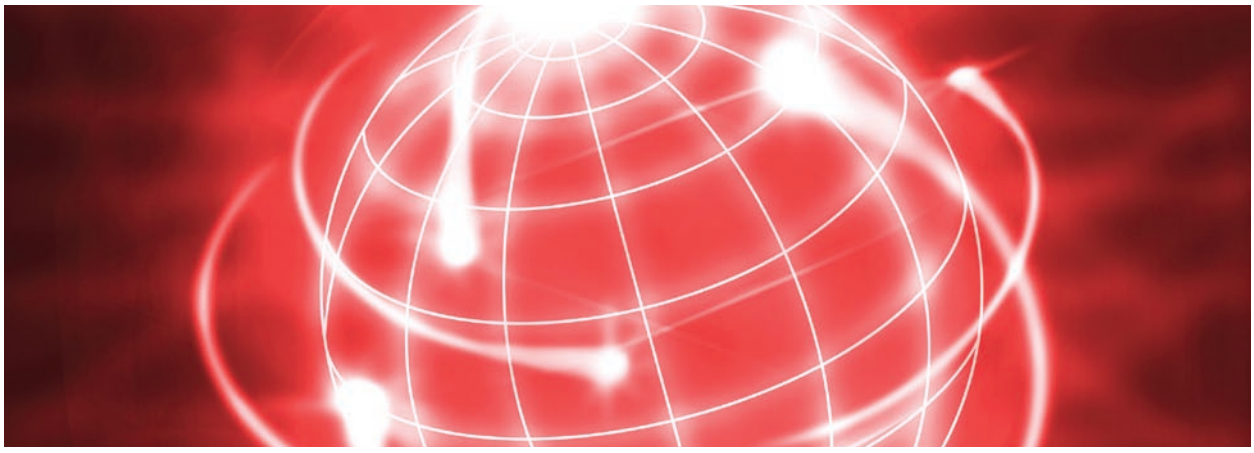
Taxability of Liaison Offices in India



Globalisation is the new buzzword that has come to dominate the world since the nineties. Also, globalisation has brought in new opportunities to developing countries. The past decade and a half has seen India transforming itself into a very alluring destination for foreign investments. As a part of commencing their foray into India, foreign Companies usually establish a Liaison Office ('LOs') in India, for testing the local waters before deciding whether a full-fledged business must be established. It is a first logical step to create an initial presence that works as a bridge between the exploratory stage and establishing a full commercial presence in the overseas jurisdiction. However, recently, there has been a lot of controversy on the issue as to whether the LOs transgress the line of permitted activities and constitute the Company's PE in India. The ensuing discussion captures the list of permitted activities of the LO in India and the tax scenario that looms over the LOs activities in India.

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In common parlance, a liaison office (LO) is in the nature of a representative office set up primarily to explore and understand the business and investment climate. It is not permitted to undertake any commercial/ trading/industrial activity, directly or indirectly, and is required to maintain itself out of inward remittances received from parent company through normal banking channel. Generally speaking, the activities of LO cannot be held to be earning any income from the activities in India, and if it is established that there is no business connection in India, no income could be said to be accruing to the parent company in India. Further, most of India's Double Tax Avoidance Agreements ('DTAA') exclude from the definition of a permanent establishment ('PE'), a fixed place of business engaged in carrying out preparatory or auxiliary activities.

Regulatory Environment in India

Any foreign company intending to open an LO in India is required to obtain prior approval from the RBI, the apex foreign exchange management authority in India

which lays down the restrictive conditions, at the time of granting permission for the opening of an LO.

Regulation 2(e) of Foreign Exchange Management Act (FEMA) 2000 defines LO as follows:

"(e) Liaison office means a place of business to act as a channel of communication between the principal place of business or Head Office by whatever name called and entities in India, but which does not undertake any commercial/trading/industrial activity, directly or indirectly and maintains itself out of inward remittances received from abroad through normal banking channel"

Further, schedule II to the FEMA read with Regulation 6(1) gives the following list of activities, which can be carried on, through an LO:

"(i) Representing the parent company/group companies in India.
(ii) Promoting export/import from/to India.
(iii) Promoting technical/financial collaboration between parent/group companies and Indian companies.
(iv) Acting as communication channel between parent and Indian companies."

Hence, from the above discussion, it can be deduced that LOs can act as a lynchpin between overseas and the Indian activities. However, the above listed permitted activities of an LO are amenable to wide connotations and diverse interpretations.

Tax Implications

As per Section 9(1)(i) of the Income-tax Act, 1961 (hereafter referred to as the Act), an LO would be deemed to be liable to tax on its income in India in case it constitutes a 'business connection' of its foreign parent in India. However, under the provisions of the Act, no income shall be deemed to accrue or arise in India to the foreign parent through or from 'operations which are confined to the purchase of goods' in India for the purpose of export.

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Moving towards the provisions of the Double Tax Avoidance Agreement ('DTAA'), a conjoint reading of Article 5 with Article 7, an LO would be taxable in India, in case it constitutes a PE of its foreign parent in India. However, most of India's tax treaties exclude from the definition of a PE, a fixed place of business engaged in carrying out preparatory or auxiliary activities. Hence, as per the provisions enunciated by the law, an LO may undertake preparatory and auxiliary activities in India and escape the taxation cobweb. However, it is a matter of debate as to what constitutes preparatory and auxiliary activities that the LO can undertake in India and move out of the tax net. Accordingly, at this juncture, it would be quite appropriate to refer to the connotations of the phraseology 'preparatory and auxiliary'. The word 'Preparatory' has been defined in Oxford Dictionary as 'serving to prepare' or 'introductory'. Further, the word 'auxiliary' has been defined in Black Law Dictionary 7th Edition at page 130 as meaning: 'aiding or supporting, subsidiary'.

While analysing the Permanent Establishment (PE) implications, the OECD Commentary 2010 in paragraph 4 of Article 5, has analysed preparatory and auxiliary activities as under:

'It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.'

The technical explanation of the convention and protocol between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed on September 12, 1989, has held as follows:

"The maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or solely for activities that have a preparatory or auxiliary character for the enterprise such as advertising, the supply of information, or scientific activities, will not constitute a permanent establishment of the enterprise. A combination of these activities will not give rise to a permanent establishment."

Hence, from the above, an insight can be gathered as to what constitutes preparatory and auxiliary activities undertaken by the LO. One may also like to place reliance on the discussion on Article 5(4)(e) by a commentary on Double Taxation Conventions of Klaus Vogel, which is reproduced as follows:

"To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisation which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of businesses solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

Further, a collection of information has also been captured in Arvid A. Skaar's Commentary as falling in the definition of 'preparatory and auxiliary activity'. The relevant extract from the commentary is reproduced below:

"Collecting information for an enterprise's headquarters through an office abroad is considered an auxiliary activity, unless the collecting of information is the primary purpose of the enterprise".

Hence, from the above, it can be inferred that a fixed place of business whose general purpose is identical to the general purpose of the whole enterprise, cannot be treated as preparatory or auxiliary services. However, where the LOs are established solely for undertaking preparatory and auxiliary activities and do not divulge into any core activity of the enterprise, it can be argued that their operations are different from the enterprise and hence their activities may qualify as preparatory and auxiliary in nature.

Judicial Pronouncement on Procurement Activities Undertaken by LOs in India

Various LOs are engaged in undertaking procurement activities in India. An insight may be taken from various judicial pronouncements to understand the role and activities that an LO may undertake in India without invoking any adverse tax implications.

In this regard, reference may be made to the Ruling pronounced by the Bangalore Tribunal in the case of *Nike Inc Vs. ACIT (2008) 122 TTJ 201*. In this case,

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the assessee was incorporated in USA. It purchased goods in India through its LO in India for the purpose of exports from India. Thus, the assessee argued that the LO had been opened solely for the purpose of helping its affiliates located at different parts of the world to buy the goods for trading operations. The Tribunal held that the assessee was a purchasing agent of the affiliates to procure goods from India. Accordingly, Explanation 1(b) of Section 9(1) of the Act was applicable to the assessee and, hence, no income was derived by it in India through its operations of the LO in India.

A similar view has been taken in the case of *IKEA Trading (Hong Kong) Ltd. Vs. DIT (2009) 308 ITR 422* wherein the company incorporated in Hong Kong set up an LO in India for purposes of liaisoning activities in connection with purchase of goods from India. The Authority for Advance Ruling ('AAR') held that the

activities of the LO were confined to only purchase of goods and no sale was effected in India. Accordingly, it was not possible to attribute/apportion any income on account of purchase operations.

Another judicial pronouncement that deserves mention here is the case *ADIT (IT) Vs. Fabrikant & Sons Ltd. (Appeal Nos. 4657 to 4660 and 3342)* dated 28th January 2011. In this case, M Fabrikant and Sons Inc (F&S Inc), a company based in USA was engaged in the business of sale of loose diamonds and diamond jewellery. It set up an LO in India for purchase of finished loose diamonds from the Indian market. The Tribunal observed that the LO was only part of the purchasing process of the diamonds and did not bring any physical or qualitative change in the goods purchased. F&S Inc was purchasing goods through LO and all the activities carried out by the LO were of a basic and preliminary nature in the purchasing process/operation. Hence, no income could be deemed to accrue or arise in India to F&S Inc by virtue of the purchases made by F&S Inc through the LO for export.

Holding a similar view, the Authority for Advance Rulings (AAR) in the case of *Angel Garment Ltd (2006) 287 ITR 341* has held that an LO established with a view to merely undertaking 'purchasing activities' in India (such as collecting information about Indian suppliers, acting as a communication channel between the foreign parent and Indian suppliers etc) cannot be held liable to tax in India, as there is a specific exclusion to this effect prescribed under Section 9(1)(i) of the Act. However, the issue as regards what activities can be said to be comprised within the meaning of the term 'operations which are confined to the purchase of goods' (i.e. the specific exclusion laid down in Section 9(1)(i) of the Act) was not raised before the AAR.

However, a different view has been taken by the Delhi Tribunal as held in the case of *Linmark International (Hong Kong) Ltd. Vs. DDIT (2011) 57 DTR 340*. In the case under consideration, the ITAT held that the income earned by a foreign company from procurement activities carried out through its LO in India is taxable in India. In terms of the background, Linmark Development (BVI) Ltd. operated in India through its three LOs. During the course of assessment proceedings, the Revenue authorities held that the LOs were carrying activities such as vendor interaction, selection and development, developing garment designs jointly with the vendors and the overseas clients, sample preparation/approval, price negotiation, order tracking, production/process control, supply chain management etc. Accordingly, the Tribunal held that the income earned by the assessee through its LOs from procurement activities in India was accruing or arising in India u/s. 5(2)(b) of the Act as Indian offices were carrying out real and substantial part of the business operations of the assessee. Accordingly, the Tribunal, relying on the judgement of Rajasthan High Court in the case of *Bikaner Textiles Mercantile Merchandise Ltd. Vs. CIT (1965) 58 ITR 169,* held that even purchase activities may also lead to earning of profits in India.

This view has also been iterated by the Karnataka High court in the case of *Jebon Corporation India Vs. Commissioner of Income Tax (2010) 127 TTJ 98*. On the basis of material available on record, the Tribunal held that the activities carried on by the LO were not confined only to the liaison work. The LO was actually carrying on the commercial activates of procuring purchase orders, identifying the buyers, negotiating with the buyers, agreeing to the price and thereafter requesting them to place a purchase order.

A similar view has been iterated by the AAR in the case of *Columbia Sportswear Company (2011-TII-21-ARA-Intl)*. In this case, a US company, engaged in worldwide wholesaling and retailing of outdoor apparel, set up an LO in India to act as a liaison for the purchase of goods in India. The LO also assisted the US company in procuring the goods from Egypt and Bangladesh. The AAR observed that the activities of the LO were not restricted to purchasing goods, but it was practically involved in all the activities connected with the business of the US Company and hence constituted the Company's PE in India.

Hence, from the above discussion, it can be inferred that there are divergent views taken by the judiciary while interpreting the procurement activities undertaken by the LOs in India.

Judicial Pronouncements on Research Activity Undertaken by LOs

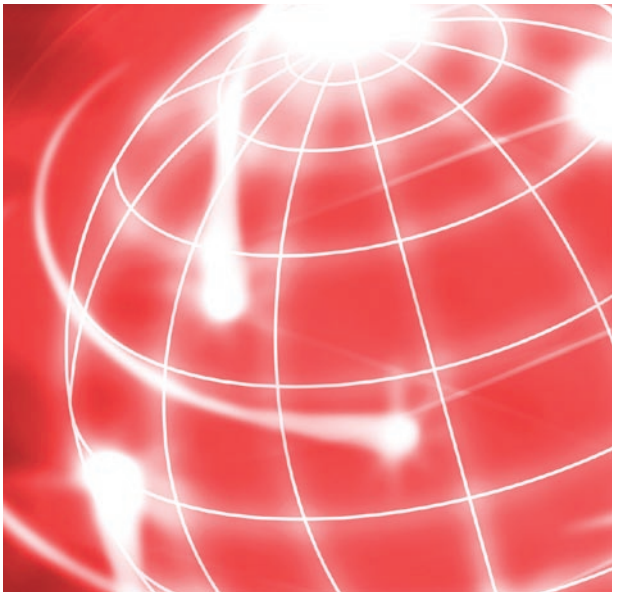
An insight may also be done on the tax scenario for the LOs engaged in market research activities in India.

It may be relevant here to mention the judgement pronounced in the case of *Western Union Financial Services Inc.,(2006) 101 TTJ 56*, wherein the Delhi Tribunal held that no PE can be constituted where the office of foreign entity in India only carried out the activities in the nature of preparatory & auxiliary activities. The following activities of the LO were held as preparatory and auxiliary in nature:

- It acted as a communication link between the agents and the head office of the foreign entity;
- It trained and installed agents of the foreign entity;

- It provided training and refresher courses in connection with the operations of the foreign entity;
- It organised local production of posters for display at the agents' locations;
- It facilitated visit of managerial person from head office of the foreign entity to agents' locations;
- It provided management software to the agents (free of cost) and trained their staff on its usage.

Another judgement that deserves mention here is the judicial pronouncement in the case of *Mitsui & Co. Ltd Vs. Commissioner of Income Tax (2008) 114 TTJ 903* pronounced by the Delhi ITAT. In this case, the LO in India was carrying on various activities in the nature of supplying of business information to Head Office HO. Accordingly, these activities were construed as preparatory and auxiliary in character for the business of the Head Office, since the same were in the nature of support services for business being undertaken by the Head Office.



To add to the woes of the LOs in India, through introduction of Section 285 of the Income-tax Act, 1961, the Government has made it mandatory for the LOs to file an annual statement of their activities in India. In line with the same, the CBDT has recently introduced Rule 114DA providing that the Annual statement is required to be produced in Form 49C.

Further, in the case of *Sojitz Corp. Vs. Assistant Director of Income Tax (2008) 117 TTJ 792*, the ITAT held that where the LO was engaged in the activities of collecting information on economic and Industrial matters of India and sending it to the Head office in Japan, the activities would fall in the definition of preparatory and auxiliary activities.

Another landmark judgement that deserves a striking mention here is the case of *Motorola Inc. Vs. DCIT (2005) 96 TTJ 1*. In this case, the Delhi ITAT held that the activities undertaken by the LO before the commencement of the assessee's business such as market survey, industry analysis, economic evaluation, furnishing of product information, ensuring distributorship and their warranty obligation, ensuring technical presentations to potential users, development of market opportunities, providing services and support information, procurement of raw materials for Motorola and accounting and finance services, etc. would fall only in the definition of preparatory and auxiliary activities of the LO in India and, hence, would not be considered as PE in view of Article 5(3)(e) of the DTAA. The Delhi ITAT held that these activities cannot be considered as activities in the course of carrying on of the business by Motorola in India, but they are anterior thereto.

Further, in case of Ruling pronounced by the Authority for Advance Ruling (AAR) in the case of *K.T. Corporation (2009) 224 CTR 234*, it was held that the LO did not perform any core business activity and hence it did not constitute PE in India. The LO carried out following activities in India:

- Holding of seminars, conferences
- Receiving trade enquiries from customers
- Advertising about the technology being used by applicants in providing wired/wireless services and to answer the queries of the customers
- Collecting feedback from prospective customers/ consumers, trade organisations, etc.

The AAR held that the aforementioned LO activities were defined as preparatory and auxiliary in nature and hence did not constitute assessee's PE in India.

However, the journey for the LOs is not free from hassles. For instance, the judiciary has held a contrary view in case of *UAE Exchange Center (2004) 268 ITR 9*. While interpreting the tax treaty between India and UAE, the Authority for Advance Ruling held that the LO created both a PE in India as well as a business connection. However, while interpreting the same DTAA, in case of *Gutal Trading (2005)*

The issue of taxability of LOs still looms the foreign entities and is not free from ambiguity. To capture the entities in the tax clutches, the tax authorities have been contending that the LOs are transgressing the list of permitted activities and constitute Company's PE in India. On the other hand, while holding the crutches of various judicial pronouncements, the foreign companies are formidably arguing that the scope of activities of the LOs is well within the domain defined by the RBI.

278 ITR 643, the AAR held a different view that the LO neither created a PE nor any business connection and that the LO was carrying on activities strictly in terms of the conditions specified by the RBI. The Authority scrutinised the activities of the LO and held that the scope of activities of the LO were not contemplated either under the definitions of business connection or the judicial elucidation on the same. It also held that since the activities were only in the nature of dissemination and collection of information and not for the procurement of any contracts, the LO operated only on the lines of a communication channel between the potential customers, traders, and industry on the one hand and the principal company on the other. Accordingly, the Authority concluded that the activities of the LO cannot be held to be earning any income for the applicant in India, and since there was no business connection in India no income could be said to be accruing to the applicant in India.

Another recent development on this issue is the judgement pronounced by the Delhi ITAT in the case of *Metal One Corporation Vs. DDIT (I.T.A No. 5377/Del/2011)*, wherein it was held that no PE is created by the LO in the absence of any violation noted by the RBI on its functioning. Hence, the LO would be presumed to be carrying on preparatory and auxiliary activities, unless RBI has any contrary finding. Further, the ITAT also relied on the co-ordinate Bench's decision in the case of *Sofema SA (I.T.A. No. 3900/Del/2002)* that had been confirmed by the High Court and also by the Supreme Court, and held that the revenue is prima facie responsible for establishing that the LO activity is not limited to being auxiliary or preparatory in character. This judgement brings some respite for the LOs since it places the onus on the revenue to establish that the LO creates PE in India.

It is imperative to note here that, where the tax authorities have been adopting a position that the LO constitutes a PE/business connection of its foreign parent in India, any receipt (or part thereof) due to the LO or to its foreign parent from any activity in India have been held as liable to tax in India. This is contrary to the LO's contention that they are prohibited from carrying on business in India (as per RBI guidelines) and also that no profits are attributable to the activities carried out by them in India.

From the above, it can be inferred that the judicial pronouncements are divided on the issue and there is a lot of uncertainty on the subject. The matter is subject to diverse connotations and requires formidable arguments based on the factual matrix.

Stringent Reporting Imposed on LOs

To add to the woes of the LOs in India, through introduction of Section 285 of the Income-tax Act, 1961, the Government has made it mandatory for the LOs to file an annual statement of their activities in India. In line with the same, the CBDT has recently introduced Rule 114DA providing that the Annual statement is required to be produced in Form 49C.

The Annual Statement for the financial year 2011-12 is required to be filed mandatorily by 30th September, 2012. It requisitions huge volume of data, making it a cumbersome exercise to comply with. It seeks to collect extensive details about the activities of the non-resident from India or their operation in India. The non-residents are required to obtain and file voluminous information pertaining to their operations from or in India, including the role played by the LO in the overall operations.

Conclusion

LOs are very popular forms of business in India since a long time. However, the issue of taxability of LOs still looms over the foreign entities and is not free from ambiguity. To capture the entities in tax clutches, tax authorities have been contending that the LOs are transgressing the list of permitted activities and constitute company's PE in India. On the other hand, while holding the crutches of various judicial pronouncements, foreign companies are formidably arguing that the scope of activities of LOs is well within the domain defined by the RBI. Unless the clear laws are laid down, the assessees shall continue to face hardships from the revenue authorities. ■