Tax Hotline

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DELHI TRIBUNAL: HITACHI SINGAPORE'S LIAISON OFFICE IN INDIA IS A PERMANENT ESTABLISHMENT, SCOPE OF EXCLUSION UNDER SINGAPORE TREATY RESTRICTIVE

- PE exclusion clause in India-Singapore treaty is more restrictive than corresponding clauses in Indian treaties with the USA and Canada.
- Liaison Office of Singapore entity in India is a PE, unless maintained solely for advertising, supply of information, scientific research, or 'similar' activities which are preparatory or auxiliary.
- Limits quantum of additions to those made in first round of assessment which was set aside, stating Tribunal could not make a taxpayer worse off.

The Delhi bench of the Income Tax Appellate Tribunal ("**Tribunal**") in a set of batch appeals in *Hitachi High Technologies v. DCIT*[1], held that a Liaison Office ("**LO**") of Hitachi High Technologies Singapore Pte. Ltd. ("**Appellant**") in India constituted a Permanent Establishment ("**PE**") of the Appellant on account of the activities undertaken by it, which were not simply preparatory or auxiliary in nature. The Tribunal compared the PE exclusion clause for preparatory and auxiliary activities in Article 5(7)(e) of the India-Singapore tax treaty, against the language in India's treaties with the USA and Canada; and concluded that the India-Singapore treaty envisaged a narrower exclusion which the Appellant did not qualify.

Notably, this was the second round of appeal before the Tribunal, as the Tribunal had set aside the first assessment order since the Dispute Resolution Panel ("**DRP**") had not passed a speaking order. In this second round, the Tribunal held that it could not put the Appellant in a worse position than it was in before filing the Appeal with the Tribunal in the first instance. Resultantly, the Tribunal capped overall additions to the quantum of additions that had been made by the Assessing Officer ("**AO**") in the first round.

BACKGROUND

The Appellant, a Singapore company and a wholly owned subsidiary of Hitachi High-Technologies Corporation, Japan, was engaged in trading operations across Southeast Asia. In 1988, the Appellant established an LO in India for providing 'preparatory and auxiliary services, including market research and liaison activities'.

Based on employee statements recorded in a survey conducted at the LO's premises in 2008, the AO initiated assessment against the Appellant under the Income Tax Act, 1961 ("**ITA**") for assessment years 2002-03 to 2007-08. A draft assessment order was passed holding that the LO was negotiating and executing contracts for the Appellant in India, and was not limited to undertaking preparatory and auxiliary activities, and hence it was a PE of the Appellant in India under Article 5 of the India-Singapore treaty. The income of the Appellant attributable to the alleged PE was computed by applying the Appellant's global profit margin to sales made in India and attributing 50% thereof to the PE. Total addition of INR 72 million was made for the batch of six years assessed.

The DRP summarily upheld the draft order, following which the AO passed the final order. On appeal, the Tribunal set aside the order directing the DRP to re-adjudicate passing a speaking order.

The DRP re-adjudicated and framed its order based on which the AO passed another final order. This time the additions made were to the tune of INR 1.23 billion. The Appellant once again approached the Tribunal in appeal against the final order, on four main grounds discussed below.

TRIBUNAL'S RULING

1. Did the DRP exceed the directions of the Tribunal while re-adjudicating

During re-adjudication, the DRP altered the manner of attribution of profits to the PE, resulting in enhancement of the assessment. The Tribunal held that the DRP had merely followed its directions in re-adjudicating the matter. It further observed that the DRP is a continuation of assessment proceedings, intended as a corrective mechanism to guide the AO, and is not an appellate forum – unlike the Commission of Income Tax (Appeals).

2. Tribunal's power to put the Appellant in a position more prejudicial than it was in before filing appeal in the first instance

The Tribunal observed that while its powers in adjudicating appeals were very widely couched, their power to enhance an assessment in the absence of cross appeals or cross objections by the revenue was limited. For this, the Tribunal relied on the decision of the Supreme Court in *State of Kerala v. Vijaya Stores*[2]. On this basis, the Tribunal stated that the addition to the Appellant's income in the proceedings should be restricted to INR 72 million – being the additions made in the first instance.

3. LO of the Appellant constituting a PE in India

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The Tribunal analyzed the text of the PE exclusion clause in Article 5(7)(e) of the India-Singapore tax treaty, observing that the words 'for similar activities' used after 'advertising', 'supply of information' or 'scientific research'[3] were noticeably different from the phrase 'for other activities' used in India's treaties with Canada, or the USA.[4] The use of 'similar activities' necessitated the application of the principle of *ejusdem generis,* meaning the scope of the residuary phrase had to be interpreted in light of the words preceding it, being: advertising, supply of information and scientific research. Therefore, unless the LO was being used only for advertisement, for supply of information, for scientific research, or activities similar to these three which have preparatory or auxiliary character, they could not fall in the PE exclusion clause.

The nature of activities, as evidenced by the statements gathered during the survey, were market research and sales promotion – *sine qua non* for a trading business, and hence could not be regarded as preparatory or auxiliary, especially under the restricted scope of the exclusion clause in the India-Singapore treaty. Therefore, the Appellant had a PE in India under the treaty.

4. Attribution of profits to the PE

The DRP directed the AO to use the profit margin of an independent agent used by the Appellant – called ForeVision – as an internal comparable, because it found its activities to be similar to that of the LO.

The Tribunal, basis Article 7 of the India-Singapore tax treaty and the decision of the Supreme Court in *DIT v. Morgan Stanley*,[5] stated that the attribution of profits of the PE was to be determined as if the PE was an independent enterprise, with reference to an analysis of functions performed, assets employed, and risks assumed ("**FAR Analysis**") by the PE. The Tribunal observed that no such comparative FAR Analysis had been undertaken in respect of the LO and ForeVision, and that based on the business profiles ForeVision was not a good comparable. It then observed that the LO was performing routine and limited functions and was operating in a risk-free environment, in which case a profit attribution by the revenue of 163% to 2357% was absurd, and the allocation should have been done by applying the Transactional Net Margin Method.

ANALYSIS

In its order, the Tribunal has distinguished the PE exclusion clause in the India-Singapore treaty which uses the residuary phrase 'for similar activities', from the clauses in the India-US and India-Canada treaties which use the phrase 'for other activities'. The Tribunal's holding means that all tax treaties that use the 'similar activities' phrasing will be interpreted to have a very restricted PE exclusion clause, wherein the exclusion for preparatory and auxiliary activities will have to be assessed in light of the preceding specified activities – such as advertising, supply of information and scientific research in case of the India-Singapore treaty. In comparison, treaties using the 'other activities' phrasing continue to provide for a wider exclusion for any activity that is 'preparatory or auxiliary'.

This difference in interpretation can create potential tax arbitrage opportunities and can also be litigious as there is little support for this position in Indian or international commentary and jurisprudence. Notably, the text of the erstwhile OECD Model, UN Model, and the US Model treaties all used the 'other activity' terminology in their pre-2017 versions. The pre-amended OECD Model Commentary observed that the use of the phrase negated the need for an exhaustive list of PE exceptions. In the currents post-2017 versions of the OECD and UN Model Conventions, the construction of the PE exclusion clause has been altered to accommodate the recommendations of the BEPS reports. However, the residuary exception for 'any other activity' has been retained, provided that 'the activity of the fixed place of business, is of a preparatory or auxiliary character'.[6] The OECD's Commentary to the revised Model Convention observes, as it did in the pre-2017 version, that the use of the phrase 'other activity' negates the need for an exhaustive list of exclusions.[7] It is worth noting that even after incorporation of the base-protective changes recommended by the OECD as part of the BEPS action reports, the wider phrase of the PE exclusion has been retained in the 2017 OECD Model, and brings into question the basis of interpreting a restrictive meaning in a treaty using the 'similar activities' phrase. Time will tell whether this view of the Tribunal gains traction in decisions to follow and is upheld by higher authorities.

Interestingly in the present case, to conclude on whether the activities of the LO were preparatory and auxiliary in nature, the Tribunal relied on employee statements - specifically correspondence between the LO and the head office - where statements have been made that the representative office *clearly was actively involved in commercial activities*. This sheds light on the importance of written communication within an organization, and that such communication can also be used as evidence, especially where survey operations are carried out.

Another issue in this decision is regarding the limitation of additions to those made by the AO in the first round of proceedings. While the principle that the taxpayer cannot be put in a worse position than it was before it appealed to the Tribunal is one that is largely settled, it is important to acknowledge that the basis of the principle lies in the fundamental idea that a party that has not appealed a decision is assumed to be satisfied with it. The logic of applying this principle in a situation in which one of the parties – the revenue in this case – was not statutorily allowed to file an appeal, brings into question the tenability of this holding of the Tribunal. While the Tribunal acknowledges this key difference in the facts compared to the *Vijaya Stores* decision, it does not address this difference and moves forward to follow the Supreme Court's dictate without appreciating that this key difference forms the basis of the Supreme Court's decision and hence renders it inapplicable in the present facts.

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– Varsha Bhattacharya & Shipra Padhi
You can direct your queries or comments to the authors

[1] ITA Nos. 2683 to 2688/DEL/2015, decision dated September 17, 2019.

[2] (1978) 4 SCC 41

[3] Article 5(7)(e), India-Singapore tax treaty:
"*7. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include: (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise.*"

September 26, 2024

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September 22, 2024

[4] Article 5(3)(e), India-US tax treaty:
"*3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:*
(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise."

[5] [2007] 292 ITR 416 (SC)

[6] OECD Model Tax Convention, 2017 – Article 5 Permanent Establishment
"*4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*
(a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character."

[7] OECD Model Tax Convention, 2017 – Commentary on Article 5, Paragraph 70