Brown And Sharpe Inc. vs Commissioner Of Income Tax And Anr. on 11 November, 2014

Author: P.K.S. Baghel

Bench: Pradeep Kumar Singh Baghel

HIGH COURT OF JUDICATURE AT ALLAHABAD

AFR

Chief Justice's Court

Case :- INCOME TAX APPEAL No. - 219 of 2014

Appellant :- Brown And Sharpe Inc.

Respondent :- Commissioner Of Income Tax And Anr.

Counsel for Appellant :- R.S. Agrawal

Counsel for Respondent :- C.S.C. It

Hon'ble Dr. Dhananjaya Yeshwant Chandrachud,Chief Justice

Hon'ble Pradeep Kumar Singh Baghel,J.

This appeal under Section 260A of the Income Tax Act, 19611 arises from a decision of the Income Tax Appellate Tribunal2 for Assessment Year 2003-043 which was rendered on 17 January 2014. The assessee is in appeal and has raised the following questions of law:

> "1. Whether on the facts and circumstances of the case the Tribunal erred in law in upholding the findings of the assessing officer that since the Liaison Office ('LO') was engaged in marketing/ promoting appellant's products in India, the appellant was liable to tax in India on business income;

2. Whether on the facts and circumstances of the case, the Tribunal erred in law in not appreciating that since activity of advertising/ marketing carried out by LO in India fell within the exclusion contained in Article 5(3)(e) of India-USA DTAA, the LO did not constitute PE of appellant in India and consequently no business profits were liable to tax in India as per Article 7 of that DTAA;

3. Without prejudice, whether the Tribunal erred in law in assessing the surplus funds remitted by the appellant/ Head Office as business income liable to tax in India;

4. Without prejudice, whether the Tribunal erred in law in not appreciating that only profits attributable to alleged business activities carried out by LO in India could have been brought to tax in India, having regard to functions performed, assets employed and risk assumed ('FAR analysis') by LO;

5. Whether on the facts and circumstances of the case, the decision arrived at by the Tribunal is such that no reasonable person correctly informed of the position in law could come to; and,

6. Whether on the facts and circumstances of the case, the findings arrived at by the Tribunal are perverse."

The assessee is a company incorporated in the US. The Registrar of Companies issued a certificate of registration to the assessee under Section 591 of the Companies Act, 1956 on 14 November 2002. During the accounting year, the assessee had received an approval from the Reserve Bank of India on 30 May 2002 for establishing a liaison office in India subject inter alia to the following conditions:

"(i) Except the proposed liaison work, the office in India will not undertake any other activity of a trading, commercial or industrial nature nor shall it enter into any business contracts in its own name without our prior permission.

(ii) No commission/fees will be charged or any other remuneration received/income earned by the office in India for the liaison activities rendered by it or otherwise in India.

(iii) The entire expenses of the office in India will be met exclusively out of the funds received from abroad through normal banking channels.

(iv) The office in India shall not borrow or lend any money from/to any person in India without prior permission.

**** **** ****

(vii) The office in India will not render any consultancy or any other services directly/ indirectly, with or without any consideration."

The assessee filed its return of income and returned a loss of Rs.38.86 lacs. The assessee had shown a receipt of Rs.63.72 lacs under the Head Office account. During the course of the assessment proceedings, the assessee claimed that it was maintaining a liaison office and the receipts were on account of a remittance of expenses incurred. The assessee stated that the expenses included the salary of its Consultants and Chief Representative Officer to whom a payment of Rs.7,20,000/- per annum was paid as remuneration. Besides, a remuneration of Rs.6,60,000/- per annum was paid to the Technical Support Manager. The assessee disclosed that besides the fixed remuneration, it had a sales incentive plan under which the employees were entitled to receive upto 25% of their annual remuneration as an incentive. When called upon to disclose the details of the targets which were fixed, and the receipts under the sales incentive plan, the assessee submitted that during the assessment year no incentive had been paid. The Assessing Officer, while completing the assessment under Section 143(3) of the Act, passed an order dated 21 February 2006. The Assessing Officer noted that the assessee had claimed depreciation in the income and expenditure account and ultimately had shown a loss of Rs.38.86 lacs. Depreciation under Section 32(1) of the Act was claimed in respect of assets used for the purpose of business activities. The Assessing Officer recorded the statement of the Chief Representative Officer of the assessee and came to the conclusion that the activities of the assessee were not restricted only to providing a channel of communication between the buyers of the products sold by the parent company but the activities were, it was found, extended to searching for prospective buyers, providing required information and persuading them of the worth of the brand of the assessee in the US, which was, in turn, a subsidiary of a Swedish company. The Assessing Officer held that the activities of the assessee involved marketing activities in India and that the assessee was, in fact, carrying on business activities. On this basis, the income of the assessee was computed at Rs.24.86 lacs, comprising of the receipts of Rs.63.72 lacs less the expenses of Rs.38.86 lacs, which was taken as the profit from business activities carried on in India.

The Commissioner of Income Tax (Appeals)4 confirmed the order of the Assessing Officer. The Tribunal by its judgment and order dated 17 January 2014 has come to the conclusion that the activities of the assessee which were carried on by its liaison office were to promote the sales of the assessee in India and that the Assessing Officer was justified in holding that the income attributable to the liaison office was taxable in India. The Tribunal has also held that the liaison office had received an amount in excess of what was actually incurred by way of expenditure and hence, the Assessing Officer had correctly taxed the amount received by the assessee over and above the reimbursement of the expenses. The assessee is in appeal.

Learned counsel appearing on behalf of the assessee submits that: (i) under Article 5(3)(e) of the Indo-US Double Taxation Avoidance Agreement5 a 'permanent establishment' has been defined so as to not include inter alia the maintenance of a fixed place of business solely for the purpose of advertising or for other activities which have a preparatory or auxiliary character for the enterprise; (ii) in the present case, the activities of the liaison office in India fall within the exception which is carved out by Article 5(3)(e) of the DTAA. The liaison office was engaged merely in acting as a

communication link between the Head Office in the US and prospective buyers in India and the activities that were carried out in India were not in the nature of marketing activities. More specifically, the following submissions have been urged on each of the points, which have been held against the assessee concurrently by the Assessing Officer, the CIT (A) and by the Tribunal:

> (A) The certificate of registration which has been issued by the Registrar of Companies under Section 591 of the Companies Act, 1956, it is urged, is given to any office established by a foreign company in India, irrespective of the nature of the activity;
>
> (B) The approval which has been granted to the assessee by the Reserve Bank of India specifically prohibits the liaison office from carrying on trading, commercial or industrial activities and there is no violation by the assessee of the approval;
>
> (C) The provision under the employment agreement for a sales incentive plan is a standard term which is incorporated in such contracts. The only purpose of the liaison office is to inform customers in India about the range of products of the assessee, and promoting a product is different from procuring orders. In the present case, there was no evidence of the liaison office having either conducted negotiations or of having executed any contract; and, (D) The assessee while filing its return of income had claimed a loss under the head of 'profits and gains of business and profession' and had made a claim of depreciation inadvertently, which should not be held against the assessee.

In the alternative, it has been submitted on behalf of the assessee that under Article 7 of the DTAA, even if an enterprise carries on a business in India, the profits of the enterprise may be taxed only to the extent as is attributable to the permanent establishment in India.

On the other hand, learned Standing Counsel appearing on behalf of the Revenue has submitted that:

> (i) The Assessing Officer has proceeded on the basis of the admitted factual position as it emerged from the answers which were furnished by the representative of the assessee during the course of the assessment proceedings. The material disclosed by the assessee would make it clear that the activity of the liaison office in India was not merely to carry on work of a preparatory or auxiliary nature but was to promote the products of the assessee and hence, the assessee directly engaged in marketing activities. This is evident from the replies furnished by the Chief Representative Officer of the assessee which have been extracted in the order passed by the Assessing Officer;
>
> (ii) In the present case, the assessee had a permanent establishment in India within the meaning of Article 5 of the DTAA, since it had a fixed place of business through which the business of the enterprise is partly or wholly carried on. The expression

"permanent establishment" includes 'an office' under Article 5(2)(c) of the DTAA. The exclusion contemplated under Article 5(3)(e) of the DTAA is not attracted since the activity which was carried on was not merely in the nature of advertising or of a preparatory or auxiliary character for the enterprise;

(iii) As a matter of fact, the assessee had filed a return of income, claiming a loss under the head of 'profits and gains in business or profession' and had claimed a depreciation under Section 32(1) of the Act. Hence, it was not open to the assessee to resile from its claim. The submissions which have now been urged by the assessee are in the nature of an afterthought.

The rival submissions fall for consideration.

Article 7 of the DTAA reads as follows, insofar as is material:

"ARTICLE 7- 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 that 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."

Under Article 7 of the DTAA, where an enterprise of a contracting State results in profits, these profits are taxable only in that contracting State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. The expression

"permanent establishment" is governed by Article 5 of the DTAA, which reads as follows, insofar as is material:

> "ARTICLE 5- Permanent establishment- 1. For the purpose of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

> (a) a place of management;
>
> (b) a branch;
>
> (c) an office;
>
> (d) a factory;
>
> (e) a workshop;

....

....

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 place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise."

A permanent establishment is a fixed place of business through which the business of an enterprise is carried on either wholly or in part. The definition of the expression "permanent establishment" in

Clause (2) of Article 5 includes in sub-clause (c) "an office". Article 5(3) of the DTAA contains a deeming fiction where, notwithstanding the preceding provisions of the Article, certain activities of the nature stipulated therein would not be deemed to constitute a permanent establishment. But for the exclusion in Article 5(3) of the DTAA, the activities which are elucidated in Clause (3) may have fallen within the broad sweep and purview of Article 5(1). But if the activity falls within the description of one of the activities contained under Article 5(3), as a result of the deeming provisions, the expression "permanent establishment" shall not be deemed to include such an activity. The assessee relies on Article 5(3)(e) of the DTAA in support of the plea of exclusion. That provision relates to the maintenance of a fixed place of business solely for the purpose of advertising or inter alia for other activities which have a preparatory or auxiliary character, for the enterprise.

In the present case, the Assessing Officer, during the course of the assessment proceedings, had called upon the assessee to explain the nature of its activities. The Chief Representative Officer of the assessee, who attended the proceedings before the Assessing Officer on 12 February 2006, furnished a detailed explanation to the queries which were raised by the Assessing Officer. Both the queries and the answers have a material bearing on the issue which arises in these proceedings and are hence reproduced below:

> "QUESTION NO. 8. Whether the company of USA has deputed their agent in India to procure the order and got supplied the goods or have maintained their own office for this purpose in India, if so give the details of the both.
>
> ANSWER M/s Brown & Sharpe INC has maintained a liaison office in India which is called Brown & Sharpe INC India liaison office. There was one agent during the year 2002-03 only but thereafter there is no agent. The liaison office explain about the product/ the machine to the buyer and according to their requirement intimation is sent, the technician to discuss the commercial issue comes, thereafter order is placed by the buyer direct to the factory.
>
> QUESTION NO. 9. What is your activities in the company in India.
>
> ANSWER My activities is to visit prospective clients and inform them about Brown & Sharpe INC and its products and organize further technical discussion with the client.
>
> QUESTION NO. 14 How the employee of the liaison office justify their expenses to the parent company of USA. Is there any minimum performance to the undertaken by the employee or any incentive has to be given, if the better performance is shown in providing/procuring the order to get supplied the machines from the company.
>
> ANSWER The employee of the liaison office was assigned the task to promote Brown & Sharpe Brand's products and to understand the Indian market. The performance judged by number of direct orders that the company received as well as extend the awareness of the Brown & Sharpe Company in India. There was an Incentive Plan which was based on assessment by the parent company about the extent of awareness

> of Brown & Sharpe in Indian market and the same has been established. With the result and taken into the demand of the market, the parent company of USA M/s Hexagon Metrology of Sweden has established Indian company namely Hexagon Metrology India Private Limited at the same address of this company in which I am the Managing Director."

The assessee also explained before the Assessing Officer in pursuance of a notice to show cause dated 13 February 2006 that initially it had an agent in India for the purpose of contacting buyers but during the year relevant to the assessment year, the assessee had set up a liaison office. The assessee also explained before the Assessing Officer that the activities of the liaison office also included various activities, for instance, coordinating the commercial activities like purchase orders, letters of credit and shipment. This was carried out through the office of the assessee at NOIDA by the Chief Representative Officer and other technical staff. The office also coordinated the technical service and sales visits of the company's representatives who visited India from the overseas office.

The disclosures which were made by the assessee before the Assessing Officer clearly indicate that during the year previous to the assessment year in question, the activities of the liaison office were not confined only to being a channel of communication between the Head Office in the US and prospective buyers in India. The activities of the liaison office included: (i) explaining the products to buyers in India; (ii) furnishing intimation in accordance with the requirements of the buyers; and, (iii) a discussion of commercial issues pertaining to the contract through the technical representative, after which an order was placed by the buyer directly. Apart from this, it is significant that the performance of the personnel in India was, as disclosed by the Chief Representative Officer, judged by the number of direct orders that the assessee received and by the extent of awareness of the assessee that was generated in India. The assessee had an incentive plan, and it is not in dispute, as was disclosed by the Chief Representative Officer, that in the sales incentive plan an employee was allowed to receive upto 25% of its annual remuneration as SIP. Whether or not any incentive was, in fact, paid to an employee during the year in question, is not material. What is relevant is that the nature of the incentive plan would clearly indicate that the purpose of the liaison office in India was not merely to advertise the products of the assessee or to act as a link of communication between the assessee and a prospective buyer but involved activities which traversed the actual marketing of the products of the assessee in India because it was on the basis of the orders generated that an incentive was envisaged for the employees. The assessee sought to explain away the incentive plan by stating before the Assessing Officer that the incentive which was provided for in the letters of the appointment was only "standard language of the appointment letter of the company", which had inadvertently not been deleted from the contract of appointment by the liaison office. Such an explanation was, to say the least, far-fetched because the assessee which has a transnational business with a range of advisors cannot readily be assumed to have committed an inadvertent mistake on an issue as significant as this. The Assessing Officer has quite justifiably declined to accept the explanation.

The Tribunal while affirming the order of the CIT (A) has relied upon relevant documentary material in arriving at the conclusion that the activities of the liaison office established that it was promoting the sales of the assessee in India and the Assessing Officer was justified in holding that

the income attributable to the liaison office was taxable in India.

In an appeal under Section 260A of the Act, this Court ought not to interfere with the aforesaid finding. There has been no perversity in the approach of the Tribunal nor has it misapplied itself either in fact or in law.

Reliance was sought to be placed in the present case on a decision of the Delhi High Court in U.A.E. Exchange Centre Ltd. v. Union of India and another6. That decision is distinguishable. This is evident from the nature of the activity which was carried on in that case by the liaison office in India of a company based in the UAE. This is evident from the following extract from the decision of the Delhi High Court:

> "The only activity of the liaison offices in India is simply to download information which is contained in the main servers located in the UAE based on which cheques are drawn on banks in India whereupon the said cheques are couriered or despatched to the beneficiaries in India, keeping in mind the instructions of the NRI remitter. Can such an activity be anything but auxiliary in character. Plainly to our minds, the instant activity is in "aid" or "support" of the main activity."

The liaison office, in that case, therefore, was only engaged in downloading information contained in the main servers located in UAE, based on which certain cheques were drawn in India and couriered to beneficiaries in India in accordance with the NRI remitter. This was held to be merely in aid or support of the main activity. In clear distinction, the Tribunal has correctly noted that in the present case, the liaison office was promoting the sales of the goods of the assessee company through its employees, to whom a sales incentive plan was provided for achieving a sales target and the performance of the employees was being judged by the orders secured by the assessee.

Similarly, in an earlier decision of the Delhi High Court in Director of Income Tax v. Noikia Networks OY7 it was held by the Tribunal that the liaison office was not carrying on any business activity for the assessee in India and that its role was only to assist the assessee in preliminary and preparatory work. In contrast, in the present case the activity of the liaison office during the year relevant to the assessment year was not of a preliminary or preparatory nature so as to attract the exclusion under Article 5(3)(e) of the DTAA.

For these reasons, we hold that Question Nos. 1, 2, 5 and 6 will not give rise to any substantial question of law.

We now deal with the alternative submission.

Article 7(1) of the DTAA provides that if an enterprise carries on business in the other contracting State through a permanent establishment situated therein, "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. The Assessing Officer did not apply his mind to this crucial requirement which defines the extent of taxability. The Assessing Officer followed a simplistic course of deducting the expenses of Rs.38.86 lacs from the receipts of Rs.63.72 lacs from the head office. Whether any part of the profits were attributable to the permanent establishment, has not been considered either in the order of the Assessing Officer or, for that matter, by the Tribunal. In this view of the matter, we are of the view that on the alternative submission, it would be appropriate and proper to restore the proceedings back to the Assessing Officer for a fresh determination of the extent of the taxable income having due regard to the provisions of Article 7 of the DTAA. The proceedings shall, accordingly, stand restored back to the Assessing Officer for that purpose.

The appeal is, accordingly, disposed of in the aforesaid terms.

There shall be no order as to costs.

Order Date :- 11.11.2014 SKT/-

(Dr. D.Y. Chandrachud, CJ.) (P.K.S. Baghel, J.) Hon'ble Dr. D.Y. Chandrachud, Chief Justice Hon'ble P.K.S. Baghel,J.

Disposed of.

For order, see our order of the date passed on the separate sheets (seventeen pages).

Order Date :- 11.11.2014 SKT/-

(Dr. D.Y. Chandrachud, CJ.) (P.K.S. Baghel, J.)