

Tax Hotline

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DELHI HIGH COURT PREMATURELY APPLIES BEPS STANDARDS TO RULE THAT GE OVERSEAS ENTITIES HAD A PE IN INDIA

- In a recent ruling, the Delhi High Court held that the General Electric overseas group of companies had a fixed place PE and a dependent agent PE in India.
- The Court ruled that the liaison office in India through which the GE overseas entities carried out essential business activities (not being preparatory and auxiliary) constituted a fixed place PE in India.
- Applying what appear to be the standards on PE proposed under BEPS Action Plans, the Court ruled that negotiation and participation resulting in conclusion of contracts should constitute 'authority to conclude contracts' for the purposes of forming a dependent agent PE. Accordingly, held GE to constitute a dependent agent PE in India considering that GE India through its employees and GE expatriates negotiated and participated in contract formation in India.
- Refused to dissect the issue on attribution which was determined by lower authorities based on subjective parameters.

Recently, while upholding an order of the Delhi Income Tax Appellate Tribunal ("ITAT"), the Delhi High Court ("Court") held that the General Electric ("GE") overseas group of companies ("GE Overseas / Taxpayer") constituted a fixed place permanent establishment ("PE") and a dependent agent PE ("DAPE") in India for the assessment year ("AY") 2001-02.

FACTS

The GE group is a diversified technology, media and financial services company spread across the globe. GE Energy Parts Inc. ("GEP"), a tax resident of the US is engaged in the business of manufacture and offshore sales of highly sophisticated industrial equipments. GEP sells its products offshore on a principal to principal basis, including to customers in India, where the title to goods sold to Indian customers is transferred outside India. General Electric International Operations Company Inc. ("GEIOC"), part of the GE group and a tax resident of the US, set up a liaison office ("LO") in India in 1991 with the RBI's permission to act only as a communication channel and not to carry on any business activity. Further, GE India Industrial Pvt. Ltd. ("GEIPL / GE India"), also part of the GE group, is an Indian company which provides marketing support services to GE Overseas including to GEP under a Global Service Agreement ("GSA") with GEIOC, for which it is remunerated on a cost-plus basis. For the year under consideration, GE India was assessed by the Transfer Pricing Officer who held that the transactions of GE India with its associated enterprises were at arm's length. As per the GSA, GE India is restricted from entering into contracts on behalf of or acting as agents of GE Overseas. Further, in the year under consideration, GEIOC had about 50 employees, of which most were designated as Head India Operations and deputed to India.

The GE Overseas entities had not filed tax returns in India for the year under consideration. In 2007, Indian tax authorities conducted a survey under section 133A of the (Indian) Income Tax Act, 1961 ("ITA") at the premises of the LO ("Survey"). Further, in accordance with section 131, the tax authorities also summoned GE Overseas to furnish information, which was duly furnished. The Survey and review of furnished information revealed that GE's presence in India (which existed since 1902) was significant with over 12,000 employees and over 1 billion dollars in exports to support the global business operations of GE. Further, GE had pioneered the idea of sourcing software from India and had become one of the largest customers of the Indian Information Technology industry. Based on these observations, the assessing officer ("AO") initiated re-assessment proceedings and passed an order dated December 31, 2008 holding that the GE Group had a fixed place PE and a DAPE in India. Further, the AO deemed 10% of the value of the sales made to Indian customers as profits arising from them and attributed 35% of the said profits to the PE in India. Upon appeal, the first appellate authority – the Commissioner of Income Tax (Appeals) ("CIT(A)") upheld the order of the AO.

In second appeal, the ITAT, based on its analysis of the facts, held that GEIOC's employees who were deputed to India and GE India's employees ("GE Professionals") used the premises of the LO for carrying on core business activities (not being preparatory and auxiliary) of GE Overseas in India and hence constituted a fixed place PE. Further, it also held that the activities conducted by GE India, through the GE Professionals were core in nature, which demonstrated its authority to conclude contracts on behalf of GE Overseas in India. Accordingly, it was concluded that GE India constituted a DAPE of GE Overseas. Further, the ITAT concurred with the AO on estimating the profits to be 10% of the value of the sales made to Indian clients. However, it reduced the attribution of the profits to Indian PE from 35% (accorded by the AO) to 26%, effectively concluding that 2.6% of the value of the sales should be profits attributed to India.

In further appeal before the Court, the following three questions of law were posed: (i) whether the GE Group had a

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fixed place PE in India, (ii) whether the GE Group separately had a DAPE in India, and (iii) whether the ITAT was justified in attributing as high as 26% of the estimated profits (10% of the value of sales) to the PE in India. The submissions put forth by the parties were as follows:

TAXPAYER'S ARGUMENTS

- As per the definition of fixed place PE, activities which are merely 'preparatory and auxiliary' in respect of the overall business shall be excluded for the determination of a fixed place PE. In the present case, the existence of a fixed place PE is alleged only in respect of the sales function, which function is only a small part of the overall business involving research and development, design, fabrication and manufacture, all of which happened outside India. Accordingly, the activities conducted in India, restricted merely to sales were 'preparatory and auxiliary' and could not have created a PE in India.
- The question whether activities constitute 'preparatory or auxiliary activities' is not to be analysed from the viewpoint of the importance of the activities in isolation, but the role of those activities in the overall business of the Taxpayer. The Taxpayer relied on *UAE Exchange Centre Ltd. v. Union of India*¹, *Formula One World Championship v. Commissioner of Income Tax*² and *National Petroleum Construction Company*³ for its submissions on 'preparatory and auxiliary'.
- The OECD commentary on the Model Tax Convention ("**OECD Commentary**") unambiguously states that mere participation in negotiation does not lead to formation of a fixed place PE or a DAPE. Further, as per well settled jurisprudence under Indian contract law, the authority to negotiate is different from authority to conclude contracts and unless the agent is authorized to conclude all (or at least crucial elements) of a contract, he cannot be said to have the authority to bind the principal.⁴
- Specifically, with respect to the formation of DAPE, the exception to DAPE is for the agent to be of independent status acting in its ordinary course of business, i.e. not acting exclusively or almost exclusively on behalf of an enterprise ("**Independent Agent Exception**"). In this context, the Revenue's argument that the GE Professionals together constitute dependent agents of 24 foreign GE entities is self-defeating as it indicates that GE India does not act wholly or almost wholly on behalf any one entity and hence cannot constitute a DAPE. Further, GE India, apart from rendering the marketing and sales functions to GE Overseas, has 12 different business divisions and they cannot therefore be said to be dependent, on GE Overseas. Reliance for this argument was placed on *Varian India (P.) Ltd. v. Additional Director of Income Tax*.⁵
- From the Survey documents, it is clear that that the GE Professionals merely provided sales support and participated in negotiations, without any express or implied authority to conclude contracts. Accordingly, the relevant condition for a dependent agent to qualify as a DAPE, i.e. to have the authority to conclude contracts on behalf of the principal does not get satisfied in the present case. Further, as per relevant provisions of the OECD Commentary, even if the so-called agent exercised the authority to conclude contracts in India, they could not have formed a DAPE if the nature of the activities were 'preparatory and auxiliary'.
- Relied on *E-Funds IT Solutions Inc.*⁶, and *Honda Motor Company Ltd. v. Commissioner of Income Tax*⁷ to submit that since the so called dependent agent, i.e. GE India was remunerated at arm's length, no further attribution could be made to the PE.
- Considering the amount and nature of activities performed in India in comparison to the overall business activities, the ITAT erred in attribution as high as 26% of the estimated profits to India.

REVENUE'S ARGUMENTS

- Several activities relating to marketing and sales took place in India. The GE Professionals constituted the 'Indian team' which was intensely involved in such activities including negotiating crucial terms of customer contracts, discussing the terms of the MOU with the Indian customers, submission of bids on behalf of GE Overseas etc. The GE Professionals were highly qualified and worked for different business interests of GE Overseas in India. Further, the GE Overseas entities remotely sitting in foreign countries could not make any sales in India without the active involvement of GE India comprising of the GE Professionals. Accordingly, GE Overseas had a 'business connection' in India in accordance with section 9(1)(i) of the ITA - a position which was not challenged by the Taxpayer.
- Additionally, the GE Group created a PE in India in two forms, i.e. the LO constituted a fixed place PE and GE India comprising of the GE Professionals constituted a DAPE. The activities carried out in the LO were core functions integral to the business of GE Overseas in India and hence were not 'preparatory or auxiliary'. Further, the role of the GE Professionals in the formation of the contracts included sourcing the market, development, market strategy, negotiations, price adjustments etc. which were essential for formation of the contracts and could not be termed as mere negotiations without the authority to conclude contracts.
- Attribution of 35% of the estimated profits to the PE, as determined by the AO, was correct and reasonable.

RULING

On the question whether GE Overseas constituted a fixed place PE in India, the Court observed:

- As per the India – US tax treaty, the three conditions required for formation of a fixed place PE are – (i) the enterprise must have a fixed place of business; (ii) the business of the enterprise must be wholly or partly carried on through the fixed place; and (iii) the fixed place of business must not be solely for the purposes of advertising, supply of information, scientific research or other activities which have a preparatory or auxiliary character.
- With respect to condition (i) above, the Court referred to the OECD Commentary and *Formula One* as per which 'place of business' has been understood to mean any premises, facilities or installations used for carrying on the business of the foreign enterprise, even if not used 'exclusively' for that purpose. Applying this understanding to the facts, the Court held that the LO, being at the constant disposal of the GE Professionals, constituted a 'fixed place of business'.
- As regards condition (ii) above, it was observed that the term 'through which' is to be given a wide interpretation and business being carried out at a particular location at the disposal of the foreign enterprise, as in the present case, should suffice to satisfy the condition of 'through which' business is carried out.
- With respect to condition (iii) above, the Court observed that the determination of whether a practice is 'preparatory

or auxiliary' requires asking whether the activities undertaken at the fixed place of business constitute essential and significant parts of the overall business activities. The Court also noted that for the activities to not be 'preparatory or auxiliary', the activities must be responsible for the realization of profits. The Court rejected the Taxpayer's argument that business activities in India must include authority to conclude contracts for such activities to not be 'preparatory and auxiliary', regarding the argument as a misapplication of applicable treaty provisions. In this context, the Court analyzed the job descriptions, email exchanges, appraisal reports, assignment letters forming part of the Survey documents to conclude that the role of the GE Professionals involved participating in certain core functions such as negotiation and finalization of contracts, helping GE Overseas to develop their strategy in India, aligning GE solutions with customer needs, helping shape policy to realize opportunities, facilitating business development discussions etc. Based on the Survey documents, the Court also noted that GE India (comprising of GE Professionals) was involved in all the stages of business development in India. Based on the aforementioned findings, the Court concluded that the LO was a fixed place of business through which GE Overseas carried out its core business activities (not being preparatory and auxiliary) and hence constituted a fixed place PE.

On the question whether GE Overseas constituted a DAPE in India, the Court observed:

- With respect to the Independent Agent Exception, the Court rejected the Taxpayer's contention that since GE India works on behalf of 24 foreign GE enterprises, it cannot be considered to be devoted wholly or almost wholly to one foreign enterprise and hence cannot form a DAPE. The Court held that an entity can be considered as 'devoted wholly or almost wholly' even if it is devoted to several related enterprises part of the same group. Applying the finding to the facts, the Court held that while GE India was devoted to 24 foreign GE enterprises, since they all were part of the same group, it formed a DAPE of GE Overseas in India.
- The discussion on the interpretation of the term 'authority to conclude contracts', which is a pre-requisite for a dependent agent to constitute a DAPE, was an interesting one. The Taxpayer relied on Paragraph 33 of the OECD Commentary which reads as follows:

'a person who is authorized to negotiate all elements and details of a contract in a binding way on the enterprise can be said to have exercised this authority and the mere fact, however, that a person has attended or even participated in negotiations...will not be sufficient, by itself, to conclude that a person has exercised in that State an authority to conclude contracts.' [Emphasis Supplied.]

The Revenue, on the other hand relied on Paragraph 32.1 of the OECD Commentary, introduced in 2008 as India's reservation to the language of the Commentary on 'authority to conclude contracts', which reads as:

'a person has attended or participated in negotiations in a State between an enterprise and a client, can in certain circumstances, be sufficient, by itself to conclude that the person has exercised an authority to conclude contracts in the name of the enterprise; and that a person who is authorized to negotiate the essential elements of a contract and not all the elements, can be said to exercise the authority to conclude contracts.' [Emphasis Supplied]

On the apparent contradiction between Paragraphs 33 and 32.1, the ITAT's opinion was that the latter, which was introduced in 2008 cannot have a retroactive application on treaties entered into prior to 2008 (including the India – US tax treaty). Further, it noted that the OECD Commentary is not binding and can only serve as a guidance as it does not form part of the treaties under the doctrine of incorporation.

The Court however, taking a very aggressive stand, held that since the OECD Commentary appears to be contradictory regarding the interpretation of the phrase 'authority to conclude contracts', it cannot be relied upon wholly. The Court instead noted that enterprises these days do not necessarily organize businesses in a way which may be envisioned by tax treaties. The tax treaty regimes are based on known patterns of business and cannot cater to all situations which today's innovative and complex enterprises may present. In this context, the Court instead of going by the letter of the law (definition and interpretation of DAPE), relied on the overall facts (indicating GE India and GE Professionals' involvement in the core business activities) and adopted a substance over form approach to rule that GE Overseas had a DAPE in India.

The Court also relied on *Ministry of Finance (Tax Office) v. Phillip Morris (GmbH), Corte Suprema di*

*Cassazione*⁸ which held that even in the absence of a formal authority to conclude contracts, mere participation of representatives or employees in the phase of conclusion of contracts may in some instances constitute the authority to conclude contracts. Further, the court also relied on *Rolls Royce Plc v. Director of Income Tax*⁹ where although the dependent agent in India did not have the authority to conclude contracts, it was held to be a DAPE on the basis of the overall facts.

On the question of attribution, the Court observed:

- The AO had asked for year-wise India specific accounts, however the same were not available as accounts were not maintained in all countries where GE had presence, and for those countries the accounts were covered in the consolidated financials. Due to the absence of accounts, the AO had held that the attribution was to be decided in accordance with Rule 10(iii) of the (Indian) Income Tax Rules, 1962 which prescribes that attribution may be determined *'in such other manner as the Assessing Officer may deem suitable'*. The AO took guidance from sections 44BBB and 44BB – special provisions for computing profits and gains in connection with the business of exploration, etc. of mineral oils, / operation of aircraft wherein the profits are deemed to be 10% of the revenue – to estimate the profit to be 10% of the total volume of sales. Further, it relied on *Rolls Royce* – where 35% of the total profits was held to be pertaining to marketing activities in India – to attribute 35% of the estimated profits to be the income attributed to India.
- The ITAT noted that the proportion of activities performed in India in the case of *Rolls Royce* were greater compared to that of GE. Based on the overall facts, it estimated about one-fourth of GE's activities to be taking place in India and accordingly, reduced the attribution from 35% to 26%.

Following through on the above observations, the Court did not dissect the question on attribution and upheld the attribution by the ITAT, specifically based on the fact that the question was already extensively discussed and concluded on at three levels, i.e. the AO, CIT(A) and the ITAT. The Court noted that the absence of statutory or formal framework render the task on attribution dependent on some extent of guess work and the endeavor will only be to approximate the correct figure. The Court specifically relied on *Hukum Chand v. UOI*¹⁰ where it was held *'there*

cannot in the very nature of things be great precision and exactness in matters. As long as the attribution fixed by the Tribunal is based upon the relevant material, it should not be disturbed’ to not interfere with the attribution fixed by the ITAT in the present case.

ANALYSIS

In the landscape of India’s tax judgments on PE, this can be viewed as a conservative one. This judgment is a reminder that judicial authorities are moving from a formal rule-based approach to a substance-based approach. Glaring evidence of this lies in the present case, where the Court completely ignored some crucial clauses in the GSA (the contract on the basis of which GE India was conducting its activities in India) such as ‘*GSA forbids GE India from entering into any contract on behalf of the GE Group companies*’ etc. to determine the question on ‘authority to conclude contracts’. In order to record its intention of doing business in a particular manner, enterprises tend to ensure robust documentation. However, with the current trend that courts are adopting, it seems that what is recorded in documents may be of little consequence and that courts will in all cases, pierce the form to analyse the substance of transactions, structures etc.

Further, with respect to the determination of DAPE, the Court’s approach to disregard the treaty definition due to inherent contradictions in the OECD Commentary (owing to India’s reservation) seems to be an act of judicial overreach. In doing so, the Court has also ignored the observation of the Kolkata ITAT in *ITO v. Right Florists (P.) Ltd.*¹¹ where the Tribunal had categorically denounced India’s reservations to the OECD Commentary playing a role in judicial analysis.

Action 7 of the Base Erosion and Profit Shifting (“**BEPS**”) Action Plans, has proposed to amend one of the tests of DAPE, i.e. ‘*authority to conclude contracts*’ to ‘*playing a principal role leading to conclusion of contracts*’. In line with this proposal, India, through Finance Act, 2018, has also amended its definition of ‘business connection’ with prospective effect from April 1, 2019. The approach adopted by the Court in the determination of DAPE seems to be in line with the amended standard proposed under BEPS. However, the said BEPS proposal is keeping in mind the current global business scenario and has a specific objective, i.e. to prevent the widespread base erosion and profit shifting in today’s world and hence should be made applicable only prospectively. Further, the proposed changes have not yet been incorporated in most tax treaties. In this context, having adopted the BEPS proposed standard for determination of DAPE, that too retrospectively for AY 2001-2002, is premature and harsh. Businesses can only arrange themselves based on the currently existing laws. The possibility of them being scrutinized in the future based on newer standards being applied retrospectively, as done in the present case, instills a sense of uncertainty in them and hampers the ecosystem of doing business in India.

With respect to the applicability of Independent Agent Exception, the Court held that an entity can be considered as ‘devoted wholly or almost wholly’ even if it is devoted to several related enterprises part of the same group. In doing so, it went against the ratio laid down in by the Mumbai Tribunal in *Varian India (P) Ltd. v. ADIT*¹² that an entity can be considered as ‘devoted wholly or almost wholly’ only if it is devoted to any one foreign enterprise. The Court distinguished Varian on the basis of the fact that unlike in the case of GE, the concerned Indian entity had entered into separate contracts with every related entity of the concerned foreign group. Based on this distinction, going forward, it may be feasible for Indian entities working on behalf of a multinational group to enter into separate contracts with each entity in the group to possibly avail the ‘Independent Agent Exception’.

Lastly, owing to the element of subjectivity involved in this case, the Court’s decision to not dissect the question on attribution could be viewed as questionable. Given the considerations on the question of attribution, i.e. it (attribution) was based on subjective parameters relying on other provisions and similar judgments, the workings by the AO were reworked by the ITAT etc.; there was a need for the Court to have dissected this question to ensure that the attribution was undertaken properly. The Court’s refusal to address the question, observing that attribution by its nature involves an amount of guess-work, raises concerns about judicial propriety, and makes one wonder how a Taxpayer is expected to have any assurance on legal principles around attribution of profits to a PE if admittedly it is undertaken by the courts of India through guess-work and approximation.

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¹ 2009 (313) ITR 94 (Del.)

² CIT 2017 (394) ITR 80 (SC).

³ 2016 (383) ITR 648

⁴ For the argument on the position under Indian Contract Law, the taxpayer relied upon the *Black’s law dictionary, 10 Edition (Pgs 350, 1199, 1200)*; *Major Law Lexicon P.R. Aiyar, 4th Edition 2010, (Pgs 1361 (Vol2), 4530 (Vol4))*; and *Devkubai N. Mankar v. Rajesh Builders* AIR 1997 Bom 142.

⁵ 2013 (142) ITD 692 (Mum).

⁶ 2014 (364) ITR 256

⁷ 2018 (6) 6 SCC 70

⁸ No. 7682/02 of May 25, 2002.

⁹ 2011 (339) ITR 147 Del.

¹⁰ 1976 (103) ITR 548.

¹¹ [2013] 25 ITR(T) 639 (Kolkata - Trib.)

¹² [2013] 142 ITD 692 (Mumbai-Trib)

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