VIII. RECENT CONTOURS IN INDIAN JURISPRUDENCE RELATING TO PERMANENT ESTABLISHMENT: SUBSTANCE OVER FORM

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ABSTRACT

The debate about the position of Permanent Establishment status concerning various projects/ operations undertaken by assessees remains endemic to the jurisprudence on tax liability. The multifarious developments which have inundated the subject matter calls for a need to carefully analyse contracts and project details before entering into them. The fact that PE plays a crucial role in determining the jurisdiction and tax liability of the assessee company, only makes it all the more pertinent to be studied in detail. The case of Director of Income Tax- II, New Delhi & Anr. v. M/s Samsung Heavy Industries Co. Ltd. becomes a landmark in this regard as it reaffirms the 'substance over form' doctrine while determining tax liability. It focuses on the procedural principle of conducting a 'look at' test while viewing the case in a holistic manner rather than splitting it into its component details. In this regard, the implications of the judgment for the Department and assessees vis-à-vis factual enquiry and the initial burden of proving PE have been studied. Therefore, the objective of this study is to elucidate the recent developments pertinent to determining PE status derived from international contracts with regards to the Double Taxation Avoidance Agreements, specifically the India-South Korea Double Tax Avoidance Agreement in the current case.

Introduction 150
Case Overview..... 151
Background..... 151
Arguments by the Revenue Authority……...153
Arguments by the Assessee (Samsung)…….....155
Decision of the Bench..... 156
Substance Over Form Principle..... 158
Substance Over Form – The Indian Scenario.....159
Analysis and Implications.....162

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I. INTRODUCTION

The rise of globalization, structural reforms in major economies, and the associated increase in the volume of international trade have led to constant friction between nations about policy matters related to international trade. One such area of conflict between nations that trade with one another is taxation. This has naturally led to a plethora of developments in the domain of Permanent Establishment ("PE"), a subject that is constantly evolving and maturing with the flows of international trade. India, over the past few decades, has embraced this universal trend of globalization and structural reforms. Being a developing country, it has aggressive revenue authorities/agencies which means that the concept of PE in India is highly dynamic in nature.

In light of the same, the Hon'ble Supreme Court of India gave a verdict that has significant implications for the concept of PE, its determination, and other correlated aspects. This judgement named *Director of Income Tax-II (International Taxation) New Delhi & Anr. v. M/s Samsung Heavy Industries Co. Ltd*.[1] is important due to a few facets/aspects of PE that it sheds light on. Firstly, due to its specificity on turnkey projects, which are often viewed as singular, indivisible contracts. Secondly, as it lays down in specific terms that the PE of a foreign enterprise/assessee can only be determined by a detailed factual enquiry and not merely by the prima-facie conclusions. Lastly, the case reiterates that the initial burden of proving that a foreign enterprise/assessee has PE in India lies on the Tax/Revenue Department.

[1] Director of Income Tax - II (International Taxation), New Delhi & Anr. v. M/s Samsung Heavy Industries Co. Ltd., 2020 SCC OnLine SC 590.

The case also clarifies the PE of a Project Office/Liaison Office ("PO") with reference to, inter alia, Article 5 of the 'Agreement for Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion' with the Republic of Korea ("DTAA").[2] Furthermore, it clarifies and reiterates the positions of the Hon'ble Court in various precedents dealing with the concept of PE and the Income Tax Act, 1961.[3]

II. CASE OVERVIEW

A. Background

The facts in the instant case originated in 2006 when a 'turnkey contract' was awarded by Oil and Natural Gas Corporation ("ONGC") to a consortium which included M/s Samsung Heavy Industries Co. Ltd. ("Assessee"/"Samsung"/"Company"). In the same year, Samsung set up a PO in Mumbai to establish a 'communication channel' between itself and ONGC. The assessee carried out activities in pursuance of the contract such as pre-engineering, survey, engineering, procurement, and fabrication, in 2006. It is imperative to note here that these activities were carried out abroad. Starting in 2007, platforms associated with the project were brought outside Mumbai for installation. In August 2007, the assessee filed a return for the Assessment Year ("AY") 2007-2008, wherein the assessee showed nil profit due to a loss of Rs. 23.5 lakhs in relation to its activities carried out in India.

[2] Agreement for Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion with Korea, India-Korea, August 19, 1985, MINISTRY OF FINANCE, No. GSR 111(E), (Notified on September 26, 1986).
[3] The Income-Tax Act, 1961, No. 43, Acts of Parliament, 1961, (India).

The Department took note of this return and subsequently, in 2008, served a show-cause notice to the assessee which required them to explain the nil return filed. The assessee replied to the show cause notice in 2009. The Assessing Officer ("AO") examined the reply as well as the terms of agreement and passed a draft order. The AO concluded that the project was a single, indivisible turnkey project wherein the entire scope of work was wholly executed by the PO which constitutes a PE in India, and thus consequently, the profits arising from such project would be taxable in India. The draft order further went on to attribute 25 percent of the revenue earned outside India as being the income that was eligible to tax in India.

The case then proceeded to the Dispute Resolution Panel ("Panel") which considered the objections of Samsung and subsequently affirmed the findings of the AO. The Panel had examined data about similar projects to conclude that the figure of 25 percent arrived at by the AO is justified. The draft order was made final by the AO in 2010.

The assessee then filed an appeal before the Income Tax Appellate Tribunal ("ITAT").[4] The ITAT went into great detail and examined the application submitted by the assessee to the Reserve Bank of India ("RBI") for opening the project office, the board resolution authorizing opening the project office, and the subsequent RBI approval for opening the office. Whilst agreeing with the AO on the indivisibility of the contract, it observed that with the amount of material on hand, it was not possible to ascertain the profits

[4] Samsung Heavy Industries Co. Ltd. v. ADIT, (International Taxation) Dehradun, 2011 SCC OnLine ITAT 7454.

attributable to the Mumbai PO and sent the case back to the AO for ascertaining the same.

The decision of the ITAT was appealed by the assessee before the Hon'ble Uttarakhand High Court.[5] Substantial questions of law relating to the status of the PO under the DTAA, activities executed by the PO, income attributable to PE, and divisibility of the contract were raised in the said appeal. Subsequently, the Hon'ble High Court allowed the appeal and ruled in favour of the assessee. It observed, inter alia, that tax liability could not be fastened on the appellant without proving that the revenue was attributable to the tax identity/PE of the appellant in India. Thus, the Hon'ble High Court did not decide on the substantial questions of law raised in the appeal and merely stated that attribution of income to the PE was not established by the Department/Revenue Authority with sufficient evidence.

Aggrieved by this judgment of the Hon'ble Uttarakhand High Court, the revenue authorities appealed against the same in the Hon'ble Supreme Court, thus leading to the present case. The matter came up before a bench consisting of Justice R.F. Nariman, Justice Navin Sinha, and Justice B.R. Gavai. Both sides made detailed arguments by using precedents and differentiating them, which are detailed hereunder.

B. Arguments by the Revenue Authority

- The Additional Solicitor General (appearing for the revenue authorities) ("ASG") argued that the project here was a 'turnkey'

[5] Samsung Heavy Industries Co. Ltd. v. Director of Income Tax - I (International Taxation), New Delhi, 2013 SCC OnLine Utt 4016.

project and thus is an indivisible contract, thereby meaning that the entire revenue would be taxable in India.

- The authorities then distinguished the judgment in *Commissioner of Income Tax and Another v. Hyundai Heavy Industries Co. Ltd.* [6] *(Hyundai)* from the facts in the present case. It was stated that the contract in Hyundai was a turnkey contract that could be bifurcated into two parts as there were two separate agreements in that instance. One agreement dealt with design, manufacture, erection, etc. and another dealt with the installation. It was observed that the PE herein was established during the installation phase, long after the revenue had been earned in the previous agreement.
- The ASG also distinguished the facts in this instance from the facts in *DIT (International Taxation) v. Morgan Stanley & Co. Inc.*[7] and stated that the judgment of the Hon'ble Uttarakhand High Court was cryptic and that no substantial questions were answered in it.
- The ASG relied on documents examined by ITAT to argue that the Mumbai office was connected to the 'core' activities of the business. He further argued that in the absence of figures given by the assessee, a 'best judgement' had to be made based on profits which can be attributed to the PE. The 'best judgement' so made was not accepted by the ITAT and was remanded back to the AO. Thus, the ASG concluded that there was nothing wrong with the order of the tribunal

[6] Commissioner of Income Tax and Another v. Hyundai Heavy Industries Co. Ltd., (2007) 7 SCC 422.
[7] DIT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 7 SCC 1.

and that the order should not have been interfered with by the High Court.

In a nutshell, the revenue authorities argued that the contract was an indivisible one, the PO was involved in core business activities and thus revenue attributable to the PO/PE would be eligible to tax in India.

C. Arguments by the Assessee (Samsung)

- The assessee stated that the PO in Mumbai consisted merely of two employees and that neither had any technical qualifications necessary for the core functions of the project.
- The assessee produced audited accounts to show that the PO had incurred no expenditure on the project. It was further argued that even assuming that the PO carried out core activities, no taxable income can be attributed to it as the audited accounts show that there were no profits made.
- The assessee relied on the Hyundai case to argue that profits (if any) arising from activities outside India cannot be attributed to the PO in India. It was further argued that the facts in the Hyundai case are the same as the facts in the present case and that the decision in Hyundai would squarely apply herein.
- Finally, it was argued that the initial burden of establishing that a foreign assessee has PE lies squarely on the revenue authorities and that this burden was not discharged in the present case.

Thus, the arguments of the assessee centred around the office not being involved in core activities, the audited accounts not showing any expenditure

or profit, the department not discharging its duty of proving that a PE exists, and precedents supporting the position of the Company.

D. Decision of the Bench

After hearing the contentions from both parties, the Bench examined Article 5 & Article 7 of the DTAA and allied decisions,[8] and laid down the following points which enunciate its position on the subject matter:

For the ascertainment of PE (and the applicability of Article 5.1 of the DTAA), it is imperative that there must be an establishment through which the business of an enterprise is carried out either wholly or in part.

For the business profits of a foreign enterprise to be taxed in India, there must be a PE engaged in the core business of such foreign enterprise. Only the profits attributable to such PE can be taxed in the country where it is situated.

As per the provisions of Article 5, an enterprise would not be considered a PE when the fixed place of business is of preparatory or auxiliary character.

The Bench then examined the board resolution, the letter to RBI, and the subsequent RBI approval to come to its conclusion in the present case. It held that:

[8] *See* Ishikawajma-Harima Heavy Industries Ltd. v. Director of Income Tax, Mumbai, (2007) 3 SCC 481; Asst. Director of Income Tax, New Delhi v. E-Funds IT Solution Inc. (2018) 13 SCC 294; Commissioner of Income Tax and Another v. Hyundai Heavy Industries Co. Ltd., (2007) 7 SCC 422; DIT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 7 SCC 1.

A reading of the above documents shows that the PO was established to coordinate and execute delivery documents. Thus, the finding of the ITAT that the Mumbai PO was involved in core activity was perverse.

Audited accounts maintained by the PO show that no expenditure was incurred towards the project/contract itself and that there was no profit. The tribunal had rejected these accounts and had held that the mere mode of maintaining accounts is not sufficient to determine the character of the establishment. The Bench held that this finding was also perverse and set it aside.

The position of the ITAT regarding the onus of the assessee to prove that the PO was not involved in core functions, was also found to be perverse. It reiterated the principle laid down in *Asst. Director of Income Tax, New Delhi v. E-Funds IT Solution Inc.*[9] that the onus is on the Department to prove that PE of a foreign assessee exists.

The Court also noted the finding that only two persons worked in the Mumbai PO and both of them were not qualified to be involved in core activities for the execution of the project. With all the above findings summed up, the Bench concluded that there was no PE within the meaning of Article 5 of the DTAA. Furthermore, the Bench also concluded that the PO is merely an auxiliary office and thus falls in the ambit of the exclusionary clause under Article 5(4)(e) of the DTAA.

[9] Asst. Director of Income Tax, New Delhi v. E-Funds IT Solution Inc., (2018) 13 SCC 294.

In light of the above findings, the authors would now examine the above decision in light of the principle of 'substance over form' along with the relevant contextual background for the same.

III. SUBSTANCE OVER FORM PRINCIPLE

The 'substance over form' or the 'economic substance' doctrine has evolved in the global tax regime and purports to redefine the legitimate tax net. It provides guidance to tax departments while attaching legitimate concerns and inquiring into suspicious transactions which seemingly employ tax evasion measures to avoid the tax grid. Statutorily defined as "the prevalence of social and economic reality over the literal wordings of the legal provision,"[10] the doctrine keeps a check on aggressive tax planning strategies adopted by corporations and other entities. It seeks to avoid unfair benefits to businesses on account of any grey areas in tax treaties and legislations. Thus, the principal advocates a check on certain germane issues like sham[11] and step transactions,[12] business purpose, and economic substance.[13]

One of the earliest applications of this doctrine can be traced back to the American case of *Gregory v. Helvering*,[14] wherein the US Supreme Court concurred with the decision of the Commissioner of Internal Revenue that the corresponding corporate reorganisation was solely a means to evade tax liability. Although the form of the transaction was legal, in substance and spirit

[10] OECD, International Tax Avoidance and Evasion, Double Taxation Conventions and the Use of Base Companies, Issues in International Taxation, No. 1, OECD, Paris, 1987.
[11] *See* Knetsch v. United States, 1960 SCC OnLine US SC 151.
[12] *See* Ramsay (W.T.) Ltd. v. IRC, 1982 AC 300.
[13] *See* Yosha v. Commr., 861 F 2d 494 (7th Cir 1988); Frank Lyon Co. v. United States, 1978 SCC OnLine US SC 61.
[14] Gregory v. Helvering, 1935 SCC OnLine US SC 6.

it was a violation of the law. Hence, a question over the conformity with the letter of law versus the intent of the act was raised and the Court held that the ultimate test for legality of a transaction would be its conformity with the intendment of a statute. Thereby, it gave primacy to the intent or substance of the transaction. However, considerable uncertainty regarding the 'economic substance' doctrine was observed in the global legal fraternity, especially with the ruling in the *Westminster case*[15] which somewhat favoured the 'form over substance' doctrine. The judgment ascribed legitimacy to tax planning measures as long as they did not breach the legal threshold, emphasizing the difference between tax avoidance and illegal tax evasion practices. It was so held,

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[16]

Thus, unlike *Gregory v. Helvering*, a case for drawing a distinction between legitimate and illegitimate arrangements of breaching the object of the statute can be observed in *Westminster*, hence forwarding the 'form over substance' principle.

A. Substance Over Form – The Indian Scenario

The period ensuing these landmark judgments was characterized by several judicial attempts to provide some conceptual clarity to rules applied

[15] Duke of Westminster v. Inland Revenue Commissioners, [1935] UKHL 4.
[16] *Id*. at 19- 20.

globally. However, the major lacuna of failing to define 'substance' in terms of either economic or legal substance was prominently observed. This lack of consistent approach could also be seen in the Indian legal framework where a tussle between a strict and more purposive interpretation of tax statutes remained pertinent. *McDowell and Co. Ltd. v. CTO*[17] was important in this regard that it had imported the 'substance over form' doctrine by diffusing the distinction between tax avoidance and tax evasion and holding them in a similar light. It pressed on an individual's duty of paying their tax liabilities without resorting to any subterfuges, thereby narrowing down the definition of legal tax planning. This view was, however, not followed in the Division Bench judgment of *Azadi Bachao Andolan*[18] which reverted back to the 'form over substance' principle.

Over the years, the judiciary has vacillated between adopting a literal/strict interpretation of statutes and a purposive one established on facts and documentary evidence. In *Ardex Investments Mauritius Ltd.*,[19] it was held that while determining the substance of a transaction, the Department must undertake an objective test based on documentary evidence and lifting the corporate veil, rather than presuming the transaction to be a sham. It must be noted here that while the literal interpretation is given primacy,[20] the judiciary has evolved to adopt a construction favourable to the assessee in case of any uncertainty or ambiguity regarding the statutory interpretation. Thus, if the transaction does not specifically fall under the provision, the scope of the tax

[17] McDowell & Co. Ltd. v. CTO, AIR 1986 SC 649.
[18] Union of India v. Azadi Bachao Andolan, (2004) 10 SCC 1; *See also* Gujarat State Financial v. M/s. Natson Manufacturing Co., (P) 1978 AIR 1765.
[19] Ardex Investments Mauritius Ltd., *In Re*, 2011 SCC OnLine AAR 26.
[20] A. V. Fernandes v. State of Kerala, AIR 1957 SC 657; Innamuri Gopalam v. State of A. P., 1964 2 SCR 888.

statute must not be unnecessarily widened to implicate the assessee.[21] On the other hand, if the taxing provisions are unambiguous, full thrust must be given to them without any consideration of equity.[22] It is also established that a liberal interpretation must give way to a reasonable one to avoid causing any infraction to the plain language of the statute.[23]

Hence, it becomes quintessential for the Department to analyse the factual matrix of the case while determining the nature of the transaction, i.e., whether the 'investment transaction is for participation' or is it a 'pre-ordained transaction for tax evasion'. Some guidance in this regard has been provided in the *Vodafone case*[24] wherein a few parameters were laid down by the Hon'ble Supreme Court to distinguish between the same; namely the concept of participation, period of existence of the holding structure, period of business in India, generation of taxable revenues, the time of exit and continuity of business during such time. The Apex Court, in this case, ruled that the Department must employ the 'look at' test by looking at the transaction holistically rather than the 'look through' test by splitting/dissecting the transaction. The Court also advised against the authorities reaching any premature conclusions premised on suspicions and cautioned against applying the 'substance over form' test until evidence was found indicating the duplicitous nature of the transaction. Thereby indicating the importance of the initial factual and functional assessment based on the 'look at' test and

[21] State of Punjab v. Jullundar Vegetables Syndicate, 1966 SCR (2) 457.
[22] CIT v. Madho Pd. Jatia, (1976) 4 SCC 92.
[23] CIT v. N.C. Budharaja & Co., 1993 SC 2529.
[24] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.

substance over form principle undertaken by revenue authorities while determining tax liability cases.

Additionally, the incorporation of General Anti-Avoidance Rules ("GAAR"), amendments to various DTAAs like those with Mauritius[25] and Singapore,[26] and the Joint Declaration for the Implementation of Automatic Exchange of Information ("AEoI")[27] with Switzerland in November 2016 indicate a paradigm shift in national and transnational tax frameworks towards substance over form principle. Apropos to the above discussion, the authors have herein attempted to analyse the judgment based on this key principle.

IV. ANALYSIS AND IMPLICATIONS

The Samsung case assumes primary importance as it imports the principle of substance over form in determining the tax liability of a project based on its permanent establishment status. The Apex Court in this case rightly observed that the PO in Mumbai was not involved in any 'core' activities of the corporation, thereby reducing the argument of it attracting any

[25] *India-Mauritius DTAA Amended to Tackle Round Tripping of Funds*, TAXGURU (May 10, 2016), https://taxguru.in/income-tax/indiamauritius-dtaa-amended-tackle-tripping-funds.html; *See also, India and Mauritius sign the Protocol for amendment of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains,* PRESS INFORMATION BUREAU, MINISTRY OF FINANCE, GOVERNMENT OF INDIA (May 10, 2016, 6: 12 PM), https://pib.gov.in/newsite/PrintRelease.aspx?relid=145185.

[26] *India and Singapore Sign a Third Protocol for Amending DTAA*, TAXGURU (Dec. 30, 2016), https://taxguru.in/income-tax/india-singapore-sign-protocol-amending-double-taxation-avoidance-agreement-dtaa.html.

[27] *Id*.; *See also* India-Switzerland Joint Statement during the State Visit of the President of the Swiss Confederation to India (August 30-September 02, 2017), MINISTRY OF EXTERNAL AFFAIRS, GOVERNMENT OF INDIA (Aug. 31, 2017), https://mea.gov.in/bilateral-documents.htm?dtl/28908/IndiaSwitzerland_Joint_Statement_during_the_State_Visit_of_the_President_of_the_Swiss_Confederation_to_India_August_30September_02_2017.

tax liability to naught. It becomes imperative to note that Article 5(1) of the DTAA delineates a 'fixed place' PE as one through which the business operations of the assessee are either wholly or partially carried out. The operations in question must form the 'core' activity of the assessee. Mere maintenance of a fixed place of business that is of auxiliary or preparatory nature cannot be termed as a PE and would therefore attract the exception under Article 5(4)(e). Thus, the Court by observing that the PO only had two employees who were not qualified to perform the 'core' functions of business, held that the branch was simply like an 'auxiliary' liaison office between the contracting parties. The question of attaching any 'economic substance' to the operations of the Mumbai office, therefore, does not arise. Additionally, R. F. Nariman, J. qua the Court laid special emphasis on the 'intention' behind the Board of Directors' resolution passed in the Company's Seoul office on April 3, 2006, pursuant to which the Mumbai PO had been established. The Revenue Department's failure in observing that the establishment of the PO at Mumbai, India was for coordination and execution of "delivery of documents in connection with the construction of offshore platform modification of existing facilities for ONGC" was also highlighted.

Another fallacy of the Department that the Hon'ble Supreme Court underlined was the failure to apply the 'look at' test while determining the Assessee's tax liability. As held in the *Vodafone* case, a holistic overview of the factual matrix of the case must be adopted by tax authorities. It remains a settled position in procedural law that an exhaustive functional and factual assessment of the case must be conducted by the Department while making the 'best judgement' assessment. The Department has to initially establish a *prima facie* case by proving the existence of a duplicitous act or that the

business was not conducted at the arm's length principle. Unless this is achieved, it would be arbitrary and somewhat presumptuous of the Department to prematurely shift the burden of proving the legality of the transaction on the assessee. In the present case, the ITAT had thus erred by directing the assessee to prove the existence of the preparatory or auxiliary nature of its Mumbai office. This failure to discharge the initial burden of proof by the Department has also been noted by the Uttarakhand High Court in the impugned order.

Hence, it can be inferred from the above discussion that tax authorities have the paramount responsibility of conducting a holistic factual and functional analysis of the case at hand. The initial burden of proving the existence of a PE lies with the Department. The Samsung case sets good precedence in this regard by importing the ‘substance over form’ principle in PE cases and attaching importance to the intention behind contracts. It becomes imperative to give supreme importance to the intention behind the conduct of business between the contracting parties. Simultaneously, a contextual analysis of the contract between the parties must be conducted. Thus, it can be safely deduced that using the 'look at' test and ‘substance over form’ doctrine when determining tax liability with regards to permanent establishment status is quintessential.

This judgment is therefore seminal as it sets an operative precedent of the construction and interpretation of DTAAs and other tax statutes with regards to the qualification of a PE business unit. The case reiterates the importance of conducting a deep factual and functional inquiry by the revenue authorities before shifting the burden on assessees. It further establishes that in cases where multiple interpretations of the tax statute are

possible, preference must be given to the one favourable to the assessee. The position of the ‘substance over form’ principle and the holistic ‘look at’ test is also buttressed through the said judgment. In addition to this, the case sets forth a lucid position regarding the attraction of tax liability in the country along with the importance of having a precise intention before entering into multinational contracts. This consideration would prove to be helpful for potential foreign investors who are looking to set up projects in the country, thereby establishing the judgment's precedential value.