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Recent Developments

India

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Analysis of the *Samsung* Case on the Determination of a Permanent Establishment for Services Provided by Seconded Employees of a Korean Parent to Its Subsidiary in India

This article examines the ruling of the Delhi Bench of the Income Tax Appellate Tribunal (ITAT or the Tribunal), i.e. the highest fact-finding authority under the Indian Income Tax Act (the Act), in the case of *Samsung Electronics Co. Ltd.* and the ramifications of that case for the interpretation of the treaty article on the determination of a permanent establishment, especially in the case of expatriate employees seconded and visiting the Indian subsidiary and the attribution of profits to a PE. The issue of reassessment proceedings under Indian law is also considered.

1. Introduction

The concept of permanent establishment (PE) is of considerable importance with the growing trend of globalization in order to facilitate reasonable and transparent taxation of cross-border transactions in this dynamic business landscape. Article 5 of the OECD Model Tax Convention[1] and the UN Model Double Taxation Convention[2] defines the term "permanent establishment", and this definition has been adopted by countries around the world in their double taxation avoidance agreements (DTAAs) signed with other countries.

The concept of a PE in tax treaties is one of the central elements of international taxation and is primarily used for the purpose of the allocation of taxing rights when an enterprise of one state derives business profits from another state. The concept of a PE or its equivalent also appears in the domestic laws of countries. For example, in India, there is the concept of a "business connection", which encompasses the same idea, but is wider in scope in subjecting the income of non-residents to tax in India.

In India, the taxability of any entity depends on its residential status. Pursuant to section 5 of the Act, a resident taxpayer is subject to tax in India with regard to its global income. However, in the case of a non-resident, only the income that accrues, arises or is received in India or income deemed to accrue or arise in India under section 5 read with section 9 of the Act is subject to tax in India. Nevertheless, even in determining the income deemed to accrue or arise in India, only the income that is "reasonably attributable" to its operations in the country is taxable in India.

In order to determine the reasonable level of profits to be attributed under such deeming fiction to the business connection in India, a methodology for the attribution of such profit is provided in the Indian Income Tax Rules, 1962 (the Rules).[3]

Under the Act, every taxpayer that earns income and is subject to tax has to provide the return of income to the Income Tax Department (to the Assessing Officer (AO) or the regular tax officer) within the prescribed time limit. Once the return of income is filed by the taxpayer, the AO may issue a scrutiny assessment (audit) notice requiring the production of documentary evidence.

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1. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Models IBFD.
2. *United Nations Model Double Taxation Convention between Developed and Developing Countries – 2017 Update* (1 Jan. 2017), Models IBFD.
3. IN: Income Tax Rules, 1961, Rule 10.

However, the AO has the power to subsequently reopen the assessment if he has reason to believe that any income has escaped assessment for any assessment year. The AO has the power to reassess or recompute income that has escaped assessment.

Further, the time limit for issuing a notice by the AO under section 148 of the Act for reopening the assessment is:

- within 4 years from the end of the relevant assessment year if the escaped income is less than INR 100 thousand;
- up to 6 years from the end of the relevant assessment year if the income that escaped assessment is equal to or more than INR 100 thousand; and
- up to 16 years from the end of the relevant assessment year if the escaped income is associated with any assets located outside of India. This includes financial interest in any entity.

It can also be noted that the notice under section 148 of the Act can be issued by the AO only after receiving prior approval from the higher prescribed authority mentioned in section 151 of the Act. In response to the said notice, the taxpayer has to file his return of income again, which is then assessed, and the final escaped income is determined, on the basis of which the final tax demand or refund is calculated.

In light of the above information, the authors now examine the facts of the *Samsung* case[4] and findings of the ITAT on the determination of a PE as regards the services provided by the seconded employees of Samsung Electronics Co. Ltd. (hereinafter the Korean parent/the company/the taxpayer) to its subsidiary in India and the expatriate employees visiting India.

Article 5 of the India-Korea Double Taxation Avoidance Agreement (DTAA) (as it existed then)[5] is quoted below for ease of reference:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term "permanent establishment" shall include especially –
   (a) a place of management;
   (b) a branch;
   (c) an office;
   (d) a factory;
   (e) a workshop; and
   (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. The term "permanent establishment" likewise encompasses a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than nine months.
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 for collecting information, for the enterprise;

4. IN: Delhi Income Tax Appellate Tribunal, 22 Mar. 2018, *Samsung Electronics Co. Ltd. v. Deputy Commissioner of Income Tax (Int. Taxation)*, [2018] 64 ITR(T) 99 (Delhi - Trib.)
5. *Convention between the Government of the Republic of India and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (19 July 1985), Treaties IBFD.

(e) the maintenance of a fixed place of business solely for the purpose of advertising, the supply of information, scientific research or any other activity, if it has a preparatory or auxiliary character in the trade or business of the enterprise;

(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs (1) and (2), if a person – other than an agent of independent status to whom paragraph (6) applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise unless the activities of such person are limited to those mentioned in paragraph (4) which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment by virtue of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either a company a permanent establishment of the other.

2. Facts of the Case

Samsung Electronics Co. Ltd. was a tax resident of Korea (Rep.). The principal activity of the Korean parent was manufacturing and selling consumer electronic products, namely various categories of television, home appliances, telecommunications terminals, semi-conductors and other state-of-the-art information technology products for global markets.

The Korean parent had two wholly owned subsidiaries in India, i.e. Samsung India Electronics Private Limited (SIEL/ the Indian company/the Indian subsidiary) and Samsung India Software Operations Private Limited, now known as Samsung R&D Institute India Bangalore Private Limited. The Korean parent deputed employees to the Indian subsidiary, based on the tripartite agreement between the Korean parent, Indian subsidiary and the employees. The seconded employees worked under the direction and supervision of the Indian subsidiary. Further, they received a portion of their salary in Korea (Rep.) directly from the Korean parent for administrative convenience in order to meet their personal obligations in their home countries. Such costs were reimbursed by the Indian subsidiary to the Korean parent.

During the relevant year, a survey was conducted by the revenue authorities on the premises of the Indian subsidiary, wherein it was found that the Indian subsidiary was manufacturing the items under the technical assistance of the Korean parent, for which the Korean parent used to receive income from royalties or fees for technical services (FTS). The AO observed that the Korean parent had not paid tax on the royalties received by it for the use of its brand name (Samsung) by the Indian subsidiary. Thus, the income of the Korean parent in the form of royalty income had escaped assessment.

3. Findings/Conclusions of the AO

The AO, pursuant to the said survey, issued a notice to the Korean parent under section 148 of the Act for initiating reassessment proceedings for the 6 assessment years (AYs) from 2004/05 to 2009/10. In response to the said notice, the Korean parent filed its Indian tax returns for all of the years, declaring income from its branch activities (which was also declared in the original tax return) as well as income from royalties or FTS (which was not declared in the original return for any year).

The AO observed that the Indian subsidiary's office was being used as the place of management for the South Asian operations of the Korean parent, and therefore, the Indian subsidiary would constitute a PE of the Korean parent under article 5(2)(a) of the DTAA between them and a part of income from the sales in the South Asian countries should have been attributable to the Korean parent.

The AO held that the Indian subsidiary was also acting as a dependent agent of the Korean parent in terms of article 5(5) of the DTAA and that the transactions between the Indian subsidiary and the Korean parent were not at arm's length; hence, an adjustment was needed in this regard. The AO also held that the expatriate employees

created a PE of the Korean parent in India by rendering services to the Indian subsidiary. The AO estimated the profit attributable to such PE, at 10% of the remuneration paid to such expatriate employees during the years under consideration, by applying clause (iii) of Rule 10 of the Rules.

The AO based the above conclusions on the following facts:

- there was continuity of business between the Indian subsidiary and the Korean parent;
- the Korean parent was doing business in India through its employees who were heading various divisions in the Indian subsidiary and also through employees visiting India regularly;
- there was a close business connection in terms of the dependence of the Indian subsidiary on the Korean parent for all imports because the Indian subsidiary did not have the authority to receive imports from any other source other than Samsung affiliates;
- the transactions between both parties were so interlinked that the Indian subsidiary could not move an inch without the support and supplies of the Korean parent;
- the postings and recruitment of senior employees were decided by the Korean parent; and
- the expatriate employees in India were working under the complete guidance, control and supervision of the Korean bosses.

The Korean parent filed its objection before the Dispute Resolution Panel (DRP)[6] against the draft assessment order filed by the AO.

4. Findings/Conclusions of the DRP

The DRP held that the Indian subsidiary should be treated as a deemed fixed-place PE of the Korean parent on account of regular communication between expatriate employees and the Korean parent. According to the DRP, there was dependency on the Korean parent to take decisions relating to pricing, the development of new markets, etc.

The DRP concluded the following:

- the Indian subsidiary was a company incorporated under Indian laws and complied with all of the related rules and regulations that govern the operations of a corporate body in India by filing its return of income, paying taxes and reporting the international transactions under the transfer pricing regulations. Hence, SIEL, which was a Indian subsidiary company of the Korean parent, could not be treated as a PE;
- there was no agency PE or PE under article 5(2)(a) of the tax treaty with regard to the place of management for the South East Asian operations;
- the Indian subsidiary could not be considered a service PE of the Korean parent since the tax treaty did not have such a clause; and
- the Indian subsidiary had nothing to do with the provision of royalties and FTS.

The DRP thus held that the services rendered by expatriate employees were essentially for the benefit of the Korean parent, with these services being performed in addition to their services for the Indian subsidiary. The DRP also held that the Indian subsidiary acted as a fixed place from where the Korean parent conducted its business. Further, according to the DRP, there were many other employees of the Korean parent who frequently travelled to India on short visits, and hence, there was existence of a PE.

Accordingly, the AO passed the final assessment order, giving effect to the DRP's order. The Korean parent, dissatisfied with the final order passed by the AO, filed an appeal before the ITAT.

6. The Dispute Resolution Panel is the first authority to adjudicate disputes arising due to transfer pricing and other issues as stated in the Income Tax Act.

5. Findings/Conclusions of the ITAT

5.1. Reassessment proceedings under sections 147-148 of the Act

The ITAT held that the reopening proceedings were not solely based on the statements of the expatriate employees, but also indicated – because of the non-disclosure of the receipt of royalties as disclosed by the tax returns of the branch of the Korean parent – that the royalties/FTS received from the Indian subsidiary were not disclosed. The Korean parent also admitted that they did not declare the receipt of royalties/FTS in the original return of income.

The ITAT observed that there was a huge difference between the income as reported in the original return of income and the return provided for under section 148 of the Act. Thus, the ITAT held that the non-reporting of the receipt of income with regard to royalties/FTS was a valid ground for the AO to propose the reopening of the assessment of the Korean parent for the AYs between 2004/05 and 2009/10. Further, the ITAT disagreed with the Korean parent's contention that there was no escape of income from assessment merely because the tax was deducted at source on such income by the Indian subsidiary on the payments made to the Korean parent.

The ITAT rejected the contention of the Korean parent that the reopening proceedings were not in accordance with the law and upheld the reassessment proceedings.

5.2. Fixed-place PE

According to the ITAT, the entire dispute/issue was with regard to the status of the expatriate employees working with the Indian subsidiary and the nature of the functions they were performing. In other words, the issue was about whether they were actually employees of the Korean parent and placed with the Indian subsidiary to run the business of the Korean parent or whether they were employees of the Korean parent who were seconded to the Indian subsidiary and the Indian subsidiary was the economic employer who exercised full control over them.

The ITAT considered the observations of the DRP and stated that there was seamless information exchange between the employees of the Korean parent and the expatriate employees.

The ITAT agreed with the argument of the authorized representative (i.e. the counsel representing the Korean parent) that any activity of the global business management (GBM) that had ever been conducted in India or any market survey that would have been conducted in India, as stated by the expatriate employees, had nothing to do with the business of the Korean parent and it was solely for the benefit of the Indian subsidiary. Thus, the ITAT ruled that the expatriate employees functioned wholly for the benefit of the Indian subsidiary.

The ITAT held that all of the following activities, among others, as stated by the expatriate employees, fell within the ambit of the business of the Indian subsidiary and would primarily benefit the Indian subsidiary:

- specification of the products;
- stock verification;
- designing activities according to the preferences of the Indian consumers; and
- market strategies to be adopted.

Further, the ITAT held that the same would also benefit the business of the Indian subsidiary to make the GBM understand the priorities and preferences of the Indian customers by providing India-specific information. The GBM in turn would carry out research and development to develop India-specific products. Thus, the ITAT held that it could not be said that it was furtherance of the business of the Korean parent *dehors* the business of the Indian subsidiary.

The ITAT further stated that, at best, the statements and other material relied upon by the revenue authorities indicated that, by way of seamless communication between the Indian subsidiary and the Korean parent, the expatriate employees were only discharging the duties of the subsidiary company towards the holding company.

The ITAT observed that the benefits that were derived by the Indian subsidiary by such communication were subject to tax in India. The ITAT thus held that the activities, as stated above, performed by the expatriate employees in their statements were of the nature of the reporting requirements in the course of discharge of the functions of the subsidiary company towards the holding company. Thus, such activities were exempt activities according to the negative list in the PE article and hence did not contribute to the existence of a PE under article 5(4)(d), (e) and (f) of the DTAA.

The ITAT also agreed with the argument of the authorized representative of the Korean parent that, even if the activities of the seconded employees amounted to the rendering of services to the Indian subsidiary by the Korean

parent, in view of the fact that there was no provision for a service PE under the then-DTAA, no question of a service PE arose in the Korean parent's case.

Further, the ITAT, upon perusal of article 5 of the DTAA, observed that in order to constitute a PE, there must be a fixed place of business available to the Korean parent through which the business of the taxpayer is wholly or partly carried on.

The Tribunal, in its decision, held that the revenue authorities were not able to substantiate that the Korean parent, through the expatriate employees, had been conducting its business in India. It also stated that the Korean parent did not perform the following activities for the purposes of determining that it had a PE in India under the DTAA:

- any management activity conducted in India;
- decisions relating to the products manufactured in India;
- pricing in the domestic markets; and
- decisions relating to the launch of such products in India.

The ITAT also observed that the AO had only stated that 10% of the remuneration of the employees had to be assumed as the income of the Korean parent. There was no evidence that was placed on record by the AO to show that any business income was derived by the Korean parent in India by way of business through the expatriate and seconded employees.

Accordingly, for all of the above reasons, the ITAT held that there was neither any business conducted by the Korean parent in India through the expatriate employees nor any income derived by them through the activities of the employees. Consequently, the ITAT held that there was no fixed-place PE of the Korean parent through such expatriate employees. Hence, the question of estimated income also did not arise.

6. Conclusion

The determination of a PE of a foreign company through its subsidiary shall depend not only on its existence or even a defined set of parameters, but on the commercial arrangement between the two entities as a whole. The existence of a PE through a foreign company's subsidiary is to be determined only if the characterization criteria stated in the PE article of the DTAA are fulfilled.

The ITAT decision in *Samsung* reiterates the principle that in order to constitute a fixed-place PE, there has to be a fixed place "at the disposal" of the enterprise, and the "business of the enterprise must be carried on through the fixed place". The said principle was enunciated by the Honourable Supreme Court in the case of *Formula One*.[7]

Further, in the *Samsung* case, whether the services rendered by the expatriates would constitute a service PE is still an open question, as the article relating to service PEs is absent in the former DTAA. However, the same has been included in the present DTAA entered into between India and Korea (Rep.). The relevant part of article 5(3)(b) of the present DTAA is quoted hereunder for easy reference:

> the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or connected project) within the country for a period or periods aggregating more than 183 days within any 12-month period […][8]

The *Samsung* case, as well as the recent judicial rulings in India, have developed new principles to determine the taxable presence of non-resident persons in India, especially with the evolution of innovative business processes and models, which require less physical presence and more digital presence. The judicial decisions in this new era of doing business globally and seamlessly may be influenced more by the substance of the business transactions rather than only the legal form of such transactions.

7. IN: Supreme Court, 24 Apr. 2017, *Formula One World Championship Ltd. v. Commissioner of Income Tax*, Civil Appeal No. 2849 of 2017, Tax Treaty Case Law IBFD.
8. *Convention between the Government of the Republic of India and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 5(3)(b) (18 May 2015), Treaties IBFD.