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This alert summarises the decision of the Delhi Income-tax Appellate Tribunal on the existence of a Permanent Establishment and the attribution of profits to that Permanent Establishment

FACTS OF THE CASE

Galileo International Inc., USA (Galileo or the Appellant) is a foreign company incorporated in USA. Galileo provides electronic global distribution services to the travel industry using a Computerized Reservation System (CRS). The CRS of Appellant consists of a Master Computer System (MCS) with 18 main frame computers and servers located in the USA. The MCS is connected to Airline Servers to/ from which data is continuously sent and obtained.

The Appellant has entered into Participating Carrier Agreements (PCAs) with participating airlines to provide CRS services to the airlines. The Appellant appoints Distributors to market and distribute the CRS services to Travel Agents (TAs).

In India, the Appellant has entered into a Distribution Agreement with an unrelated company which acts as its 'Distributor' in India. The Distributor is responsible for initiating relationships with the TAs and also installing the subscriber computer equipment, maintaining hardware and software supplied to subscribers and providing ongoing customer support services. Pursuant to the terms of the Distribution Agreement, the Distributor enters into Subscriber Agreements with TAs which enable them to use the Appellant's CRS. The TAs access the CRS by means of a modem for the purpose of undertaking flight bookings for the airline companies. The software enables the subscriber to access information such as display of schedules and fares, display of flight availability status, provision of booking capability etc. The Appellant is also responsible for securing the telecommunication network to enable the TAs to access the CRS.

The Appellant earns booking fees from participating airlines when a TA books a flight on such airlines with the assistance of the CRS. The Appellant in-turn pays a Distribution Fee to the Distributor for its services.

Galileo is a tax resident of USA as defined under Article 4 of the Double Taxation Avoidance Agreement between India and USA (DTAA) and is therefore eligible for the benefits of the DTAA.

It filed a NIL return of income for 4 years from the Assessment Years (AY) 1995-96 to 1998-99, pursuant to a notice issued by the Income-tax Department and contended as follows:

- It did not have taxable income in India under section 5(2) or 9(1)(i) of the Income-tax Act, 1961 (the Act);
- The booking fees were in the nature of 'Business Profits' and in the absence of a Permanent Establishment (PE) of Galileo in India under Article 5 of the DTAA, the same is not taxable.

In the course of assessment proceedings and the first-level appellate proceedings, it was held that Galileo has a 'Business Connection' (BC) in India under section 9 of the Act as well as a PE under Article 5 of the DTAA. Being aggrieved by the order of the first appellate authority, Galileo preferred an appeal with the Delhi Income-tax Appellate Tribunal (ITAT).

KEY ISSUES BEFORE THE ITAT

The key issues before the ITAT were as follows:

- Whether Galileo has any income chargeable to tax in India under section 5(2) of the Act and whether it has any BC in India under section 9(1)(i) of the Act?
- Whether Galileo has a PE in India under Article 5 of the DTAA?
- What is the extent of income earned by Galileo that is chargeable to tax in India?

DECISION OF THE ITAT

Business Connection under the Act

- The expression 'BC' has a wide though uncertain meaning. It admits no precise definition and the facts of each particular case would have to be analysed to determine the existence of a BC.

- The CRS, even though located in USA, extends to Indian territory in the form of connectivity in India. Income accrues to the Appellant when the booking is completed at the desk, through the TA's computer in India.

- There is a continuous seamless process involved, at least part of which is in India, and hence, there is a BC in India.

- As there is a BC, income in respect of the booking which takes place from the equipment in India can be deemed to accrue or arise in India and hence taxable in India.

Income Accruing or Arising under the Act

- Majority of the work which contributes to the earning of income for Galileo is carried out outside India. The extent of work carried out in India is in relation to generating requests and receiving the end result of the process in India.

- The ITAT held that it could reasonably attribute 15 per cent of the revenues accruing to Galileo in respect of the bookings made in India as accruing or arising in India and therefore chargeable to tax in India.

- The ITAT also held that the Appellant would be eligible deduct the Distribution Fee paid to the Indian Distributor while determining the taxable income. As the fee paid to the Distributor was in excess of the proportion of the booking fee accruing or arising in India, the ITAT held that no further income could be charged to tax in India. In arriving at the aforesaid conclusion, the ITAT referred to Circular No: 23 dated July 23, 1969 issued by the Central Board of Direct Taxes and the decision of the Supreme Court in the case of Morgan Stanley & Co (292 ITR 406).

PE under the DTAA

<u>Article 5(1) – Basic Rule</u>

- Article 5(1) postulates the existence of a PE where there is a fixed place of business through which the business of the foreign enterprise is wholly or partly carried on.

- CRS, which is the source of revenue for Galileo is partially existent in the various computers installed at the premises of the subscribers. The computers so connected and configured which perform the function of reservation and ticketing are a part and parcel of the entire CRS.

- Galileo exercises complete control over the computers installed at the premises of the subscribers which could not be shifted from one place to another, even within the premises of the subscribers.

- The ITAT held that Galileo has a fixed place of business (computers installed in the premises of the subscribers) through which its business (partly operating the CRS system) is being carried on and therefore has a PE under Article 5(1) of the DTAA.

<u>Article 5(3) – Activities having a preparatory or auxiliary character</u>

- Article 5(3) lists a number of activities which are treated as exceptions to the general definition laid down in Article 5(1) and which are not regarded as PEs, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are in general, preparatory or auxiliary activities.

- The ITAT held that part of the function which contributes to the earning of the income is carried out in India which cannot be said to have a preparatory or auxiliary character and therefore the exclusion granted under Article 5(3) of the DTAA is not available to Galileo.

<u>Article 5(4) – Agency PE</u>

- Article 5(4) postulates the existence of a PE by virtue of an enterprise having 'Dependant Agent' (DA) carrying out any one/more of the activities on its behalf as specified under Article 5(4) of the DTAA. One of the specified activities relates to the DA habitually exercising an authority to conclude contracts on behalf of the foreign enterprise.

- The ITAT held that the Distributor was dependent on the Appellant in respect of rendering of services to subscribers in India. Even though the Distributor may have other business activities, in respect of the CRS business the Distributor acts only for the Appellant and not for any other person. It can therefore be said that the Distributor is a DA of the Appellant.

- Even though the Subscribers Agreement with the TAs is entered by the Distributor on his own behalf (and not as an agent of the Appellant), the agreement is entered into by the Distributor under an authority available to it under the Distribution Agreement.

- The ITAT accordingly held that the Distributor is a DA of the Appellant who habitually exercises the authority to conclude contracts on behalf of the Appellant. To that extent the Appellant has a PE in India under Article 5(4) of the DTAA.

Attribution of Income to PE

- Having held that the Appellant had a PE in India both under the fixed place rule as well as under the agency rule, the ITAT examined the extent of profits which could be attributable to the PE under Article 7 of the DTAA.

- Profits as are arising due to the assets and the activities of the PE can be brought to tax and if the whole of the business activities are not carried out in India, the profit should be apportioned between that arising in India and outside India.

- Since the whole of the business activities of Galileo are not carried out in India, only profits attributable to the functions carried out through the PE of Galileo are taxable in India.

- The ITAT held that income attributable to the PE would be similar to that which it held as accruing or arising to the Appellant in India under the domestic tax laws. Accordingly, it held that 15 per cent of the revenues generated from the bookings made in India are taxable in India. It further held that since payment to the Indian Distributor is more than the income attributable to the PE, no further income can be taxed in India.

OUR COMMENTS

The decision addresses two key issues in international taxation: (1) the existence of a PE; and (2) the extent of income attribution in the context of a business using digital and internet technology. Some of the principles relating to taxation of such business activities are still evolving globally.

The ITAT's observations seem to suggest that a foreign enterprise could have a fixed place of business in India as a master computer system/ server located outside India exists in the various computers installed in India through an inter-connected communication network. It may be pertinent to note that in the year 2000 the Organization for Economic Cooperation Development (OECD) amended the Commentary on Article 5 to the Model Convention to clarify the application of the PE definition in the context

of electronic commerce. The Commentary makes a distinction between computer equipment, which could constitute a PE and the data and software which is used by that equipment. According to the Commentary, unless the server (on which the data is stored) itself may be said to be a fixed place of business of the latter enterprise, the mere operation of the Web site of that enterprise cannot constitute a PE for that enterprise. It appears that the ITAT has not recognised this distinction while holding that the Galileo had a PE under the fixed place rule on account of the hardware located in India for accessing the server in the USA.

The ITAT held the Appellant had an agency PE as the Distributor was a Dependent Agent of the Appellant who had authority to conclude contracts on behalf of the Appellant. However, the ITAT has not analysed whether the Distributor was legally & economically dependent on the Appellant before concluding on dependency. Instead, it observed that the Distributor was financially and functionally dependent on the Appellant. As mentioned in the OECD Commentary for an agent to be of dependent status, the principal should exercise comprehensive control over the activities of the agent and the agent should be absolved from entrepreneurial risks. Further, the ITAT has not appreciated the fact that even though the Distributor may be representing the Appellant in India, he does not have a legal authority to conclude contracts which are binding on the Appellant.

With regard to attribution of income, while the observations suggest the need for a functional analysis of the activities of the PE, the ruling does not provide the manner in which the analysis was carried out to conclude that 15 per cent of the booking fee from India is attributable to the PE.

Even though the ITAT has made reference to the decision of the Supreme Court in the case of Morgan Stanley & Co *supra* and a Circular of the CBDT *supra* while addressing the question of income attribution, it is unclear as to how the principles from this ruling/ circular was applied. The conclusion that there should be no additional income taxable in India for the Appellant appears to be on the basis that the expenses incurred by the Appellant exceeded the income attributed and not on account of the fact that an arm's length compensation to the agent extinguished income attribution to the PE.

CONCLUSION

The ruling, which follows other recent rulings on similar issues relating to PE and Income Attribution, highlights the importance of managing the PE risk for multi-national enterprises (MNEs). MNEs which do business with India using the internet and digital technology may also need to review the impact of this decision on their operations.

Contact us at ey.taxalert@in.ey.com