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Law of preparatory and auxiliary services**NOOPUR AGASHE**

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Background

With a dynamic culture, robust young population and ever increasing domestic demand, India, at the verge of completing third decade of economic liberalization and globalization, has always attracted foreign investment from around the world. According to United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2018, India acquired 11th slot in the top 20 countries attracting highest Foreign Direct Investment inflows globally in 2017.

With such pace of globalization and the complex international tax laws, the multinational corporates are often faced with a challenge in respect of the country in which the income derived by them from their operations in the host country shall be taxed. The Indian domestic tax regulation¹ provide that a non-resident taxpayer shall be liable to be taxed in India in respect of such income as is reasonably attributable to the business operations carried out in India. That apart, there are separate rules with regard to taxability of certain streams of income on gross basis. Thus, it may so happen that the income derived by multinational corporates from Indian operations may get taxed twice, once in India as well as in the home country in which such business entity is taxable on its worldwide income. This double taxation of income is not only detrimental to the business but also discourages the inflow of foreign investment in India.

In order to prevent such hardship of double taxation, India has signed Double Taxation Avoidance Agreements (DTAAs), with the Government of different countries. The DTAAs are in the nature of alternate taxation regime, which have been mutually agreed between India and the Government of other countries to act as a tie breaker on the taxing rights.

As per the DTAAs entered by India with various countries, the non-resident business is taxed in India only in respect of such business income as is attributable to the operations carried out by such business through a Permanent Establishment (PE) in India. Thus, PE becomes a determinative factor for the purpose of taxation of non-resident business in India.

A PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. While the definition per se looks clear and simplistic, however, a PE can take many shapes

(branch office, management office etc.) or implied forms (presence of expatriate employees in host country for certain activity). The DTAA's also provide certain exempt activities which do not lead to constitution of a PE in India.

These exceptional activities *inter alia* includes maintenance of a fixed place of business solely for the purpose of undertaking activities for the enterprise which have a preparatory or auxiliary character. It is pertinent to note that the term 'preparatory or auxiliary' is neither defined under the DTAA's nor has been defined under Indian domestic tax regulation. Further, the term, 'preparatory or auxiliary' has also not been defined in the UN or OECD Model Double Tax Convention. Accordingly, there is no specific guidance to determine whether or not the activities undertaken by a non-resident business in India would have a preparatory or auxiliary character and therefore, such determination has been a subject matter of litigation in India.

Meaning of 'preparatory or auxiliary' services

OECD commentary² does not define 'preparatory or auxiliary', however, it lays down the following key factors to analyze whether the activity is in the nature of preparatory/auxiliary nature or not

- ◆ Does the activity of the fixed place of business in itself forms an essential or significant part of the activities of the enterprise as a whole;
- ◆ Is the general purpose of the fixed place of business identical to the general purpose of the whole enterprise

If the answer to the above questions is in affirmative, the activity is typically not a 'preparatory or auxiliary' activity.

The concept of 'preparatory and auxiliary' has been examined by the Indian judiciary in the context of the following:

- ◆ Activities carried out by Liaison office of foreign entities in India
- ◆ Significance of the activities carried out by the Indian group entities vis-à-vis the overall activities of the foreign companies.

The Apex Court in the matter of *DIT (International Taxation) v. Morgan Stanley and Co. Inc.* [2007] 292 ITR 416/162 Taxman 165 (SC) had opined that the Indian group entity rendering back office support function to the parent entity was only rendering services of preparatory and auxiliary character and accordingly, the foreign parent entity did not have a PE in India. Though, while pronouncing the ruling, the Apex Court did not explicitly comment on what constitutes 'preparatory or auxiliary'. However, it can be inferred that the activities of the Indian group entity were not forming a significant and essential part of the activities of the foreign parent as a whole. Therefore, such activities were considered as preparatory or auxiliary activities.

The pronouncement of the Authority of Advance Rulings (AAR) in the matter of *K T Corpn. In re* [2009] 181 Taxman 94 (AAR) is also worth considering. In the said ruling the Applicant, a Korean company engaged in the business of telecommunication carriers/resellers, had opened a Liaison Office (LO) in India to act as a communication channel between the head office and the Indian companies within the parameters listed out by the Reserve Bank of India. The AAR ruled that since the Korean Company was not in the business of collecting of information, the activities performed by the LO, viz collecting a host of information concerning various Indian companies and transmitting them to the head office, preparation of reports dealing with India market scenario are in 'aid' or 'support' of the main activities of the Korean company and, accordingly, rest in the realm of preparatory and auxiliary activities.

On a similar note the Delhi High Court in the matter of *U.A.E. Exchange Centre Ltd. v. Union of India* [[2009](#)].[313 ITR 94/183 Taxman 495 \(Delhi\)](#) held that the activities of the Indian LO, viz downloading information which was contained in the main servers located in the UAE, drawing of cheque based on such information, dispatching of cheques to the beneficiaries in India, keeping in mind the instructions of the NRI remitter etc, was in 'aid' or 'support' of the main activity of the foreign entity. The Court noted that once an activity is construed as being subsidiary or in aid or support of the main activity, it would fall within the exclusionary clause.

In contrast to the above, there is the pronouncement of the Karnataka High Court in the matter of *Jebon Corpn. India v. CIT (IT)* [[2012](#)].[19 taxmann.com 119/206 Taxman 7 \(Kar.\)](#). In the said pronouncement, Jebon Corporation Assessee was engaged in the business of trading in semi-conductor components manufactured by various companies across world. It had set up a LO in India for performing liaisoning activities in India. However, basis the material on records, the Court observed that the LO was actually carrying out commercial activities of procuring orders, identifying buyers, negotiating with the buyers and agreeing to the price. It was only thereafter that the purchase orders were placed with the head office and the material was dispatched to the customers. The LO was also undertaking the activity of following up regarding the payments and offering after sale support. Therefore, the Karnataka High Court was of the view that the work done by the LO is not preparatory or auxiliary in nature.

Similarly, in the case of *Arrow Electronics India Ltd.* TS-142-ITAT-2017 (Bang.) the Bangalore Income Tax Appellate Tribunal (ITAT) opined that the activity of finding potential customers, price negotiations, concluding contracts etc. was not in the nature of 'preparatory or auxiliary'.

Recently the AAR in the matter of *Master Card Asia Pacific Pte. Ltd. In re* [[2018](#)].[406 ITR 43/94 taxmann.com 195 \(AAR - New Delhi\)](#), *interalia* observed that the activities performed by the card interface processor in India, viz. preliminary verification and encryption of data using the related network of transmission tower etc., was significant activity in the context of overall functions of transaction processing and thus, was not merely 'preparatory and auxiliary' in nature. Accordingly, such activities lead to constitution of PE of the foreign taxpayer in India.

From the discussion in the foregoing paragraphs it can be seen that there is no universal formula to determine when shall an activity be said to be in the nature of 'preparatory or auxiliary'. Every case has to be evaluated independently on facts on a periodic/annual basis in light of available jurisprudence.

Impact of Action plan 7 on the definition of preparatory and auxiliary services

Considering the rapidly evolving tax landscape, The Organisation of Economic Co-operation and Development (OECD) released the Action plan 7 under the Base Erosion and Profit Shifting Project. The Action Plan 7 has provided certain recommendations to suggest an end to this tug of war between the tax authorities and the tax payers.

As per the Action plan, a preparatory activity is the one that satisfies the following conditions :

1. *Nature test*: The activity is carried on in contemplation of the carrying on another activity (hereinafter referred to as second activity) whereby the second activity constitutes the essential and significant part of the activity of the enterprise as a whole.
2. *Duration test*: Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. However, the duration test will not always be determinative as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else.

Further, as per the report, an activity shall be of auxiliary character if it is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely

that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

In light of the above guidelines, as provided under Action plan, a particular activity may be deemed to be of 'preparatory' character if such activity is carried out merely in contemplation of another activity and such other activity forms an essential and significant part of the activities of the enterprise as a whole. At the same time, it is imperative to ensure that, although the activities may well contribute to the productivity of the enterprise, for these to qualify as preparatory, the services should be distant from the actual realisation of profits

Proving, with sufficient and adequate evidences, that the activities are being undertaken purely to support, without being part of, the essential and significant part of the activity of the enterprise as a whole, and thus being of auxiliary nature is essential to qualify a no PE situation.

Therefore, in the absence of any specific and definitive guidance, determination of 'preparatory and auxiliary' nature of an activity remains to be a factual exercise.

Conclusion

The concept of 'preparatory and auxiliary' continues to face new challenges in light of the evolving tax landscapes. For tax payers, it is all the more important to create a strong factual background coupled with strong underlying documentation.

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1. Income-tax Act, 1961 read with Income-tax Rules, 1962.

2. Even other international tax commentaries like Philip Baker etc. do not specifically define 'preparatory and auxiliary' activities.