

Constituting Agency Permanent Establishment



This article is in continuation to the article under this column published in June 2012 issue of this journal. In that article, we analysed basic concepts of Agency Permanent Establishment (agency PE) and, specifically, various principles/tests to ascertain as to when a person, whose services are availed by the foreign enterprise, may be regarded as an agent of the foreign enterprise as per commercial laws of the source country; and whether such an agent, is an independent agent acting in its ordinary course of his business or is a dependent agent. If after determination of the above two steps, it is found that the agent is dependent or is independent but works wholly or mainly on behalf of his principal, the third step would be to ascertain whether he undertakes any of the specified activities. If such an agent is found to undertake any of the specified activities, the foreign enterprise would have an agency PE. These aspects pertaining to dependent agent PE have been discussed in this article.

1 Basic Concepts – Constituting Agency PE

As per provisions of the Income-tax Act, 1961, following conditions are required to be satisfied for a business connection in nature of an Agency PE to arise in India:

(A) An agent, (other than an independent agent), undertakes business activity on behalf of a foreign enterprise;

AND

(B) Such an agent has and habitually exercises authority to conclude

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contracts on behalf of the foreign enterprise. However, activities undertaken by agent limited to only purchase of goods on behalf of non-resident would not be covered in this clause

OR

- (C) The agent has no authority but habitually maintains stock of goods from which goods are delivered on behalf of the foreign enterprise

OR

- (D) The agent habitually secures orders in India mainly or wholly for the foreign enterprise

Thus, if a foreign enterprise conducts business in India through an agent and fulfills condition (A) along with any of the conditions prescribed in (B) or (C) or (D) above, it would constitute business connection in the nature of agency PE in India.

The 2010 OECD Model Convention ('the OECD MC') postulates presence of only two conditions for creating Agency PE i.e. Condition (A) pertaining to presence of an agent; and Condition (B) pertaining to authority to conclude contracts.

Under the 2011 United Nations Model Convention ('the UNMC'), Agency PE can be created upon fulfillment of above Condition (A) and Condition (B) as well as on fulfillment of Condition (A) and Condition (C). However, condition (D) has not been prescribed under the UNMC.

2 Analysis of the Three Conditions With Reference to Model Commentaries and Judicial Precedents

2.1 Authority to conclude contracts:

A dependent agent having authority to conclude contracts in the name of the foreign enterprise constitutes dependent agent PE. If the agent is only participating in negotiations and not concluding the contract *per se*, following factors may be relevant to ascertain whether the agent has *authority to conclude contracts*:

- Exact functions performed on behalf of the enterprise;
- Formal or implied powers to negotiate

up to a point of actually concluding contracts;

- Undertaking substantial negotiation;
- Creation of bonafide belief in eyes of third party as acting on behalf of the authorisation given by the foreign enterprise and hence, creates an obligation on it to respect the terms of the contract.

Thus, the authority to conclude the contract need not be explicit. Even an implied authority to conclude contracts would be relevant while determining Agency PE. Further, in certain situations, an authority could also be inferred, even if the agent concludes the contracts that are not in the name of the foreign enterprise.

However, the above factors are not, by themselves, determinative. All the facts and surrounding circumstances should be taken into account while determining whether the agent has authority to conclude contracts on behalf of the foreign enterprise.

Further, it is essential that the authority relates to the core business operations of the foreign enterprise, and not just internal or incidental operations.

It should be noted that mere existence of authority to conclude contracts may not lead to dependent agent PE unless the agent is actually engaged and concludes contracts on behalf of the foreign enterprise. Further, mere one-off contract or a single contract concluded by the agent may not lead to a dependent agent PE.

Signing of the Contract:

It is not necessary that contracts are signed by the agent. A person who is authorised to negotiate all elements and details of the contract in a way binding on the enterprise can be said to exercise the authority even if the contracts are signed by any other person in India or outside India.

Place of signing of the contract:

The place of signing of the contract is not relevant. The facts and circumstances should confirm that the agent has performed the core or substantial part of the activities on behalf of

the foreign enterprise in India with a binding power on the foreign enterprise.

2.1.1 *Model commentaries on authority to conclude contracts:*

The OECD MC and UNMC states that:

- The phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.
- The authority to conclude contracts must cover contracts relating to operations which constitute the proper business of the enterprise. It would be irrelevant, for instance, if the agent had authority to conclude contracts, in the name of the enterprise, which belonged to internal operations of the foreign enterprise.
- A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority “in that State”, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation.
- Mere fact that a person has attended or even participated in negotiations

With regard to OECD MC, India is of the view that the mere fact that 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 in that State an authority to conclude contracts in the name of the enterprise. India is also of the view that a person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts.

in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.

- The “authority to conclude contracts” must be **habitually** exercised and should not be merely transitory. The extent and frequency of activity for determining whether the agent is “habitually exercising” contracting authority will depend on the nature of the contracts and the business of the principal.
- The UNMC additionally states that a person who is authorised to negotiate all the essential elements of the contract, though not “all elements and details of a contract”, would be considered as person exercising the authority, whether or not that person’s involvement in the negotiation also extends to other non-essential aspects.

2.1.2 *India’s position on the OECD MC:*

With regard to OECD MC, India is of the view that the mere fact that 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 in that State an authority to conclude contracts in the name of the enterprise. India is also of the view that a person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts.

2.1.3 *Important Indian jurisprudence on authority to conclude contracts*

2.1.3.1 *Authority to conclude contracts*

- *Morgan Stanley and Co. Inc. (292 ITR 416) (SC)*

In the landmark ruling, the Supreme Court held that Indian subsidiary

rendering BPO services to foreign client of the US parent company for reconciliation, research etc. does not result in agency PE of the parent company as the Indian subsidiary did not have any authority to conclude contracts on behalf of the parent company.

- *Al Nisr (239 ITR 879) (AAR)*
Al Nisr was a partnership tax that was resident in the United Arab Emirates. It was engaged in publishing, printing and distributing newspapers, magazines and other publications in the United Arab Emirates, and had appointed an Indian company as its sole advertisement representative for soliciting advertisement orders and collecting fees from Indian customers on behalf of Al Nisr. The Indian company was not authorised to enter into any contract on behalf of Al Nisr or to bind Al Nisr in any way. The Indian company was also required to inform all prospective Indian advertisers that all orders were subject to acceptance by Al Nisr under its standard terms and conditions.

Al Nisr argued that, as it was entitled to decline an order solicited by the Indian company, it was evident that the Indian company lacked the authority to conclude contracts on its behalf. The tax authorities, however, contended that Al Nisr's right to reject any advertisement order was "ineffective and meaningless".

Al Nisr successfully responded to this argument by demonstrating the possible reasons for the rejection of orders, for example, certain adverts were prohibited under the law of the United Arab Emirates. The AAR, therefore, held that Al Nisr's arrangement with the Indian company did not give rise to a dependent agency PE in India.

- *Dun and Bradstreet Espana S.A (272 ITR 99) (AAR)*
Dun and Bradstreet Espana ("D & B") was tax resident in Spain. It was a part of the Dun and Bradstreet group ("D & B group"). The D & B group had a

database covering 79 million business entities worldwide. As one of the products, the D & B group provided business information reports (BIRs) in electronic and hardcopy formats that were relevant for various customers in making credit, marketing and purchasing decisions.

The D & B group had subsidiaries and associates in various countries, including India. The subsidiaries and associates were engaged in the business of compiling and selling BIRs in their local markets and to other associated companies worldwide. The subsidiaries and associates compiled information regarding their jurisdiction and uploaded this onto their servers and the D & B group's central server. The servers were situated in a server farm in the United States.

As and when Indian customers placed orders with D & B India for BIRs in respect of Spanish companies, D & B India downloaded, printed and delivered the BIRs from D & B's server. D & B India was not allowed to: (1) make additional copies of the said BIRs; (2) reproduce the BIRs in any way; or (3) sell the BIRs to any customers other than the Indian customers, at whose requests the BIRs were downloaded.

The copyright in a BIR vested with the subsidiary or the associate company that had prepared the BIR. The Indian customers were only permitted to use the BIRs for their own purposes. Copyright in a BIR concerning a Spanish company was neither licensed nor assigned to D & B India or to the Indian customers. D & B India, however, was free to determine the price to be charged by it to the Indian customer. On the other hand, D & B charged a pre-determined price to D & B India. [32]

The AAR observed that D & B had neither authorised D & B India to conclude contracts on its behalf nor had D & B India exercised any such authority. [33] D & B India was carrying on its own business and it was

not controlled or instructed by D & B. D & B India obtained BIRs from D & B on its own account and charged its own price to the Indian customers. In view of this, the AAR held that D & B India could not be regarded as a dependent agent PE of D & B under 5(4) of the India-Spain Income and Capital Tax Treaty (1993).

- *Daimler Chrysler AG (272 ITR 99) (AAR)*

Daimler Chrysler AG ("DCAG"), Daimler Chrysler AG ("DCAG") had sold to the Indian subsidiary raw materials and parts and completely knocked-down kits (parts/CKD). DCAG had also directly sold completely built-up (CBU) cars to Indian customers, in respect of which the Indian subsidiary had rendered certain assistance services.

Based on the facts of the case, ITAT held that mere sale of raw materials and/or components could not give rise to a business connection and, even if it did, no income accrued to DCAG, as all of the activities relating to the sales were carried out by DCAG outside India. ITAT further held that the tax authorities could not establish that the Indian subsidiary was actively engaged in negotiating and concluding contracts on behalf of DCAG. Accordingly, the ITAT held that the limited role played by the Indian subsidiary could not give rise to DCAG's dependent agency PE in India.

- *Western Union Financial Services Inc. (104 ITD 34) (Delhi)*

Western Union, a tax resident of the United States, was engaged in the business of providing money transfer services. In order to facilitate money transfers from foreign countries to India. Western Union had entered into agency agreements with the following four types of agents in India: (1) the Department of Posts (part of the Government of India); (2) commercial banks; (3) non-banking financial companies; and (4) tour operators and

paid commission for providing money transmission services.

Based on the facts, the ITAT observed that the agents did not have authority to conclude contracts on behalf of Western Union. The ITAT rejected the arguments of the tax authorities that (a) as the agents were allowed to appoint sub-agents in India, this amounted to an authority to conclude contracts on behalf of Western Union; and (b) because the agents appointed sub-agents, the agents had habitually exercised such an authority and held that the arrangements between Western Union and the Indian agents did not give rise to a dependent agency PE.

- *Aramex International Logistics (P.) Ltd (22 Taxmann.com 74) (AAR)*

Based on the facts of the case, AAR held that the wholly owned subsidiary (AIPL) of Aramex group amounts to agency PE as

- AIPL secures orders in India wholly for the Aramex group;
- AIPL also has the right to conclude and concludes contracts for the group for its Express shipment business; and
- AIPL is an essential part of the business of the group.

2.1.3.2 Habitual exercise of the authority

The mere authority to conclude contracts on the principal's behalf is not adequate to constitute a dependent agency PE. Rather, the agent must habitually exercise such authority.

- *Salil Shah (2010-TII-199-ITAT-MUM-NRI) (Mum)*

The taxpayer was an individual who was a tax resident of Thailand. The taxpayer had invested in the shares of Indian companies. In the relevant tax year, the taxpayer had disposed of some of the shares and realised capital gains. The transactions were carried out through a stock-broking house. The taxpayer had given a general power of attorney to his father, including the power to transact in respect of the shares, etc.

The OECD or UN models do not specify that mere securing of orders constitutes an agency PE. However, in terms of the provisions of the Act as well as several tax treaties entered by India, a dependent agent who habitually secures orders in India, wholly or almost wholly for a foreign enterprise or for foreign enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that foreign enterprise, constitutes an agency PE.

In course of the tax assessment proceedings, the tax authorities argued that the taxpayer's income from the sale of the shares was of the nature of "business income" and not capital gains. The tax authorities also argued that the power of attorney gave rise to a dependent agent PE in India in terms of article 5(4) of the India-Thailand Income Tax Treaty (1985).

In this context, the ITAT observed that the taxpayer's father had not exercised the authority, which the taxpayer had granted through the power of attorney, except for signing a few cheques. The ITAT held that the mere fact that the taxpayer had given a power of attorney to his father could not give rise to a dependent agent PE in India.

2.1.3.3 Implied authority to conclude contracts

This authority need not be explicit and could be even implied.

- *Amadeus Global Travel Distribution S.A. 113 TTJ 767 (Delhi)*
Amadeus Global Travel Distribution ("Amadeus Global"), which was tax resident in Spain, had developed a fully automatic computerised reservation system (CRS). The CRS was capable of performing comprehensive information search, communications, reservations, ticketing, distribution and related functions on a worldwide basis for the travel industry. Airlines from all over the world had entered into participating carriers agreements (PCAs) with Amadeus Global in respect of displaying their information and/or

products, etc. through the CRS. The airlines compensated Amadeus Global on the basis of "net bookings" made through the CRS.

In order to promote the CRS in India, Amadeus Global had entered into a distribution agreement with an unrelated Indian company ("Amadeus India"). Amadeus India was responsible for seeking subscribers, i.e. travel agents and entering into contracts with them in India. Amadeus Global paid Amadeus India a distribution fee per net segment processed through the CRS by a subscriber located in India.

Amadeus Global provided computers to subscribers and/or travel agents in India free, through Amadeus India to access the CRS in the travel agents' offices. The subscribers' systems were connected to Amadeus India's computer, through which the information requests were channelled to Amadeus Global's mainframe computer system in Germany.

The ITAT observed, inter alia, that

- Amadeus Global made use of the services of Amadeus India to promote the use of the CRS in India.
- Amadeus India was authorised by Amadeus Global to enter into contracts with the subscribers. Amadeus Global bound itself in respect of bookings made by the travel agents using the CRS. Accordingly, what could have been done directly by Amadeus Global was realised through the services of Amadeus India. Consequently, Amadeus India should be treated as an agent of Amadeus Global in India.
- Although Amadeus Global had denied that its arrangement with Amadeus India was an agency relationship, this was not conclusive if a de facto agency relationship existed between Amadeus India and Amadeus Global.

- Under the agreement with Amadeus Global, Amadeus India was responsible for entering into contracts with subscribers (travel agents) in India. Though Amadeus Global was not a party to the agreements between Amadeus India and the subscribers, Amadeus Global had ensured that the subscribers were authorised to use the CRS. The reservations and ticketing carried out via the CRS were honoured by the participating airlines, in respect of which the airlines compensated Amadeus Global. Accordingly, Amadeus India could be regarded as having, and having exercised, an authority to conclude contracts on behalf of Amadeus Global.

In the ITAT's view, the phrase "authority to conclude contracts on behalf of the enterprise" for the purposes of article 5(4) of the India-Spain tax treaty was not confined to an agent who had entered into contract literally in the name of the enterprise. The provision equally applied to an agent who concluded contracts that were, even though not in name of the foreign enterprise (principal), binding on the foreign enterprise.

- *Galileo International (19 SOT 257) (Delhi)*
Based on fact pattern similar to Amadeus, the ITAT held that the phrase "authority to conclude contracts on behalf of the enterprise" in the India-United States tax treaty was not limited to an agent who had entered into contract literally in the name of the enterprise. This provision also applied to an agent who had concluded contracts that were binding on the enterprise, even if those contracts were not actually in the name of the enterprise.

2.2 *Habitually maintains stock of goods or merchandise:*

A dependent agent who habitually maintains

a stock of goods or merchandise from which he regularly delivers goods or merchandise is considered as dependent agent PE of the foreign enterprise.

2.2.1 *Model commentaries on habitual maintenance of stock of goods or merchandise:*

The criterion of habitual maintenance of stock of goods or merchandise is absent in OECD MC. The UNMC on this condition states as under:

If all the sales-related activities take place outside the State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment. However, if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist.

2.2.2 *India's position on the OECD MC:*

Since the criterion of maintenance of stock is absent in the OECD MC, India has merely stated its intention to treat an agent who maintains stock of goods or merchandise from which he delivers goods or merchandise on behalf of the foreign enterprise as a dependent agent PE.

2.2.3 *Important jurisprudence on habitual maintenance of stock of goods or merchandise:*

Though there are many case laws which have analysed the issue of PE arising out of maintenance and or delivery of stock in/from warehouse etc. situated in India by the foreign enterprise, these case laws are in the context of fixed place PE and not on Agency PE.

2.3 *Habitually secures orders:*

The OECD or UN models do not specify that mere securing of orders constitutes an agency PE. However, in terms of the provisions of the Act as well as several tax treaties entered by India, a dependent agent who habitually secures orders in India, wholly or almost wholly for a foreign enterprise or for foreign enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that foreign enterprise, constitutes an agency PE.

Ordinary meaning of the term “securing orders”

As may be noted, there is not much guidance on interpretation of the term "securing orders" as used in the tax treaty. Hence, having regard to the principles of tax treaty interpretation, the term would need to be given its ordinary or natural meaning. Ordinary meaning of "securing" could mean safety and certainty of order. Securing order therefore could mean either obtaining an order or where there is a certainty to obtain an order. Therefore, those activities of a service provider or agent that result in ensuring or making certain that the foreign principal gets an order for sale or supply of goods could fall within the scope of this provision.

While it would be difficult to lay down terms which can be considered in securing orders, following illustrative activities may not be, *per se*, regarded as resulting in orders being secured:

- Carrying out market research;
- Updating the customer about the products in which the principal engaged in;
- Providing details of the personnel of the principal who could be approached for placing an order;
- Collecting the customers' requirement/ specifications etc.

Meaning accorded by Klaus Vogel

It may be noted that Klaus Vogel in his **Commentary on Double Taxation Conventions** (page no. 155 - 157) appears to take a fairly narrow interpretation of the term. The author seems to suggest that mere soliciting orders could be sufficient for the agency PE rule to apply as per observations given below.

"...a permanent establishment is created by an agent who habitually secures orders wholly or almost wholly for the enterprise itself; or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it, viz. a dependent exclusive order-securing agent. These result in a considerable extension of the permanent

establishment concept, since here the employees of a foreign enterprise or persons acting on behalf of a specific enterprise or group of enterprises would already be deemed to constitute a permanent establishment merely by soliciting orders for such enterprise or group of enterprises. One condition however is that the orders involved, rather than being isolated ones, must be secured with a certain regularity... Such rules undermine the permanent establishment concept and, as a result, virtually every transaction beyond a simple shipment of goods may lead to a permanent establishment. The term 'permanent establishment' is thus completely deprived of its original contents. Fortunately, international treaty practice has at least so far refrained from adopting similar arrangements which could have undesirable effects on cross-frontier business relations."

Interpretation of the term under the India-USA tax treaty

The India USA tax treaty has similar language as far as securing of orders by a dependent agent is concerned. The protocol to the said tax treaty has given the following criteria for determining whether an agent is habitually securing orders for the foreign enterprise:

- such person frequently accepts orders for goods or merchandise on behalf of the enterprise;

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In case, the agent in spite of being dependent agent undertakes activities which are preparatory or auxiliary in nature, the same may not constitute Agency PE for the foreign enterprise. The Supreme Court in the case of Morgan Stanley and Co. Inc. (supra), made significant observations stating that carrying out of back office operations by the Indian subsidiary for the US parent would be preparatory or auxiliary activities and hence, may not result in formation of PE for the US parent company engaged in front office operations.

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- substantially all of such person's sales related activities in the contracting state consist of activities for the enterprise;
- such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and
- the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

Issues arising from the different interpretation

The important question that arises is whether the interpretation of the term in India-USA tax treaty can be considered for interpreting the term used in another tax treaty/the Act or the term "securing orders" would need to be accorded its ordinary meaning.

As noted above, currently no jurisprudence has been developed on this issue. However it may be said that while at a conceptual/theoretical level one may try to make a distinction between soliciting v securing orders, in practice, it may be a line which will be difficult to draw and chances of the same blurring does exist.

2.3.1 Model commentaries on securing orders:

The criterion of securing orders is absent in OECD MC and UMMC.

2.3.2 India's position on the OECD MC:

There is no specific mention of India's intention on this aspect in the commentaries on the OECD MC.

2.3.3 Important jurisprudence on securing orders:

Delhi ITAT in the case of *Rolls Royce PLC vs DDIT* (113 TTJ 446) held that even if the Indian company being dependent agent of the foreign enterprise had no authority to conclude contracts, it still habitually secured orders for the foreign enterprise in India. Hence, as the dependent agent habitually secured orders wholly for the foreign enterprise, it constituted agency PE of the foreign enterprise.

3 Exclusion to the Agency PE – Activities are Preparatory or Auxiliary in Nature

In case, the agent in spite of being dependent agent undertakes activities which are preparatory or auxiliary in nature, the same may not constitute Agency PE for the foreign enterprise.

The Supreme Court in the case of *Morgan Stanley and Co. Inc.* (supra), made significant observations stating that carrying out of back office operations by the Indian subsidiary for the US parent would be preparatory or auxiliary activities and hence, may not result in formation of PE for the US parent company engaged in front office operations.

Further, the Delhi High Court in the case of *U.A.E. Exchange Centre Limited* (313 ITR 94) (Delhi) applied the above principle of Supreme Court and held that as the activities carried out by the Indian liaison office were in the nature of preparatory or auxiliary character, the foreign enterprise did not constitute PE in India.

In *Rolls Royce Plc*, (supra), the Delhi Bench of the Tribunal held that a foreign company availing support services from an Indian subsidiary had a PE in India. It was further held that the operations carried out in India cannot be regarded as preparatory or auxiliary functions because they were essential and significant part of the activity of the enterprise as a whole.

4 Concluding Thoughts

Dependent agent PE has emerged as one of the most complex issues in domestic tax and international tax law. In the light of the above discussions, foreign enterprises undertaking business in India through agency agreements would need to consider the above factors for determining whether their agent constitutes PE in India. The same would be dependent on a mixture of facts, documentation and conduct of parties involved.

Once it is concluded that agency PE exists, the next question which arises for consideration is the amount of profits to be attributed to the PE. These aspects related to attribution of profits will be covered in another article. ■