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TAX FLASH NEWS

7 June 2016

Indian subsidiary of a US company does not constitute a PE in India as it does not satisfy any of the tests of PE Article of the India-USA tax treaty

Background

Recently, the Delhi High Court in the case of Adobe Systems Incorporated[1] (the taxpayer) while dealing with the issue of whether the Indian subsidiary of a US company was having any type of Permanent Establishment (PE) in India held that Indian subsidiary did not satisfy any of the tests under PE Article of the India-USA tax treaty (tax treaty). Accordingly, though it was a subsidiary of a foreign company, it does not constitute a PE in India.

There is no material that would suggest that the taxpayer has undertaken any activity in India other than services which have already been subjected to Arm's Length Price (ALP) scrutiny/adjustment in the hands of Adobe India. Even if the Assessing Officer (AO) is correct in its assumption that Adobe India constituted the taxpayer's PE in India, the facts of the present case do not provide the AO any reason to believe that any part of the taxpayer's income had escaped assessment under the Act. Accordingly, the High Court set aside the reassessment proceedings.

Facts of the case

- The taxpayer is a U.S. based company engaged in the business of providing software solutions for network publishing which includes the web, print, video, wireless and broadband applications.
- The taxpayer has a wholly owned subsidiary in India i.e. Adobe India. Adobe India provides software related Research and Development (R&D) services to the taxpayer. The taxpayer does not have any business operations in India.
- In terms of an agreement entered into between the taxpayer and Adobe India, the R&D services rendered by Adobe India were paid by the taxpayer on cost plus basis. R&D activities carried out by Adobe India were on an assignment basis, and it did not entail an end to end software development.
- Since Adobe India provides R&D services to its holding company, its transaction has been subjected to examination by the Transfer Pricing Officer (TPO). The TPO for Assessment Year (AY) 2004-05 and 2005-06 has accepted the fees paid by the taxpayer on cost plus 15 per cent basis as being on ALP and made an assessment in the hands of Adobe India accordingly.
- Subsequently, for AY 2006-07, the TPO/AO did not accept the TP study as he did not accept the set of comparables used by Adobe India to determine ALP. However, the Income-tax Appellate Tribunal (the Tribunal) accepted a set of comparables used by Adobe India to determine ALP.
- Further, for AY 2007-08, transfer pricing study furnished by Adobe India was not accepted by the TPO, who sought to apply Profit Split Method (PSM) for determining the ALP instead of Transactional Net Margin Method (TNMM) used in the preceding years. On an appeal to the Dispute Resolution Panel (DRP), the DRP held that ALP shall be determined by applying TNMM as in the preceding years.

[1] Adobe Systems Incorporated v. ADIT (Writ Petition (C) 2384/2013 & CM 4515/2013) – Taxsutra.com

- Subsequently, the AO issued the reassessment notices[2] under Section 148 of the Income-tax Act, 1961 (the Act). In response to the said notice, the taxpayer claimed that since it did not conduct any business activity in India and had not earned any taxable income except the interest on advances received from Adobe India, it was not liable to file its return of income under Section 139(1) of the Act by virtue of the provisions of Section 115A(5)[3] of the Act. The taxpayer claimed that it did not have a PE in India, and since Adobe India has been assessed at arm's length, no part of the taxpayer's income could be attributed to Adobe India.
- The AO passed an order under Section 148 of the Act for a reason to believe that the taxpayer's income for AYs in question had escaped assessment. The AO recorded various reasons for reopening the assessment. The AO held that activities carried out by Adobe India were a part of the taxpayer's core business activities and hence Adobe India constituted as the taxpayer's PE under Article 5(1) of the tax treaty. In terms of the agreement, the taxpayer was obliged to provide assistance, specifications and supervision and was further entitled to audit the facilities of Adobe India for maintenance of the requisite standards. This indicates that the taxpayer had a Service PE in India in terms of Article 5(2)(l) of the tax treaty. The AO also held that Adobe India is a dependent agent of the taxpayer. It was held that a part of the profit accruing to the taxpayer attributable to the activities in India was chargeable to tax under the Act.
- The taxpayer filed a writ petition before the Delhi High Court against the AOs order.

High Court's ruling

Transfer pricing and reassessment

- The purpose of enacting the transfer pricing regulations is to ensure that income from transactions between the related parties is not shifted out of India so as to escape or mitigate the incidence of tax payable under the Act. Thus, the transfer pricing regulations are to be read as providing the framework, to tax the real income of a taxpayer derived from international transactions with a related party. They cannot be read as provisions to impute any hypothetical income in the hands of a taxpayer. Thus, the transfer pricing adjustments in respect of the activities of Adobe India must be read to have resulted in capturing the entire income from the said activities in the net of tax.
- Services provided by Adobe India to the taxpayer have been remunerated by the taxpayer on cost plus basis, and the same has been accepted in AYs 2004-05 and 2005-06. Thus, the real income of Adobe India, which is related to the activities carried out by Adobe India, has been brought to tax in its hands.
- Even if Adobe India is considered to be the taxpayer's PE, the entire income which could be brought in the net of tax in the hands of the taxpayer has already been taxed in the hands of Adobe India.
- There was no material that would suggest that the taxpayer had undertaken any activity in India other than services which have already been subjected to ALP scrutiny/adjustment in the hands of Adobe India. Even if the AO was correct in its assumption that Adobe India constituted the taxpayer's PE in terms of Article 5(1), 5(2)(l) or 5(5) of the tax treaty, the facts of the present case do not provide the AO any reason to believe that any part of the taxpayer's income had escaped assessment under the Act.
- According to the AO, the profits attributable to the activities carried out by Adobe India are to be ascertained by PSM as, according to him, the method used by Adobe India for determining the ALP did not fairly capture the profits which could legitimately be taxed under the Act. The High Court observed that the question as to which is the correct method of determining the ALP could only be debated in proceedings relating to the assessment of Adobe India. The fact that the AO had not succeeded in persuading the DRP to accept his point of view cannot possibly provide him a reason to now try and assess profits calculated on PSM in the hands of the taxpayer. Accordingly, the reassessment notices and the proceedings initiated by the AO are liable to be set aside.

Subsidiary PE

- In the present case, Adobe India is a separate taxpayer and is liable to pay tax on its income. The fact that a holding company in another contracting state exercises certain control and management over a subsidiary would not render the subsidiary as a PE of the holding company. This is expressly spelt out in Article 5(6) of the tax treaty.

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[2] For AYs 2004-05, 2005-06 and 2006-07 respectively

[3] Section 115A(5) of the provides that the non-resident whose income is in the nature of dividend, royalty, and technical service fees, it shall not be necessary to furnish return of income under Section 139(1) of the Act if (a) its total income in respect of which he is assessable during the previous year consisted only of income referred to in Section 115A(1)(a) of the Act (b) the tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income

- However, the fact that a subsidiary company is a separate tax entity does not mean that it could never constitute a PE of its holding company. In certain circumstances, where the specified parameters defining PE are met, a subsidiary would constitute a PE of its holding company. However, in determining whether the requisite parameters are met, it is necessary to bear in mind that a subsidiary is a separate legal entity and its activities, the income from which are assessed in its hands at arm's length pricing, cannot be the sole basis for the purposes of imputing the subsidiary to be a PE of its holding company.
- It has been observed that a subsidiary is liable to pay tax on its income, and a foreign holding company is liable to pay tax on its income. The same set of activities cannot be construed as that of a holding company through its PE and that of the subsidiary as its own activity resulting in income from the same activities being taxed twice over; once in the hands of the subsidiary and again in the hands of the holding company.
- In cases where a subsidiary acts as an agent of its holding company, the income from the activities conducted by the subsidiary for and on behalf of its principal would be assessed in the hands of the principal i.e. the holding company and not in the hands of the subsidiary.
- The subsidiary would only be liable to pay tax on the remuneration receivable as an agent, and such remuneration would clearly be deductable while computing the income in the hands of the holding company.

Fixed place PE

- The fixed place must be at the disposal of an enterprise through which it carries on its business wholly or partly. Although the word 'through' has been interpreted liberally but the very least, it indicates that the particular location should be at the disposal of the taxpayer for it to carry on its business through it. These attributes of a PE under Article 5(1) of the tax treaty were elucidated by the Supreme Court in Morgan Stanley[4].
- In the case of E-Funds IT Solution[5] the Delhi High Court has held that 'the term 'through' postulates that the taxpayer should have the power or liberty to control the place and, hence, the right to determine the conditions according to its needs. However, in the present case, there was no allegation that the taxpayer has any branch office or any other office or establishment through which it was carrying on any business other than simply stating that Adobe India's constitutes the taxpayer's PE. There was no evidence that the taxpayer had any right to use the premises or any fixed place at its disposal.
- Thus, the right to use test or the disposal test was not satisfied for holding that the taxpayer had a PE in India in terms of Article 5(1) of the tax treaty. In the case of E-Funds IT Solution, the Delhi High Court had expressly negated that an assignment or a sub-contract of any work to a subsidiary in India could be a factor for determining the applicability of Article 5(1) of the tax treaty.
- Thus, the AO's view that Adobe India constituted the taxpayer's PE under Article 5(1) of the tax treaty is palpably erroneous and not sustainable on the basis of the facts as recorded by him.

Service PE

- There was no material to hold that the taxpayer's employees constituted a Service PE in terms of Article 5(2)(l) of the tax treaty. The AO has concluded that the taxpayer has a PE in India in terms of India-USA tax treaty, only on the basis that the taxpayer has right to audit Adobe India and that agreement between the taxpayer and Adobe India entails that the taxpayer would provide specification, assistance, and supervision for the R&D services procured by the taxpayer. The said terms of the agreement do not in any manner indicate that the taxpayer has been providing services in India.
- The agreement referred to by the AO indicates that the taxpayer authorised to audit the Indian subsidiary, so as to ensure that Adobe India adheres to the standards required by the taxpayer. The same cannot possibly lead to the inference that the taxpayer has been rendering services to Adobe India.

[4] DIT v. Morgan Stanley & Company Inc.[2007] 292 ITR 416 (SC)

[5] DIT v. E-Funds IT Solution [2014] 364 ITR 256 (Del)

- The stipulation as to provide specification and further assistance is only for the purpose of ensuring that the taxpayer procures the service that it has contracted for from Adobe India. Such clauses in the agreement cannot lead to the inference that the taxpayer has a PE in India for rendering services as per the provisions of Article 5(2)(l) of the tax treaty. This has also been clarified by the Supreme Court in the case of Morgan Stanley.

Agency PE

- One of the necessary conditions for holding that an agent constitutes a PE of an enterprise is that the agent must have authority to conclude contracts or should have been found to be habitually entering into or concluding contracts on behalf of the enterprise. In the present case, there is no allegation that Adobe India was authorised to conclude contracts on behalf of the taxpayer or has been habitually doing so. There was neither any agreement which states so nor any material which indicated that Adobe India acts as such.
- It is not disputed that Adobe India was assessed on its income determined at ALP, and therefore, there was no occasion to assume that Adobe India constituted the taxpayer's PE under Article 5(5) of the tax treaty.

Our comments

The issue of determination of a PE of a foreign company in India has been a matter of debate before the courts/tribunal. The issue gets even more complex when the foreign company has a subsidiary in India. Various Courts/Tribunal have held that having a subsidiary in another state itself does not result into a PE in that state. The subsidiary can become a PE of the holding company if it satisfies the conditions of PE Article of the tax treaty.

The Delhi High Court, in the instant case, observed that where a holding company in another contracting state exercises certain control and management over a subsidiary, would not render the subsidiary as a PE of the holding company. However, it was also observed that the fact that a subsidiary company is a separate tax entity does not mean that it could never constitute a PE of its holding company. In certain circumstances, where the specified parameters defining a PE are met, a subsidiary would constitute a PE of its holding company. However, in determining whether the requisite parameters are met, it is necessary to bear in mind that a subsidiary is a separate legal entity and its activities, the income from which are assessed in its hands at arm's length price, cannot be the sole basis for the purposes of imputing the subsidiary to be a PE of its holding company.

The High Court has dealt with all the test under the PE Article of the tax treaty and held that the US company was not having a PE in India. Further, it has been observed that there was no material that would suggest that the taxpayer has undertaken any activity in India other than services which have already been subjected to ALP scrutiny/adjustment in the hands of the Indian company. Even if the AO is correct in its assumption that Adobe India constituted the taxpayer's PE in India, the facts of the present case do not provide the AO any reason to believe that any part of the taxpayer's income had escaped assessment under the Act.

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