

Tax Alert on Indian Apex Court's ruling in the context of Permanent Establishment

Hyatt International Southwest Asia Ltd. v ADIT

1 Facts of the case

- The taxpayer is a Dubai-based company and a tax resident of UAE. It has entered into a Strategic Oversight Services Agreement ('SOSA') agreement with two hotels in India located at Mumbai & Delhi (hereinafter referred to as 'Indian Hotels'). Under such agreement, the taxpayer agreed to provide strategic planning services and know-how to ensure that the Indian Hotels are developed and operated efficiently as high quality international full-service hotels.
- The taxpayer was issued a notice against the NIL tax return filed. Thereafter, the taxpayer responded to said notice stating that the 'Strategic Fees' earned under the SOSA constitutes Fees for Technical Services ('FTS'). 'Strategic Fees' shall not be taxable in India, due to the absence of a specific article for FTS in the India-UAE tax treaty ('the Treaty') and the absence of Permanent Establishment ('PE') in India as per Article 5 of the Treaty;
- However, the tax authorities had issued an order stating that the taxpayer has a PE in India and therefore the income of the taxpayer is chargeable to tax in the source state i.e., India under Article 7 of the Treaty;
- The taxpayer challenged the impugned order before the Dispute Resolution Panel, the Income Tax Appellate Tribunal (ITAT) and thereafter the Delhi High Court, all of which upheld the tax authorities' view. Aggrieved by the aforesaid rulings, the taxpayer filed an appeal before the Indian Apex Court ('the Court').

2 Key principles from the ruling

'Core characteristics' test

Test for 'productivity'

- The Court observed that the remuneration to the taxpayer against services rendered under the relevant clauses of SOSA (termed therein as 'Strategic Fees') is not a fixed fee.
- Under the SOSA, consideration payable to the taxpayer had been provided to be calculated as a percentage of room revenue and other relevant revenues of the Indian hotels.
- Given the above, the Court emphasised that such remuneration structure reflects the taxpayer's active commercial involvement, since herein the consideration is linked to the Indian Hotels financial & operational performance.
- Furthermore, the Court noted that the taxpayer's role extended to implementation, rather than high-level policy formulation and direction. The activities performed by the taxpayer involved core business functions such as policy enforcement of HR & procurement, control over pricing & marketing, strategic planning, etc.
- The Court therefore held that the test for productivity – wherein the underlying activity's contribution towards realisation of profits is ascertained (*vis-a-vis* merely aiding profit earning) – has also been met in the instant case.

Test for 'stability'

- The Court *inter alia* emphasised on the core characteristics necessary to constitute a PE in this ruling. The characteristic of 'stability' is construed to be the 'right to control' the concerned premises for conducting business.
- The Court found that the tenure of the SOSA had been for a period of 20 years and the taxpayer is entitled to broad and continued control over the Indian Hotels' functions during such period as per the contractual clauses contained in such agreement.
- The Court noted that the taxpayer's executives & employees had frequently visited India for the purpose of oversight and implementation of the SOSA. It was further noted, based on the travel logs and the job functions of such executives & employees, that there had been a continuity in terms of business presence of the taxpayer in India.
- Even though the nine month threshold for PE determination under Article 5(2)(i) of the Treaty is not exceeded by each such executive or employee, the Court emphasised that continuity of business presence in aggregate shall be material to determine a PE's existence.
- With the above said, drawing precedence from its decisions in *Formula One World Championship Ltd vs CIT* (hereinafter referred to as 'Formula One'), the Court held that the SOSA satisfies the test for stability, since the 'right to control' exists and the duration of access is not *per se* a factor to determine a PE's existence.

Test for 'dependence'

- The test for dependence can be construed to test the degree of control and integration that a foreign enterprise has over a place of business or a related activity in the source country.
- Further to the above, the Court held that exclusive possession of physical space is not a prerequisite for existence of a PE.
- The Court further held that temporary or shared use of space is sufficient and the absence of a designated space within the Indian hotels' physical space does not preclude existence of PE, provided business is carried out from such place of business.
- Given that the taxpayer's business is carried on through the executives and employees stationed at the Indian Hotels premises, it is evident that the taxpayer is 'dependent' on such premises and also exercises certain degree of control in order to access the same.

Under Article 5(1) of the Treaty, to determine PE, two essential conditions shall be met –

- a) The place must be in the disposal of the taxpayer; and***
- b) Such place must be used to carry on business by the taxpayer.***

In the instant case, the satisfaction of both stability and dependence test inherently indicates a substantial degree of control over the right to use the premises, implying that the place is effectively at the disposal of the taxpayer. Therefore, the PE exposure in India for the taxpayer is established.

'Auxiliary activity' test

01

As per Article 5(3)(e) of the Treaty, PE is deemed to exclude the place of business if the same is used for carrying on activities in the nature of preparatory or auxiliary in nature.

02

In light of the above provision, the Court drew reference from its ruling in *CIT vs. Morgan Stanley and Co Inc and ADIT vs. M/s. E-Funds IT Solutions Inc.* (hereinafter referred to as 'Morgan Stanley' and 'E-Funds' respectively) wherein it was held that back-office support functions such as provision of ITeS or other technical services for supporting front-office functions shall be construed to be 'auxiliary activities'.

03

However, the Court noted that the taxpayer had conducted principal business activities such as oversight of key staff, enforcement of HR and procurement policies, pricing & marketing control, bank account management and independent assignment of hotel personnel.

In the *Morgan Stanley* ruling, the Court established a clear dichotomy between the treatment of stewardship activities and other activities not in such nature for the purpose of determination of PE existence.

Stewardship activities

Refers to functions performed by a foreign/ parent company solely to protect its investment and not for providing services to the Indian entity.

This includes generic strategic oversight and monitoring of operations of the Group entities by the foreign HQ to ensure global standards are appropriately maintained.

In the ruling of *Morgan Stanley*, the Court held that activities in the nature of:

Stewardship

- Reviewing the performance of Indian employees to ensure that global standards are maintained cannot be inferred as a service provided by the foreign entity.
- Therefore, service PE is not constituted in the instant case.

Other than stewardship

- Deputation of foreign employees for core business functions triggers service PE.
- Such employees are functionally integrated into Indian operations, going beyond stewardship, thereby making the foreign entity taxable on profits attributable to the PE.

04

With the above said, given the clear distinction in the factual matrix, the Court ruled that the place of business of Indian hotels shall form PE under the purview of *Article 5(1)* of the Treaty.

'Substance over form' test

A

The Court found no merit in taxpayer's contention that absence of specific clause in the SOSA to permit conduct of business in the Indian hotels' premises negates the existence of PE in India.

B

As held in *Formula One* ruling, the Court ruled that a formal right to use the concerned premises is not necessary for existence of PE.

C

The Court called for evaluation of substance over form, since in substance the premises were at the disposal of the taxpayer and the same was used for conducting the business activities under the SOSA.

D

The Court ruled that the mere legal form of Indian hotels in carrying out the day-to-day operations does not override economic reality of the taxpayer undertaking principal and key functions, in order to determine the PE status.

3

Conclusion

- *The Court concluded that the taxpayer's role was not limited to high-level strategic decision making, instead substantive operational control and involvement was exercised by the taxpayer in implementation of the business functions under the SOSA.*
- *Key indicators of the taxpayer's control included the ability to enforce compliance with operational standards, exercise oversight over the Indian hotels' day-to-day operations and the entitlement to derive profit-linked fees.*
- *The above said indicators collectively established a continuous and direct commercial nexus between the taxpayer and the Indian hotels' core functions.*
- *Given the level of involvement of the taxpayer under the SOSA, the Court ruled in favour of the tax authorities holding that the taxpayer has a fixed place PE in India and therefore income attributable under the SOSA shall be taxable in India.*
- *Therefore, the appeal made by the taxpayer had been dismissed by the Court on lack of merit.*
- *It is imperative to note that the Court had only made a passing reference to Delhi High Court's decision on the principle of taxability under PE and the same had not been categorically adjudicated. This principle calls for taxation based on business presence and not on global profitability.*

4 Key takeaways from the ruling

Tenure of agreements

- The term of the service agreement is indicative of the extent of control and access a foreign entity has over the place of business.
- For PE determination, the contractual term of access takes precedence over the actual duration of use by the foreign entity.

Scope of activities under agreements

- Stewardship activities performed under a service agreement do not result in PE exposure for a foreign entity.
- However, if the activities involve core business or day-to-day operational functions, a PE shall be constituted.

'Designated' place of business

- Existence of PE does not call for an exclusive or designated possession of place of business/ physical space.
- Therefore, even temporary or shared use of a physical space suffices if the business is conducted through the same.

Remuneration structure under agreements

- Revenue-based remuneration indicates a foreign entity's direct involvement in the financial performance of its Indian counterpart.
- Such profit-linked fees reflect a continuous commercial nexus between the foreign entity and the Indian counterpart.

Service PE implications

- The number of days of stay by a foreign entity's employees in India has been disregarded in assessing service PE.
- Instead, continuance of business operations, irrespective of individual stay durations, is considered to determine PE exposure.

5 Next steps

Review of inter-company (I/C) agreements

- Examine key contractual clauses for indicators of control, supervision or right of access to premises by the foreign entity – which can trigger PE exposure.
- Identify revenue-based/ profit-linked remuneration structures that suggest a commercial nexus with Indian operations.

PE-sensitive activity matrix

- Clear definition of permissible and restricted activities for foreign personnel, focusing on business presence, interaction levels and decision-making authority with respect to the Indian entity's operations
- Establish activity boundaries and behavioral protocols to avoid the rigours of PE-based taxation in India through inadvertent operational involvement.

Guidelines framework

- Develop a framework to include acceptable support functions that can be performed in India without creating a PE exposure.
- Establish procedures for periodic assessment of PE considerations for concerned MNE entities.

Interplay with Transfer Pricing

- Ensure alignment of the scope of services under the I/C agreement with the characterization of the tested party per transfer pricing regulations.
- This is to ensure that the rationalization of scope of activities to mitigate PE exposure should not jeopardize the functional characterization and the arm's length pricing of the international transaction from transfer pricing perspective.

Thank You

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