When does Liasion Office become a PE?

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A Liaison Office (**LO**
) is a place of business which is permitted to act as a conduit of communication between the principal place of business and entities in India. For opening a LO in India, the Reserve Bank of India (**RBI**
) grants permission under section 29(1) (a) of the Foreign Exchange Regulation Act, 1973, subject to certain conditions which defines the ambit of work that can be performed by LO. The scope of LO activities includes representing in India the parent company/group companies, promoting export import from/to India, promoting technical/financial collaborations between parent/group companies and companies in India.

A LO is required to operate and maintain solely out of inward remittances received from abroad through normal banking channel. Generally, without prior permission of the RBI, a LO is not supposed to undertake any activity of a trading/commercial/industrial nature or enter into any business contracts in its own capacity, charge any commission/fee for LO activities/services rendered by it or otherwise in India, borrow/lend any money from/to any person in India, acquire (otherwise than by way of lease for a period not exceeding 5 years) transfer or dispose of any immovable property in India.

The basic premise to decide whether LO is a Permanent Establishment (**PE**
) or not is to draw an inference from what it does in India and not from what it is ordinarily expected to do. This inference can be drawn from various rulings of the Income Tax Tribunal and the Authority for Advance Ruling that have defined the scope of activity of a LO. In *UAE Exchange Centre LLC, In re [* 2004-TIOL-03-ARA-IT), it was held that any LO engaged in part-performance and not merely auxiliary services is deemed to be a PE . The service involved in such cases will itself be understood as business in view of the regularity and continuity of such service. However, if the activities undertaken by a LO are merely "preparatory and auxiliary" in nature, there can be no inference of a PE. Further, in *Western Union Financial Services*, 2006-TIOL-58-ITAT-Del, maintenance of fixed place of business, solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which had a preparatory or auxiliary character was not considered a PE.

In order to verify whether the activities of an LO are auxiliary or have transgressed the scope of the permitted conditions, there needs to be clarity on the meaning of "auxiliary". Per Black's law dictionary, "auxiliary" means "aiding or supporting" and "subsidiary". Any activity beyond the scope of the define functions such as the frequent use of the premises by the parent company staff, "soliciting and receiving" on behalf of the parent company and part performance of any contract by a LO would impact the LO and constitute it as a PE in India.

A non-resident or a foreign company is treated as having a PE in India under Article 5 of the Double Taxation Avoidance Agreements (**DTAA**
) entered into by India with different countries, if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal.

This notion of PE excludes "sporadic or isolated activities", but covers activities which have "continuity" or "durability." PE shall not include enterprises engaged for the maintenance of fixed place of business solely for the purpose of purchasing goods or merchandise, or collecting information for the enterprise, or maintenance of a stock of goods or merchandise belonging to the enterprise solely of processing by another enterprise, or the purpose of advertising for the supply of information, or scientific research, or other activities which have a preparatory or auxiliary character for the enterprise, or any combination of activities mentioned hereinabove, business through a broker, commission agent or any agent of independent status, provided that such person is acting in the ordinary course of their business.

Clearly LO is not a PE, but it can come within the meaning of PE in case some of its activities goes beyond the prescribed/permitted premise by the RBI. When a PE, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the PE becomes taxable in India under Article 7 of the DTAA.

If a foreign enterprise carries on business in India through a PE situated here, the profits of the enterprise may be taxed in India but only to the extent attributable to the PE. Even the profits which those enterprises might expect to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE, will be taxed in India. The

profits to be attributed to a PE are those which that PE would have made if instead of dealing with its head office, it had been independently dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the “arm's length principle” which per the section 92F (iii) of the Income Tax Act means a transaction in which the buyers and sellers of a product act independently, have no relationship to each other and ensure that they are acting in their own self interest and are not subject to any pressure or duress from the other party.

In a matter concerning taxation of Sony Entertainment Television (**“SET”**, Singapore, the Bombay High Court (**“HC”**) in August 2008 held that foreign companies remunerating their Indian subsidiaries on an arm's length basis will not be liable to pay tax in India. If the arm's length basis is not maintained then the parent company is very likely to be taxed in India. The HC upheld the contention of SET Singapore, according to which even if the foreign company has a PE in India, it is not liable to pay tax if the foreign entity pays arm's-length remuneration to the PE of the company and accordingly, SET Singapore is not liable to pay tax in India and only SET India is liable for tax with regard to its own income.

A non-resident entity may outsource certain services to a resident (Indian) entity. If there is no business connection between the two, the resident entity will not be a PE of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. However, it is possible that the non-resident entity may have a business connection with the resident (Indian) entity. In such a case, the resident (Indian) entity would be treated as the PE of the non-resident entity. Clearly, for a LO, if the scope of its activity expands from being auxiliary or preparatory to anything more, it would be a PE.

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