Can subsidiary company of a foreign enterprise per se constitute PE ?

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There have been a few rulings delivered by Tax Tribunals and the Authority of Advance Rulings in the recent past, where, amongst others, the judicial authorities have held that an Indian subsidiary of a foreign MNE can per se constitute a fixed place of business permanent establishment (PE) of the foreign enterprise in India. The trend of such rulings does create apprehensions and uncertainties amongst MNE taxpayers; and an attempt is made in this article to clinically assess and address the issue.

The concept of PE under tax treaties generally connotes the significant presence of a foreign enterprise in a host jurisdiction, such that the enterprise can be said to participate in the economy of the host jurisdiction, so that the host country can be said to have reasonable rights to levy tax on the foreign MNE for the economic activities carried out therein. Of course, we are not concerned with the source-based form of taxation of royalties, fees for technical services, interest, capital gains, etc., which developing countries generally resort to, for levying tax on such items of income in the hands of foreign MNEs, which are sourced from the host country, even absent physical presence of foreign MNEs in the host jurisdictions.

There are different types of PEs, which are envisaged in a tax treaty. However, I am restricting the discussions only to fixed place of business PE and dependent agent PE (DAPE), for analysing the sole question as to whether a subsidiary company of a foreign MNE, namely a separate legal entity, albeit a related party, can per se constitute a fixed place of business PE of the foreign MNE in the host jurisdiction, in this case, being India ?

The commentary on OECD model convention (MC); and also Courts across the world, including the Supreme Court and High Courts of India, have unanimously laid down the three basic characteristics of a fixed place of business PE, namely that – (a) the place needs to be fixed or have a degree of permanency, though the level of permanency may vary depending upon the unique features of business or industry; (b) the place needs to be at the disposal of the non-resident enterprise; and (c) the non-resident enterprise needs to carry out business through such place.

Where a foreign enterprise itself has a fixed place of such insignia at its disposal in the host country, through which it itself carries out business, then it is easy to comprehend that the foreign enterprise may be said to have a fixed place of business PE in the host country, for being caught within the taxation web of such country.

However, where the foreign enterprise deals with a subsidiary company in the host jurisdiction, then one would hesitate to cast a verdict in favour of the subsidiary company creating a PE of the foreign enterprise, except in the case of DAPE, namely where it acts as an agent to secure orders or conclude contracts on behalf of the foreign enterprise. The rationale behind such view is explained in the following paragraphs.

The concept of PE under tax treaties is relevant to the extent it provides the Revenue Officer of the host jurisdiction with necessary ammunition to bring within the tax net, profits emanating from economic activities carried out in the host jurisdiction, which may otherwise fall beyond the purview of transfer pricing (TP). Where services rendered by a subsidiary company in the host jurisdiction in favour of its foreign parent company, are not properly remunerated by the parent company as may be commensurate to its functional, asset and risk (FAR) profile, then the Revenue Officer of the host jurisdiction would be free to allocate proper arm's length profits in the hands of the subsidiary company by applying the provisions of TP, contained in Article 9 of the relevant tax treaty.

There would not arise any logical need to treat the subsidiary company as a fixed place of business PE of the foreign parent company for attributing arm's length profits to such PE by applying the provisions of Article 7 of the tax treaty, as such profits can and should be taxed in the hands of the subsidiary company in the host jurisdiction through the application of TP under Article 9 of the tax treaty.

One needs to bear in mind that the TP provisions have been in vogue in India not just from fiscal year 2001-02, when formal TP documentation compliance rules were first introduced, but also had its existence in the Income Tax Act, 1922, though it is a different matter altogether that probably due to sparse level of cross border trade between related parties in the pre-globalisation era, resulting in the lack of awareness on the part of Indian Revenue Officers in matters of TP, the Indian Revenue Officers had hardly invoked the provisions of TP to allocate arm's length profits in the hands of Indian entities engaged in cross border trade with related parties.

However, that did not mean that the Revenue Officers did not have the necessary authority to apply the provisions of TP in India prior to 2001, so as to be taken as a pretext by the Indian Revenue to assert a PE of the foreign enterprise under the circumstance that the Indian subsidiary company of the foreign enterprise had not earned arm's length profits from the foreign enterprise. Such deficiency could have been addressed by invoking the provisions of TP, which always existed in the domestic tax laws of India; and in Article 9 of the tax treaties signed by India. Failure on the part of the Indian Revenue Officer to carry out such official duty cannot be said to provide him with any ammunition to try and allocate such deficiency in arm's length profits in the hands of the foreign enterprise by alleging that the subsidiary company created a fixed place of business PE of the foreign enterprise, when the existing texture or fabric of Article 5 of tax treaties does not permit triggering of PE in such cases.

The need to resort to Article 7 in the hands of a foreign enterprise, in the context of the presence of a subsidiary company in the host jurisdiction, would arise only where Article 9 by itself, cannot address the issue of subjecting the arm's length profits, as commensurate to the overall activities carried out in the host country, to tax in the hands of the subsidiary company. Can such situation arise in practice ? The answer is certainly yes, however, under unique conditions or circumstances, which are not difficult to conceive of.

Let us first take the example of a subsidiary company in India, which acts as a contract/ toll manufacturer or contract service provider of its foreign parent under a principal to principal model, against receipt of remuneration for such services. The question of such subsidiary company per se creating a fixed place of business PE of the foreign parent can never arise. Any shortfall in remuneration below the arm's length level can be easily allocated in the hands of the subsidiary company by the Revenue Officer by applying TP provisions under Article 9.

As an extension of facts, let us assume that the foreign parent, as the recipient of services, wishes to intermittently depute its expatriates to India for a proper vigil on the activities of the subsidiary company, being the service provider, vis-à-vis whether the services so provided are as per the standards or specifications of the foreign enterprise; and for that purpose, the subsidiary company makes available certain amount of space at its business premises at the disposal of the foreign enterprise.

In such case, it is not the legally incorporated subsidiary company, but the physical space at its premises, which is available at the disposal of the foreign enterprise, that can create a fixed place of business PE of the foreign enterprise, if the necessary tests of permanency are satisfied, namely if the expatriates of the foreign enterprise occupy such space for such duration, as satisfying the generally accepted threshold of permanency.

It is through the presence of such expatriates that the foreign enterprise may be said to carry on business at such fixed place available at its disposal. Arm's length profits commensurate to the activities carried out by such expatriates can be said to be attributed to such fixed place of business PE, through the application of Article 7, by resorting to the machinery provisions of TP, contained in Article 9. Since the activities carried out by the expatriates and also the costs associated with the same are not; or cannot be reflected in the FAR profile of the subsidiary company, namely the service provider, arm's length profits commensurate to such activities cannot be allocated in the hands of the subsidiary company through the stand-alone provisions of Article 9, thus necessitating invoking of Article 7 to tax such profits in India in the hands of the foreign enterprise.

If under a given circumstance, as in the case of Morgan Stanley before the Supreme Court, the costs of the deputed expatriates are charged by the foreign enterprise to the Indian subsidiary; and the same forms part of the cost base of the Indian subsidiary for the purposes of computing the arm's length mark-up thereon, then though the presence of the expatriates would otherwise trigger a PE of the foreign company in India, however, since the arm's length profits with respect to their activities would have been captured in the books; and taxed in the hands, of the Indian subsidiary company, no meaningful purpose would be served in attributing the same profits in the hands of such PE of the foreign enterprise again.

Yet, this is a more convenient approach to the issue; and not the classical approach, since if the expatriates actually represented the foreign enterprise, so as to trigger a PE of such foreign enterprise in India, then ideally their costs should have been borne by the foreign enterprise and not by the Indian subsidiary. However, in case the ultimate allocation or attribution results in the same quantum of profits being taxed in India irrespective of in the hands of whichever entity, then the Supreme Court, as the apex legal institution of the country, has clearly laid down the principle for everyone in the country to follow, that convenience needs to have precedence over any copy-book style of tax administration, a view, which even the OECD and also the APA team of the Indian Revenue Board have since been professing and practising, as would be highlighted in the following paragraphs.

The other example would be one of DAPE, created through the agency functions carried out by the Indian subsidiary company of the foreign enterprise, of securing of orders or conclusion of contracts on behalf of the foreign enterprise. For carrying out such agency functions, the Indian subsidiary company would have earned arm's length remuneration from the foreign enterprise, which may be properly monitored through the application of TP under Article 9 of the relevant tax treaty.

Now, in case the agent also carries out significant people's functions for assumption of risks or economic ownership of assets on behalf of the foreign enterprise, being ideally debtors and inventory functions, then a need might arise to attribute arm's length reward for such significant people's functions, which ideally a buy-sell distributor would perform; and not a routine agent, in the hands of the DAPE of the foreign enterprise by invoking Article 7, by deeming the same as a distributor of products, where the additional profits would represent the difference between the arm's length profits of a commensurate distributor, having similar FAR profile or intensity of selling functions; and the commission received by the Indian subsidiary in the capacity of the agent.

The reason for having to invoke Article 7 for attributing such additional profits in the hands of the DAPE, is that as per the classical approach of TP under Article 9, the rewards commensurate to distribution functions are generally not allocated to an agent; and thus the arm's length profits relating to the significant people's functions for assumption of risks and economic ownership of assets, carried out by the agent, would not have otherwise been brought to tax in the host jurisdiction; and one would have had to create an artificial or deemed entity of the foreign enterprise, in the form of DAPE, with commensurate FAR profile of a distributor; and attribute such profits in the hands of such PE under Article 7.

Thus, it is stated, even for the sake of repetition, that under the classical approach of TP, Article 9 would have been an insufficient machinery provision for taxing such additional profits in India in the hands of the subsidiary company; and one would have needed to invoke the charging provisions of Articles 5 and 7 under the treaty, for first artificially creating a presence of the foreign enterprise in India in the form of a PE, namely DAPE; and then defining the income to be allocated to such DAPE.

Having discussed the classical approach, as above, let us address the issue of convenience, which should never be read or understood in a disrespectful manner, as having received the blessing of the Supreme Court of our country. The OECD has said in the final discussion paper on attribution of profits to PE, which was released as per BEPS Action 7, that for the sake of convenience, such additional profits, which could have otherwise been taxed in the hands of the DAPE of the foreign enterprise in the host jurisdiction, may be taxed in the hands of the agent, namely the local subsidiary company, with a view to absolve the tax administration of the host jurisdiction from the unnecessary hassle of conducting two separate assessments, namely one in the hands of the subsidiary company; and the other in the hands of the DAPE of the foreign enterprise.

Incidentally, the unilateral APA team of India has also been pleased to adopt such convenient approach in some of the concluded unilateral APAs in the hands of Indian subsidiary companies of foreign MNCs, being agents, wherein, by agreeing to allocate the arm's length profits commensurate to distribution functions in the hands of the Indian subsidiaries, an understanding is entered into in the APAs that the foreign enterprises would be insulated from any tax liability, in the event the respective Revenue Officers were to assert existence of DAPEs of such foreign enterprises at any future time.

Thus, by following the convenient or non-conventional approach, which has had the blessing of the Supreme Court of India, OECD and also the Indian unilateral APA team, TP under Article 9 by may itself be a sufficient machinery tool for allocating arm's length profits in India, even in the scenario of an admitted DAPE of a foreign enterprise, however, under the classical or conventional approach, the Indian Revenue may have to invoke both Article 7 and Article 9 for collecting its fair share of taxes in such cases

It would be thus be clear from the aforesaid discussions that except in the case of a DAPE, the legally incorporated Indian subsidiary of a foreign enterprise cannot by itself, constitute a fixed place of business PE of such enterprise