Liaison office Taxation: Factual functional test

1.There has been litigation on whether activities carried out by a liaison office (LO) constitute permanent establishment of the foreign entity in India or not?

2.The income generated by the foreign parent entity should not be attributable to LO since it does not undertake commercial activities (and merely acts as a communication channel), but in practice, LOs are often exposed to PE primarily for two reasons. Firstly, by invoking the business connection between the LO and its parent foreign entity in terms of section 9(1)(i) of the IT Act and secondly, LO falling within the definition of PE under Article 5 of the relevant tax treaty.

3. It can be noted that there are few exceptions are carved out in the relevant tax treaty (Article 5(3) of DTAA) which mentions that if the activities carried by the LO are preparatory or auxiliary in nature, PE is not constituted. However, judicial precedents in India have been inconsistent in examining if the LOs activities are preparatory or auxiliary in nature for the reason that the facts in the said disputes were different.

4.The terms 'preparatory' and 'auxiliary' were neither defined in the Income Tax Act, 1961 nor the Tax Treaty. The test of 'preparatory and auxiliary' becomes very difficult to apply, due to factual subjectivity. There are precedents which provide guidelines for the 'preparatory and auxiliary' test such as (i) to check whether the activities performed in the fixed place of business form an essential and significant part of the enterprise as a whole, (ii) whether the activities performed in the fixed place of business form part of the core business activities of the enterprise.

5.The onerous conditions specified in the RBI Approval Letter to be a determining factor to decide that whether the activities of the Taxpayer are of a preparatory or auxiliary character or not?

6.It can be noted that Article 13 of the Multilateral Instrument (MLI) deals with the artificial avoidance of PE through specific activity exemptions i.e. activities which are preparatory or auxiliary in nature.

7.It provides two options i.e. ‘Option A’ which does not change the list of activities already negotiated between the countries. It ensures that all such activities (or combinations of activities) must be of a preparatory or auxiliary nature in order to qualify as exempt activities and ‘Option B’ which provides that any activity already existing in the tax treaty which is not specifically required to be of a preparatory or auxiliary nature may continue to fall within the specific activity exemptions.

8. All activities (or combinations of activities) not already mentioned in the existing tax treaty must be of a preparatory or auxiliary nature to qualify under the specific activity exemption. Further Article 13(4) of the MLI tackles the issue of multinational enterprises splitting up their business activities or altering their structures in order to take the benefit of the specific activity exemptions.