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SUPREME COURT RULES THAT LIAISON OFFICE DOES NOT CONSTITUTE A TAXABLE PRESENCE IN INDIA

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Introduction

The Supreme Court of India (SC) in Union of India & Anr v UAE Exchange Centre [Civil Appeal No. 9775 of 2011], held that the liaison office (LO) set up by UAE Exchange Centre LLC (Taxpayer) in India does not constitute its permanent establishment (PE) in India.

Background

The Taxpayer, a company incorporated in the United Arab Emirates (UAE) offered remittance services to persons based in UAE (Clients) for transferring funds from the UAE to various places in India.

The Taxpayer had opened its LO in India in the year 1996 under a specific permission granted by the Reserve Bank of India (RBI). The RBI's permission contained an exhaustive list of permitted activities that the LO could undertake and corresponding restrictions.

Permitted Activities

- responding quickly and economically to enquiries from correspondent banks with regard to suspected fraudulent drafts;
- undertaking reconciliation of bank accounts held in India;
- acting as a communication centre receiving computer (via modem) advices of mail transfer TT (telegraphic transfer) stop payments messages, payments details, etc., originating from the Taxpayer's several branches in UAE and transmitting to its Indian correspondent banks;
- printing Indian Rupee drafts with facsimile signature from the Taxpayer's head office and countersignature by the authorised signatory of the LO; and,
- following up with the Indian correspondent banks.

Restrictions

- undertaking activities other than the Permitted Activities in India;

- charging any fees/commission for carrying out the Permitted Activities in India, ie the LO shall not earn any 'income' in India;
- entering into any business contracts in its own name;
- rendering any consultancy or any other services directly/indirectly, with or without any consideration;
- borrowing or lending any money from or to any person in India;
- no signing authority with the in charge of the LO in India except those required for normal functioning of LO on behalf of the head office; and,
- the entire expenses of the LO in India to be met exclusively out of the funds received from abroad through normal banking channels.

In compliance with the above conditions, the contracts between the Clients and Taxpayer were executed in the UAE. Further, the remittance amount and Taxpayer's commission was received in the UAE by the Taxpayer from its Clients.

As a part of its contract, Taxpayer remitted funds on behalf of its Clients, based on their instructions, in either of the following modes: -

(i) by telegraphic transfer through normal bank channels; or

(ii) by couriering cheques through its LO to the designated beneficiaries in India.

The Taxpayer had earlier approached the Authority for Advance Rulings, Income Tax (AAR), for guidance on whether any income is accrued/deemed to be accrued in India from the activities of the LO in India. The AAR had observed that in the second mode of remittance money to India, the LO downloads the particulars of remittance using electronic media and prints cheques/drafts drawn on the banks in India, which are then couriered to beneficiaries in India as per the instructions of the Clients (Remittance Activities). The AAR held the Remittance Activities of the LO are a significant part of Taxpayer's main business, without which its contractual obligations to its Clients cannot be fulfilled Accordingly, the LO constitutes the Taxpayer's PE in India and the income attributable to such PE would be taxable in India.

On a writ filed by the Taxpayer before the Delhi High Court (HC), the AAR's decision was set aside by the HC, where the HC noted that the Permitted Activities were 'preparatory and auxiliary' in nature and therefore, were excluded from the scope of PE under the India-UAE Tax Treaty (Tax Treaty).

Aggrieved, the tax authorities approached the SC, asserting the existence of the Taxpayer's PE in India.

Decision

At the outset, the SC observed that in view of section 90 of the Income Tax Act 1961 (IT Act), the Taxpayer's case would need to be examined under the provisions of the Tax Treaty and not under the provisions of the IT Act. The core question in the case was whether the Remittance Activities (downloading, printing of and dispatching of cheques to Indian beneficiaries) would fall within the expression "of preparatory or auxiliary character"?

The SC relied on the following restrictions set out in the RBI Permission (i) rendering any consultancy or any other service directly or indirectly, (ii) charging any commission/fee or receive remuneration or income in respect of its activities in India, (iii) lending or borrowing any money from a person in India without RBI's permission.

Based on these restrictions contained in the RBI's permission and that the LO's activities were well within the scope of the RBI's permission, the SC held that the Remittance Activities of the LO were 'preparatory or auxiliary' in nature as covered under Article 5(3)(e) of the Tax Treaty.

Comment

The ruling has reiterated the well-settled principle that the tax treaty overrides the domestic tax law provisions unless the domestic tax law provisions are more beneficial. The Taxpayer's case was also bolstered by the fact that the Remittance Activities of the LO were specifically permitted by RBI.

In the past, where a LO has exceeded its scope of permitted activities, courts have held that such an LO can constitute the PE of the foreign entity in India. Therefore, it is important to ensure at all times that an LO in India operates within limits set-out by RBI.

Additionally, in relation to tax treaties to which the provisions of Multilateral Instrument (MLI) regarding specific activity-based exemption apply, it will become important to demonstrate that the stated activity in the exclusion clause (advertising, storage, delivery, etc.) is indeed 'preparatory or auxiliary' in nature. As we move towards complex and innovative business models which rely on limited physical presence in the country where the customers reside, foreign players must assess, based on their facts, about whether their Indian presence can still be said to be merely aiding the core business, in order to avail exemption under the respective tax treaty.

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