* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **INCOME TAX APPEAL NO. 735/2011**

Reserved on: 29th October, 2013

% **Date of Decision:** 5th February, 2014

DIRECTOR OF INCOME TAX ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS IT SOLUTION ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NOS. 736/2011 & 737/2011

DIT-1 INTERNATIONAL TAXATION ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS CROPORATION ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NO. 738/2011

DIT-1 INTERNATIONAL TAXATION ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS IT SOLUTION INC. ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NOS. 739/2011 & 740/2011

DIRECTOR OF INCOME TAX ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS CORPORATION ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NO. 802/2011

DIRECTOR OF INCOME TAX ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS IT SOLUTION INC. ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NO. 845/2011

DIRECTOR OF INCOME TAX ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS CORPORATION INC ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NO. 912/2011

E FUNDS CORPORATION ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NO. 913/2011

E FUNDS CORPORATION ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NOS. 914/2011& 915/2011

E FUNDS CORPORATION ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NO. 916/2011

E FUNDS IT SOLUTIONS GROUP INC ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NO. 917/2011

E FUNDS CORPORATION ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NOS. 918/2011,919/2011 & 920/2011

E FUNDS IT SOLUTIONS GROUP INC ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOME TAX ..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NOS. 1002/2011

DIRECTOR OF INCOME TAX ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

E FUNDS IT SOLUTION INC ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NOS. 1200/2011 & 1201/2011

E FUNDS IT SOLUTION GROUP INC ..... Appellant

Through Mr. S. Ganesh, Sr. Advocate with M
Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOMNE TAX..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NOS. 1202/2011 & 1203/2011

E FUNDS CORPORATION ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

Versus

ASSISTANT DIRECTOR OF INCOMNE TAX..... Respondent
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

INCOME TAX APPEAL NOS. 1217/2011 & 1218/2011

DIT-1 INTERNATIONAL TAXATION ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS IT SOLUTION INC ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

INCOME TAX APPEAL NOS. 1219/2011 & 1221/2011

DIT-1 INTERNATIONAL TAXATION ..... Appellant
Through Mr. Sanjeev Sabharwal & Mr. N.P. Sahni, Sr. Standing Counsel.

Versus

M/S E FUNDS CORPORATION ..... Respondent
Through Mr. S. Ganesh, Sr. Advocate with Mr. Anand Sukumar, Advocate.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE SANJEEV SACHDEVA

SANJIV KHANNA, J.:

This common judgment will dispose of these two sets of cross-appeals by the Director of Income Tax, International Taxation and e-Fund Corporation, USA (e-Fund Corp., for short) relating to Assessment Years 2000-01, 2001-02, 2002-03, 2004-05, 2005-06, 2006-07 and 2007-08 and e-Fund IT Solutions Group Inc., USA (e-Fund Inc., for short) relating to Assessment Years 2000-01, 2001-02, 2002-03, 2005-06, 2006-07 and 2007-08. The e-Fund Corp. and e-Fund Inc., when referred together have been described as the 'assessee' and the Director of Income Tax, International Taxation has been referred to as the 'Revenue'. The cross-appeals arise out of two common orders passed by the Income Tax Appellate Tribunal (tribunal, for short). The first order dated 30th September, 2010 relates to all assessment years, except assessment

years 2006-07 and 2007-08, which are subject matter of the seco order of the tribunal dated 15th March, 2011.

2. The assessee are primarily aggrieved by the finding of the tribunal that they have Permanent Establishment (PE, for short) in India. They are also aggrieved with the initiation of the assessment proceedings under Section 147 read with Section 148 of the Income Tax Act, 1961 (Act, for short), whereas the Revenue is aggrieved by the finding of the tribunal relating to computation or attribution of the income earned by the assessee through the PE in India.

3. By order dated 27th September, 2011, the following substantial common questions of law were framed in the appeals Nos. 912/2011, 913/2011, 914/2011, 915/2011, 916/2011, 917/2011, 918/2011, 919/2011 and 920/2011 relating to assessment years 2000-01, 2001-02, 2002-03, 2004-05 and 2005-06 filed by the assessee:-

> "1. Whether, on the facts and circumstances of the case and in law, the Assessing Officer was justified in reopening the assessment under Section 147/148 of the Income-Tax Act?
>
> 2. Whether on the facts and in the circumstances of the case and in law, the Tribunal was justified in holding that Appellant has a business connection in India under Section 9(1) of the Act?
>
> 3. Whether on the facts and in the circumstances of the case and in law, the Tribunal was justified in holding that the Appellant has a permanent establishment in India under Articles 5(1), 5(2) (1) and 5(4) of the India-US DTAA?

> 4. Whether on the facts and in the circumstances of the case, and in law, the Tribunal was justified in holding that appellant is liable to interest under Section 234A and 234B of the Act?"

4. By subsequent order dated 2nd March, 2012, two more questions of law being question Nos. 5 and 6 were framed and read as under:-

> "5. Whether any income of eFunds International India Pvt. Ltd. Can be attributed and assessed in the hands of the appellant?
>
> 6. In case question no. (5) is answered against the appellant, whether the Tribunal was justified and correct in adopting the formula mentioned in the order and not accepting the stand of the assessee?"

4A. By order dated 17th November, 2011, the following substantial common questions of law were framed in the appeals ITA Nos. 1200/2011, 1201/2011, 1202/2011 and 1203/2011 relating to assessment years 2006-07 and 2007-08 filed by the assessee:-

> "1. Whether the tribunal is correct in holding that the appellant has business connection in India under Section 9(1)(i) of the IT Act?
> 2. Whether the tribunal was correct in holding that the appellant has a permanent establishment in India under Arts 5(1), 5(2) (1) and 5(4) of the India-US DTAA?
> 3. Whether any income of e-funds international India pvt ltd can be attributed and assessed in the hands of the appellant?
> 4. In case Ques 3. Is answered against the appellant whether the tribunal was justified and correct in adopting the formula mentioned in the order and not accepting the stand of the assessee?"

In ITA Nos. 1201/2011 and 1203/2011 relating to assessment yea 2006-07 the following additional substantial questions relating to initiation of assessment proceedings under section 147/148 of the Act, was raised:-

> "Whether the action of the Assessing officer in reopening the assessment under Section 147/148 of the IT Act is correct?"

5. The substantial questions of law framed on the appeals being ITA Nos. 735/2011, 736/2011, 737/2011, 738/2011, 739/2011, 740/2011, 802/2011, 845/2011 and 1002/2011 filed by the Revenue vide order dated 27th September, 2011 read as under:-

> "1. Whether on the facts and circumstances of the case, the Income Tax Appellate Tribunal has erred in law I not appreciating that the method adopted by the AO for attributing the profit to the PE of the assessee is based on the lines of MAP proceedings based on A.Y. 2003-04?
> 2. Whether on the facts and circumstances of the case, the order of the ITAT is not perverse?"

5A. In ITA Nos. 1217/2011, 1218/2011, 1219/2011 and 1221/2011 for Assessment Years 2006-07 and 2007-08 filed by the Revenue, the following substantial questions of law were framed vide order dated 21st November, 2011:-

> "(1) Whether the Income Tax Appellate Tribunal has correctly rejected the computation of profit attributed to the Permanent Establishment on the lines of the MAP proceedings?"
> (2) Whether the formula prescribed by Income Tax Appellate Tribunal for computation of profit attributable to a Permanent Establishment is correct and as per law?

(3) Whether the order of the Income Tax Appellate Tribunal is perverse?"

6. Undisputed facts in brief may be first noticed. The assessees are companies incorporated in United States of America (USA, for short) and were residents of the said country. They were assessed and have paid taxes on their global income in USA. e-Fund Corp. was the holding company having almost 100% shares in IDLX Corporation, another company incorporated in USA. IDLX Corporation held almost 100% shares in IDLX International BV, incorporated in Netherlands and later in turn held almost 100% shares in IDLX Holding BV, which was a subsidiary again incorporated in Netherlands. IDLX Holding BV was almost a 100% shareholder of e-Funds International India Private Limited, a company incorporated and resident of India (e-Fund International India Private Limited has been described as 'e-Fund India'). IDLX International BV was also the parent/holding company having almost 100% shares in e-Fund Inc., which as noticed above, was a company incorporated in USA.

7. Both e-Fund Inc. and e-Fund Corp. have entered into international transactions with e-Fund India. The details of these transactions have to be examined in depth and have to be referred below. e-Fund India being a domestic company and resident in India

was taxed on the income earned in India as well as its global income accordance with the provisions of the Act. The international transactions between the assessees and e-Fund India and the income of e-Fund India, it is accepted, were made subject matter of "arms length pricing" adjudication by the Transfer Pricing Officer (TPO, for short) and the Assessing Officer (AO, for short) in the returns of income filed by e-Fund India. We are not primarily concerned with the merits of the computation of income declared and assessed in the hands of e-Fund India in the present appeals, though the factum that e-Fund India was assessed to tax on its global income as per law or on "arms length pricing" in relation to associated transactions and the basis of the said computation of income earned by e-Fund India, as noticed below, is a relevant and an important fact. Revenue has not disputed the said legal position. It is the contention of the Revenue that income of the two assessees were attributable to India because the two assessees had PE in India and should be taxed in India, irrespective of whether the said assessees had paid taxes in USA. Income earned and taxed in the hands of e-Fund India was different from the income attributable to the two assesses. Thus the balance or differential amount, i.e., income attributable to the two assesses, which was not included in income

earned and taxed in the hands of e-Fund India, should be taxed India.

8. As a principle what is stated and submitted by the Revenue cannot be contested and in fact not contested by the assessees as it is a principle applicable to international taxation. A foreign or a non-resident company can be taxed in the country where it has a subsidiary, which is also a PE on the income attributable to the said PE, even if the subsidiary (in the present case of e-Fund India) is being taxed in the said country. The principle being that subsidiary being an independent and a distinct entity is taxed for its income, whereas the foreign entity, i.e., holding company is taxed for the income earned by the said independent entity attributable to the PE in the country where subsidiary is situated. The income of the subsidiary is not taxed in the hands of the non-resident principal and vice-versa. Thus, there is no double taxation in the hands of the holding company as income of the subsidiary is not taxed as income of foreign holding assessee. The principle is that a subsidiary constitutes an independent legal entity for the purpose of taxation.

9. Before we examine whether e-Fund India and its activities constitute PE of the foreign assessees as under the applicable Double Taxation Avoidance Agreement between India and USA, (The

agreement for the sake of convenience is being referred to as DTAA", it would be appropriate, at the outset, dispel any doubt or contention that establishing a subsidiary in the other treaty country would result in creating or establishing a PE of a foreign holding company in the said third country. Again to be fair to the Revenue, no such contention has been raised and the said legal position is clear and luminescent from paragraph 6 to Article 5 of the DTAA. The said paragraph reads:-

> "6. 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 company a permanent establishment of the other."

10. The aforesaid paragraph in categorical terms states that a holding or a subsidiary company by themselves would not become PE of each other. The words used in the said paragraph are equally important because the term "holding" or "parent company" or a "subsidiary company" is not used. The said paragraph uses the expression "controls or is controlled by a company", which is resident of the other contracting State. Use of the word "controls" or "controlled" is significant and defines the scope and ambit of the said clause. Paragraph 6 states that the company, which controls or is controlled and carries on business in the other State, would by itself not

constitute PE of the other company. Therefore, even carrying business in the other country by either the "controlled company" or the "controlling company", but and though the other company would not make them, i.e. the two companies, a PE of each other. However, this does not mean that a subsidiary can never be a PE of the holding company, though there is opinion that the holding company or the controlling company possibly may not be a PE of a subsidiary (the later question is not subject matter of the present decision and we express no opinion on the said question though it may be a relevant aspect, which the tax adjudicators, policy makers and the legal draftsmen in India and abroad may have to deal with). Indeed if this principle is not applicable it could be argued that the Indian subsidiary, i.e., eFund India's income could be taxed in the country from where it is controlled or managed. A subsidiary can become a PE of the holding/controlling company or the related company, if it satisfies the postulates and requirements of other paragraphs of Article 5, notwithstanding and negating the protection provided under paragraph 6 of Article 5, which recognizes legal independence of the two entities for tax purposes. This legal principle that the holding or contracting company and the subsidiary or the controlled company are two separate and independent tax entities and must be so treated permeates

and pervades but will give way to the exceptions carved out and stat in the DTAA. The legal principle is simple, a subsidiary being a resident of the State in which it is incorporated and functioning is taxed for its income. Subsidiary's income is separately allocated and brought to tax in the country where it is situated or is a resident of. This clearly distinguishes a subsidiary form a foreign assessee, which is directly carrying on business and has residence in another country through their own branches/offices, personnel, etc.

11. *Klaus Vogel on Double Taxation Conventions*, Third Edition, states the following principle:-

> "40. [Principle] It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company."

12. Similarly, in Arvid A. Skaar in Permanent Establishment, Erosion of Tax Treaty Principle, Second Indian, Reprint, 2008 has succinctly explained the legal position at page 540 paragraph 36.2.1 as under:-

> "The treaty-based protection of related companies recognizes the legal independence of related companies for tax purposes as a material reality until the opposite is

proved. This affects both the constitution of PE, and the allocation of income to a separate entity."

13. It is further clarified and elucidated at pages 541-42 paragraph 36.2.3 as :-

"36.2.3 POLICY CONSIDERATIONS

A neutral tax system would allow a subsidiary PE to be constituted in all cases where the same conclusion would be reached for unrelated companies. This solution is expressly stated for a subsidiary PE under the agency clause. Consequently, the position of some older pre-OECD authors, that a subsidiary can never constitute a PE for the parent, has not been sustained. The conventional position of the OECD-based tax treaty doctrine is that a subsidiary PE can only be based on the agency clause. However, the tax treaties aim at allowing the source state to tax business profits with a certain economic allegiance to the country expressed through the enterprise's PE. This intention must also apply when the parent company's business income is earned by the intermediation of a subsidiary. Thus, from a *de lege ferenda* point of view, PE taxation of the parent company is justified in cases where residence state taxation of the subsidiary does not adequately attribute taxing jurisdiction to the source state. The commentaries to the OECD model treaty do not *de lege lata* give conclusive reasons for the conventional wisdom with regard to this question."

A part of the above observations are in the nature of justification of right of taxation in source State and relate to the domain of PE principle and inter-state neutrality as a theory. Issue of source State in the present factual matrix has been touched below.

14. The aforesaid principle is no longer *res integra* and has been lucidly elucidated by the Supreme Court in ***DIT versus Morgan***

Stanley and Co. Inc., (2007) 292 ITR 416 (SC) in the following words:-

> "32. The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not all profits of MSCO would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry-forward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporate on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE)."
>
> (Emphasis supplied)

15. ECONOMIC AND SOCIAL COUNCIL in their report date 17.10.2008 have stated;-

> *"38.1* In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies."

16. It has been observed below, that subsidiary can constitute PE, other than dependent agent PE. A write up in Bulletin for International Taxation, February 2011 titled "The Subsidiary as a Permanent Establishment" has summarized the true and correct legal position in the following words;-

> "A PE is, however, not always easy to identify. This is particularly true where a PE is hidden behind a dependent operating company, i.e. if an operating company in addition to its own business also carries on another company's business as a PE of the latter. In this regard, the 2010 OECD Model Tax Convention (the "OECD Model") states in Art. 5(7) that:
>
> [t]he 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 company a permanent establishment of the other (emphasis added)

> This follows from the principle that, for the purpose of taxation, such a subsidiary constitutes an independent legal entity.7 Accordingly, both companies are subject to unlimited tax liability in the state in which they are resident or where their place of management is located.
>
> However, by using the wording "not of itself ", the provision clarifies that a parent company (parent) can have an (agent) PE in its subsidiary's state of residence if the general requirements for a PE set out inArt. 5(1) to (5) of the OECD Model are met. Accordingly, any space or premises belonging to the subsidiary that is at the disposal of the parent (the "right-to-use test") and that constitutes a fixed place of business (the "location test" and the "duration test") through which the parent carries on its own business (the "business activity test"), gives rise to a PE of the parent under Art. 5(1), subject to Art. 5(3) and (4), of the OECD Model. In addition, under Art. 5(5) of the OECD Model, a subsidiary constitutes an agency PE of its parent if the subsidiary has the authority to conclude contracts in the name of its parent and habitually exercises this authority, unless these activities are limited to those referred to in Art. 5(4) or unless the subsidiary does not act in the ordinary course of its business as an independent agent within the meaning of Art. 5(6)……."

Subsidiary as a Permanent Establishment

17. This brings us to paragraphs 1 to 5 of Article 5 of the DTAA and the exceptions to paragraph 6 to Article 5. Article 7, which relates to business profit, may be also of some relevance. Paragraphs 1 to 5 of Article 5 and the entire Article 7 are being reproduced below:-

> "**Article5**
> **PERMANENT ESTABLISHMENT**
>
> 1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of

business through which the business of an enterprise wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

(g) a warehouse, in relation to a person providing storage facilities for others;

(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

(i) a store or premises used as a sales outlet;

(j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve month period;

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects- or activities, if any) continue for a period of more than 120 days in any twelve month period;

(l) the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services), within Contracting State by an enterprise through employees or other personnel, but only if;

(i) activities of that nature continue within that State for a period or periods aggregating more than 90 within any twelve-month period; or

(ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprise).

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

(a) the use of facilities solely for the purpose of storage, display or occasional 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 occasional 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 of collecting information, for the enterprise;

(e) the maintenance of a fixed base of business solely for the purpose of advertising, for the supply of information, for scientific research, or for other activities which have preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 5 applies is acting in a Contracting State on behalf of an enterprise of the other Contracting State other Contracting State, that enterprise shall be deemed to have permanent establishment in the first-mentioned State if:

(a) he has an habitually exercises in that first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

(b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise

on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

(c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other 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, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

Article7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's length with the enterprise of which it is a permanent

establishment and other enterprises controlling, controlled by or subject to the same common control as the enterprise, in any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses, incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or except in the case of banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that

permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the (sic) to be attributed to the permanent establishment as provided in paragraph 1 (a) of this Article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business including income from the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services) and including income from the rental of tangible personal properly other than property described in paragraph 3 (b) of Article 12 (Royalties and Fees for Included Services)."

18. Article 7 paragraph 1, states that profit of an enterprise of contracting State shall be taxed only in that State, i.e., in the State where it is a resident and not in the other State even if its activities have a business connection in the second State. This ensures that the same income is not taxed twice in the hands of the same person merely because there is a business connection between income earned by one assessee from "activities" in two States. Income of the said assessee can be taxed in the second State only if and when the said enterprise carries on business in the said State through a PE. However, in such circumstances only such income, which is attributable to the PE, is

taxable in the PE State of which the assessee is not a resident. Su clauses (b) and (c) to paragraph 1 of Article 7 incorporate a limited force of attraction principle. Under sub-clause (b) in addition to income attributable to the PE, income earned from sale of goods or merchandise or of same or similar kind sold through the PE in the other State, which are similar or same as effected through PE, are to be added. Clause (b) would come into operation only if there is sale of goods or merchandise in the second State and not otherwise and then goods or merchandise should be similar or of same kind as are being sold through the PE. We need not dwell into sub-clause (b) as it is not the case of the Revenue that the two foreign assessees were selling merchandise or goods in India or the PE in India, i.e., the subsidiary was selling goods or the merchandise. Sub-clause (c) is also not applicable as it is not the case of the Revenue that the two foreign assessees were carrying on business activities in India other than those "effected through the PE". Activities carried on by the foreign assessees outside India are not covered under sub-clause (c) to paragraph 1 of Article 7. We shall be referring to other paragraphs of Article 7 subsequently as at this stage we would first like to examine Article 5 paragraphs 1 to 5 of the DTAA.

Location or fixed place PE under Article 5(1) and (2) of DTAA.

19. Paragraph 1 of Article 5 refers to what can be described as fix place PE. Tiiu Albin commentary, Problems with PE; problems in determining permanent establishment on the basis of Article 5(1) has stated that the said Article encapsulates three requirements, namely, (i) the existence of place of business at the disposal of the enterprise; (ii) the place of business must be of a "fixed nature" (geographical and temporal permanence); and (iii) the enterprise being carried on is required to be "carried on through the place of business".

20. The word "permanent" in the expression PE is of significance and imperial importance. It refers to some degree of permanency and not a mere transitory nature of the business in the other State. Further, the enterprise must have a fixed place of business. The expression "fixed place of business" refers not only to physical location in the form of immovable property or premises but in certain instances can mean machinery and equipment. The word "fixed" refers to a distinct place with some or certain degree of permanence. The relevant and important word used in the definition clause for the purpose of the present case is "through" and i.e., "the carrying on of business" should be "through" the fixed place of business. In ***Morgan Stanley*** (supra), the Supreme Court has observed that back office operations by the Indian subsidiary to the parent to support the main office functions and

equity and fixed income research, account reconciliation and providi g IT enabled services such as data processing and support centre do not satisfy the second requirement of Article 5(1), i.e., carrying on of business in India "through" such fixed place. The Indian subsidiary was in fact merely supporting the front operations of the principal company and on functional and factual analysis, Section 5(1) was not applicable. In ***Morgan Stanley*** (supra), the Supreme Court observed:-

> "**EXISTENCE OF P.E. IN INDIA**
>
> 6. With globalization, many economic activities spread over to several tax jurisdiction. This is where the concept of P.E. becomes important under Article 5(1). There exists a P.E. if there is a fixed place through which the business of an enterprise, which is multinational enterprise (MNE), is wholly or partly carried on. In the present case MSCO is a multinational entity. As stated above it has outsourced some of its activities to MSAS in India. A general definition of the P.E. in the first part of Article 5(1) postulates the existence of a fixed place of business whereas the second part of Article 5(1) postulates that the business of the MNE is carried out in India through such fixed place. One of the questions which we are called upon to decide is whether the activities to be undertaken by MSAS consists of back office operations of the MSCO and if so whether such operations would fall within the ambit of the expression "the place through which the business of an enterprise is wholly or partly carried out" in Article 5(1)."

21. The aforesaid observations are perhaps more appropriate and relevant when we will refer to the exclusionary clause, i.e., paragraph 3 of Article 5 of DTAA. For the purpose of present decision, we would like to reproduce the interpretation in the amended commentary of UN Model to Article 5, the relevant portion of which reads:

"B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5
Paragraph 1

3. This paragraph, which reproduces Article 5(1) of the OECD Model, defines the term "permanent establishment", emphasizing its essential nature as a "fixed place of business" with a specific "situs". According to paragraph 2 of the OECD Commentary (the 2005 version of which is cited below), this definition contains the following conditions:
- the existence of a "place of business", i.e., a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be "fixed", i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

The OECD Commentary goes on to observe:-

"3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character—i.e., contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has "a productive character" it is consequently a permanent stablishment to which profits can properly be attributed for the purpose of tax in a particular territory.

4. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it

simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance, where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other

company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise. *4.5* A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

XXXXX

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. the discussion at paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are

> occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business."

22. The UN Commentary observes that place of business to constitute PE, the enterprise using it must carry on its business wholly or partly "through" it, though the activity need not be productive in character and need not be permanent in the sense that there is no disruption, but the operations must be carried out on regular basis. Branch, offices and factory mentioned in paragraph 2 are examples of fixed place of business. In paragraph 4.6 of the OECD Commentary, the words "through which" have been interpreted to have a wide meaning but postulate that the particular location should be at the disposal of the enterprise for that purpose and only then the business is carried through the location where the activity takes place. The word "through" has been interpreted and read in a manner that the foreign enterprise should have the right to use the location in the second State. The said right may or may not be formalized through legal documentation, but right to use should be established and shown. Then and then alone fixed place PE shall exist.

23. Fixed location test may be in form of a legal right or can inferred from the facts when the foreign establishment and its employees are allowed right to use the place of business belonging to a subsidiary, a third party. Arvid A. Skaar in Permanent Establishment (supra) has observed:-

> "(at page 155) 11.1 General
> The definition of the basic-rule PE of the modern tax treaties explicitly requires the enterprise's "objective" presence in the other country through the existence of a "fixed place of business." It also requires a "business" activity as a condition for PE. Furthermore it is a clear condition that there must be a connection between the place of business and the activity, i.e. that the activity has to be conducted "through" the place of business.
> xxx
> xxx
>
> (at pages 157-8) 11.3 The problem: A "factual" or a "legal" approach?
> x x x x x
> x x x x x
> x x x x x
> x x x x x
> The present author's hypothesis concerning tax-treaty law is that the "right of use test" is met if the taxpayer's use of the place of business cannot be prevented without his consent. Evidence of the enterprise's right to use the place of business, according to this hypothesis, can be found in the business arrangements in which the taxpayer is involved."

24. The term "through" postulates that the taxpayer should have the power or liberty to control the place and hence the right to determine the conditions according to its needs.

Phillip Baker in his commentary on Double Taxation Conventions a International Tax Law (Sweet & Maxwell publications, 2nd edition) has stated that:-

> "requirement of a fixed place of business which is implicit under Article 5(1), is that the place of business must be at the disposal of the enterprise". The 'right to use' test or the requirement that "the place of business must be at the disposal of the enterprise" is rationally and logically implicit in Article 5(1) in the expressions "fixed place of business" and "through which the business of enterprise is carried on". It is not extraneous and the interpretation does not imply adding or substracting words to Article 5(1). The OECD and UN Model Commentaries quoted above adopts a reasonable and a rational approach in the commentaries for interpretation of Article 5(1) to not only include places which are legally at the disposal of an enterprise but also places where the non-resident assessee can as a matter of right claim is right to use. The said right to use can be inferred from the conduct etc".

25. There is some controversy whether the examples given in paragraph 2 to Article 5 are *per se* and *ex facie* permanent establishments or the requirements of paragraph 1 should also be satisfied. This controversy is in respect of building and construction sites etc. We need not give an affirmative opinion on the said question in relation building/construction sites etc. Overwhelming international commentaries, write ups and decisions support the position that for applying the location test, requirements of paragraph 1 to Article 5 must be independently satisfied. Therefore, to create a location PE, requirements of paragraph 1 to Article 5 should be satisfied. To some

extent, the controversy and contention to the contrary is academic view of the negative list given in paragraph 3, which is fairly comprehensive and the restrictive; and postulates of paragraph 1 to Article 7 and other paragraphs to Article 7. Even otherwise, a mine, oil or gas fuel etc. or plantation or a factory in most cases would satisfy requirements of paragraph 1 to Article 5. United Nations Handbook on Selected issues in Administration of Double Tax Treaties for Developing Countries states that Article 5(2) lists some examples of fixed place of business. However, we need not address this issue further for the purpose of the present decision as the two foreign assessees did not have any branch office or factory or workshop in India and merely because they had a subsidiary in India by itself did not create a fixed place of business/location PE within the meaning of Article 5, paragraph 2, sub-clauses (b) to (k) thereof.

Service PE under Article 5(2)(l) of the DTAA.

26. Sub-clause (l) to Article 5(2) defines what can be called service PE. Sub-clause (k) is also a type of service PE, but this clause is not relevant for the purpose of the present decision. The sub-clause (l) requires furnishing of services within the second contracting State by a foreign enterprise through its employees or other personnel. But a PE is created only if activities of that nature continue for a period or

periods aggregating more than 90 days in 12 months period or unc clause (ii) services are performed within that State for a related enterprise as defined in Article 9 paragraph 1. For application of clause (ii) no time period stipulation is postulated. Sub-clause (l) would apply only if the foreign enterprise or the two assessees had performed services in India through their employees or personnel, i.e., personnel engaged or appointed by the foreign assessee. Employees of E-Fund India were their employees, i.e. employees of an Indian entity and not employees of the assessee. The employees of e-fund India did not become "other personnel" of the two assessee, once and if the said persons were *defacto* and *dejure* employed by the Indian entity/enterprise, i.e., e-Fund India. The words "employees" and "other personnel" have to be read along with the word "through" and furnishing of services by the foreign enterprise within India. Thus the employees and other personnel must be of the non-resident assessee to create a service PE. Any other interpretation or treating employees of the Indian entity, i.e., e-Fund India as "other personnel" of the foreign assessee would lead to incongruities and irrational result, for every subsidiary which engages an employee, would always become a PE of the controlling foreign company. The said submission of the Revenue is misconceived and has to be rejected. This would be contrary to the

overriding mandate of Article 5 paragraph 6. Decision in the case ***Morgan Stanley*** (supra) as suggested and submitted by the Revenue does not hold or propound to the contrary. In the said case, the Supreme Court has held as under:-

> "13. However, the question which arises for determination in the present case is the nature of activities performed by stewards and deputationists deployed by MSCO to work in India as employees of MSAS. Under Article 5(a)(1) furnishing of services through the fixed place in India can constitute a P.E. The AAR In the impugned ruling has held that the stewards and deputationists are proposed to be sent by the MSCO from U.S. According to the AAR there is a flow of service from the MSCO to the MSAS when the former deputes its own employees to work in India in MSAS. Therefore, according to the AAR the service Agreement between MSCO and MSAS dated 14.4.3005 would fall under Article 5(2)(1) and consequently the transfer pricing regulation would apply for evaluating the charges payable by MSCO to MSAS in India for such service contract, This ruling has been challenged by the applicant.
>
> 14. Article 5(2)(1) of the DTAA applies in cases where the MNE furnishes services within India and those services are furnished through its employees. In the present case we are concerned with two activities namely stewardship activities and the work to be performed by deputationists in India as employees of MSAS. A customer like an MSCO who has world wide operations is entitled to insist on quality control and confidentiality from the service provider. For example in the case of software P.E. a server stores the data which may require confidentiality. A service provider may also be required to act according to the quality control specifications imposed by its customer. It may be required to maintain confidentiality. Stewardship activities involve briefing of the MSAS staff to ensure that the output meets the requirements of the MSCO. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of the MSCO. These stewards are not involved in day to day management or in any specific services to be

undertaken by MSAS. The stewardship activity is basically to protect the interest of the customer. In the present case as held hereinabove the MSAS is a service P.E. It is in a sense a service provider. A customer is entitled to protect its interest both in terms of confidentiality and in terms of quality control. In such a case it cannot be said that MSCO has been rendering the services to MSAS. In our view MSCO is merely protecting its own interests in the competitive world by ensuring, the quality and confidentiality of MSAS services. We do not agree with the ruling of the AAR that the stewardship activity would fall under Article 5(2)(1). To this extent we find merit in the civil appeal filed by the appellant (MSCO) and accordingly its appeal to that extent stands partly allowed.

15. As regards the question of deputation, we are of the view that an employee of MSCO when deputed to MSAS does not become an employee of MSAS. A deputationist has a lien on his employment with MSCO. As long as the lien remains with the MSCO the said company retains control over the deputationist's terms and employment. The concept of a service PE finds place in the U.N. Convention. It is constituted if the multinational enterprise renders services through its employees in India provided the services are rendered for a specified period. In this case, it extends to two years on the request of MSAS. It is important to note that where the activities of the multinational enterprise entails it being responsible for the work of deputationists and the employees continue to be on the payroll of "the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE can emerge. Applying the above tests to the facts of this case we find that on request/requisition from MSAS the applicant deputes its staff. The request comes from MSAS depending upon its requirement. Generally, occasions do arise when MSAS needs the expertise of the staff of MSCO. In such circumstances, generally, MSAS makes a request to MSCO. A deputationist under such circumstances is expected to be experienced in banking and finance. On completion of his tenure he is repatriated to his parent job. He retains his lien when he comes to India. He lends his experience to MSAS in India as an employee of MSCO as he retains his lien and in that sense there is a service PE (MSAS) under Article 5(2)(1). We find no infirmity in the ruling of the ARR on this aspect. In the above situation, MSCO is rendering services through its employees to MSAS. Therefore, the Department is right

> in its contention that under the above situation there exists a Service PE in India (MSAS). Accordingly, the civil appeal filed by the Department stands partly allowed."

27. In respect of stewardship activities by employees of the non-resident assessee, it was observed that the "employees" were not involved in any day-to-day management or any specific services undertaken by the Indian subsidiary and it was basically to protect the interest of the customers, i.e., the third parties. It was also noticed, as in the present case, that the Indian subsidiary therein was a service provider. The aforesaid observations of the Supreme Court affirm our view that the services must be performed in respect of the activities within India. The distinction being activities "within India" and activities "between" the foreign enterprise/assessee and the Indian enterprise, i.e., the resident assessee is relevant. Thus, merely because the non-resident assessee to protect their interest, for ensuring quality and confidentiality has sent its employees to provide stewardship services, will not make the Indian subsidiary or another entity, a PE of the non-resident company. However, in respect of deputationists, the same principle was not applied in ***Morgan Stanley*** (supra) as the non-resident enterprise had retained control over deputationists' terms of employment, they continued to remain on the pay rolls of the foreign enterprise and their lien in the foreign enterprise was not disturbed. In

Morgan Stanley (supra), on completion of the deputation term, t said deputationists were to revert back and was repatriated to their parent job. Here, the Supreme Court has placed reliance on substance rather than form. An important factor and fact, which was noticed by the Authority on Advance Ruling in ***Morgan Stanley & Co. Inc., In re***[2006] 284 ITR 260 was:-

> "The staff deputed to MSAS would be on the payroll of the applicant and the remuneration paid by it will be reimbursed by MSAS. Out of a total remuneration of Rs.49,402,704 paid to employees, reimbursement to associate company for deputed staff aggregates to Rs.24,220,631 ; performance appraisal, pro-motion and discipline, etc., would be carried out in consultation with the applicant. Clause (4) of the agreement expressly stipulates that MSAS shall comply with all performance standards as specified by the Morgan group and that it shall comply with all reasonable directions or instructions of the group. Operation manual would be prepared and updated in conformity with the policy, procedures and practices of the Morgan group. Clause 7 enjoins upon MSAS to submit reports or other information concerning the services that the group may require. It further enjoins MSAS to attend all meetings convened for reviewing the services at the appointed time, place and agenda fixed by the group. By virtue of clause 8, MSAS is required to maintain a complete record which would be subject to audit and investi-gation by the applicant. The persons authorized by the Morgan group are provided unrestricted access to the business premises of the MSAS for audit and investigation. While clause 19 of the agreement disables MSAS from disclosing the information contained in the software products to any party except the Morgan group which has the liberty to share the infor-mation with any member of the Morgan group. All this would show that the applicant would be in a position to exercise close control and super-vision on the working of MSAS. Further these features in the agreement vividly bring out that the business of MSAS is inextricably linked with the business of the applicant and the other two entities of the Morgan Stanley group

> so as to make activities of MSAS projection of Morgan group."

28. In ***Morgan Stanley & Co. Inc., In re*** (supra) one of the findings recorded by the Authority for Advanced Ruling was that the salary payable to the deputed staff from associated enterprises aggregated to 50% of the total remuneration to be paid to the employees of the Indian subsidiary. Further performance appraisal, promotion and discipline etc. was to be carried out in consultation with the foreign assessee.

29. Thus, on the question of seconded employees by the foreign enterprise/assessee to the Indian enterprise/subsidiary, we have to examine the nature and functions performed by the said seconded employees and who exercised control and supervised them. When and if the said employees had provided stewardship function, no PE exists even if the employees of the non-resident assesse were taken on deputation.

Article 5(3) and its over-riding effect and consequences.

30. Paragraph 3 of Article 5 is a non-obstante provision which overrides paragraphs 1 and 2. In the said paragraph list of negative activities, which are deemed not to create PE are stipulated. These consist of sub-clauses (a) to (e). Clause (e) stipulates that maintenance of fixed place of business for the purpose of advertising, supply

information, scientific research or for activities of preparatory ancillary character would deem not to create a PE. One clarification may be made. Paragraph 3 of Article 5 sets out a negative list or excludes activities performed through a "fixed place" in India or USA by a foreign enterprise/assessee, from application of paragraphs 1 and 2 to Article 5. It may also cover and protect "service PE" cases when sub-clauses (a) to (c) apply or when sub-clauses (d) and (e) apply and "fixed place" or "base" is created. Nature of the activities of the employees and other personnel of the non-resident assessee is important and relevant. This formed the foundation and basis of the distinction made by the Supreme Court in Morgan Stanley (supra) between stewardship activities and primary or core activities. Therefore, first and foremost, Article 5(1)/(2) should be applicable but then if the activities fall within parameters of paragraph 3, PE is not created for imposing tax in the second state. It does not follow that if activities are not covered in the negative or exclusions set out in paragraph 3, a PE is established or deemed to be established under paragraphs 1 or 2 of Article 5. This principle is relevant. As noticed below, the tribunal has erred and has referred and applied paragraph 3 of Article 5 as if all activities performed and undertaken by the Indian subsidiary and their employees would still create a PE in India of the

assessees, because the activities of e-funds India were not preparato y or auxiliary in character. This is not the correct legal position.

Agency PE under Article 5(4) and (5) of DTAA.

31. Paragraphs 4 and 5 of Article 5 relate to creation of agency PE in the second contracting country. Agency replaces fixed place with personal connection. Arvid K. Skaar in his work 'Permanent Establishment' has opined that primacy of 'location test' of the basic rule is consistent with the conceptual structure of the PE clause itself. An agency will constitute a PE only when a PE cannot be found according to those conditions in the basic rule which are altered or replaced by the agency clause. OECD and UN Model Treaties recognize agency PE. The principle being, that a foreign enterprise may choose to perform business activities itself or through a third person in the other States. An agent is a representative who acts on behalf of another with third persons. International taxation laws recognize and accept two distinct types of agency PE, dependent and independent. Every agent by very nature of principle of agency is to follow principal's instructions. But this principle is not squarely applicable to DTAAs, as third parties may not be strictly an agent under the domestic law. Further, the aforesaid dependency cannot be the distinguishing factor which determines whether the agency is

dependent or an independent agency for the purpose of Article paragraphs 4 and 5 respectively. A dependent agency is one which is bound to follow instructions and is personally dependent on the enterprise he represents. Such dependency must not be isolated or once in a while transaction but should be of comprehensive nature.

32. The 'dependency test' as per Arvid A. Skaar requires examination and answer whether the business interest of the principal and the agency have merged. When there is evidence of merging of interest, then power to instruct the agent exceeds a certain level. In such cases the Principal regularly participates in the process of settling current business problems or exercises discretionary power in the said respects. OECD Commentary does not accept dependency based on financial support, supply of patents etc. as itself creating agency PE. Klaus Vogel on Double Taxation Conventions, Third Edition at page 345 in paragraph 170 states that interdependence must exist in both legal and economic respects but the independence is the main criteria. The expression 'independent agent' is used with the words 'brokers and general commission agents' in paragraph 5 of Article 5 will, therefore, normally not include agents who have power to conclude contracts. Paragraph 38.1 of the OECD Commentary has been quoted

above (see paragraph 15). The commentary elucidates and giv illustrations and tests.

33. Earlier U.N. commentary had deviated in some respect from the OECD commentary and had observed that an agent who was wholly or almost wholly engaged by one principal shall be considered to be a dependent agent. This initial position stated in UN commentary has, however, not been accept in subsequent commentaries. The essential criteria being arms length relationship though engagement with one or a group might serve as an indicator of absence of independence of an agent.

34. Subsidiary by itself cannot be considered to be a dependent agent PE of the Principal, otherwise it would negate the overriding effect of paragraph 6 to Article 5, a provision which precedes and seeks to give recognition to separate legal entity principle associated with juristic incorporated enterprises. However, a subsidiary may become dependent or an independent PE agent provided the tests as specified in paragraphs 4 and 5 are satisfied. A dependent agent is deemed to be PE of the principal establishment under paragraph 4, if one of the three conditions specified in sub-clause (a) to (c) are satisfied. Under sub-clause (a), a dependent agent should have authority and should habitually exercise the said authority to conclude

contracts on behalf of the foreign enterprise. What is meant by t term 'authority to conclude contract' has been subject matter of controversy on whether participation in negotiations by the agent is sufficient or not. However, this is not relevant for the decision of the present appeals in view of the factual matrix of the present case. Sub-clause (b) refers to an agent who habitually maintains stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the principal enterprise. In such cases, the agent should also perform some additional activities in its country on behalf of the foreign enterprise which has contributed to the sale of goods or merchandise. Sub-clause (c) applies when the agent habitually secures orders in the said country i.e. where he is located, almost wholly or wholly for the foreign enterprise.

35. Transactions between a foreign enterprise and an independent agent, do not result in establishment of a permanent establishment under paragraph 5 to Article 5 if the independent agent is acting in ordinary course of their business. The expression "ordinary course of their business" has reference to activity of the agent tested by reference to normal customs in the case in issue. It has reference to normal practice in the line of business in question. However as per paragraph 5 of Article 5, an agent is not considered to be an independent agent if

his activities are wholly or mostly wholly on behalf of foreign enterprise and the transactions between the two are not made under arm's length conditions. The twin conditions have to be satisfied to deny an agent character of an independent agent. In case the transactions between an agent and the foreign principal are under arm's length conditions the second stipulation in paragraph 5 of Article 5 would not be satisfied, even if the said agent is devoted wholly or almost wholly to the foreign enterprise.

36. In ***Morgan Stanley (supra)*** Supreme Court rejected the contention of the Revenue that dependent agency was created after recording that Indian subsidiary had no authority to enter into or conclude contracts on behalf of the foreign establishment/agency. The contracts were entered into in America and were concluded there. Only implementation of those contracts to the extent of back office operations were carried out in India. This legal position is relevant in the present case.

37. In ***TVM Ltd. vs. Commissioner of Income Tax*** (1999) 237 ITR 230, Authority of Advance Ruling has interpreted the two expression 'has' and 'habitually exercises' in the case of dependent agent. It has been observed that the expression 'has' may have reference to the legal existence of such authority on terms of the contract between the

Principal and the Agent, the expression 'habitually exercises' h certainly reference to systematic course of conduct on the part of the agent. Reference to OECD Commentary and Klaus Vogel was made and it has been observed :-

> "…..Para. 4 uses two expressions : "has" and "habitually exercises" an authority to conclude contracts on behalf of the enterprise in question. While the expression "has" may have reference to the legal exist- ence of such authority on the terms of the contract between the principal and agent, the expression "habitually exercises" has certainly reference to a systematic course of conduct on the part of the agent. If, despite the specific provision of the soliciting agreement, it is found, as a matter of fact, that TVI is habitually concluding contracts on behalf of TVM without any protest or dissent, perhaps it could be presumed either that the rele- vant provisions of the agency contract are a dead letter ignored by the parties or that the principal has agreed implicitly to TVI exercising such powers notwithstanding the terms of the contract. If such a situation is found to exist, then perhaps it could be said that TVI constitutes a permanent establishment for TVM despite the clauses of the contract relied upon."

38. Judgment of the Delhi High Court in the case of ***Rolls Royce PLC versus Director of Income Tax (International Taxation)*** (2011) 339 ITR (Del) is a good authority for the proposition that subsidiary can constitute and become a PE of the controlling company. The said decision proceeds on its own peculiar facts and we do not find that any legal principle and the elucidation in the present decision is contrary to the legal ratio propounded in the case of ***Rolls Royce*** (supra).

Mutual Agreement Procedure

39. Before we go on the factual matrix and apply the aforesaid principles to the facts of present case, we would like to deal with the contention of the Revenue that the PE issue stands determined as India and USA had resorted to Mutual Agreement Procedure (MAP, for short) as envisaged under Article 27 of the DTAA. Tribunal in the impugned order has referred to the determination under the MAP and relied upon the determination and it has been observed that the competent authorities of the two countries had resorted to the said procedure and had agreed to taxation of income of the assessee in India.

40. MAP procedure as envisaged under Article 27 of the DTAA was resorted to in the case of e-Fund Corp for the assessment years 2003-04 and in the case of e-Fund Inc. for the assessment years 2003-04 and 2004-05. The letter or communication issued by the competent authority in India dated 23rd April, 2007 vide file No. 480/4/2006-FTD-1 reads as under:-

> "The Acting Director (International) competent authority of USA initiated Mutual Agreement Procedure in the case of M/s e Funds Corporation and e Funds I.T. Solution. Inc., for the previous year ending 31.3.2003 with the Competent Authority of India under the Double Taxation Avoidance Agreement vide their letter No. SE LM IM: T: ? : IN dated 8.5.2006. Subsequently vide letter dated 16.2.2007 Competent Authority of USA initiated Mutual

Agreement Procedure for the previous year ending 31.3.2004 in the case of the Solutions Group Inc. The Competent Authorities of both the countries after examined the facts of the case and issues involved have arrived at a resolution in terms of Section 90 of Income Tax Act, 1961 read with Article 27 of Indo —USA Double Taxation Avoidance Agreement and Rule 44 I-I of Income Tax Rules, 1962. The Competent Authorities of USA and India have reached an agreement as follows with respect to the Tax assessment on M/s e Funds Corporation and e Funds IT Solution Group Inc:

Income will be attributed to the Indian PEs based on the ratio of certain developed and acquired tangible and intangible assets in India and outside India. Out of the total assets for the AY 2003-04 , 10.48% of the assets were located in India and accordingly 10.48% of the Income would be attributable to India. The percentage attributable to India for the AY ending 2005 was arrived of 11.11% These percentages will be applied to the base of consolidated gross income as reduced by the income of subsidiary e Funds India Pvt. Ltd. Already reported in India. Thereafter the total income so attributed will be apportioned between e Funds and IT solutions in the ratio of 85% (to e Funds) and 15% (to IT Solutions) for the AY 2003-04 and 87% (to e Funds) and 13% (to IT solutions) for the AY 2004-05.

In view of the above, the income attribution , as agreed upon is given below:

	AY 2003-04	AY 2004-05
	Figures in US $ million	Figures in US $ million
Apportionable base income	25.12	30.71
Percentage attributed to India	10.48%	11.11%
Income attributed to India	2.63	3.14
Allocation between IT Solutions and e Funds IT Solutions E Funds	0.39 (15%) 2.24 (85%)	0.45 (13%) 2.96 (87%)

”

41. The assessee has placed on record communication dated May, 2005 written by Department of Treasury, Internal Revenue Services, Washington in which they have stated that they did not agree on technical merits that e-Fund Corp or e-Fund Inc. had a PE in India but they had agreed to mutual agreement to divide income to avoid double taxation. As per the terms of mutual agreement, income of the two assessees would be attributed to India taxation as per calculations. In terms of the said determination, there would be decrease in income of e-Fund Corp and e-Fund Inc. under the USA tax laws and they would be also entitled to foreign tax credit. The letter states that the said decision would not be binding on subsequent years. Pursuant to these letters, the two assessees had written letter dated 14th May, 2007 to the Income Tax authorities in which it was specifically stated that they did not agree on technical merits that they had PE in India but had agreed to accept the mutual settlement.

42. The MAP procedure and agreement, is no doubt relevant but cannot be determinative or the primary basis to decide whether the assessee had PE in India. There are several reasons for the same, including communication dated 7th May, 2007 of the Internal Revenue Services, America. Whether or not PE exists is a matter of law and fact, and there has to be determination of the said issue on merits. A

decision on merits will normally be 'persuasively' conclusive f subsequent or other assessment years, unless there are good and sufficient reasons to take a contrary or divergent view. However, a concession on point of law, is not binding for other assessment years or a different assessee. It is always open to the competent authorities of the two countries to enter into an agreement for avoidance of double taxation and bring a litigation/dispute to an end. Double taxation means taxation of the same subject matter or income in the hands of one assessee or one person in the two different countries. Double taxation can be avoided by either granting exemption or giving tax credit paid in the third country. As per the MAP procedure, there was decrease in the American taxable income and the tax paid on income in India was credited under the American laws.

FACTS AND APPLICATION OF AFORESAID PRINCIPLES TO THE FACTS

43. Tribunal in the impugned order has held that the assessee had fixed place PE under Article 5(1) and also service PE under Article 5(2)(l) of the DTAA. The assessment order on the said aspect is rather ambiguous and unclear. In paragraph 7 of the assessment order, it is observed that the assessee had permanent establishment in India in various forms without elucidating any specific paragraph of Article 5 which was invoked and held to be applicable. However, in paragraph

8 reference is made to the assessment order for assessment year 200 04 in the case of e-Fund Corp and it was observed that assessee had fixed place PE as well as dependent agent PE i.e. PE under Article 5(1) and Article 5(4) of the DTAA.

44. Commissioner of Income Tax (Appeals) has held that the assessees had PE in India under paragraph 5(1), 5(2)(l) and both dependent PE and independent PE under Article 5(4) and 5(5) of the DTAA.

45. Tribunal in the impugned order has primarily referred to and quoted findings of the Assessing Officer. The assessee have placed on record copies of the written submissions filed before the appellate authorities i.e. Commissioner (Appeals) and tribunal wherein they have specifically questioned and challenged the facts recorded by the Assessing Officer/Commissioner (Appeals). Unfortunately, these have not been dealt with specifically in the appellate orders and to this extent we as an appellate court under Section 260A, are handicapped and faced with rather a difficult task. Further the assessment orders are confusing and the expression 'it is not known', reflective of uncertainty and no firm finding, is repeatedly used and finds mention throughout. In case, the assessee had withheld facts, adverse inference could have been drawn and accordingly facts recorded but there should

be affirmative or negative factual finding. Use of expression 'it is n known' has not helped and has created confusion as the expression reflects ambiguity and lack of factual finding.

46. On the question as to the activities of the assessee and the agreements between the two assessee and e-Fund India, we find there is elaboration and reference in the order of Commissioner (Appeals). However, the tribunal has not commented upon the same. Explanations and details furnished before the Assessing Officer and observations made in the assessment order have been quoted. In the assessment order it is mentioned that the two assessees had four main business lines, namely (a) Electronic Payments; (b) ATM Management Service; (c) Decision support and risk management; and (d) Professional Services. Specific details of these activities as stated by the assessee have been noted in paragraph 6.14 of the order of the tribunal and for the sake of convenience are reproduced below. These details have not been questioned in the orders of the Assessing Officer, Commissioner (Appeals) or the tribunal. These are:-

> "a) ATM Management Services
> Those appellants had installed ATM machines and point of sale machines in USA and Canada and, not in India. On the transactions carried out through the ATMs, revenues were generated by the appellants outside India and, therefore no income accrued in India. All the servers processing the transactions were not

> installed in India and were located wholly outside India.
>
> Electronic Payments
>
> That ATM machines installed by other companies not belonging to the appellants outside India were also managed i.e. the transactions for these ATM machines were routed through servers installed by the appellant. These servers contained database of various cardholders for the purpose of verification and, revenues were shared from the ATM machine installers. Here also no activity was carried on by the appellants in India and, therefore no income accrued in India.
>
> Decision Support and Risk Management
>
> That appellants further provide decision support and, risk management services providing risk management based data and other products to financial institutions, retailers and other businesses that assist in detecting fraud and assessing the risk of opening a new account or accepting a check. These products and services are based on or enhanced by appellant's proprietary databases such as Debit Bureau®, ChexSystems (SM) and SCAN(SM) and other sources. Neither the customers to whom such services are provided are situated in India nor the services are provided from India and, therefore no income accrued to the appellants in India.
>
> d) Professional Services
>
> Professional Services include business process management and IT outsourcing services, EFT software sales and software applications development, maintenance and installation services. The appellant's business process management and outsourcing services focus on both back-office and customer support business processes, such as accounting operations, help desk services, account management, and call center operations to customers outside India."

47. As per the assessment/appellate orders e-Fund India had performed back office operations in respect of the first three. This included data entry operations etc. in respect of "Decision Support and

Risk Management". Reference to the activities in India etc. examined in detail below.

48. We shall first examine whether the assessees had fixed place PE in India. It was stated by the assessee that they did not have any assets or presence in India with no licenced office or business activity in India, consequently no income was chargeable to tax in India under clause 5(1) i.e. Fixed Place of Business. Neither in the assessment order nor in the appellate order including order of the tribunal, we find any material and relevant discussion to hold that the two assessee had a fixed place of business in India through which business of enterprise was wholly or partly carried on. None of the authorities including the tribunal have held that the two assessee had right to use any of the premises belonging to e-Fund India. It has not been adverted to or stated that premises of e-Fund India were at the disposal, legally or otherwise, of the two assessees. The 'right to use test' or 'disposal test' has not been adverted to or applied nor is there any observation or finding to the said aspect. In the absence of any such finding Article 5(1) cannot be invoked and applied. As elucidated above, Article 5(1) has to be read with paragraph 6 of Article 5 which relates to subsidiary companies.

49. The Assessing Officer, Commissioner (Appeals) and the tribur have primarily relied upon the close association between e-Fund India and the two assessee and applied functions performed, assets used and risk assumed, criteria to determine whether or not the assessee has fixed place of business. This is not a proper and appropriate test to determine location PE. The fixed place of business PE test is different. Therefore, the fact that e-Fund India provides various services to the assessee and was dependent for its earning upon the two assessees is not the relevant test to determine and decide location PE. The allegation that e-Fund India did not bear sufficient risk is irrelevant when deciding whether location PE exists. The fact that e-Fund India was reimbursed the cost of the call centre operations plus 16% basis or the basis of margin fixation was not known, is not relevant for determining location or fixed place PE. Similarly what were the direct or indirect costs and corporate allocations in software development centre or BPO does not help or determine location PE. Assignment or sub-contract to e-Fund India is not a factor or rule which is to be applied to determine applicability of Article 5(1). Further whether or not any provisions for intangible software was made or had been supplied free of cost is not the relevant criteria/test. e-Fund India was/is a separate entity and was/is entitled to provide services to the

assessees who were/are independent separate taxpayer. Indian enti y i.e. subsidiary company will not become location PE under Article 5(1) merely because there is interaction or cross transactions between the Indian subsidiary and the foreign Principal under Article 5(1). Even if the foreign entities have saved and reduced their expenditure by transferring business or back office operations to the Indian subsidiary, it would not by itself create a fixed place or location PE. The manner and mode of the payment of royalty or associated transactions is not a test which can be applied to determine, whether fixed place PE exists.

50. Reference to core of auxiliary or preliminary activity is relevant when we apply paragraph 3 of Article 5 or when sub-clause (a) to paragraph 4 to Article 5 is under consideration. The fact that the subsidiary company was carrying on core activities as performed by the foreign assessee does not create a fixed place PE. Paragraph 3 of Article 5 lists negative activities which when performed from a fixed placed in the other contracting State would not create a PE. The activities specified in Article 5, paragraph 3 would not create a PE, even when the conditions specified in paragraphs (1) and (2) of Article 5 are satisfied. Paragraph 3 is not a positive provision but a negative list. The said paragraph does not create a PE but has a negative connotation and activities specified when carried on do not create a PE.

51. Learned standing counsel for the Revenue submitted that t facts found by the tribunal and the authorities show that assessee were a joint venture or in partnership with e-Fund India as the business of the assessee and the Indian subsidiary were interlinked and closely connected. Our attention was specifically drawn to the 10K report which has been quoted by the Assessing Officer, Commissioner (Appeals) and the tribunal and also observations of Klaus Vogel quoted by the Commissioner (Appeals)/tribunal in their order, the relevant portion of which reads :

> "b) Subsidiary as an agent: On the basis of a special parent/subsidiary relationship — other than one of control under company law a subsidiary may; however, in individual cases **be** an agent, and consequently, for that reason a permanent establishment, of its parent company. The Mfg: make this clear by using the words 'of itself'. Also the transformation of a permanent establishment into a subsidiary does not yet lead, therefore, to the characterization of the subsidiary as a permanent establishment. In such cases, the subsidiary continues to be a separately taxable entity. his its parent company's permanent establishment only to the extent that it satisfies the agency requirement set out in Art. 5(5). and (6) MC. Paragraph 41 MC Comm.Art. 5 makes express mention of this only in regard to the independent agent within the meaning of Art. 5(5). Like any **other unrelated company, however, a subsidiary, if an independent agent, can very well also constitute a permanent establishment of its parent company under, the conditions laid down in Art. 5(6).** A subsidiary may, for instance, act as an agent of its parent nd conclude such contracts for the latter on the b as is of a corresponding authority as go beyond the limits of the ordinary course of its business. The independence of the subsidiary under company law also remains authoritative for tax purposes if it subcontracts. entirely or partially to associated enterprises or it acquires the means required for the contract's

> execution from associated enterprises. The latter is particularly true ,fir the hiring out of employees as temporary workers. If the parent company makes personnel available to the subsidiary.* remuneration, then the activity of this 'hired labour' is to be attributed to the subsidiary and does not constitute a permanent establishment of the parent doing the hiring-out. **This is different, however, as well as in cases of subcontracts if the parent assumes the economic risk of the contract's fulfillment in relation to the main customer. In this situation the parent company and the subsidiary have in fact established a company of which they are partners. This will lead to a permanent establishment for the partners f the general preconditions are fulfilled."**

52. The aforesaid observations are in the context of dependent agency and not in the context of Article 5(1) or fixed place PE. The observations of Klaus Vogel have been misread and understood out of context. The said observations have been made in the context of independence of subsidiary and it has been observed that such independence for tax purposes is retained and is not negated, even if there is a sub-contract or assignment entirely or partially between the associated enterprises, or the subsidiary acquires means for execution from associated enterprises including hiring out of employees and works. It is observed that even hiring of labour by the subsidiary from the associated enterprise does not constitute permanent establishment of the parent company. The last portion of the aforesaid quotation refers to position where two companies or enterprises work as partners and in this situation permanent establishment of the partners may be a

PE, if general preconditions are fulfilled. The last words 'if gene preconditions are fulfilled' are not superfluous but material and core of the principle. "Permanent establishment of partners" or a "joint venture PE", as a concept and principle has not been invoked and applied in the present case. The said concept itself has been subject matter of significant debate. PE cannot be and is not established by mere transactions between two associated enterprises or the principal sub-contracting or assigning the contract to the subsidiary. An agency PE will be established and created if the requirements of paragraphs 4 and 5 of Article 5 are fulfilled and not otherwise. It is not uncommon for an enterprise to enter into contracts assign or sub-contract works, or service to their subsidiary. The subsidiary may also render services to a third party on behalf of the principal. This by itself would not lead to a subsidiary becoming a PE unless requirements of paragraphs 1, 2, 4 or 5 are satisfied. The observations of the Klaus Vogel in fact support the assessee as it postulates that partnership PE would be created only when the principal of the foreign enterprise retains the economic risk of contract and other general conditions i.e. Articles 5(1), 5(2), 5(4) and 5(5) of the DTAA are fulfilled. Tax authorities have to be cautious and aware of consequences when they apply joint venture or partnership principle in a case like the present one as it could be argued

that substantial or significant part of the income of the joint ventu entity should be taxed in the source State.

53. This is also the view and opinion of Arvind K. Skaar, wherein he has referred to the principle of altered ego companies and decision of American courts in ***National Carbide Corporation vs. Commissioner*** 336 US 422***; Moline Properties Inc. vs. Commissioner*** 319 US 436 and ***Bollinger vs. Commissioner*** 108 S.Ct. 1173 and has referred to six point as the National Carbide criteria. These are:

> "(1) The corporation must operate in the name and for the account of the principal,
> (2) it must bind the principal by its actions,
> (3) it must transmit money received to the principal,
> (4) it must be considered whether the receipt of income is attributable to the services of the employees of the principal or to assets belonging to the principal,
> (5) the relations between the principal and the agent must not depend upon the fact that it is owned by the principal, and
> (6) the business purpose must be carrying on the normal duties of an agent."

54. With reference to criteria 5 and 6 in ***Bollinger*** (supra), observations and clarifications were made relying upon separate entity doctrine. Thereafter the text refers to problem of 'empty' and 'slander' companies which are used to avoid PE taxation. In the summary and conclusions Arvid A Skaar concludes that related enterprises which cooperate and join like Joint Venture may constitute subsidiary PE of

each other i.e. both the principal and subsidiary are PE inter se. It further observed that international practice seems to suggest that subsidiary PE is not constituted for an enterprise which sub-contracts an assignment, if the enterprise does not take part in the physical work itself even though it contributes the equipment necessary for the work (service PE question and physical work has been examined below).

55. In the present case, we are not concerned with construction PE or bifurcations of contract or multiple contracts for installation, execution, supply, manufacture etc. The considerations and tests applicable in said cases may be different.

56. 10K report referred to in the orders was filed by the assessee with the S.E.C. USA. The details submitted in this document not only pertain to the two assessee incorporated and paying tax in USA but the entire group companies including e-Fund India. The assets, revenues, income earned, employees of e-Fund India etc. have to be disclosed and elucidated in the said report. The report, no doubt, is relevant and material but has to be examined with due care and caution to determine and decide whether the two assessees have PE in India. The fact that business has been transferred or sub contracted or assigned to e-Fund India is not relevant and material, unless we are determining applicability of paragraph 3 to paragraph 5 and the question is whether

the Indian company is performing core or auxiliary and preliminary activities. The fact, the report refers to and give details of or number of employees of e-Fund India which are part of the e-Fund group is not relevant. Neither income earned by eFund India nor activities in India by the Indian subsidiary by itself, relevant in determining whether or not PE exists under paragraphs 1, 2, 4 and 5 of Article 5. Thus and therefore, the fact that 40% of the employees of the entire group were in India i.e. were employees of e-Fund India, will not make the said company agency subsidiary PE or fixed place PE of the assessee. Neither provision of any software, intangible data etc. whether free of cost or otherwise, make e-Fund India an agency or fixed place PE of the two foreign assessees. Whether or not and on what basis e-Fund India was reimbursed expenses of xerox, courier charges etc. will not make e-Fund India as PE of the assessee under Articles 5(1), 5(4) or 5(5). Conditions and stipulates under Articles 5(1), 5(4) or 5(5) will create a PE and not the said facts as highlighted in the impugned orders. Therefore, we will now examine the facts found and refer to Articles 5(4) and 5(5) of DTAA.

57. Conditions of Articles 5(4) are not satisfied in the present case. It is not the case of the Revenue that e-Fund India was authorized and habitually exercised authority to 'conclude' contract or was

maintaining stock or merchandise from which it delivered goods merchandise on behalf of the assessee or secured orders on behalf of the assessee. Therefore, the conditions and requirements of sub-clauses (a), (b) and (c) to Article 5(4) are not satisfied.

58. The assessment order does not state or mention how and why the transactions between the assessee and e-Fund India were not at arm's length and consequently Article 5(5) was applicable. The assessment order does mention that software was provided to e-Fund India free of cost. However, it was not stated that this showed that the transactions between the assessee and e-Fund India were not at arm's length basis. The assessees have submitted that e-Fund India had undertaken and carried out custom application development, integration and maintenance and management of the software in e-Fund India's software development facilities. e-Fund India undertook code development in accordance with product specifications defined by e-Fund Corp or Deluxe, (a third company). The code generated was subsequently tested to ensure that the functions performed by the code were as per the protocol design and standard specifications. Final testing was undertaken by e-Fund Corp. The software was owned by e-Fund Corp or Deluxe and e-Fund India did not have any intangible right in the software. This plea has been repeatedly taken by the

assessee and has not been controverted or found to be incorrect. submission or statement by an assessee should be accepted unless there are good grounds and reasons to reject the statement of fact. In case of any suspicion and when verification is required, further enquiry or investigation may be undertaken but the facts stated by the assessee cannot be rejected without cogent and good reasons. The transactions between the assessees and e-Fund India were at arm's length and were taxed on arm's length principle. There was no allegation or considered finding of the tribunal that the transactions were not in ordinary course of business. In these circumstances, even otherwise requirements of Article 5(5) are not satisfied in the present case.

59. This brings us to Article 5(2)(l) i.e. service PE. As already recorded above, employees of e-Fund India are not to be counted and treated as employees of the assessees; e-Fund India being a separate entity and taxable assessee. The tribunal and the authorities have erred in treating employees of e-Fund India as employees of the assessees for determining whether service PE under Article 5(2)(l) was created. There are no other factual findings recorded by the tribunal in respect of service PE under Article 5(2)(l). The assessment order also does not record any other relevant finding for creation of service PE under Article 5(2)(l), other than payment received by e-Fund India for

providing management and support service by the President and Sal Team to overseas group entities. Payment by e-Fund Corp on the said account were received for the year ending 31st March, 2002, but stopped thereafter. This no doubt is a relevant aspect with reference to Article 5(2)(a) but the said provision has not been invoked in the assessment order and in the appellate orders including order of the tribunal. We do not have details with regard to the exact nature and character of the management services provided to the overseas group entities.

60. Before the Commissioner (Appeals), the assessee in their submission had stated that the President of e-Fund Indian provided management support services in U.K. and Australia, while certain personnel of South-east Asia region provided marketing support services to e-Fund India as well as e-Fund group entities overseas. The e-Fund India had an international division which consisted of President's office and South-east Asia Region office. Thus services rendered by e-Fund India personnel comprised of marketing support provided by President and Sales Team to U.K. and Australia and e-Fund Group overseas. It was further mentioned by the assessee that the President's office managed operations of e-Fund Group entities in U.K. and Australia and accordingly employees of said entities reported

to the President. The President in turn was reporting to e-Fund Co[illegible]. Aforesaid factual position prima facie indicates that the said activities may have resulted in a PE under Article 5(2)(a) under the heading 'Place of Management' but the said provision has not been invoked. This court while exercising jurisdiction under Section 260A of the Act would not like to invoke the said provision as it requires factual determination as well as computation of the income attributable to the PE. We do not have any finding on the exact nature of the services rendered whether it was only relating to accounts, receivables, human resource management or related to other direct management services. Services of the nature specified in paragraph 3 of Article 5 have to be excluding while in determining and deciding whether or not a PE exists under Article 5(2). There is another difficulty if we apply Article 5(2)(a) – Place of Management principle; – enterprises in UK and Australia were subsidiaries or legal entities and not branches of the assessees. To what extent and when "place of management" principle will be applicable in such cases, DTAA which will be applicable as the associated enterprise were located in UK and Australia and computation of income attributable to the PE are highly debatable and contentious questions which require findings of facts at the first

instance and cannot be made matters to be decided for the first time an appeal under section 260A of the Act.

61. The President and international sales division or regional office may have also constituted service PE in India for the year ending 31st March, 2002, if we treat the President and employees whose salary was reimbursed as "other personnel" who had performed services within that State for a related enterprise as defined in paragraph 1 of Article 9. Thus, at best service PE for the year ending 31st March, 2002 would have been created under Article 5(2)(l) but again there has not been thorough and detailed discussion on the nature and type of services rendered and determination on question of salary and whether the President and employees of Regional Office could be treated as 'employees or other personnel' of the assessee.

62. The appellants had pleaded before the authorities and the tribunal that prior to assessment year 2005-06 not even a single employee of the assessee ever visited India even for a short period and in 2005-06, two employees of e-Fund were transferred to e-Fund India and that the entire expenditure for these two employees were borne by e-Fund India. No employees were present in India after 2005-06. Presence of employees in India is relevant under Article 5(2)(l) but the said employees should furnish services within the contracting State.

These services should not be mere stewardship services. T Assessing Officer has recorded that employees were seconded to e-Fund India but the functions they performed and whether they performed functions and reported to e-Fund Corp/associated enterprise was not known or ascertained. This was not the correct way of determining and deciding whether service PE existed. Whether the seconded employees were performing stewardship services or were directly involved with the working operations was relevant. It is also not known whether the services were performed related to services provided to an associated enterprise in which case clause 5(2)(l)(ii) would be applicable. In the said situation, the question of attribution of income etc. would also arise.

63. Two employees of e-Fund Corp were deputed to e-Fund India in the assessment years 2005-06. The case of the assessee and e-Fund India is that they were deputed to look towards development of domestic work in India. Payment of these employees as per the Revenue to the extent of 25% was borne by e-Fund India and balance 75% was borne by e-Fund Corp. The Assessing Officer on this basis has observed that this reduced cost base of e-Fund India as remuneration was paid by e-Fund Corp and the said employees were at liberty to perform functions of e-Fund Corp even while working for e-

Fund India. The response of the assessee as quoted in the assessme order was that e-Fund India, apart from export activities had also domestic business in India. This was evident from the return of income filed by e-Fund India where domestic income was computed separately as it was not eligible for deduction under Section 10A of the Act. Copy of the return was furnished. It was further stated that cost of personnel seconded in India was fully borne by e-Fund India i.e. 100% of the salary paid to the said employees seconded to India were debited to profit and loss accounts. 75% of the salary component was paid abroad by e-Fund Corp but the same was reimbursed by e-Fund India. This was in accordance with and permitted under the Indian Exchange Control Regulations. It was further stated that the Assessing Officer was wrong in assuming that the two seconded employees were at liberty to function for e-Fund Corp while they were working for e-Fund India. The seconded employees were working under the control and supervision of e-Fund India. The Assessing Officer thereupon has not commented on the reply of the assessee, though he has recorded comments in respect of replies to other issues raised by him (see paragraph 7 of the assessment order). The aforesaid factual assertion made by the assessee, therefore, was not negated or questioned by the Assessing Officer.

64. Commissioner (Appeals) has referred to technical explanation DTAA issued by the US Department of Treasury. The said explanation refers to the definition of term 'PE' including service PE and states as under:-

> "Subparagraph (1) provides the rule for determining the conditions under which the activity of furnishing services, through employees **or other personnel, constitutes a PE. These rules apply only to the provision of services which** are not considered to be **"included services", as the term is defined in article 12 (Royalties and Fees for included Services). Under the subparagraph, the furnishing of services gives rise to** a PE if either the activity continues for an **aggregate of more than 90 days in a twelve month period, or the services are** performed fir a person related to the enterprise providing the services. **In the latter case, no time threshold test** must be met for a PE to exist. The determination of whether persons are related for purposes of this test is made in accordance with the rules of article 9 (Associated Enterprises)."

65. The aforesaid explanation has been misunderstood by Commissioner (Appeals). Sub-clause (l) to Article 5(2) creates service PE when the overseas assessee is involved in the activity of furnishing services within the other contracting State through employees or other personnel but only if conditions stipulated in clauses (i) or (ii) are satisfied. Clause (i) stipulates a threshold period or aggregation of the threshold period which should be satisfied. Clause (ii), however, does not stipulate any time threshold. Clause (ii), therefore, is much wider but is applicable when the foreign enterprise through employees or other personnel performs service within the other contracting State for

a related enterprise defined in Article 9 paragraph 1. But the sa employees or other personnel "of the assessee" should have performed services in India for an associated enterprise. They should not have performed services for e-fund India's domestic activities.

66. Control and supervision of workers is a relevant and important factor as was noticed by the Authority for Advance Ruling in ***Tekniskil (Sendirian) Berhard Vs. Commissioner of Income Tax*** *[1999] 222 ITR 551*. In the said case, a Malaysian company had provided skilled labour to a Korean company, who had worked in India. As the said labour had worked under the supervision and control of Korean company, it was held that Malaysian company did not have "permanent establishment" in India as per Article 7 of DTAA between Indian and Malaysia. In P.No.28 of 1999 In Re Authority for Advance Ruling in its decision reported in [2000] 242 ITR 208 took an opposite view after noticing that the Indian joint venture did not pay any remuneration to the foreign employees and the employees continued to be the employees of the foreign company and were paid by the foreign company. Thus, the applicant company was rendering services through its employees to the Indian company, therefore this created a PE.

67. The assessment order refers to the net income or loss of e-Fu Corp and has come to the conclusion that once operations of e-Fund India started and grew, the profits of e-Fund Corp also increased. This is a very simplistic method and manner of analyzing data. Profits or losses depend upon several factors like, business environment, quality of business operations etc. including transfer of back office operations or other operations to a more efficient and cost effective locations. The said finding can be given after minute and meticulous examination of the data, reasons and not by a straight forward and simplistic inference. Further existence of PE does not depend upon transfer of assignment or sub-contracting work/services to India, with an intent and purpose to save costs and to increase profitability of the assessee resident abroad. This is not the stipulation or requirement in Article 5.

68. The contention of the Revenue is that if rights in the software had been transferred to e-Fund India, compensation was required to be paid by e-Fund India and this would have required deduction of tax at source. The argument is farfetched. We are not dealing with assessment or failure of e fund India to deduct tax at source. The argument cannot be accepted as it would interfere with the working or business model adopted by the assessee and e-Fund India. The said

working model is not a sham or a camouflage having no busine character.

69. Similarly, the contention and finding recorded that e-Fund India had provided necessary input or information to e-Fund Corp or e-Fund Inc. to enable them to enter into contracts which were sub-contracted or assigned to e-Fund India, will not make e-Fund India a permanent establishment of the assessee. This is not covered under any of the clauses or stipulations of Article 5. It is not the case that employees of e-Fund India had participated and/or were present in the negotiations of the assessee with the third parties, in respect of contracts to be paid/sourced from India or even executed/performed abroad.

70. The Assessing Officer has recorded and in our opinion incorrectly that majority of the employees of the two assessees operate from India. The said finding is legally untenable and drawn on a wrong legal principle. Employees of e-Fund India were not employees of e-Fund Corp or e-Fund Inc. Seconded employees were only two in number and only in assessment year 2005-06. It is further observed that the two assessee had significant assets in India on wrong legal assumption that assets of e-Fund India were assets of e-Fund Corp and e-Fund Inc. He has held that the assessee and e-fund India did not operate on arm's length basis as in respect of some contracts, e-

Fund India had raised bills directly to the customer but for simil contracts/ arrangement the entire amount was paid to the two foreign assessees and only a miniscule amount or profit was transferred or paid to e-Fund India. The said finding/conclusion again is not a correct inference. It is not born out from the record and has not been accepted by the tribunal as it has accepted attribution of income made by the assessee.

71. India has expressed reservation on some of the paragraphs in OECD commentary; primarily on the ground that India as a source State is entitled to tax services in the form of fee for technical/included service or royalty payment. The stand of the Indian tax authorities is that the services need not be rendered physically in India but when the payment is sourced from India and the services are to be utilized in India, income of the foreign resident is taxable in the source State i.e. India. We need not examine the said stand of the tax authorities in the present case as this is not in dispute or issue in question. The source State in the present case was USA. It was the State where the contract of service was performed and utilized, though certain operations took place in India. The beneficiaries of the services and the payment of the services were sourced in USA. Casual examination of India's balance for payments in US Dollars available on Reserve Bank of

India's website from the year 2000-01 to 2010-11, would indicate th India has substantial inflow under the head "invisible" i.e. payments for services and products which do not result in transfer of physical objects. A significant portion of India's services, which contributes almost 55% to the Indian Gross Domestic Product, are for outbound and cross borders services. A greater and in-depth study is required to understand the full tax or revenue implication as far as India is concerned including study of proposed amendments to the OECD Model Treaty.

Section 9(1)(i) of the Act

72. No arguments have been addressed before us on the aspect of legal connection which justifies taxation of a non-resident under Section 9(1)(i) of the Act on income which is deemed to be accrue or arise in India. The tribunal in the impugned order has held that the assessees had business connection in India for the points noted in paragraph 18.3. Though the reasons stated in paragraph 18.3 do appear to be widely and broadly stated, but keeping in view the mandate and the ratio of the decisions of the Supreme Court in ***Commissioner of Income Tax, Punjab Vs. R.D. Aggarwal and Company*** *[1965] 56 ITR 20,* ***Commissioner of Income Tax, Andhra Pradesh Vs. Toshoku Ltd., Guntur and Ors.*** (1980) 125 ITR 525, ***Ishikawajma-Harima Heavy***

Industries Ltd. Vs. Director of Income Tax, Mumbai [2007] 288 ITR 408 and the amendments incorporated and made to Section 9 (1)(i), it has to be held that business connection did exist, not because the assessees were associated enterprise or had a subsidiary in India, but because the e-Funds India was providing information and details to the assessees in USA for the purpose of entering into contracts with third parties and subsequently the said contracts were performed fully or partly by e-Funds India as an assignee or sub-contractee and looking at the nature of the said transactions and the manner in which contracts were executed and where the asssessee had assumed and agreed to third party claims and risks; business connection is established. However, even when business connection under Section 9(1)(i) stands established, the provision does not seek to bring to tax, all profits of the non-resident. Only income reasonably attributed to operations carried out in India can be taxed under the Act. Real and intimate connection must exist between operations carried out in India and business by non-resident outside India, and profits of business outside India attributed to operations carried out in India, can be only subjected to tax. This is clear from the explanation to Section 9(1)(i) and only such income operations carried out in India have to be attributed and taxed. This would have entailed an intrusive and exhaustive exercise into each

contract executed by E fund India, and on involvement of the assess and E fund India. In the present case, attributions of profit to business connection has not been undertaken/applied keeping in mind the aforesaid stipulation, but by applying Article 7 of the DTAA. It appears and is apparent that the assessee and Revenue felt that application of DTAA was more beneficial to the assessee.

73. In ***Director of Income Tax Vs. Rio Tinto Technical Services*** [2012] 340 ITR 507 (Delhi) it has been observed that Section 90 (2) mandates that where the Central Government has entered into DTAA and the said agreement applies, the provisions of that Act will apply to the extent they are more beneficial to the assessee. In other words, when DTAA and provisions of the Act apply to an assessee, then the Article of DTAA or the provision of the Act will apply depending upon, which one of the two is more beneficial or advantageous to the assessee.

Challenge to the initiation of proceedings under Section 147/148 of the Act.

74. Challenge to the initiation of proceedings under Sections 147/148 of the Act by the two assessees is devoid of merits. In the present case, the assessee had not filed returns of income and were not subjected to regular assessment under Section 143(3). Challenge on

the ground of change of opinion etc. is not available. The only grou on which proceedings can be challenged is that the reasons recorded do not disclose any rational or relevant nexus with the formation of belief that income of the two assessees had escaped assessment. At the stage of issue of notice only a tentative or prima facie view, justifies initiation of proceedings under Section 147/148 of the Act, though the reasons or grounds recorded must not be based on gossip, rumour or mere suspicion. In the present case, reassessment proceedings were initiated after assessment orders in respect of assessment year 2003-04 were passed by the Assessing Officer. In respect of the said year, MAP procedure was adopted and income of the two assessees has been partly taxed in India. We, therefore, do not accept the contention of the assessee that there was no justification or valid reason to initiate proceedings under Section 147/148 of the Act.

75. Learned counsel for the assessees has submitted that reasons to believe for the assessment year 2000-01 were not communicated and this was in violation of law. Failure to communicate reasons to believe, may result in setting aside of the assessment order as an assessee has a right to challenge the proceedings initiated under Section 147/148 of the Act, after following procedure as per ***GKN Driveshafts (India) Limited. vs. Income-tax Officer***

(2003) 259 ITR 19 (SC). However, in the facts of the present case, we are not inclined to set aside the assessment order for the Assessment Year 2000-01 and the appellate proceedings for this reason. Reasons to believe recorded for 2000-01 and subsequent years are identical. Reasons to believe for all assessment years, other than 2000-01 were communicated. The assessees did not object or protest before the Assessing Officer that they had not been served with the reason to believe for the assessment year 2000-01. No doubt, it was the obligation and duty of the Assessing Officer to furnish the reasons to believe and mere change in incumbent, did not absolve or wash away this duty or obligation, but in the facts of the present case, we are of the firm belief that the assessee was aware of the reasons to believe and was not prejudiced and in fact in full knowledge and were aware of the reason to believe for the assessment year 2000-01. They took a conscious and considered decision not to challenge the proceedings at the initiation stage. Thus non communication of reasons to believe was inconsequential and did not prejudice the assessee. Tribunal has on examining the original records came to a factual finding giving cogent reasons, why reasons to believe were in fact recorded before issue of notice. Challenge to the proceedings under Section 147/148 of the Act is therefore, rejected.

Computation, apportionment or accumulation of income/profit

76. The assessment order drawing authority from Article 7(2) of the DTAA and Rule 10 of the Income Tax Rules, holds that profit of the two assessees attributable to Indian PE should be computed on reasonable basis. The Assessing Officer took into account the assets of the two assessees located outside India and located in India, i.e., the assets of e-Fund India. In proportion to the assets located in and outside India, income from operations was attributed to the Indian PE. However, in computing the income from operations, the net profit of e-Fund India was reduced from the total income and then 2.51% of the net profit was attributed to India, 2.51% being the percentage of assets in India. The aforesaid income was divided in the ratio of 15% and 85% towards as income of Indian PE of e-Fund Inc. and e-Fund Corp. In view of the said computation, the total income of the two assessees determined for the relevant assessment years is as under:-

For e-Funds Corporation & e-funds IT Solutions Group Inc.

<table>
<tr><td>S.No.</td><td>Assessment Year</td><td>Post AO’s Decision</td></tr>
<tr><td rowspan="3">1.</td><td rowspan="3">2000-01</td><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10 K)</td><td>1.28</td></tr>
<tr><td>Less; Net profits (eFunds</td><td>0.82</td></tr>
</table>

		India)	
		Attributable Income (In Million of USD) (A)	0.46
		Percentage allocated to India (B)	2.51%
		Income attributed to the India PE (A*B)	0.012
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solution Group Inc. (15%)	0.002
		eFunds Corporation (85%)	0.010
		Exchange Rate	43.62
		eFunds IT Solution Group Inc. (in Rs.)	87,240
		eFunds Corporation (In Rs.)	436,200
2.	2001-02	Particulars	Amount(In Million USD)
		Income from operations (10 K)	18.99
		Less; Net profits (eFunds India)	6.41
		Attributable Income (In Million of USD) (A)	12.57
		Percentage allocated to India (B)	5.65%
		Income attributed to the India PE (A*B)	0.711
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solution Group Inc. (15%)	0.107
		eFunds Corporation (85%)	0.604
		Exchange Rate	46.64

		eFunds IT Solution Group Inc. (in Rs.)	4,990,480
		eFunds Corporation (In Rs.)	28,170,560
3.	2002-03	Particulars	Amount (In Million USD)
		Income from operations (10 K)	46.97
		Less; Net profits (eFunds India)	15.53
		Attributable Income (In Million of USD) (A)	31.44
		Percentage allocated to India (B)	9.03%
		Income attributed to the India PE (A*B)	2.838
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solution Group Inc. (15%)	0.426
		eFunds Corporation (85%)	2.413
		Exchange Rate	48.80
		eFunds IT Solution Group Inc. (in Rs.)	20,788,800
		eFunds Corporation (In Rs.)	117,754,400
4.	2004-05	Particulars	Amount (In Million USD)
		Income from operations (10 K)	43.67
		Less; Net profits (eFunds India)	7.16
		Attributable Income (In Million of USD) (A)	36.50
		Percentage allocated to India (B)	12.37%

		Income attributed to the India PE (A*B)	4.514
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solution Group Inc. (15%)	NA
		eFunds Corporation (85%)	3.927
		Exchange Rate	43.86
		eFunds IT Solution Group Inc. (in Rs.)	NA
		eFunds Corporation (In Rs.)	172,238,220
5.	2005-06	Particulars	Amount (In Million USD)
		Income from operations (10 K)	62.70
		Less; Net profits (eFunds India)	6.12
		Attributable Income (In Million of USD) (A)	56.57
		Percentage allocated to India (B)	9.02%
		Income attributed to the India PE (A*B)	5.105
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solution Group Inc. (15%)	0.766
		eFunds Corporation (85%)	4.339
		Exchange Rate	43.75
		eFunds IT Solution Group Inc. (in Rs.)	33,512,500
		eFunds Corporation (In Rs.)	189,831,250

<table>
<tr><td>6.</td><td>2006-07</td><td>
<table>
<tr><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10 K)</td><td>77.20</td></tr>
<tr><td>Less; Net profits (eFunds India)</td><td>6.76</td></tr>
<tr><td>Attributable Income (In Million of USD) (A)</td><td>70.44</td></tr>
<tr><td>Percentage allocated to India (B)</td><td>5.74%</td></tr>
<tr><td>Income attributed to the India PE (A*B)</td><td>4.042</td></tr>
<tr><td colspan="2">Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation</td></tr>
<tr><td>eFunds IT Solution Group Inc. (15%)</td><td>0.606</td></tr>
<tr><td>eFunds Corporation (85%)</td><td>3.436</td></tr>
<tr><td>Exchange Rate</td><td>44.61</td></tr>
<tr><td>eFunds IT Solution Group Inc. (in Rs.)</td><td>2,70,46,039</td></tr>
<tr><td>eFunds Corporation (In Rs.)</td><td>15,32,60,890</td></tr>
</table>
</td></tr>
<tr><td>7.</td><td>2007-08</td><td>
<table>
<tr><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10 K)</td><td>79.03</td></tr>
<tr><td>Less; Net profits (eFunds India)</td><td>7.00</td></tr>
<tr><td>Attributable Income (In Million of USD) (A)</td><td>72.03</td></tr>
<tr><td>Percentage allocated to India (B)</td><td>5.06%</td></tr>
<tr><td>Income attributed to the India PE (A*B)</td><td>3.645</td></tr>
<tr><td colspan="2">Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation</td></tr>
</table>
</td></tr>
</table>

		eFunds IT Solution Group Inc (15%)	0.547
		eFunds Corporation (85%)	3.098
		Exchange Rate	43.59
		eFunds IT Solution Group Inc (in Rs.)	2,38,33,642
		eFunds Corporation (In Rs.)	13,50,57,303

77. Commissioner (Appeals) did not interfere with the aforesaid computation except that for the purpose of attribution, he held that the value of assets should be taken at actual cost and not on written down value. The value of the assets was taken by the Assessing Officer at written down value. The Commissioner (Appeals) observed that taking written down value could result in different rates of attribution for various years as depreciation rates might vary for various assets and without change in business model or assets, business attribution would also vary. This probably had resulted in reduction of income attributable to the two assessees and, therefore, Revenue preferred appeals. Assessee also preferred appeals before the tribunal.

78. Tribunal in the impugned order has modified the method of computation or attribution of profits to Indian PE. The method adopted by the tribunal is as under:-

> "8.36. In our view, the proper method for estimating the profits attributable to PE shall be worked out in the following manner/order, which, according to us, gives a fair and is reasonable basis:-
>
> (i) Determination of Proportion of Indian assets to Global assets i.e.including eFunds India assets.
>
> (ii) Aggregate of global profits of group (inclusive of eFunds India profits).
>
> (iii) Working of total profits attributable to India out of global profits in same proportion as (i) above.
>
> (iv) Aggregate India attributable profits of group-X
>
> (v) Less: (-) eFunds India International assessed Profits – 'Y'
>
> (vi) Balance: Z (X-Y) i.e. Surplus profits attributable to Indian PEs of both assessees.
>
> Surplus profits i.e. 'Z' is to be further distributed in both assessees: 85% attributable to PE of eFunds Corporation; and 15% attributable to eFunds I.T. Solutions.
>
> 8.37. In our view, this working is more scientific and equitable. It will take care of the apprehension raised by the learned counsel that though eFunds India income was reduced on first stage in MAP proceedings, corresponding assets are not reduced, while adopting the global assets. This methodology/formula will be more helpful in arriving at the reasonably correct amount of attributable income, being comparatively just, fair and equitable."

79. It was further observed that it was desirable to adopt depreciated cost of assets as the base as held by the Assessing Officer. The tribunal observed that the reasoning of the Commissioner (Appeals) required interference because computation on the basis of actual cost would require reference to earlier records and reverse calculations, which was undesirable. Besides income generating capacity of the assets would diminish with the lapse of time and depreciation, as

provided in the respective statutes, should be given due regard. In su circumstances, it was desirable and expedient to base attribution on depreciated cost of assets for purpose of apportionment as it would be fairer, practical and hassle free method. As a result of the direction given by the tribunal, income of the two assessees has been computed as under:-

For e-funds Corporation & e-funds IT Solutions Group Inc.

<table>
<tr><th>S.No</th><th>Assessment Year</th><th>Post ITAT Decision</th></tr>
<tr><td>1.</td><td>2000-01</td><td>
<table>
<tr><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10K) (A)</td><td>1.28</td></tr>
<tr><td>Percentage allocated to India (B)</td><td>2.51%</td></tr>
<tr><td>Attributable Income (In Millions of USD) (C=A*B)</td><td>0.032</td></tr>
<tr><td>Less; Net profits (eFunds India) (D)</td><td>0.82</td></tr>
<tr><td>Income attributed to the India PE (C-D)</td><td>NIL</td></tr>
<tr><td colspan="2">Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation</td></tr>
<tr><td>eFunds IT Solutions Group Inc. (15%)</td><td>NIL</td></tr>
<tr><td>eFunds Corporation (85%)</td><td>NIL</td></tr>
</table>
</td></tr>
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<table>
<tr><td>2.</td><td>2001-02</td><td>
<table>
<tr><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10K) (A)</td><td>18.99</td></tr>
<tr><td>Percentage allocated to India (B)</td><td>5.65%</td></tr>
<tr><td>Attributable Income (In Millions of USD) (C=A*B)</td><td>1.07</td></tr>
<tr><td>Less; Net profits (eFunds India) (D)</td><td>6.41</td></tr>
<tr><td>Income attributed to the India PE (C-D)</td><td>NIL</td></tr>
<tr><td colspan="2">Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation</td></tr>
<tr><td>eFunds IT Solutions Group Inc. (15%)</td><td>NIL</td></tr>
<tr><td>eFunds Corporation (85%)</td><td>NIL</td></tr>
</table>
</td></tr>
<tr><td>3.</td><td>2002-03</td><td>
<table>
<tr><td>Particulars</td><td>Amount (In Million USD)</td></tr>
<tr><td>Income from operations (10K) (A)</td><td>46.97</td></tr>
<tr><td>Percentage allocated to India (B)</td><td>9.03%</td></tr>
<tr><td>Attributable Income (In Millions of USD) (C=A*B)</td><td>4.24</td></tr>
<tr><td>Less; Net profits (eFunds India) (D)</td><td>15.53</td></tr>
<tr><td>Income attributed to the India PE (C-D)</td><td>NIL</td></tr>
<tr><td colspan="2">Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds</td></tr>
</table>
</td></tr>
</table>

		Corporation	
		eFunds IT Solutions Group Inc. (15%)	NIL
		eFunds Corporation (85%)	NIL
4.	2004-05	Particulars	Amount (In Million USD)
		Income from operations (10K) (A)	43.67
		Percentage allocated to India (B)	12.37%
		Attributable Income (In Millions of USD) (C=A*B)	5.40
		Less; Net profits (eFunds India) (D)	7.16
		Income attributed to the India PE (C-D)	NIL
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solutions Group Inc. (15%)	NA
		eFunds Corporation (85%)	NIL
5.	2005-06	Particulars	Amount (In Million USD)
		Income from operations (10K) (A)	62.70
		Percentage allocated to India (B)	9.02%
		Attributable Income (In Millions of USD) (C=A*B)	5.66
		Less; Net profits	6.12

		(eFunds India) (D)	
		Income attributed to the India PE (C-D)	NIL
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solutions Group Inc. (15%)	NIL
		eFunds Corporation (85%)	NIL
6.	2006-07	Particulars	Amount (In Million USD)
		Income from operations (10K) (A)	77.20
		Percentage allocated to India (B)	5.74%
		Attributable Income (In Millions of USD) (C=A*B)	4.43
		Less; Net profits (eFunds India) (D)	6.76
		Income attributed to the India PE (C-D)	NIL
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solutions Group Inc. (15%)	NIL
		eFunds Corporation (85%)	NIL
7.	2007-08	Particulars	Amount (In Million USD)
		Income from operations (10K) (A)	79.03

		Percentage allocated to India (B)	5.06%
		Attributable Income (In Millions of USD) (C=A*B)	4.00
		Less; Net profits (eFunds India) (D)	7.00
		Income attributed to the India PE (C-D)	NIL
		Allocation of revenue between company eFunds IT Solution Group Inc. and eFunds Corporation	
		eFunds IT Solutions Group Inc. (15%)	NIL
		eFunds Corporation (85%)	NIL

Thus, no tax is payable by the two assessees in any year because e-Fund India had declared and stands taxed on a higher income.

80. Learned counsel for the Revenue has raised three contentions. Firstly, the method adopted by the Assessing Officer was in terms of the method adopted and accepted in the MAP proceedings and, therefore, the most reasonable method. Order of the tribunal does not set out or give reasons why the method adopted in the MAP proceedings was unreasonable and inappropriate. Secondly, as per Article 7, method once adopted should be followed from year to year and can be only altered under paragraph 5 of Article 7 for good and sufficient reasons. Lastly and in alternative, the bifurcation or

appropriation should be based on Rule 10 by applying turnover criter and not on the basis of assets criteria.

81. Article 7 has been quoted above. Paragraph 2 of the said Article stipulates that business income attributed to permanent establishment will be calculated as if the permanent establishment in a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at 'arms length' with other associated enterprises. In case profits attributable to permanent establishment are incapable of determination or determination presents exceptional difficulties, the profits attributable must be estimated on reasonable basis but in accordance with the principles stated above. Paragraph 3 postulates deductions in respect of expenses incurred for business of the PE, including reasonable allocation of executive and general expenses, research and development expenses whether incurred in the State where PE is situated or elsewhere, should be allowed but in accordance with and subject to limitations of taxation laws of the country in which PE is situated. However, in respect of royalties, fee or similar payments in return for use of patent, know-how or other rights etc., only reimbursement of actual expenses can be allowed. Paragraph 5 states that profit attributed to permanent establishment in clause (a) paragraph 1 of Article 7 shall only include

profits derived from assets and activities of permanent establishme The determination should be by the same method from year to year unless there are good and sufficient reasons.

82. Paragraph 5 affirms scope of paragraph 1(a) of Article 7 to profits derived from assets and activities of the PE. In other words, only assets and activities of PE i.e. "e-Fund India" can be taken into consideration for attribution of profits to the two assessee, if it is assumed that e-Fund India was PE of the assessee. The activities, which were not undertaken by e-Fund India and the assets of the two assesses outside India, cannot be taken into account or attributed for earning/income of the two assessees. This is subject to the limited force of attraction principle mentioned above, which in the present case is not applicable.

83. We have already quoted passages from decision in ***Morgan Stanley*** (supra) on the question of attribution when the Indian company, i.e., e-Fund India itself was assessed and subjected to tax on 'arms length' basis. The Supreme Court has observed that in such cases when transfer pricing analysis includes and takes into account risk taking functions of the PE enterprise, nothing further would be attributable to the foreign or non-resident enterprise. However, if the transfer pricing order or computation does not adequately reflect the

functions performed and risk assumed by the Indian enterprise, there need to attribute profits for those functions or risks which have not been considered. Data placed by the taxpayer, which is examined and considered in transfer pricing analysis is, therefore, of importance and has to be examined in each case.

84. Apportionment criteria or method is beset with difficulties and complications. Recent OECD attempt for application of people functions tests etc. has been subject matter of unfavourable comments. The criteria or apportionment principles can be grouped as:-

(i) Receipt of enterprise based on turnover or commission.

(ii) Expenses i.e. based upon wages paid.

(iii) The capital structure i.e. based upon apportionment of total working capital of the enterprise allocated to each enterprise or part. Asset can form the basis of apportionment.

(iv) Amalgamation of one two or more of the above criteria can be also adopted in different proportions.

85. As noticed above, Article 7 of the DTAA refers to the asset and functions method. Normally, turnover or commission method is applied in case of enterprise providing service as net profits significantly depends upon turnover. In ***Morgan Stanley*** (supra), the Supreme Court has also observed that Transactional Net Margin

Method (TNMM, for short) is most appropriate method in case service PE. The assessment order itself indicates and states that the said method was adopted for computing arms length pricing in the case of e-Fund India.

86. In the present case, the Assessing Officer, in our opinion, rightly did not invoke wages method as it would have lead to inequitable and inappropriate results. In the present case the assessees' activities though broadly divided into four heads were interconnected and not independent as the heads/lines were interdependent and had direct relationship. Assets in form of ATM equipment, location/installation charges etc. were significant and important for the entire business including back office operations. As the Assessing Officer had applied asset and income method and the Commissioner (Appeals) did not adversely comment; the tribunal did not interfere or adopt a different apportionment criteria but corrected an obvious anomaly noticed and apparent. The anomaly being; that while computing the proportion of net income attributable to Indian PE, the net income of the group less income of eFund India was attributed to the group assets including assets of e-fund India. Thus, the net income excluded income earned by e-fund India was divided or attributed to the assets, including Indian assets, though Indian assets had also contributed in

earning of the net income. This inconsistency was highlighted by t assessee before the Commissioner (Appeals) and the tribunal. Commissioner (Appeals) referred to the written submissions; that the formula adopted was iniquitous and irrational. The said contention was elucidated by giving a specific example noticed in paragraph 7.7 of the order of the Commissioner (Appeals). The contention was rejected stating that the example was a theoretical. Method of apportionment has to be fair, rational and logical. Assets and net income criteria applied must collate and refer to the assets which have contributed to the earning of the net income. The tribunal, therefore, rightly interfered and corrected the error, which was apparent. In the MAP proceedings a formula was adopted and should be consistently followed but if the said formula was irrational and inappropriate, it could be corrected in other and subsequent years. The approach of the tribunal, therefore, cannot be faulted.

87. On the question whether depreciated/written down value or the original cost of assets should be taken as the basis, the tribunal has accepted the written down value of the assets adopted by the Assessing Officer. Revenue has not specifically questioned the said finding and had contested original cost basis adopted by Commissioner (Appeals). Moreover, the tribunal has given valid and cogent reasons for the same,

though in a given case, adjustments may have to be made when there material to show that written down value may lead to irrational or illogical results due to difference in rate of depreciation or 100% depreciation was/is allowed under applicable tax laws of one of the countries. No such contention or issue has been raised by the Revenue before us.

88. Noticing the position that turnover method or TNMM is considered appropriate in case of service industry, while reserving judgment, the assessee was directed to file a computation of attribution of income on the basis of turnover method. Thereafter, the assessee filed a chart working out attribution on turnover basis. The calculation read:-

"

Year	Assessment Year (AY)	eFunds US	eFunds India	% of eFunds India Vs eFunds US Turnover
1	2	3	4	5=4/3*100
31-Mar-00	2000-01	14,448,252,600	435,344,000	3.01
31-Mar-01	2001-02	20,606,718,000	1,097,752,000	5.33
31-Mar-02	2002-03	25,289,380,000	1,785,150,000	7.06
31-Mar-04	2004-05	23,556,109,500	2,084,474,000	8.85
31-Mar-05	2005-06	23,603,125,000	2,174,630,000	9.21
31-Mar-06	2006-07	22,957,421,250	2,229,147,000	9.71
31-Mar-07	2007-08	23,905,497,030	2,146,683,000	8.98

"

89. Accordingly it is stated that in view of the income declared a taxed in the hands of e-Fund India, nothing remains to be attributed or taxed in the hands of the two assessee.

90. In the order dated 29th October, 2013, it was recorded that both the parties have mentioned the appeals and calculations made by the assessee had been furnished to the Revenue and in case Revenue wanted to give counter calculations, the same be filed after examining their records within 10 days. No calculations have been filed by the Revenue. We had directed the said calculations to be filed, as we were uncertain about our decision. We were concerned that if turnover method was applied or partly applied, then whether an order of remand would be justified. Details were asked to be furnished to avoid another round of litigation with an order of remit, if it was not necessary. We did not seek details with an intention to get on record new or fresh facts, which were not elucidated or relied upon by the parties before the tribunal but in case we found merit in the contention raised by the learned counsel for the Revenue whether an order of remand would be justified. For reasons stated above we have not deemed it appropriate to interfere with the findings of the tribunal on apportionment.

91. In view of the aforesaid discussion, we answer questions of la in the following manner:-

> "Whether, on the facts and circumstances of the case and in law, the Assessing Officer was justified in reopening the assessment under Section 147/148 of the Income-Tax Act?"
>
> Notices under Section 147/148 are valid and as per law.

> "Whether on the facts and in the circumstances of the case and in law, the Tribunal was justified in holding that Appellant has a business connection in India under Section 9(1) [or 9(1)(i)] of the Act ?"

The assessees have business connection in India, but the tribunal has given a wide and broad meaning to the term "business connection" and what is attributable and taxable as "business connection" has not been adjudicated and decided. This is because both the Assessing Officer and the assessees have proceeded that in terms of Section 90(2) of the Act, provisions of the DTAA were more beneficial to the assessee. Question No. 2 is accordingly answered.

> "Whether on the facts and in the circumstances of the case and in law, the Tribunal was justified in holding that the Appellant has a permanent establishment in India under Articles 5(1), 5(2) (1) and 5(4) of the India-US DTAA?"

The assessees did not have "permanent establishment" in India under Articles 5(1), 5(2)(l) and 5(4) of the DTAA.

> "Whether any income of eFunds International India Pvt. Ltd. Can be attributed and assessed in the hands of the appellant?

No income of the e-Funds India could be attributed and assessed in the hands of the assessee/appellants.

> "In case question no. (5) or question No.(3) (i.e. immediately preceding question) is answered against the appellant, whether the Tribunal was justified and correct in adopting the formula mentioned in the order and not accepting the stand of the assessee?"

This question need not be answered in view of answer to the preceding question . However, this question has been substantially answered while deciding the appeals of the Revenue.

> "Whether on the facts and in the circumstances of the case, and in law, the Tribunal was justified in holding that appellant is liable to interest under Section 234A and 234B of the Act?"

This question need not be answered in view of the findings that the assessee did not have income taxable in India/taxable income.

92. The substantial questions of law raised in the appeals by the Revenue except appeals relating to Assessment Years 2006-07 and 2007-08 read:-

> "Whether on the facts and circumstances of the case, the Income Tax Appellate Tribunal has erred in law in not appreciating that the method adopted by the AO for attributing the profit to the PE of the assessee is based on the lines of MAP proceedings based on A.Y. 2003-04?

> Whether on the facts and circumstances of the case, the order of the ITAT is not perverse?

The substantial questions of law raised in appeals of the Revenue relating to Assessment Years 2006-07 and 2007-08 read:-

> Whether the Income Tax Appellate Tribunal has correctly rejected the computation of profit attributed to the Permanent Establishment on the lines of the MAP proceedings?"
>
> Whether the formula prescribed by Income Tax Appellate Tribunal for computation of profit attributable to a Permanent Establishment is correct and as per law?
>
> Whether the order of the Income Tax Appellate Tribunal is perverse?"

These questions have to be answered against the Revenue and in favour of the assessees. The findings of the tribunal are not perverse and the tribunal is justified in not accepting the formula/method adopted/applied by the Assessing Officer or in the MAP proceedings to compute purported income attributable to the two assessee.

93. The appeals are disposed of. In the facts, there will be no order as to costs.

(SANJIV KHANNA)
JUDGE

(SANJEEV SACHDEVA)
JUDGE

FEBRUARY 05th, 2014
VKR/KKB/NA