Tax liability in case of Dependent Agent Permanent Establishment of Assessee : *A Case Study*

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In a recent Delhi High Court ruling(Rolls Royce, Singapore Pvt. Ltd. v. Assistant Director of Income Tax)[1], it was held that Rolls Royce's operations of supplying repair and maintenance services, and spare parts to customers in the Indian oil and gas industry, created a permanent establishment in terms of Indo-Singapore Double Taxation Avoidance Agreement (DTAA) and hence the company was liable to pay tax in India.

The ruling upholds the October 2007 decision of the Delhi Income Tax Appellate Tribunal.[2] This case study includes a brief overview of the concept of DTAA in India and related legal provisions of the Income Tax Act, 1961, and a thorough analysis of the Delhi High Court ruling and its implications.

1. Concept of Double Taxation and Double Taxation Avoidance Agreement

Double taxation refers to taxation by two or more countries of the same income, asset or transaction. A business or individual who is resident in one country often makes a taxable gain in another country. In such a situation, such business or individual might be obliged by domestic laws to pay tax on that gain locally and pay again in the country in which the gain was made. To avoid such double taxation, many nations enter into bilateral Double Taxation Avoidance Agreements (DTAA) with each other.[3]

2. DTAA in India

India has a DTAA with more than 100 countries till date, including Singapore, with which India has a comprehensive DTAA.[4] A comprehensive DTAA means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act 1961 (the Act), there are two provisions, Sections 90 and 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to taxpayers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.[5]

It is well settled that in India the provisions of the DTAA override the provisions of the domestic statute. Moreover, with the insertion of Section 90(2) in the Act, it is clear that an Assessee has an option of choosing to be governed either by the provisions of particular DTAA or the provisions of the Income Tax Act, whichever are more beneficial. The non-resident can take the benefit of the provisions of DTAA entered into between India and the country in which he resides.[6]

3. Brief Background of the Case

Rolls Royce Singapore Pvt. Ltd. (Assessee-company) was primarily engaged in the business of sale of spare parts for various equipments such as oil field equipments, compressor systems etc. and the services rendered in connection with repair and overhauling of such equipment. It rendered repair and maintenance services and supplied spares to customers in India in the oil and gas industry and was a non-resident under the provisions of the Act. The assessment years 2000-01 to 2004-05 were the subject matter of present appeals filed by the company. In the income tax returns filed by it for that period, it had shown income from maintenance services as fee for technical services (FTS) under Section 9(1)(*vii*) read with

Sections 115A, 43(2) and 145 of the Act and paid tax @ 20 per cent thereupon as per the provisions of the Act. It had not declared any income for supply of equipments made to the Indian clients on the ground that it had no permanent establishment (PE) in India and, therefore, its business income from supply of spare parts was not chargeable to tax in India.

4. Holdings of Various Authorities on the Point of Establishment of a PE

4.1 Assessing Officer (AO)

The AO was of the view that since the Assessee-company was discharging the contractual obligation of the supplier of the original equipment, providing maintenance services as well as making supply of spares by the Assessee-company was incidental to the supply of original equipment made by the other company of Rolls Royce Group. The AO, therefore, took the view that the Assessee-company had a business connection and source of income in India in terms of Section 9(1)(*i*) of the Act and had a PE in India. The Assessee-company was thus held to be liable to pay tax in respect of income earned on supply of spares as business profit for the assessment years in question.

4.2 Commissioner of Income Tax (Appeal) [CIT(A)]

The CIT(A) agreed with the AO's view and held that the Assessee-company had a PE in India within the meaning of Article 5(1), 5(2)(*f*), 5(2)(*i*), 5(5), 5(6) and 5(8) of the DTAA on the following counts:

(*i*) That the Assessee-company had a source of income in India;

(*ii*) That the Assessee-company had established a complete set up of facility for providing services to the customers, during the whole year; and those services and facilities were provided in respect of the original equipment supplied by some others who were related/associated concern of the Assessee for a period of more than 30 days.

(*iii*) That office of the ANR Associates (ANR) was used for receiving and soliciting orders;

(*iv*) That ANR was a dependent agent permanent establishment of Assessee.

4.3 Income Tax Appellate Tribunal, Delhi (ITAT)

ITAT did not accept the fact that merely because the Assessee-company was a part of a Group Company of Rolls Royce, which had worldwide operations, because of other operations of the Group Companies, the Assessee-company could be deemed to have a PE in India. According to ITAT, the Assessee-company, like each company belonging to Rolls Royce Group was a separate entity and a separate tax Assessee. Likewise, merely because some income accrued to the Assessee-company in India from deployment of engineers and personnel in undertaking the maintenance and service of equipments at the sites of Indian clients located in India, was not a ground to hold that it had a PE in India in the absence of any material showing and indicating that the contract for providing service and supplying spare parts was inter-connected and related. The finding of AO that the Assessee-company shall be deemed to have a PE in India to carry on the business through PE as it had been providing service facility in India for a period of 183 days in a fiscal year to ONGC and GAIL in connection with their activity of exploration, exploitation or extraction of material oil in India was turned down by ITAT holding that no material was brought on record to prove and establish the same. The only reason given by the AO and accepted by the CIT (A) which was affirmed by the ITAT for holding that the Assessee-company had a PE in India was the relationship between the Assessee-company with ANR, which made ANR as the PE of the Assessee-company within the meaning of Article 5(1) and 5(2) of the Indo-Singapore DTAA. The said ANR was held to be a dependent agent of the Assessee-company within the meaning of Article 5(8) read with Articles 8 and 9 of DTAA.

5. Role of ANR Associates – The Debate

The finding of the AO and CIT (A) that the activities of ANR were much more than those provided for in the contract entered into between the Assessee-company and ANR was held to be wrong and was rejected by ITAT.

ITAT looked into the question as to whether in the light of nature of activities carried out by the ANR as per the agreement between ANR and the Assessee-company, the Assessee-company could be said to have a PE in India in the form of ANR. ITAT held that the relationship between the Assessee-company and ANR was not on principal-to-principal basis. Instead, the ANR acted as a dependent agent of the Assessee-company and its activities were controlled by it. The ANR, therefore, could not be regarded as an agent of an independent status within the meaning of Article 5(9) of DTAA. According to the ITAT, ANR was the sole agent of the Assessee-company and it was "almost wholly" earning from the Assessee-company. ANR was held not to be an independent agent within the meaning of Paragraph (9) of Article 5 of DTAA between India and Singapore because:

(*a*) All activities were performed by ANR for the Assessee-company from its fixed place of business maintained in India. ANR or its offices were used by the Assessee-company for soliciting order by performing the activities or services mentioned in the agreement;

(*b*) ANR was not acting in its ordinary course of business while acting for the Assessee-company;

(*c*) An extensive control was being exercised by the Assessee-company upon ANR who was bound to take instructions and advice from the Assessee-company or its representatives;

(*d*) The transaction between the Assessee-company and ANR, where the Assessee-company paid to ANR US$ 40,000 was not at arm's length. Prior to 1st January, 2002, commission was being paid @ 5 per cent of invoice value, which was later changed to lump-sum amount of US$ 40,000 payable annually. This sort of fixation of remuneration was usually not done between two independent parties in any uncontrolled transaction. The remuneration payable, therefore, seemed to be in the nature of transaction controlled by the Assessee-company.

As lump-sum commission of US$ 40,000 was not treated at arm's length, ITAT went into the issue of percentage of the income and concluded that the amount of profit attributable to PE at 10 per cent, as determined by CIT (A) was proper as against the AO's view that it should have been 25 per cent. The order of the CIT (A) on this aspect was sustained.

Thus, ITAT concluded that the Assessee-company had PE in India within the meaning of Article 5(1) of DTAA through its dependent agent ANR. ITAT also held that even in terms of Article 5(8), Article 5(9) of the DTAA, ANR would be deemed to be the "PE" in India.

6. Issues Decided by the High Court

Present Appeals arose out of the common order passed by ITAT. Five Appeals were filed by the Assessee-company and 12 appeals were filed by the Revenue. The following questions were answered by the Court:

6.1. Whether in the facts and circumstances of the case, the ITAT grossly erred in holding that ANR should be regarded as a dependent agent PE of the Assessee-company under Article 5 (8) of the DTAA between India and Singapore on the premise that ANR habitually secured orders wholly and mainly on behalf of the Assessee-company?

Held. It was contended by the Assessee-company that it was not the sole client of ANR and that activities of ANR were not devoted wholly or almost wholly on behalf of the Assessee-company. The question whether ANR had income from other clients as well and

the extent of such income was considered by the Court to be relevant to decide as to whether the criteria stipulated in Article 5(9) was satisfied or not. The Court held that the AO did not look into the matter from this angle and ITAT also disposed of the issue deciding against the Assessee-company without looking into ANR's income-tax returns. The matter was remanded back to the AO to decide the question of applicability of Article 5(9) as to whether the ANR was providing services to companies other than the Assessee-company as well and had substantial income from those other companies, and that ANR was wholly or almost wholly working on behalf of the Assessee-company. Onus was on the Assessee-company to show that ANR had been rendering services and earning commission from other companies on the basis of which it could not be said that the ANR devoted wholly or almost wholly on behalf of the Assessee-company. These matters were thus remanded back to the Assessing Officer for fresh adjudication.

6.2 Whether in the facts and circumstances of the case, ITAT grossly erred in concluding that ANR had not been compensated at arm's length price (ALP), without adequate basis to arrive at such a conclusion?

***Held*.** It was clear that the Assessee-company could dictate the terms of the payment by altering the same and reducing it to the US$ 40,000 per annum from 5 per cent of invoice value when Assessee found that on the basis of 5 per cent, total commission payable could be much higher. This led to the inference that the Assessee-company was in a position to dictate the terms and in the absence of any transfer pricing analysis by the transfer pricing officer in the instant case, it could not be said that such commission could fit the description of "reasonable profits" within the meaning of Article 7(2) of DTAA. The Assessee-company could not establish that the remuneration paid to ANR was equal to arm's length remuneration. To determine whether an agent is remunerative at arm's length, it was necessary to take into account all the risk taking functions of the multi-national enterprise. The Supreme Court has referred to the "functions performed and the risk assumed by the enterprise" as distinguished from the functions performed and the risk assumed by the agent (who may constitute a dependent agent PE).[7]

Question was answered in favour of the Revenue and against the Assessee-company.

6.3 Whether in the facts and circumstances of the case, the ITAT grossly erred in holding that 10 per cent of the profits on sales of spare parts made in India by the Assessee-company should have been attributable to the activities carried out by ANR in India and chargeable to tax in India under the Act?

Held. Once it was held that commission of US$ 40,000 per annum did not represent the ALP, order of the CIT (A) as well as ITAT fixing 10 per cent of the invoice value for the purpose of taxation, inasmuch as the test was "profits accepted to make", could not be faulted with. The performance of ANR was to render support service in relation to promotion of sale and the products of the Assessee-company in India and it had no authority to negotiate, accept any order or make or vary any contract or to make any warranty or representation in terms of Paragraph 8.1 of the agreement. Therefore, the risk assumed by the ANR was limited. ANR had not performed or assumed responsibility for anything beyond what was written in the agreement. Therefore, the income with respect to the supplies was to be computed in terms of Article 7 of DTAA and not under Article 12. This was the reason that the CIT (A) reduced the percentage from 25 to 10 per cent. Insofar as assessment years 2002-03, 2003-04 and 2004-05 were concerned, CIT (A) maintained the attribution of income @ 25 per cent of the profits. This view was correctly upheld by ITAT. The issue was accordingly answered and, therefore, on this point, plea of both the Assessee-company and Revenue for taxing 25 per cent of the invoice value was rejected.

7. Disposition

Appeals of the Assessee-company were partly allowed to the extent Issue No. 1 was remanded back to AO for fresh adjudication.

Appeals preferred by the Revenue were dismissed as the ITAT order was upheld in entirety.

8. Conclusion

From the above order, it can be inferred that the Court considers it critical to examine whether the agent of an Assessee-company has carried out work wholly or almost wholly for the Assessee-company, to determine if he is an independent agent under the India-Singapore Double Taxation Avoidance Agreement (DTAA) or not. Also, the ruling lays high emphasis on significance of Transfer Pricing Analysis for attribution of profit to the PE. Thus, multi-national enterprises having operations in India need to carefully examine all these factors to make an accurate assessment of a potential PE risk.

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1. MANU/DE/3479/2011 (decided on 30.08.2011).
2. Rolls Royce PLC v. Deputy Director of Income-Tax, MANU/ID/5085/2007
3. http://en.wikipedia.org/wiki/Double_taxation.
4. http://law.incometaxindia.gov.in/DIT/intDtaa.aspx.
5. http://en.wikipedia.org/wiki/Double_taxation.
6. http://www.nritaxservices.com/tax_dbl.htm.
7. DIT (International Taxation) v. Morgan Stanley and Co. Inc., MANU/SC/2750/2007.