A foreign company engaged in outsourcing services constitutes a business connection under the Income-tax Act but does not have a PE in India under the India-UK tax treaty

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Vertex Customer Management Ltd.1 (the taxpayer) held that the taxpayer has a business connection in India under Section 9(1)(i) of the Income-tax Act, 1961 (the Act). However, the taxpayer does not have a fixed place Permanent Establishment (PE), service PE or Dependent Agent PE (DAPE) in India under Article 5(1) of the India-UK tax treaty (tax treaty).

The Tribunal also held that since there is no PE of the taxpayer in India, the business income is not chargeable to tax in India. Even if it is assumed that there is a PE of the taxpayer in India, no profit can be attributed since the PE was compensated at an arm’s length price in accordance with FAR2 analysis.

Facts of the case

- The taxpayer, a UK based company, is engaged in outsourcing services for its clients in finance, utility and the public sector. The main services provided by the taxpayer are customer management outsourcing business, service outsourcing and transfer of technology.

- Vertex Customer Service India Pvt. Ltd (Vertex India) is an Indian entity in the group, which also carries out outsourced work from the taxpayer. This outsource work is in relation to contracts of the taxpayer with PowerGen Retail Ltd. and Last Minute Networks Ltd.

- The taxpayer allowed Vertex India, the right to use certain equipment located outside India and claimed reimbursement of expenses incurred on behalf of Vertex India. The taxpayer offered the payment received from Vertex India for the right to use equipment outside India as royalty under Article 13(3)(b) of the tax treaty. Regarding the reimbursement, it was claimed that the same was not taxable as it was on a cost to cost basis.

- The Assessing Officer (AO) held that the taxpayer has a PE in India under the tax treaty as well as a business connection under the Act and hence computed the profit attributable to such a PE. Regarding reimbursement as it has the effect of reducing the service fee payable to the Indian company was also considered as business profits of the PE in India. Further, royalty was also taxed as a business profit of the PE in India.

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1 DCIT v. Vertex Customer Management Ltd. (ITA No. 3759/Del/2013) – Taxsutra.com
2 Functions performed, Assets deployed, and Risk assumed

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• There are various factors, which need to be looked at while determining whether a business connection exists in a particular situation, or not. The landmark judgement of the Andhra Pradesh High Court in G V K Industries Ltd\(^7\) compiles the ratios of various other judgements and lays down various principles of business connection.

• On perusal of various decisions, it is required to test the business connection principle with respect to continuity, real and intimate connection, attribution of income and common control and professional connection. The connection of the taxpayer with the Indian entity is continuous in order to have a business connection. There must be a real and intimate connection between the activity carried on by the non-resident outside India with the activity carried out in India. Further, such activity must be one, which contributes to the earnings of profits by the non-resident in his/her business.

• It is also a settled principle that to conform with the requirements of the expression ‘business connection’, it is necessary that a common thread of mutual interest must run through the fabric of the trading activity carried on outside as well as inside India and the same can be described as a real and intimate connection.

• The commonness of interest may be by way of management or financial control or by way of sharing of profits. It may come into existence in some other manner, but there must be something more than the mere transaction of purchase and sale between ‘principal to principal’ in orders to bring the transaction within the purview of business connection.

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\(^7\) G V K Industries Ltd v. ITO [1997] 228 ITR 564 (AP)
• Further, where the Indian and the non-resident entity are both held by the same person or have common control, then the non-resident would be regarded as having a business connection in India. In this case, the taxpayer secures orders on behalf of the Indian company and outsources the job to the Indian company.

• There is a continuous relationship between the taxpayer and its affiliates and its subsidiary company in India. The contract entered into by the taxpayer and its affiliates outside India is carried out in India. The responsibility of the taxpayer vis-a-vis its customer, is concluded in India. The responsibility of the taxpayer cannot be segregated and will not be complete unless the Indian company provides services to the customers.

• Accordingly, the taxpayer had a business connection in India under Section 9(1)(i) of the Act.

**Fixed place PE**

• For establishing the fixed place PE test, certain conditions should be satisfied cumulatively i.e. there is a place of business (place of business test), such a place of business is at the disposal of the taxpayer (disposal test), such a place of business is fixed (permanence test) and that the business of the entity is carried on wholly or partly through such a fixed place of business (activity test).

• In the present case, the taxpayer satisfies the place of business test, since Vertex India is the taxpayer’s place of business. However, whether those premises are at the disposal of the taxpayer or not is an important parameter to constitute a PE. It is not necessary that the premises need to be owned or even rented by the enterprise.

• The premises should be at the disposal of the enterprise. In the present case, it is not established that the premises were made available to a foreign enterprise. The space provided was not at the disposal of the enterprise since it had no right to occupy the premises. Merely an access was given for the purpose of work, does not satisfy the disposal test.

• Relying on the Supreme Court’s decision in the case of Morgan Stanley & Co Inc. it was held that taxpayer does not have a fixed place PE in India.

**Dependent agent PE**

• Agency replaces fixed place with a personal connection. Transactions between a foreign enterprise and an independent agent do not result in the establishment of a PE under Article 5 if the independent agent is acting in the ordinary course of their business.

• The expression ‘ordinary course of their businesses’ has reference to the activity of the agent tested by reference to the normal customs in the case to issue. It has reference to the normal practice in the line of business in question. However, as per Article 5(5) of the tax treaty, an agent is not considered to be an independent agent if his/her activities are wholly or mostly wholly on behalf of the foreign enterprise and the transactions between the two are not made under arm’s length conditions.

• The twin conditions have to be satisfied to deny an agent the character of an independent agent. In case the transactions between an agent and the foreign principal are at an arm’s length, the second stipulation of Article 5(5) would not be satisfied, even if the said agent is devoted wholly or almost wholly to the foreign enterprise.

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• The AO had held that the taxpayer constituted a dependent agent PE as per Article 5(4)(a) and 5(4)(c) of the tax treaty. The AO alleged that the Indian and the UK employees co-ordinate with each other for business development as well as marketing. They also secure orders for its parent company either in India or abroad. They negotiate with customers and secure contract for Vertex and its affiliates. However, no material has been brought on record in this regard.

• Therefore, in view of the business model of the taxpayer and in the absence of material to suggest that the conditions mentioned in Article 5(4) of the tax treaty are satisfied, it was held that Vertex India does not constitute a dependent agent PE in India.

Service PE

• The AO has held that the expatriate employees of the taxpayer were providing services other than fees for technical services in India, and therefore, the taxpayer had service PE in India in terms of Article 5(2)(k) of the tax treaty. However, the AO has not furnished any material on record to prove the same. The taxpayer submitted that no employees of the taxpayer visited India and therefore, the service PE clause does not apply. Accordingly, the Tribunal held that the taxpayer does not have a service PE under Article 5(2)(k) of the tax treaty.

Profit attribution

• Since there is no PE of the taxpayer in India, the business income is not chargeable to tax in India. Even if it is assumed that there is a PE of the taxpayer in India, no profit can be attributed since the FAR of such a PE has already been compensated at an arm's length price. Therefore, nothing more should be attributed to it.

Reimbursement of royalty

• The taxpayer while relying on the decision of Modicon network private limited\(^9\) contended that there was no income element in the entire amount of reimbursements. The Tribunal held that it cannot be said that the amount allocated by the taxpayer was on a cost to cost basis. Therefore, the payment of reimbursement of expenses with respect to access circuit, networks, bandwidth and call charges are taxable as royalty under Article 13(3)(b) of the tax treaty.

Our comments

The issue with respect to a foreign company having a business connection/PE in India has been a matter of debate before the courts. The Delhi Tribunal in this decision dealt with a case of a UK company engaged in outsourcing services. The Tribunal held that the UK company was having a business connection in India under the Act. However, it did not constitute a fixed place PE or service PE or DAPE in India under the tax treaty. The Tribunal also held that even if it is assumed that there is a PE of the taxpayer in India, no profit can be attributed to it, since the PE was compensated at an arm’s length price in accordance with the FAR analysis.

The Delhi High Court in the case of e-Fund Corporation, USA\(^10\) held that the taxpayer did not create a fixed place PE under the India-USA tax treaty since the taxpayer neither had a fixed place of business in India through which business of enterprise was wholly or partly carried on nor had the right to use any of the premises belonging to e-Fund India. The High Court also held that the Indian subsidiary was neither authorised nor habitually exercised the authority to conclude a contract. Therefore, there was no agency PE of the taxpayer in India. Since appropriate income was declared and taxed in the hands of e-Fund India, nothing remains to be attributed or taxed in the hands of the taxpayer.

\(^9\) ACIT v. Modicon network private limited [2007] 14 SOT 204 (Del)
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