsuperscript{20} \textit{In Re: Morgan Stanley and Co.}, [2006] 284 ITR 260 (AAR) [Supreme Court of India].
\textsuperscript{21} Director of Income Tax v. Morgan Stanley and Co. Inc., [2007] 292 ITR 416 (SC) [Supreme Court of India].
In this context, the Supreme Court ruled that stewardship activities would not amount to a service and, therefore, the employees performing such activities would not lead to MS Inc. having a Service PE in India. However, the activities performed by the deputationists were in the nature of services being rendered by MS Inc. to MSAS, and this would constitute a Service PE if such services were rendered by them while still on the payrolls of MS Inc., or if they retained a “lien” on employment. The Court did not specify what constituted a lien, but, generally, this would mean a right to be employed by MS Inc. even if the deputationists were currently on the payroll of MSAS.

As regards the pure stewardship activities performed by XYZ Inc.'s employees in relation to services provided by XYZ India, there should be little risk of being held a Service PE. However, if some of XYZ Inc.'s personnel are on deputation and retain their original jobs with XYZ Inc., or have a lien on employment, then there will be a greater chance of being classified a Service PE if they stay in India for periods longer than those provided in the DTAA.

V. What measures can be taken to mitigate a Service PE?

The overall risk of being held a service PE can be mitigated:

1. if the deputationists act under the supervision and control of the Indian enterprise;
2. if the deputationists do not represent, or render any services on behalf of, the foreign enterprise;
3. if the foreign enterprise does not bear the risk of the deputationists' actions while they are in India; and
4. such risk is completely attributable to the Indian enterprise's account.

VI. Conclusion

Since India has emerged as a key outsourcing hub for a number of multinational enterprises, the Indian tax authorities have been aggressively trying to include multinationals operating in India within the tax net in the recent years. In such a scenario, it becomes pertinent for the foreign companies to carefully assess their current and potential outsourcing transactions in India and the PE implications that emanate from them.
Permanent Establishment Issues In Indian Outsourcing Transactions

In order to avoid a potential PE risk, the assessment made by the enterprises should be risk-based, and advice should be obtained on the risk of scrutiny and litigation because of the uncertainty regarding what constitutes control, back office functions and core income generating activities. This helps in formulating the law, providing clarification for various judicial proceedings and introducing various concepts to make the interpretation of the law simpler. An alternative plan of action, to avoid this risk, is to obtain a ruling from the AAR on whether a contemplated outsourcing activity creates a tax liability for the customer in India. The advantage of such a ruling is that it is not only binding on the tax payer and the tax authorities, but also provides for a degree of certainty. However, it is to be noted that obtaining such a ruling may take a time period of around six to eight months.