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EY Tax Alert

Mumbai ITAT ruling on PE exposure due to sales support activities of Indian affiliate



Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (ITAT) in the case of The Lubrizol Corporation USA (Taxpayer) [ITA No. 7420/Mum/2010] on the issue of whether sales support and marketing activities carried out by an Indian affiliate could result in a permanent establishment (PE) for the Taxpayer under the India-US Double Taxation Avoidance Agreement (DTAA). The ITAT held that the Taxpayer did not have a PE in India since the activities of the Indian affiliate were of an independent nature and all operations were carried out outside India and the contracts were concluded outside India on a principal-to-principal basis. Also, the Taxpayer did not have any presence in terms of a fixed place of business in India.

Facts

- ▶ The Taxpayer, a company incorporated in and a tax resident of the US, is engaged in the business of manufacture and sale of high performance chemicals used in transportation and industrial lubricants.
- ▶ Lubrizol India Pvt. Ltd. (LIPL) is a joint venture in India between Indian Oil Corporation and the Taxpayer, with both parties having 50% share in it. The Taxpayer entered into an Exclusive Sales Representation Agreement (Agreement) with LIPL to facilitate marketing and sale of its products. The key aspects of the Agreement are as under:

- ▶ LIPL would send quotations directly to the customers and would keep the Taxpayer informed of such quotations. The Taxpayer would, in turn, send the invoices to the customers and keep LIPL informed of such invoices.
- ▶ LIPL would solicit orders for the products in accordance with the terms of the Agreement. All orders received by LIPL shall be forwarded to the Taxpayer for acceptance or rejection and LIPL shall have no authority to accept any order placed on the Taxpayer.
- ▶ Once accepted, the customers would place orders for the purchase of the products directly with the Taxpayer.
- ▶ Prices of the products would be determined by the Taxpayer and LIPL would have no authority to change or fix the prices or rates in any manner.
- ▶ During the term of the Agreement, a commission at agreed rates would be paid to LIPL on all shipments of the products resulting from orders submitted by LIPL. Services rendered by LIPL (territories except India) are as follows:
 - ▶ Information of business opportunities, particularly of tenders and competitive bids from the customers
 - ▶ Reasonable efforts to promote the sale and distribution of the products
 - ▶ No power to bind or obligate the Taxpayer except as provided in the Agreement and other services as mutually agreed upon
- ▶ The Taxpayer would supply all required information/data to LIPL, indemnify LIPL from any adverse claims/demands and would not hold LIPL responsible for any defect, shortfalls, taxes payable etc.
- ▶ LIPL would assume no responsibility for the quality of the products, creditworthiness of any customers etc.
- ▶ LIPL also carried out an independent business of manufacture and sale of various products under a

technology transfer agreement with the Taxpayer in India. The commission income received by LIPL under the above Representation Agreement constituted a small fraction of LIPL's income from its own business.

- ▶ The Taxpayer was of the view that no income was taxable in India since it did not carry on business in India. LIPL, being an associated enterprise of the Taxpayer, the Tax Authority referred all transactions between the Taxpayer and LIPL to the Transfer Pricing Officer (TPO) to determine the arm's length price. The TPO accepted the agreed price with no adverse adjustments.
- ▶ During the tax proceedings, the Tax Authority took a view that LIPL was a virtual projection of the Taxpayer in India and it constituted a PE of the Taxpayer in India under the DTAA. Additional profits were attributed in the hands of the Taxpayer on account of the marketing efforts undertaken by LIPL by virtue of the force of attraction rule present in the DTAA. The Tax Authority, in its order, attributed 5% of sales made by the Taxpayer as profits of the PE.
- ▶ Against the above order, the Taxpayer filed objections before the Dispute Resolution Panel (DRP) which upheld the order of the Tax Authority in its entirety. The Taxpayer preferred an appeal before the ITAT.

Taxpayer's contentions

- ▶ No taxable income arose in India during the year under consideration. The Taxpayer neither carried out any business activity in India nor did it render any services or made any sales in India. All such sales were executed and completed outside India. The risk and title in such goods also passed to the customers outside India.
- ▶ There was no fixed place PE under the DTAA because of the following reasons:
 - ▶ The Taxpayer did not have any physical presence or fixed place of business in India. No portion of LIPL's premises was under the Taxpayer's control and it did not have access to any fixed place of business in India.
 - ▶ The activities in India were carried out by LIPL's own employees and such employees were under the control/supervision of LIPL.
- ▶ LIPL cannot be considered as acting on behalf of the Taxpayer as an agent. LIPL was engaged in the manufacturing and sale of products on its own account which represented substantial portion of the revenues of LIPL.
- ▶ An agent is independent when it enjoys both legal and economic independence and aspects of such independence include:
 - ▶ Extent of obligations which the agent has vis-à-vis the principal
 - ▶ Extent of detailed instructions and comprehensive control of principal
 - ▶ Sharing of entrepreneurial risks
 - ▶ Reliance on the special skills and knowledge of the agent and number of principals represented by the agent

- ▶ Reliance was placed on the ruling of the Authority for Advance Rulings in the case of Al Nisr Publishing^[1] which held that an agent has an authority to bind the principal vis-à-vis customers on the following conditions:
 - ▶ The agent has the authority to negotiate all parts of the contract in a manner that is binding on the principal, even if the mere formality of signing the contract is performed abroad.
 - ▶ Contracts must relate to taxpayer's business.
 - ▶ There must be a certain degree of frequency or regular conclusion of contracts by the agent on behalf of the principal.
- ▶ LIPL forwarded the quotations received from the prospective customers to the Taxpayer in its own capacity as a customer support representative only. LIPL did not have the authority to accept any orders, to represent, guarantee or commit on behalf of the Taxpayer.
- ▶ Activities of LIPL did not fall within the meaning of the term 'securing orders' on behalf of the Taxpayer and, hence, did not satisfy the tests to be regarded as a dependent agent PE under the DTAA.
- ▶ In terms of the Agreement, the income attributable to customer support operations of LIPL could only be such amount as an independent enterprise carrying on similar activity would have earned on an arm's length basis. As also accepted by the TPO, the commission income earned by LIPL from the Taxpayer was at arm's length and, therefore, no further attribution of income should be made in the hands of the Taxpayer.

^[1] [239 ITR 879]

- ▶ Reliance was placed on the ruling of the Mumbai ITAT in the case of Daimler Chrysler AG Germany^[2] to support non-existence of a PE under the India-Germany DTAA.

Tax Authority's contentions

- ▶ LIPL is an exclusive/sole agent of the Taxpayer for the following reasons:
 - ▶ LIPL has to do exclusive sales and marketing to solicit orders for the Taxpayer.
 - ▶ It has to keep the Taxpayer informed about business opportunities, particularly tenders and competitive bids from the customers.
 - ▶ LIPL is also required to use information furnished by the Taxpayer confidentially and solely for the purposes as provided in the Agreement. LIPL would not disclose such confidential matters to third parties without the prior written consent of the Taxpayer.
- ▶ LIPL has got full rights and responsibilities in respect of marketing and sales in India. Hence, making of orders directly on the Taxpayer in the US would not save the Taxpayer from taxability in India since the Agreement has to be seen as a whole.
- ▶ LIPL constituted a dependent agent PE of the Taxpayer in India under the DTAA.

^[2] [39 SOT 418]

- ▶ The Taxpayer had assumed all risks in respect of the sales made to India and, hence, the profits arising from such sales had to be taxed in India.
- ▶ Reliance was placed on the decisions of Delhi ITAT in the cases of Rolls Royce Plc and Rolls Royce Singapore P Ltd.^[3] to support the creation of a dependent agent PE.
- ▶ The ITAT followed its earlier ruling in the case Daimler Chrysler (*supra*) which held that merely by acting on behalf of a non-resident taxpayer in India would not render the person acting as an agent to be a PE in India. There should be some definite activity of the PE to which profits can be attributed.

ITAT's ruling

- ▶ LIPL has carried on an independent business of manufacture of various products in India. It has its own marketing network in India for sale of various products. The commission received by LIPL in India accounts for only 0.18% of its sales.
- ▶ The Taxpayer does not have a PE in India under the DTAA, having regard to the following facts:
 - ▶ For the customers in India, sales are made on principal-to-principal basis.
 - ▶ LIPL does not have the authority to negotiate the terms of the contract as the final decision regarding price and conditions of sale is taken by the Taxpayer.
 - ▶ The contracts of sale are concluded only when the purchase order is accepted by the Taxpayer. The invoices are raised and payments are received directly by the Taxpayer from the customers.
 - ▶ The Taxpayer also does not have any right to use LIPL's premises in India.
- ▶ Decisions relied on by the Tax Authority are not applicable due to distinguishable facts.

Comments

The present ruling examines the issue of creation of PE in India on account of certain marketing/sales support activities carried out by an Indian affiliate. The ITAT followed its earlier ruling and upheld the principles for determining whether a relationship creates a PE under the dependent agency rule of a DTAA.

^[3] [[113 TTJ 446], [40 DTR 289]

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