

Tax Hotline

February 12, 2008

FOREIGN ONLINE SERVICE PROVIDER HELD TAXABLE IN INDIA

Much after the advent of electronic commerce, the challenge to the adequacy and fundamental validity of principles of international taxation such as physical presence, place of establishment, etc., still remain. One such example is the case of taxability of foreign companies engaged in maintaining and operating a computerized reservation system ("CRS"). CRS is an automated computerized system through which its subscribers are able to offer ticketing and reservation services to their clients.

The Delhi Bench of the Income Tax Appellate Tribunal ('ITAT') has recently ruled in the case of two companies Amadeus Global Travels¹ ('Amadeus') and Galileo International Inc² ('Galileo') that a foreign company operating a CRS has a taxable presence in India. Amadeus is a tax resident of Spain whereas Galileo is a tax resident of USA.

The facts pertaining to both the said cases are similar, wherein a foreign company ("A Ltd") which had developed a fully automatic CRS had entered into an agreement with its subsidiary in India ("A India Ltd") to provide data processing, software development services and services pertaining to the distribution of the A Ltd.'s products to several subscribers in India. These subscribers were travel agents in India who use these products to make airline or hotel bookings for their clients in India. A India Ltd. had been authorized by A Ltd. to enter into contracts with subscribers/travel agents within India. A Ltd. received payments from their participating carriers based on the net bookings made by such subscribers in India and across the world.

In both these rulings the ITAT held that A Ltd's CRS system through which subscribers/ travel agents in India were able to offer ticketing and reservation services to the clients in India represented a business connection and the computer hardware/ software provided to the travel agent by A Ltd. constituted its Permanent Establishment ("PE") in India. As regards the attribution of profits, same principles were applied by the ITAT in both the rulings and 15 percent of the revenue accruing to A Ltd was attributed to the PE in India.

RULING

The questions raised before the ITAT were as follows:

1. Whether A Ltd had any business connection in India under Section 9(1) (i) of the Income Tax Act 1961 ("ITA")?
2. Whether A Ltd. had any PE in India under the terms of the relevant Double Taxation Avoidance Agreement ("DTAA")?
3. Whether the income if any earned by A Ltd. in India was attributable to the PE in India?

OBSERVATIONS OF THE ITAT

The ITAT observed that the CRS extended to the Indian territory in the form of connectivity in India. Further it observed that source of revenue to the taxpayer was the request generated from the travel agents/ subscribers from computers situated in India, without which the booking was not possible. A Ltd. was not entitled to receive the payment only for display of information but the income accrued only when the booking was completed at the desk of the subscribers' computer in India. In such case, there was a continuous seamless process involved, at least a part of which was in India and hence, there was a business connection in India under section 9(1) of the ITA. On account of the establishment of business connection³ with India the foreign company was held to be taxable to such an extent as can be reasonably attributable to its operations carried out in India.

PERMANENT ESTABLISHMENT

In so far as PE is concerned the ITAT held that;

- A Ltd. had a fixed place of business since it exercised computer control over the computer installed at the premises of the subscribers; and since the supply of computers, its configuration, connectivity were all provided by A Ltd. directly or through its agent, A India Ltd.
- The activity carried on by A Ltd in India, directly contributed to the earning of revenue by it and this in no way was preparatory or auxiliary in nature.
- A India Ltd. was a totally dependent agent on A Ltd. having authority to enter into agreements with subscribers, install computers, configure them and also provide connectivity to subscribers.
- A India Ltd. was habitually exercising authority to conclude contracts on behalf of A Ltd. by being responsible for effecting and contracting with subscribers in the Indian territory as well as used reasonable efforts to provide access to all A Ltd. products within India.

Therefore the ITAT held that A Ltd had a PE in India within the meaning of Articles 5 of the relevant DTAA.

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February 12, 2025

Attribution of Profits

As regards attribution of profit the ITAT noted that the majority of the functions in this case were performed outside India, however but for the presence of A Ltd.'s CRS system in India and the configuration and connectivity provided in India, income would not have been generated in A Ltd.'s hands. Observing this the ITAT attributed 15% of the revenue accruing to A Ltd. in respect of bookings made in India. However, referring to [Morgan Stanley's case](#)⁴ and Central Board of Direct Taxes circular No. 23rd July 1999, the ITAT held that, once the PE of the non-resident is remunerated at arm's length (in both the cases, the ITAT found that the remuneration paid to the Indian subsidiary was adequate) nothing further would be left to be attributed to the PE of the foreign companies.

Implications

Finding of a PE on the basis of connectivity in India seems to be stretching basic tenets of PE too far. Further, there seems to be a growing trend in holding Indian subsidiaries as dependent agent PEs of foreign multinationals, especially where they are given authority to secure orders on behalf of the foreign company. However, in a welcome move, unlike the ruling given by the ITAT in the case of [Rolls Royce](#)⁵ and [SET](#)⁶, the ITAT followed the principle laid down by the Supreme Court in the Morgan Stanley ruling and held that even in the event that there is a PE, so long as the remuneration is at arm's length, no further profits shall be attributable to the PE of the non-resident.

- Harshal Shah, Brinda Bellur & Shefali Goradia

[1] ITA Nos. 2143, 2144 & 2145/Del/2000 & ITA Nos. 1022, 1023, and 1024/Del/2005

[2] ITA no 1733/Del/2001, 2473 to 2475/Del/2000 and 820 to 823/Del of 2005

[3] Business connection is a concept similar to that of a Permanent Establishment under a tax treaty. The term is not precisely defined in the Indian law and has much wider connotation.

[4] (2007) 210 CTR (SC) 419; (2007) 7 SCC 1

[5] ITA Nos. 1496 to 1501/Del of 2007, Oct 26 2007

[6] (2007) 106 ITD 175 (Mum)

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