Liaison Office And Permanent Establishment: As Explained By The Supreme Court Of India

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The take of SC on Liaison Office and Permanent Establishment

One of the options available for foreign companies to ensure their presence in India is to establish a liaison office with the approval of the Reserve Bank of India ("RBI"). Liaison Offices are typically allowed to operate for a certain period and act as a communication channel between the foreign parent company and entities in India[1]. The nature of the office is such that they are not allowed to undertake any commercial activities and will have to maintain itself out of the remittances received from its parent company[2]. Given this nature, one of the issues that often arises is whether a liaison office can be considered as a Permanent Establishment ("PE") of a foreign parent company in India. Recently, the Supreme Court of India ("SCI"), in *Union of India v. U.A.E. Exchange Centre* [3]dealt with this issue. The brief facts and the analysis of SCI's ruling are in the following paragraphs.

BRIEF FACTS OF THE CASE

U.A.E Exchange Centre ("Taxpayer"), a company incorporated in the UAE had set up liaison offices ("LO") in India, post approval from the RBI. The Taxpayer is engaged in providing remittance services for money transfers to non-resident Indians in UAE. The remittance services include the collection of the funds by the Taxpayer and making an electronic remittance of the funds to the beneficiaries on behalf of its NRI customer in either of the following mechanism:

(i) Mechanism 1[4]: Telegraphic Transfer through normal banking channels without any involvement of LO;

(ii) Mechanism 2[5]: On request from the NRI remitter, the Taxpayer sends instruments such as cheques/drafts through its liaison offices to beneficiaries in India. Under this mode, LO download the particulars of remittance (while staying connected to the server in UAE), print and courier the instruments to beneficiaries in India.

An agreement in pursuant to which the funds are remitted to India was entered between the Taxpayer and NRI remitter in UAE. The collection of funds was done entirely in U.A.E. Having filed returns for the assessment years 1998-99 to 2003-04, showing nil income, the Taxpayer filed an application with the Indian Authority for Advance Rulings ("AAR") seeking a ruling on whether the income derived from the LO's activities accrued, or was deemed to accrue, in

India.
The AAR applying the business connection principle ruled the applicability of Section 9 (1) of the Income Tax Act, 1961 ("IT Act") for the activities mentioned in Mechanism 2. It further held that preparatory and auxiliary exception under the India UAE Treaty would not be applicable in respect of Mechanism 2. Challenging the order of the AAR, the Taxpayer filed a writ petition before the Delhi High Court.
The High Court, relying on the cases of Azadi Bachao Andolan[6] and Morgan Stanley[7] concluded that the Taxpayer does not have a PE in India. A special leave petition was filed by the tax department challenging the High Court ruling before the SCI. Confirming the High Court's findings that the activities conducted by the LO are excludable from the purview of PE, the SCI's analysis are paraphrased below:
ANALYSIS OF THE JUDGEMENT AND KEY TAKEAWAYS
Rejecting the arguments of the tax department and re-affirming the Delhi High Court's findings that the activities conducted by the LO are preparatory and auxiliary in nature under Article 3(e) of the India –UAE DTAA, thus excluded from the purview of the PE, following are the key take ways from the SCI's judgement:
a. DTAA will override domestic tax provisions:
Citing a number of judgements, the Court reiterated the settled principle that the provisions of the Double Taxation Avoidance Agreement notified by the Government of India in the exercise of powers conferred under 90 and 91 of the IT Act will override the domestic tax provisions (in this case Section 9 (1) (i) of the IT Act). Two significant decisions, the Court took a note are a) *Azadi Bachao Andolan & Anr* case and b) *Arabian Express Line Ltd. of United Kingdom & Ors. vs. Union of India*[8], where the Court went on to refer paragraph 28,
"28. A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that Section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a Double Taxation Avoidance Agreement. When that happens, the provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income Tax Act. We approve of the reasoning in the decisions which we have noticed.
If it was not the intention of the legislature to make a departure from the general principle of chargeability to tax under Section 4 and the general principle of ascertainment of total income under Section 5 of the Act, then there was no purpose of making those sections "subject to the provisions of the Act".
The very object of grafting the said two sections with the said clause is to enable the Central Government to issue a notification under Section 90 towards the implementation of the terms of DTACs which would automatically override the provisions of the Income Tax Act in the matter of ascertainment of chargeability to income tax and ascertainment of total income, to the extent of inconsistency with the terms of DTAC".
b. LO's exposure to PE, purely faced based:
Contrary to the general perception that the income generated by the foreign parent company should not be attributable to LO since it does not undertake commercial activities (and merely acts as a communication channel), LOs are

often exposed to PE primarily for two reasons. Firstly, invoking the business connection between the LO and its parent foreign company in terms of section 9(1)(i) of the IT Act and b) LO falling within the definition of PE under Article 5 of the relevant tax treaty (Article 5 of the India – UAE DTAA deals with PE).

Having said that, few exceptions are carved out in the relevant tax treaty (Article 5(3) of India – UAE DTAA) which mentions that if the activities carried by the LO are preparatory or auxiliary in nature, PE is not constituted. However, judicial precedents in India have been inconsistent in examining if the LOs activities are preparatory or auxiliary in nature for the reason that the facts in the said disputes were different.

The SCI acknowledged this by stating that the determination of activity (i.e., if the activity is preparatory or auxiliary) are fact-based and went on to hold that the Taxpayer did not carry out any business activity in India as such, but only dispensed with the remittances by downloading information from the main server of the parent company in UAE and printed cheques/drafts drawn on the banks in India as per the instructions given by the NRI remitters in UAE.

The Court noted that the transaction(s) being completed with the remitters in UAE, no charges towards fee/commission could have been collected by the Taxpayer in India and concluded that the liaison office is not a PE in terms of Article 5 of DTAA (as it is only carrying on the activity of a preparatory or auxiliary character).

c. RBI Approval Letter to be a determining factor:

One of the key reasoning of the SCI in holding that the activities of the Taxpayer are of a preparatory or auxiliary character, seems to be based on the onerous conditions specified in the RBI approval letter. The Court in para 9

"*The conditions make it amply clear that the office in India will not undertake any other activity of trading, commercial or industrial, nor shall it enter into any business contracts in its own name without prior permission of the RBI. The liaison office of the respondent in India cannot even charge commission/fee or receive any remuneration or income in respect of the activities undertaken by the liaison office in India.*

From the onerous stipulations specified by the RBI, it could be safely concluded, as opined by the High Court, that the activities in question of the liaison office(s) of the respondent in India are circumscribed by the permission given by the RBI and are in the nature of preparatory or auxiliary character".

Relying on the aforementioned factor in light of the cases of Morgan Stanley and E-Funds IT Solution Inc case[9], Court was of the view that LO does not constitute a PE of the Taxpayer in accordance with Article 5 of the treaty. The SCI agreed with the findings of the High Court and rejected the tax authorities' appeal.

FINAL COMMENTS

Of all the take aways mentioned in this article, reliance placed by the SCI upon the contents of the RBI permission letter in its reasoning, is in our view, extremely significant in the PE jurisprudence. The judgement of the SCI provides much-needed clarity on the PE exposure for liaison offices set up in India by foreign companies. In particular, SCI's interpretation with respect to the preparatory and auxiliary exclusion must be welcomed particularly the entities embroiled in similar disputes.

- [1] As defined under Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016
- [2] Ibid
- [3] Civil Appeal No. 9775 of 2011
- [4] Para 2 and 3 of the Judgement
- [5] Ibid
- [6] Union of India & Anr. v Azadi Bachao Andolan & Anr. 10 SCC 1 (2004) (SC)
- [7] DIT(IT) v. Morgan Stanley & Co. 7 SCC 1 (2007) (SC)
- [8] (1995) 212 ITR 31 (Guj)
- [9] Assistant Director of Income Tax-1, New Delhi vs. E-Funds IT Solution Inc. (2018) 13 SCC 294
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