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Doing business in India through Liaison Office

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The way Indian economy withstood global economic slowdown has made India a very alluring destination for foreign investments. For testing Indian waters, many Multinational Companies ('MNCs' or 'HO' or 'Non-resident') prefer opening a Liaison Office ('LO') in India. LO can be set up in India only after obtaining permission from Indian central bank i.e., Reserve Bank of India ('RBI'). LO can carry out *only* restricted activities viz.,

- Representing parent company/ group companies in India;
- Promoting export/import from/to India;
- Promoting technical/financial collaborations between parent company/ group companies and companies in India;
- Acting as a channel of communication between the MNC and the potential customers in India.

In a nutshell, LO is not permitted to undertake any business activity in India and thus, cannot earn any income in India. Further, expenses of LO are to be met *fully* through permitted channels from HO outside India.

MNCs are liable to Income tax in India as per Income Tax Act, 1961 ('the Act') if, *inter-alia,* there exists a business connection with India. The Double Taxation Avoidance Agreements ('DTAA') with other countries however supersede the Act and the Act applies only to the extent it is more beneficial to the non-resident. As per the DTAA, business profits of a non-resident can be taxed in India only if the Non-resident carries on its business in India through a permanent establishment (PE).

In recent past, Indian Revenue Authorities have found that some MNCs carried on commercial operations in India under the guise of an LO and sought tax on it as if it was a PE. There has been extensive litigation surrounding the issue as to when does an LO cross the boundaries and become a PE.

Functions of LO that were viewed as taxable presence in India

- Identifying new customers, pursuits and follow-ups with customers, price negotiation and finalization, securing orders, payments for material and post-sale support[1];
- Conducting substantial activities such as designing of apparel with material to the taste of the customers and after adequate research, supervision of the manufacturing process etc.[2];
- Payment of salaries and managing pay rolls of corporate audit staff[3];
- Vendor development, developing garment designs jointly with the vendors and overseas clients, sample preparation/

[1] [2012] 206 Taxman 7 (Karnataka High Court).

[2] *Columbia Sportswear Co.* - [2011] 337 ITR 407 [Authority for Advance Rulings (AAR)].

[3] *General Electric International Operations Co. Inc.* - [2014] 44 taxmann.com 436 (ITAT Delhi).

approval, price negotiation, order tracking, production/process control, supply chain management etc.[4];

- Procuring purchase orders, identifying the buyers, negotiating with the buyers, agreeing to the price and thereafter requesting them to place a purchase order[5];

Functions viewed as not creating a taxable presence

- Holding seminars, directing trade enquiries received to HO, advertising the technology used by the group[6];
- Communicating the decision of the HO to the customers in India[7];
- Activity of downloading information from servers, printing and forwarding to beneficiaries in India[8];
- Enabling Indian manufactures to manufacture goods of particular specification as required by HO[9];
- Providing training, conducting refresher course for agents about standards of service and security, accounting procedures, telecommunication systems and configurations, merchandising standards etc.[10]

Filing of annual statement by MNC for their LO

In addition to the requirement of ascertaining the taxable presence, the Act requires MNCs to comply with reporting requirement for an LO in India. MNCs are required to file an annual statement with the jurisdictional income-tax officer within 60 days from the end of the financial year containing information about regulatory approval for setting up the LO, its address, tax registration of HO, details of salary to staff in LO, etc. There have been many cases of failure to make due compliance regarding taxability of employees of LO including non-compliance of tax withholding provisions in that regard. It is therefore imperative to take stock of affairs and compliance with respect to LO. The said annual statement is to be filed in electronic form along with digital signature.

Conclusion

Ensuring proper tax and regulatory compliance in relation to the LO is extremely important and requires meticulous planning with careful execution. The extent to which an LO is duly compliant is to be carefully analyzed in light of the activities carried out by each LO and judicial interpretations. MNCs, therefore, have to be vigilant in structuring the format of LO so that it is not exposed to tax liability or penalties by the regulator.

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4 *Linmark International (Hong Kong) Ltd.* - [2011] 57 DTR 340 (ITAT Delhi).
5 *Jebon Corporation India* - 2011-TII-15-HC-KAR-INTL
6 *K. T. Corpn.* - [2009] 181 Taxman 94 (AAR).
7 *Mitsui & Co. Ltd.* - [1991] 39 ITD 59 (ITAT Delhi-Special Bench).
8 *UAE Exchange Centre Ltd.* - [2009] 313 ITR 94 (Delhi High Court).
9 *Nike Inc.* - [2013] 217 Taxman 1 (Karnataka High Court).
10 *Western Union Financial Services Inc.* - [2007] 104 ITD 34 (ITAT Delhi).

Circulars

Limits enhanced in respect of transfer of technical manpower for the purpose of Section 10A/10AA

By Circular No. 14 of 2014, dated 8-10-2014 and in supersession of its earlier circular, CBDT has clarified that the transfer or redeployment of technical manpower to a new unit located in SEZ, shall not be construed as splitting up or reconstruction of an existing business, provided that the number of technical manpower so transferred or redeployed as at the end of financial year does not exceed 50% of the total technical manpower engaged in the new unit and alternatively, if the assessee demonstrates that the net addition to its technical manpower in all its existing units is atleast equal to the number that represents 50% of the technical manpower of the new SEZ unit during the previous year. Further, this relaxation shall not be available in cases where the assessments have already been completed. No appeal shall be filed by the department if the order of the appellate authority is in line with this circular.

Extension of time for filing TDS/TCS returns

As per communication dated 17-10-2014, the time limit for filing of TDS and TCS return has been extended to 31st of October, 2014 and 7th of November, 2014 for non-government deductors/collectors and government deductors/ collectors who are mapped to a valid AIN respectively, in Andhra Pradesh, Jammu & Kashmir, Odisha & Telangana.

Ratio decidendi

Issue of shares does not result in income and thus cannot be subjected to transfer pricing

The taxpayer had issued shares to its parent company. The revenue authorities sought to make a transfer pricing adjustment on the ground that the issue of shares was less than the fair value of the shares. The Bombay High Court observed that transfer pricing provisions are applicable only to transactions that result in accrual of income or incurrence of expenditure and in the absence of a mandate in the statute the issue of shares cannot be regarded as resulting in income. The court also observed that transfer pricing provisions are machinery provisions and cannot be read de-hors the charging provisions of the statute. [*Vodafone India Services (P.) Ltd.* v. *UOI*, WP 871 of 2014, Order dated 10-10-2014, Bombay High Court]

AE need not necessarily compensate for advertisement expenses for benefits derived therefrom

The taxpayer was acting as airtime advertising sales representative for the television channels operated by its associated enterprises (AEs). It had incurred advertisement expenses for promoting the channels broadcasted by the AEs. The revenue authorities denied the claim of the taxpayer on the ground that the expenditure benefited the AEs and not the taxpayer. On appeal, the High Court held that the mere fact that the foreign parent was also benefited from the expenditure cannot be a ground for disallowance. Considering the nature of advertising industry, the court also held that even though the income earned by the taxpayer was much less than the advertisement expenses incurred by it, there existed a nexus between the income earned and the advertisement expense. The court further concluded that AE was not required to compensate the taxpayer for the benefits it derived in so far as the taxpayer was adequately compensated for the services rendered by it. [*CIT* .v *N.G.C. Network (India) P. Ltd.,* ITA 538 of 2012, Judgment dated 13-10-2014, Bombay High Court]

Guarantee given using limits with a financial institution is an international transaction

In respect of certain advances taken by its associated enterprise, the taxpayer extended guarantee using the credit limits availed from its banker. The taxpayer also recovered a portion of the guarantee fee from its associated enterprise. During assessment, relying on the decision of the Tribunal in *Bharti Airtel,* the taxpayer contended that extending guarantee was not an international transaction. The Tribunal observed that, unlike in the matter of *Bharti Airtel,* the taxpayer had availed its limits from its banker to issue the guarantee which had a bearing on the profits of the taxpayer and thus held that the transaction has to be tested for arm's length price. [*Everest Kanto Cylinder Limited* v. *ACIT,* ITA No. 7073/Mum/2012, Order dated 25-9-2014, ITAT Mumbai]

Functionally different comparables can be retracted later even though considered in TP study

The taxpayer had entered into an international transaction with its associated enterprise and had undertaken a Transfer Pricing study (TP study). During the assessment proceedings, the taxpayer sought for exclusion of certain comparables considered in the TP study, which was denied by the revenue on the ground that the admission made in the TP study cannot be retracted at the stage of assessment. On appeal, the Tribunal allowed the claim of the taxpayer observing that any objection to facts admitted earlier has to be considered on merits and there is always a right to object to comparables considered in TP study. [*Parexel International (India) Private Limited* v. *ACIT,* ITA No. 144/Hyd/2014, Order dated 30-9-2014, ITAT Hyderabad]

Imparting of know-how necessary for *'information concerning industrial, commercial and scientific experience'* to constitute 'royalty'

The taxpayer was rendering certain services such as accounting & financial support, legal & compliance, risk management and quality consultation & training to group companies including the Indian company. The taxpayer filed a 'Nil' return as it was not having any permanent establishment in India. The revenue authorities however, concluded that the services so rendered were in nature of '*information concerning industrial, commercial and scientific experience*' and thus, constituted as 'royalty' chargeable to tax in India. The Tribunal held that the '*information concerning industrial, commercial and scientific experience*' pointed to the concept of know-how and if services had been rendered de-hors the imparting of know-how or transfer of any knowledge, experience or skill, then such services would not constitute as 'royalty'. [*GECF Asia Ltd.* v. *DDIT* - ITA No. 8922 of 2010, Order dated 6-8-2014, ITAT Mumbai]

'Royalty' and 'technical service' under India-Austria Treaty

The taxpayer furnished technical know-how and technical assistance for manufacture of small hydro-power plants and marketing the same to an Indian company. The revenue authorities brought to tax the entire amount received by the taxpayer as 'royalty'. The High Court taking note of the specific wording of article viz., 'royalty' and 'technical services' of the India-Austria (1965) DTAA observed that in know-how one party agrees to grant 'right to use' i.e. making available and permission to use technical know-how, information as such whereas 'services' endorses reference to rendering consultation, providing guidance, imparting skills and technical information relating to implementation and actual working. The High Court held that consideration received towards 'royalty' would be entirely taxable in India whereas consideration received towards 'technical service' would be taxable only to the extent attributable to activities performed in India. [*CIT* v. *Voest Alpine AG,* ITA No. 79 -80/2001, Judgment dated 30-9-2014, Delhi High Court]

Hiring a ship for voyage constitutes 'chartering of ship'

The taxpayer operated ships in international traffic for carriage of goods wherein the agreement with the customers in India was to deliver goods till the final destination with all risk and responsibility. The taxpayer took the services of a third party for delivery of cargo from Indian port to hub port and thereafter the cargo was shipped on the ships of the taxpayer. The revenue authorities denied the benefit of Article 8 (India-Malaysia Treaty) in respect of the consideration attributable to shipping of cargo from Indian port to hub port on the basis that such operation cannot be said to be carried out by charterers of the ship as the taxpayer was not the owner of such ships. The Tribunal held that the word 'charterer' cannot be understood in the context of owner or lessee who have control of ship and thus, would cover hiring of a ship for a voyage, either whole of the ship or part of a ship. It further held that the facility of slot hire agreement with the feeder vessels to complete the voyage was not merely auxiliary or incidental activity to the operation of ships but inextricably linked i.e., to be taken as part and parcel of the operation. Accordingly, the appeal was allowed. [*Misc Berhad* v. *ADIT,* ITA 6499 of 2012, Order dated 16-7-2014, ITAT Mumbai]

Contract manufacturing results in fixed place PE

The Spanish subsidiary of Borox, a UK based entity, signed two separate contracts with its parent entity - one for warehousing & provision of services i.e., unloading, transportation, milling, packing and other administrative services that might be needed like receiving orders, sending invoices to clients, accountancy, etc., and another one for sales promotion. The Spanish subsidiary previously imported mineral, processed and sold them to third parties but was subsequently transformed into a service provider (contract manufacturer) without any apparent change in its size and functions. The revenue authorities *presumed* that there was a fixed place of business of the parent at the premises of the subsidiary and, therefore, there was a permanent establishment in Spain. The Spanish Supreme Court considered the existence of an 'established, permanent and complete business structure' as a type of a fixed place of business and concurred with the view of the lower authorities. It was, thus, held that a fixed place permanent establishment of Borox exists in the form of its Spanish subsidiary. [Appeal No. 1933/2011 dated 18-6-2014, Spanish Supreme Court]

Waiver of deferred sales tax on account of premature payment is not a benefit conferred on an assessee

The taxpayer was allowed to retain sales tax for a period of 15 years as per the scheme of the government. The tax so collected was deemed to have been paid under Section 43B of the Act and was not charged to tax as income. Subsequently as per revised scheme, a provision for premature payment was made wherein taxpayer was allowed to pay the present value of the deferred tax, whereby the entire tax liability could be discharged upon such prepayment opted for by the taxpayer. The revenue authorities sought to tax the difference between the future liability and the present value of the future liability, as a revenue receipt. While upholding the Tribunal's order, the High Court reiterated that the waiver is not a benefit conferred on an assessee and therefore the provisions of Section 41(1) of the Act could not be invoked to tax the same. [*CIT* v. *McDowell & Co Ltd*, ITA 899 of 2008, Judgment dated 2-9-2014, Karnataka High Court]

Loss on account of issue of 'sweat equity shares' is not deductible

The taxpayer having issued sweat equity shares to its key persons free of cost claimed it as revenue expenditure under Section 37(1) of the Income-tax Act. The revenue authorities however, disallowed the same by inferring that merely by issuing shares at lesser than market price, the assessee cannot be said to have incurred expenditure rather it amounts to short receipt of capital. The contentions of the taxpayer that, since fringe benefit tax has been paid on such amount the same is allowable as revenue expenditure, were rejected by the Tribunal by holding that the provisions relating to FBT may not be relevant to determine the deductibility under Section 37(1). [*Future Agrovet Ltd.* v. *ACIT* - ITA No. 2654 of 2012, Order dated 19-9-2014, ITAT Mumbai]

'Carry forward' and 'set off' of loss under head capital gains is not allowed in case of amalgamation

The taxpayer, an amalgamated company sought set off of loss under capital gains brought forward from the amalgamating company on the ground that there is no bar or prohibition in Section 74 on that aspect. The Tribunal while observing that, Section 72A was brought in the statute for extending or relaxing provision relating to carry forward and set off of accumulated losses and unabsorbed depreciation in case of amalgamation is restricted only to accumulated losses and unabsorbed depreciation and not for any other head of income including losses computed under head capital gains or speculation business, held that Section 74 cannot be read or interpreted so as to give benefit of set off and carry forward of losses under head capital gains in case of amalgamation or demerger, sans any specific provision therein. [*Clariant Chemicals (I) Ltd.* v. *ACIT,* ITA No. 4281 of 2011, Order dated 19-9-2014, ITAT Mumbai]

Order passed under Section 143(3)/144C can be revised under Section 263

The order passed under Section 143(3) read with Section 144C of the Income-tax Act was revised under Section 263 of the Act by the CIT. The taxpayer contended that since the said order was passed in compliance with the directions of the DRP, which is constituted of three CITs, the same lacks jurisdiction of being revised under Section 263 of the Act. On these facts, the Tribunal held that the order passed under Section 143(3) read with Section 144C of the Act can be revised under Section 263 since the DRP only revisits the variations and not the computation part of such order. The supplemental contention of the taxpayer were distinguished by holding that the role of DRP cannot be equated with the role of CIT under Section 158BC of the Act since the latter requires mandatory approval of the CIT. [*DCIT* v. *MsourceE (India) Pvt. Ltd.* - ITA No. 819 of 2013, Order dated 12-9-2014, ITAT Bangalore]