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Project office established to carry on preparatory or auxiliary functions does not constitute a PE: SC

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Summary

The apex court, in a recent decision, held that a Project Office (PO) established by a foreign company to act as a communication channel, does not constitute a fixed place permanent establishment (PE) in India, under the India-Korea Double Tax Avoidance Agreement (DTAA). This is because no core business activity of the taxpayer was carried out by the PO in India.

The taxpayer, a Korean company (along with another Indian entity), was awarded a turnkey project by an Indian company. The project entailed carrying out surveys, design, engineering, procurement, fabrication, installation and modification of existing facilities and starting up as well as commissioning of the entire facilities. For the purpose of the project, a PO was setup in Mumbai, India.

The apex court observed that the PO was established for co-ordination purposes and for acting as a communication channel between the taxpayer and the Indian company. There were only two persons working in Mumbai in the PO, neither of whom were qualified to perform the core activities of the business. Accordingly, it ruled that as the activities performed by the PO would fall within the meaning of 'preparatory and auxiliary', it did not constitute a PE.

Facts of the case

- The taxpayer[1], a Korean company along with an Indian entity, was awarded a turnkey project by an Indian company for carrying out the work, inter alia, of surveys, design, engineering, procurement, fabrication, installation and modification at existing facilities, and start-up and commissioning of entire facilities.
- In May 2006, the taxpayer set up a PO in Mumbai, India which was to act as a communication channel between the taxpayer and the Indian company.

[1] Samsung Heavy Industries Co. Ltd. [2020] 117 taxmann.com 870 (SC)

- Pre- engineering, survey, engineering, procurement and fabrication activities took place outside India in the year 2006. From November 2007, the platforms to be installed, were brought outside Mumbai.
- For Assessment Year 2007-08, the taxpayer filed a return of income showing nil profit and a loss on account of activities carried out in India.
- The Tax Authorities concluded that Project was a single indivisible "turnkey" project. The Indian company was to take over a Project that is completed only in India. Hence, profits arising from the successful commissioning of the Project would also arise only in India. It held that agreement was a turnkey project which could not be split.
- 25% of the revenues earned outside India was then attributed as being the income of the taxpayer liable to tax in India. This figure of 25% was justified basis the average profit margin of the four similar Projects executed by companies outside India.
- The matter travelled to the Income-tax Appellate Tribunal (Tribunal), where following documents were examined:
  – Application submitted by the taxpayer to Reserve Bank of India (RBI) for opening of PO;
  – Board Resolution of the Company for opening of PO in India;
  – Correspondence stating that the General Manager of the taxpayer has been appointed as a representative to sign documents for opening of PO and bank account in India and to look after the operations of the PO in India.
- Basis these documents, the Tribunal observed that the scope of Mumbai PO had neither been restricted by the taxpayer or by the RBI.
- Relying on the board resolution, the Tribunal held that the PO was opened for 'co-ordination and execution' of the project and thereby concluded that the PO was a fixed place of business of the taxpayer in India. It held that these documents make it clear that all the activities to be carried out in respect of Project would be routed through the PO.

- The Tribunal rejected the argument of the taxpayer that no expenditure incurred in India[2] in relation to the execution of the Project and stated that the maintenance of accounts were in the hands of the taxpayer and hence, cannot be considered to determine the character of PE.
- The High Court set aside the order of the Tribunal and held that no evidence was brought on record to justify the profit attribution of 25%.
- Thereafter, the appeal was filed by the Tax Authorities before the Supreme Court.

Department's contentions

- The tax department contended that the Project, being a turnkey project, was one and indivisible.
- It also referred to certain landmark rulings of the Supreme Court[3] on taxation of PE and distinguished the same basis facts of the case. It highlighted that in those cases there were two separate agreements for onshore and offshore part of the work.
- On the attribution of 25% of the gross revenue, the tax department referred to all the documents examined by the Tribunal to arrive at a conclusion that the PO was connected with the core business activity of the taxpayer and in the absence of figures given by the taxpayer, a best-judgment assessment had to be made of profits attributable to the PE.

Taxpayer's contentions

- It was argued that the PO consisted of only two employees, neither of whom had any technical qualification to carry on the core business activity of the taxpayer.
- It was also argued that as per the accounts produced, no expenditure was incurred by the PO on the execution of the Project.
- It was further argued that the burden of establishing that a foreign entity has a PE in India, is on the tax authorities,

[2] As per the accounts of the Project Office
[3] Hyundai Heavy Industries Co. Ltd (2007) 7 SCC 422; DIT vs. Morgan Stanley & Co Inc. (2007) 7 SCC 1; ADIT vs. E-funds IT Solution Inc. (2018) 13 SCC 294

which has not been discharged in the present case.

- Alternatively, the taxpayer contended that even assuming that there was a PE in India through which the core business activity was carried out, no taxable income would be attributable to it, as the audited accounts showed that the Project did not yield any profit, but in fact resulted in only losses.

Supreme Court's observations and order

- The apex court went through various judgments relied on by the taxpayer and the Tax Authorities and observed that the condition precedent for coming into existence of a 'fixed place' PE under a DTAA, is that there should be an establishment '**through which the business of an enterprise**' is wholly or partly carried on.
- It observed that maintenance of a fixed place of business which is of a 'preparatory or auxiliary' character would not be considered a PE.
- Referring to the Board resolution examined by the Tribunal, the Apex Court observed that the PO was established to co-ordinate and execute 'delivery documents in connection with construction of offshore platform' and not to 'co-ordinate and execute the Project' as concluded by the Tribunal
- It set aside findings of the Tribunal that mere mode of maintaining accounts alone cannot determine the character of PE, even where the accounts of the PO showed that no expenditure relating to the execution of the contract was incurred
- The apex court also rejected the contention of the tax authorities that the onus is on the taxpayer and not on the tax department to prove that the PO is a PE, being contrary to its earlier decision.[4]
- It further observed that as there were only two persons working in the PO, neither of whom were qualified to perform the core activities, therefore, no PE was formed. In such case the PO cannot be said to be a fixed place of business through which the core

[4] ADIT vs. E-funds IT Solution Inc. (supra)

business of the taxpayer was wholly or partly carried on.

- Therefore, the Court held that PO was solely an auxiliary office, meant to act as a liaison office between the taxpayer and the Indian Company and would fall within the exception provided for PE carrying on preparatory and auxiliary activities.

Our comments

The issue of fixed place PE has been a matter of debate in various tax and judicial forums in India. This judgement clearly establishes that merely constitution of PO would not automatically lead to the formation of a PE. Factual examination of the actual activities carried out is extremely important to evaluate if it is carrying out core activities of the business of the taxpayer or is merely engaged in preparatory and auxiliary work.

This is a welcome decision where the facts have been analysed carefully and principal of substance over form has been applied to arrive at the final decision. This ruling would also be useful where similar examination is to be done in cases, where the Multilateral Instruments (MLI) provisions would be applicable.

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