
Delhi Tax Tribunal: *Back Office Operations of a Subsidiary Establishes PE for Parent*

BY RAVISHANKAR RAGHAVAN
(MAJMUDAR & CO., INDIA)

The Delhi bench of the Income Tax Appellate Tribunal (the “Tribunal”) has, in the case of eFunds Corporation USA, held that rendering of services to clients outside India, by subcontracting the contractual obligations to its Indian subsidiary will result in a business connection and a Permanent Establishment (“PE”) for the non resident entity in India. Therefore, the foreign enterprise will be liable for tax in India on the profits attributable to its Indian PE operations.

eFunds Corporation, USA (“the taxpayer”) is a non resident entity incorporated in and a tax resident of USA. eFunds International India (“EFI”) is a wholly owned subsidiary of the taxpayer. The taxpayer entered into contracts with EFI which was to provide call center services, financial shared services, data entry and software development services. EFI was compensated by the taxpayer at an agreed remuneration.

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The Indian tax authorities held that the taxpayer had a business connection in India under the Income tax Act, 1961 ("the Act") and a PE in India under Article 5(1) and 5(2)(i) of the Double Taxation Avoidance Agreement between India and the USA ("the treaty"). Accordingly, it was held that the taxpayer was liable to tax in India. The taxpayer's appeal before the first appellate authority was rejected. Consequently, the taxpayers preferred a second appeal before the Tribunal.

One of the key issues before the Tribunal was whether the activities carried out by EFI in India leads to a business connection and/or a PE for the taxpayer in India. The other issues were regarding reopening of assessments, the applicability of Mutual Agreement Procedure proceedings to a particular assessment year and quantification of excessive profits attributable to the PE in India which is not being discussed in this Article. The tax authority's contentions before the Tribunal were as under:

- a) the sub-contract agreement reveals that both EFI and the taxpayer's are under a legal commitment to provide services to their clients.
- b) the transfer pricing analysis confirms that requisite assets and resources required for providing the services were not available with EFI and the same were made available to EFI by the taxpayer free of charge.
- c) EFI did not bear any significant risk as the ultimate responsibility lay with the taxpayer. The taxpayer assumed the overall risk and responsibility of the services provided to the clients. Therefore, it was contended that the taxpayer also undertook the responsibility of the activities performed by EFI.
- d) the taxpayer is operating and generating income in India through EFI and, therefore, constituting a fixed place PE under Article 5(1) of the tax treaty.
- e) the employees of EFI are rendering service to clients of the taxpayer and, therefore, qualify as 'other personnel' under Article 5(2)(l) of the tax treaty.

The taxpayer's contentions before the Tribunal were as under:

- a) the taxpayer and EFI, function on a principal to principal basis and the mere argument that some activities were outsourced by the taxpayer cannot create a business connection in India.
- b) the taxpayer does not carry out any business activity in India. EFI operations in India cannot be held to be attributable to the earning of income by the taxpayer.

- c) the taxpayer does not have a fixed place of business and neither do they have any liaison office or premise which is used as a sales outlet in India.
- d) the back office operations and software development carried out by EFI do not constitute a PE in India as they are in the nature of preparatory and auxiliary.
- e) The facilities/resources of EFI were by no means at the disposal of the taxpayer. The employees in India were employees of EFI and were not under the control of the taxpayer.
- f) EFI should be treated as independent agent because the taxpayer has compensated EFI on an arm's length basis. Further, EFI did not have an authority to conclude contracts on behalf of the taxpayer, nor did EFI secure orders or maintain any stock/merchandise on behalf of the taxpayer.

One of the key issues before the Tribunal was whether the activities carried out by eFI (the subsidiary) in India leads to a business connection and/or a PE for the taxpayer (parent) in India.

Decision of the Tribunal

The Tribunal held that the taxpayer's activities in India constituted a business connection and a PE for the following reasons:

In terms of the agreements between the parties, the taxpayer and EFI were both under a legal commitment to provide services to the clients of the taxpayer.

On perusal of the transfer pricing study regarding the functions performed, assets used and the risks assumed by the taxpayer and EFI, it was comprehensible that EFI was not in possession of material assets to perform the requisite functions independently. These assets were made available to EFI free of charge.

EFI did not bear any considerable risk as the eventual accountability rested with the taxpayer. The corporate office of EFI had an international division which consisted of the president's office and a sales team. The president's office administered global operations of the taxpayer's group entities. The sales team embarked on marketing efforts for the taxpayer's affiliates.

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The overall reporting was to the taxpayer. The activities were carried on continuously over a period of years and, therefore, the operations and its relationship clearly constituted business connections in India. Due to the activities carried out by EFI (back-office operations and software development services) and the maintenance of a sales outlet in India, EFI constituted a fixed place PE for the taxpayer in India.

A place of business need not be owned, rented or otherwise under possession or control of the enterprise in order to constitute PE.

The basic definition of the term 'PE' means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. A place of business need not be owned, rented or otherwise under possession or control of the enterprise in order to constitute PE. Based on the 'Global Annual report' (supported

from the content and description provided in the Form 10-1 (405) dated April 01, 2002), it was concluded that the activity of supervision or control of the proper performance of a contract cannot be considered to be of an auxiliary nature, as it is strictly functional to the production of income.

Majmudar & Co.'s Comments

One interesting feature of the Tribunal decision is that back office operations carried out by an Indian subsidiary have been considered as an integral core part of the foreign company's income generating activity. It appears that the Tribunal has been persuaded to reach such a conclusion due to the contents of the Global Annual Report and the contents of the Form 10-I filed by the taxpayer in USA. These documents were submitted by the taxpayer to the Indian tax authorities.

Prima facie, this decision is based on specific facts and, therefore, should generally not be construed as applicable to all foreign enterprises having outsourcing operations in India. Although a Tribunal decision is constitutionally binding on the tax authorities and the tax assessee's, it is likely that this decision will be challenged by the taxpayer before the Delhi High Court. □

For more information, please contact Ravishankar Raghavan at rraghavan@majmudarindia.com. Ravi is the Principal of the Tax Group of Majmudar & Co, Mumbai.