PERMANENT ESTABLISHMENT – Analysis of Supreme Court Judgment in the case of Samsung

1. **Introduction**

The determination of Indian tax liability of a foreign enterprise has been a contentious and litigious matter under the Indian tax law regime. One of the issues involved is the determination of whether a foreign enterprise is conducting its business in India through a permanent establishment ('PE'), and the resultant Indian tax liability of the enterprise. Many foreign enterprises have been involved in litigation with the Indian tax authorities over this issue since many years. This article briefly covers, by way of background, the concept and definition of PE and thereafter analyses the most recent Supreme Court judgment in the case of Samsung Heavy Industries Co. Ltd.

2. **Overview of PE**

1. The general principle of taxation is that a person, who is resident of a country, would normally be taxable on its global income. However, as a rule of exception to this general principle, a person may also be taxed in the country of source i.e., the place where the business of a person is carried on, though he may be a resident of another country.
2. Section 5 of the Income-tax Act, 1961 ('the Act') provides that a non-resident shall be liable to income-tax only on the income, that is received or deemed to be received in India, or that accrues or arises or is deemed to accrue or arise in India.
3. Section 9(1)(i) of the Act inter alia states that income shall be deemed to accrue or arise in India if it accrues or arises, whether directly or indirectly, through or from any 'business connection' in India. The definition of Business connection under the Act is continuously a subject matter of expansion and now it also includes a new phrase called Significant Economic Presence. However, in international tax treaties, the term Permanent Establishment (PE) is a widely used concept used to determine the right of the source country, i.e., to tax the profits of a non-resident from a business carried on by such non-resident in the source country. Nevertheless, the PE shall be liable to be taxed in the source country only to the extent of its business profits which are attributable to such PE. The Tax payer has the choice to apply the Business Connection test as is available under the Act while comparing it with Permanent Establishment provision available under the applicable Tax treaty.

4. In the context of the Transfer Pricing Provisions as per section 92F(iiia) of the Act, 'Permanent Establishment' includes a fixed place of business through which the business of the enterprise is wholly or partly carried on. This is similar to the definition as found in most of the Treaty whereas Sec 9 while dealing with the general attribution rule employs the Business Connection test which is more wider than the test of PE as laid down under the Tax Treaty.

5. Further, as per section 90 of the Act, the Central Government has the power to enter into an agreement with other country for avoidance of double taxation or for the exchange of the information or for recovery of Income Tax under this act ('DTAA' or 'Tax Treaty').

   Also, as per section 90(2) of the Act, if the DTAA provisions are more beneficial to a Tax Payer than the provisions of the Act, then he may choose to apply DTAA provisions. Therefore, the provisions of DTAA will supersede the provisions of the Act to the extent they are more beneficial to the assessee.

   In these DTAA agreements, the broad definition of Permanent Establishment has been elucidated and most of India's agreements have adopted the definition of OECD's Model Tax Convention on Income and on Capital.

6. Article 5 of both the "Organisation for Economic Co-operation and Development (OECD) Model Tax Convention" and the "United Nations Model Double Taxation Convention (UN Model)" defines the term PE, and this definition has been adopted by countries globally in their tax treaties. The main purpose of tax treaties is to encourage international trade and commerce by avoiding double taxation, eliminating tax avoidance and providing certainty by clearly delineating the taxing rights of each jurisdiction.

7. Definition of PE:

   Relevant extracts of the definition of PE as per Article 5 of OECD Model Convention are given here under for convenience:

   1. *For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

   2. *The term "permanent establishment" includes especially:*

      a. *a place of management;*

      b. *a branch;*

      c. *an office;*

      d. *a factory;*

      e. *a workshop, and*

      f. *a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

   3. *A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.*

   4. *Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*

      a. *the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*

      b. *the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*

      c. *the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*

      d. *the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*

      e. *the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;*

f. *the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),*

g. *provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.*

8. Concept of Service PE:

1. The concept of Service PE was first inserted in the U.N. Model Tax Convention in 1980 under which services provided by a non-resident may give rise to a PE. This concept has led to controversy whether a Service PE requires a fixed place of business in the source country. India's tax treaties e.g. with UK, USA also provide for clauses relating to Service PE.

2. The relevant Article 5(3) of the U.N. Model is given below:

3. The term "permanent establishment" also encompasses:

a. *A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;*

b. *The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.*

It may be noted that usually, in most treaties, the provisions relating to Service PE are included in Article 5(2) itself. It may be noted that Article 5(2) starts with the words "The term 'permanent establishment' includes especially" and then goes on to list various types of fixed places of business and also includes the supervisory nature of activities or the furnishing of services through employees without actively specifying whether such PE requires fixed place or not.

3. Thus, the issue often arises is whether a Service PE requires a fixed place of business and whether it requires physical presence of employees. The controversy emanates due to interpretation of whether Article 5(1), which defines PE as a fixed place of business in the source country is independent of Article 5(2) although Article 5(2) uses the words "includes especially" while providing for inclusions to the definition of PE.

In the case of ABB FZ-LLC [(2017) 83 taxmann.com 86], the Tribunal observed that Article 5(2) of the India- UAE Tax treaty broadened the scope of Article 5(2). Therefore, Article 5(2) was not a prerequisite to fulfilling the requirement of Article 5(1), as Article 5(2) is independent of Article 5(1) and the condition of fixed place of business is not attached. Accordingly, it determined that ABB FZ had a Service PE and held that the presence of employees is not required in the source country for a Service PE to exist. The rationale behind the Tribunal's decision appears to be contrary to the concept of tax neutrality between a sale of goods and provision of services. Profit arising from a transaction that involves a simple sale of goods from a non-resident is not taxable in the source country in the absence of a PE of such non-resident seller. By similar reasoning, services performed outside India for an Indian resident should also be free of tax in India, if only to preserve similar treatment for sales and services.

The Johannesburg Tax Court also reached a similar conclusion in AB LLC and BD Holdings LLC v. Commr. SARS, [(13276) 2015 ZATC 2] when it observed that, by using the phrase "includes especially", the drafters of the treaty intended that the factors referred to in Article 5(2)(k) of the U.S. – South Africa Tax treaty be made part of the definition referred to in Article 5(1); otherwise, they would not have used the words "includes especially." The Tax Court, therefore held that the contents of Article 5(2)(k) must be read as an integral part of Article 5(1).

Based on this analysis, an enterprise becomes liable for taxation in the non- resident country as soon as its activities fall within the ambit of Article 5(2)(k). There is no need to examine whether a fixed place of business exists under Article 5(1).

4. To conclude, the Service PE clause was first inserted in the U.N. Model Tax Convention in 1980 when electronic commerce was unheard of. It is therefore understandable that the drafters did not intend to impose tax on services provided there was no physical presence in the source country. However, with advances in technology, the concept of a fixed base seems to be out of touch with today's business practices and hence there is a discerning trend amongst various jurisdictions to move towards taxing of such digital or electronic services. Recent E.U. proposals to tax the income of U.S.- based digital companies, such as Amazon and Google, reflect a similar approach.

9. Dependant Agency PE and Independent Agency PE:

   A Dependent Agency PE ('DAPE') is created when an enterprise resident of a contracting state becomes taxable in another host country on its business profit, if it is represented by an agent in the host country, and the agent has and habitually exercises an authority to conclude the contract. The provisions relating to DAPE are stipulated in Article 5(5) of the OECD Model. Article 6(6), which deals with Independent Agent, states that Article 5(5) shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business.

   When determining the profit attributable to the DAPE, it would logically follow that if the DAPE is paid for its services equivalent to what would have been payable to an Independent agent, then no further attribution of income or profits may be required to be made on the DAPE. However, jurisprudence and OECD commentary in this regard differs with this interpretation.

   In the case of Set Satellite (Singapore) [2007 106 ITD 175 Mum], it was observed that in respect of the DAPE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (i.e., as a result of activities carried out by the dependent agent enterprise on the non- resident enterprise's behalf). For this situation, Article 7 will be the relevant article. Further, the quantum of that profit is limited to the business profits attributable to global trading operations performed through the PE in the host country. Accordingly, in order to attribute profits to the DAPE, the arms' length principle as per the authorized OECD approach involving a FAR analysis i.e. functions undertaken, assets used and risks assumed should be followed.

10. PE and BEPS Action Plan & MLI:

    1. As part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, the OECD has published in Oct. 2015 its final report on Action Plan 7 "Preventing the artificial avoidance of permanent establishment status" (BEPS Report). Action Plan 7 contains changes to the definition of PE to prevent its artificial circumvention, e.g., such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors, by commissionnaire arrangements, with a resulting shift of profits out of the country from where the sales took place, without a substantive change in the functions performed in that country.

    2. Action Plan 15 provides an analysis of legal issues related to the development of a multilateral instrument (MLI) to enable countries to streamline the implementation of the BEPS treaty measures. Accordingly, Article 12 and Article 13 of the MLI deal with "Artificial Avoidance of Permanent Establishment Status through Commissionnaire

    3. Arrangements and Similar Strategies" and "Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions" respectively. The Government of India, on 6th June 2017, has provided the provisional list of expected reservations and notification pursuant to Article 28(7) and 29(4) of the MLI, and India has accepted certain provisions of Articles 12 and 13 of the MLI.

3. **Supreme Court Judgment in the case of DIT-II New Delhi Vs Samsung Heavy Industries Co. Ltd. [DIT New Delhi Vs Samsung (Civil Appeal No. 12183 of 2016)]**

    1. This recent judgment of July 2020 is concerned with the preparatory or auxiliary activities exception to permanent establishment, otherwise known as the specific activity exemption. The case involves the India – Korea DTAA.

       As per Article 7(1) the said DTAA, the business profits of such enterprise would generally be taxable only in Korea, unless the enterprise engages in business through a PE situated in India. In such a case, the profits of enterprise would be taxable in India as well. However, only that portion of the profits which can be attributed to

the Indian PE may be taxed in India. For this, the Indian Revenue has to first establish that there is a PE of the enterprise in India.

2. **Facts of the case**

    1. In 2006, the Oil and Natural Gas Corporation, a state-owned enterprise of the government of India, awarded a turnkey contract to a consortium comprising of Samsung Heavy Industries (‘Samsung’), a company incorporated in South Korea, and an Indian company.
    2. The scope of the contract was to carry out work, inter alia, of surveys, design, engineering, procurement, fabrication, installation and modification at existing facilities, and start-up and commissioning of the entire facilities covered under the Vasai East Development Project.
    3. Samsung set up a project office in Mumbai to act as a communication channel with the Oil and Natural Gas Corporation for the project. Pre-engineering, survey, engineering, procurement, and fabrication activities took place abroad.
    4. Samsung ’s India income tax return declared a loss in relation to its activities carried out in India.

3. **Assessment Officer’s findings**

    1. The assessing tax officer issued a show cause notice, alleging that Samsung’s offshore supply and services should be taxed in India as they were attributable to a permanent establishment in India. According to the assessing officer, the project office was involved in the core activity of execution of the project the designing or fabrication of materials and therefore was a permanent establishment of Samsung in India within the meaning of Article 5.1 of the India-Korea DTAA.
    2. Samsung argued that the offshore supply and services were not attributable to the permanent establishment in India as the project office was acting as a mere communication channel and therefore was used merely for preparatory and auxiliary activities which are specific exempt activities.
    3. However, the assessing officer alleged that the project in question was a single, indivisible “turnkey” project which could not be split up and, therefore, the entire profit from the project should be taxable in India and accordingly attributed 25% of the revenues allegedly earned outside India as the profit attributable to the permanent establishment in India. The order of the assessing officer was upheld by the Dispute Resolution Panel.

4. **Tax Tribunal ruling**

    1. In appeal by Samsung, the tribunal relied on an application that was submitted by Samsung to the Reserve Bank of India for the registration of the project office. The application referred to a board resolution of the company for opening the project office in India, which stated that “the company hereby open one project office in Mumbai, India for coordination and execution of Vasai East Development Project”. The tribunal held that it was clear from the board resolution that the project office was opened for coordination and execution of the project. It then held that the project office was a fixed place of business of Samsung Heavy Industries in India.
    2. Samsung argued that even if there was a permanent establishment, the activities of the permanent establishment met the test of preparatory or auxiliary activities in Article 5.4. The tribunal rejected this argument, stating that the onus of proving that the activities were preparatory or auxiliary was on Samsung and that it brought no material on record to prove this fact.

        Samsung produced the accounts of the project office to demonstrate that there was no expenditure related to the execution of the project. Samsung also demonstrated that only two people worked in the project office, neither of whom was qualified to perform any core activity of Samsung. The tribunal rejected these arguments, stating that the accounts were in the hands of Samsung and that the mere mode of maintaining the accounts alone cannot determine the character of a permanent establishment.
    3. The tax tribunal, however, remanded the matter back to the tax officer to reconsider the deemed profit of 25% attributed by the tax officer to the permanent establishment. The tribunal found that there was insufficient information on record to ascertain the extent of business activities carried on by Samsung Heavy Industries through the project office.

5. **High Court ruling**

   The Uttarakhand High Court allowed the appeal only on the question of whether the tax officer used an arbitrary profit rate of 25% without examining whether it was attributed to the activities of the permanent establishment. According to the High Court, neither the tax officer nor the tribunal made any effort to bring on record any evidence to justify this figure.

6. **Supreme Court ruling**

   1. In appeal by the tax department in the Supreme Court, the tax department again argued that the project office was connected with Samsung's core business.

   2. However, Samsung reiterated that the Mumbai project office consisted of only two employees, neither of whom had any technical qualifications to execute the project. Further, the project office accounts demonstrated that it had not incurred any expenditure for execution of the project.

   3. The Supreme Court relied on the board resolution enclosed with the application to the Reserve Bank of India for the registration of the project office, which stated that the project office was established for coordinating and executing "delivery of documents in connection with construction of offshore platform modification of existing facilities for Oil and Natural Gas Corporation above".

      The Supreme Court stated that the findings of the tribunal were perverse to the extent of its conclusion that the project office was involved in the core activity of execution of the project and that merely maintaining accounts cannot determine the character of permanent establishment.

   4. The Supreme Court thus concluded that the activities performed by the project office were of auxiliary nature as the project office acted as a communication channel between Samsung and ONGC. In deriving the above conclusions, the Supreme Court relied on its rulings in Morgan Stanley & Co. Inc. and E-Funds IT Solutions, Inc., where, depending on the specific facts of the case, certain back office and support functions were held not to give rise to a fixed place permanent establishment.

7. **Key takeaways**

   1. In addition to the current judgment in the case of Samsung, there have been quite a few landmark judgments on the matter of fixed place PE viz. *DIT Mumbai v. Morgan Stanley & Co. (2007) 292 ITR 416, CIT v. Hyundai Heavy Industries Co. Ltd. (2007) 7 SCC 422, Ishikawajma-Harima Heavy Industries Ltd. v. DIT Mumbai (2007) 3 SCC 481 and ADIT New Delhi v. E-Funds IT Solution Inc. (2018) 13 SCC 294.*

   2. A reading of the aforesaid judgments makes it clear that when it comes to "fixed place" permanent establishments under DTAAs, the deciding factors are as follows:

      a. The condition precedent for applicability of Article 5(1) of the DTAA and the ascertainment of a "permanent establishment" is that it should be an establishment "through which the business of an enterprise" is wholly or partly carried on.

      b. The profits of the foreign enterprise are taxable only where the said enterprise carries on its core business through a permanent establishment.

      c. The maintenance of a fixed place of business which is of a preparatory or auxiliary character in the trade or business of the enterprise would not be considered to be a permanent establishment under Article 5.

      d. It is only so much of the profits of the enterprise that may be taxed in the other State as is attributable to that permanent establishment.

   3. The current ruling of Samsung as well the ruling in UAE Exchange Center demonstrates that the test of 'preparatory or auxiliary' activities is very factual. In this case of Samsung, the Supreme Court relied on the Reserve Bank of India registration and the accounts of the project office to determine the scope of the activities of the project office. Even in the UAE Exchange Center case, the Supreme Court relied on permission granted by the Reserve Bank of India (among others) in concluding that the activities of UAE Exchange Center's liaison office in India were 'preparatory or auxiliary.'

The reliance by the Supreme Court on the Reserve Bank of India permission is a significant development in jurisprudence relating to the interpretation of permanent establishment. Both of the above rulings demonstrate that assessees having a project office or liaison office should perform activities within the realm of the permission of the Reserve Bank of India.

4. The rulings also highlight the importance of a taxpayer's ability to demonstrate, through appropriate documentation, that activities performed by it are indeed preparatory or auxiliary. Also, the Supreme Court reiterated that the onus of proving that a taxpayer has a permanent establishment in India is on the tax authorities and not the taxpayer.

4. **Conclusion and Post MLI position** India and Korea has adopted an option A as provided in Article 13 dealing with the specified activities that do not constitute PE and fact pattern of this case does not even trigger application of the anti-fragmentation rules and hence there is no avoidance of the PE through specific exemption activities. In view of the above the decision the case will not be impacted by the MLI as the activities of the Samsung is limited to the one covered in the exempted activities.

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