Tax Hotline

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PERMANENT ESTABLISHMENT : SCOPE OF PRELIMINARY AND AUXILIARY ACTIVITIES EXPLAINED BY SUPREME COURT

- The Supreme Court rules that the activities performed by the Indian liaison offices of the UAE entity were 'preparatory and auxiliary' in nature and hence outside the purview of PE
- Affirms Delhi High Court's ruling in UAE Exchange Centre
- Relies on the scope of RBI permission for setting up the liaison offices for its conclusion

Recently in *Union of India v. U.A.E. Exchange Centre*,[1] the Supreme Court held that an Indian liaison office of a United Arab Emirates ('**UAE**') company engaged in fund remittance services did not constitute a permanent establishment ('**PE**') in India.

BACKGROUND

U.A.E Exchange Centre ('**Taxpayer**'), a company incorporated in the UAE is engaged inter alia in providing to non-resident Indians ('**NRIs**') in UAE the service of remitting funds to India. For its India centric business, the Taxpayer had set up four liaison offices in India after obtaining prior approval from the Reserve Bank of India ('**RBI**') under the Foreign Exchange Regulation, Act 1973 ('**FERA**')[2] (now replaced by FEMA).

The business model is such where funds collected from the NRI remitter are remitted to India by either of the following two modes:

*(i) telegraphic transfer ('**Mode A**'):* where the amount is remitted telegraphically by transferring directly from UAE through normal banking channels to the beneficiaries in India. Under this mode, the liaison offices have no role to play except attending to complaints regarding fraud etc.

*(ii) Physical dispatch of instruments ('**Mode B**'):* where 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, the liaison offices download the particulars of remittance (while staying connected to the server in UAE), print and courier the instruments to beneficiaries in India.

Importantly, the contract pursuant to which the funds are remitted to India is entered between the Taxpayer and NRI remitter in UAE. Also, the funds for remittance as well as the commission are collected in U.A.E.

Since assessment year ('**AY**') 1998-99 until 2003-04, the Taxpayer was filing NIL returns in India on the basis that no income had accrued or deemed to have accrued in India under the Income Tax Act, 1961 ('**Tax Act**') or India – UAE Double Taxation Avoidance Agreement ('**India - UAE Tax Treaty**'). However, owing to some doubt expressed by the Revenue, the Taxpayer filed an application for advance ruling before the Authority for Advance Rulings ('**AAR**') in 2003 seeking a ruling on *'whether any income is accrued / deemed to be accrued in India from the activities carried out by the Company in India'.*

AAR RULING

The AAR ruled that income of the Taxpayer was deemed to have accrued in India on the basis that it had a 'business connection' in terms of section 9(1) of the Tax Act in so far as activities set out in Mode B are concerned. The AAR observed that without the activities of the Indian liaison office, the transaction of remittance would not be complete. Further, the commission earned by the Taxpayer covers not only the activities carried out in UAE but also the activities carried out by the liaison offices in India.

The AAR also held that the 'preparatory and auxiliary' exception to formation of a PE under the India – US Treaty would not be applicable in respect of Mode B. The basis for this also was that transaction for remittance would not be completed without the activities of the Indian liaison office. Specifically, the AAR noted that the role of the liaison offices in Mode B is *'nothing short of performing the contract of remitting the amounts at least in part.'*

DELHI HIGH COURT RULING

The Taxpayer challenged the AAR order by way of a writ petition in the Delhi High Court ('**High Court**'). The High Court noted that the AAR's discussions and findings on the 'business connection' test under domestic law were unnecessary considering the scope of section 90 of the Tax Act which allows for tax treaties to override domestic law provisions. Accordingly, the High Court restricted its own analysis to the applicable provisions of the India – UAE Tax Treaty, i.e. Article 5 and 7.

Specifically, the High Court held that although liaison office comes within the inclusive list of fixed places of business under Article 5(2)(c), it is subject to exclusions under Article 5(3) including fixed places of business maintained solely

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for carrying out activities which are 'preparatory and auxiliary' in nature. While relying on the common meaning of the terms of 'preparatory and auxiliary' under Black's law dictionary (i.e. activities which aid / support the main activity) the High Court concluded that the activities performed under Mode B were merely 'preparatory and auxiliary' in nature. It observed that the error committed by the AAR was to read the test of 'preparatory and auxiliary' which permits making a value judgment on whether the transaction would or would not have been completed without the activities of the liaison offices and were therefore significant activities. The High Court indicated that the test of 'preparatory and auxiliary' is not a function only of whether the activities under consideration led to completion of the transaction.

In arriving at its conclusion, the High Court applied the judgment of the Supreme Court in *DIT v.* Morgan Stanley[3] and accorded a liberal and wide interpretation to the exclusionary clause of PE. The reason for this was that that by invoking clauses of PE, income which otherwise neither accrues / arises in India become taxable in India by virtue of a 'deeming fiction.'

SUPREME COURT RULING

The Revenue challenged the High Court ruling before the Supreme Court ('**SC**') by way of a special leave petition (SLP). In confirming the finding of the High Court that the activities conducted by the liaison offices were 'preparatory and auxiliary' and hence excludable from the purview of PE, the SC went one step further. It referred to the limited permission granted by the RBI under FERA to the Taxpayer regarding the activities to be conducted by the liaison offices.

The SC noted that as per the nature of activities allowed for under the RBI permission[4], the liaison offices were only allowed to provide service of and incidental to delivery of cheques / drafts drawn on bank in India. They were not allowed to perform business activities such as (i) entering into a contract with any party in India; (ii) rendering consultancy or any other service directly or indirectly with or without consideration to anyone in India; (iii) borrowing or lending any money from or to any person in India without RBI's permission. Thus, it was amply clear that the liaison offices in India were not to undertake any other activity of trading (commercial or industrial) or enter into any business contracts in its own name in India. On this basis, the SC concluded that the nature of activities conducted by the liaison offices as circumscribed by the RBI constituted 'preparatory and auxiliary' in character, and hence outside the purview of PE.

Additionally, the SC noted that that through the liaison offices, the Taxpayer was not carrying on any business activity in India, but only dispensing with the remittances by downloading the information from the UAE server and printing the cheques / drafts. The liaison offices could not even charge commission / fee for its services. Therefore, no income actually accrued to the liaison offices under section 2(24) of the Tax Act. Further, the RBI permission clearly provided that the liaison offices had to steer away from engaging in any business activity in India. For all these reasons, the SC also concluded that the Taxpayer was not carrying on any business in India and hence the deeming provisions under sections 5 and 9 of the Tax Act could not be invoked to begin with.

ANALYSIS

The *UAE Exchange Centre* case has been a significant case in the domain of interpretation of PE, specifically with respect to the 'preparatory and auxiliary' exclusion. The High Court ruling came out in 2009 and since then, the SC ruling on appeal was eagerly awaited. With the SC affirming the conclusion of the High Court, the ratio in this case has become the law of the land under the principle of *stare decisis.*

Owing to its subjective nature, the test of 'preparatory and auxiliary' becomes very difficult to apply. As of now, there are precedents which provide guidelines for the 'preparatory and auxiliary' test such as (i) to check whether the activities performed in the fixed place of business *form an essential and significant part of the enterprise as a whole*[5], (ii) whether the activities performed in the fixed place of business *form part of the core business activities* of the enterprise[6]. However, none of these precedents have the blessing of being a Supreme Court judgment yet. The closest SC judgement on this aspect is *DIT v. Morgan Stanley*[7], which also leaves scope of being distinguished on the ground that it dealt with the question of stewardship activities and Service PE, whereas the exclusion of 'preparatory and auxiliary' applies only to fixed place PE. Accordingly, an SC judgment which sets out guidelines for the application of the 'preparatory and auxiliary' test would have been helpful.

In the present case however, owing to the fact that this was not a regular appeal (but an SLP), the SC has limited its judgment to affirming the conclusion of the High Court. Thus, the judgment may not serve as one with guiding principles for the application of the test of 'preparatory and auxiliary'.

Having said that, one important take away from this judgment is that when it comes to questions of PE by way of branch offices, liaison offices etc. where RBI permission is needed, the nature of the permission may be taken into account for conducting the analysis.

– Afaan Arshad & Shipra Padhi
You can direct your queries or comments to the authors

[1] Civil Appeal No. 9775 of 2011

[2] This Act was replaced by the Foreign Exchange Management Act, 1999 in 1999.

[3] (2007) 7 SCC 1

[4] The activities allowed to be conducted by the liaison offices were (i) respond quickly and economically to enquiries from correspondent banks regarding suspected fraudulent drafts, (ii) undertake reconciliation of bank accounts held in India, (iii) act as a communication centre receiving computer (via modem) advices of mail transfer T.T. stop payments messages, payment details etc., originating from respondent's several branches in UAE and transmitting to its Indian correspondent banks; (iv) printing Indian Rupee drafts with facsimile signature from the Head Office and counter signature by the authorised signatory of the Office at Cochin; and (v) following up with the Indian correspondent banks.

[5] Western Union Financial Services, 16 101 TTJ 506

[6] Angel Garments Ltd, 287 ITR 341

[7] (2007) 7 SCC 1

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