Permanent Establishment and 'Virtual Projection': The Case of Nokia Networks

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Shilpa Goel (Editor) (Tax Lawyer)

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Can an Indian subsidiary be said to be the permanent establishment of its overseas parent on the ground that it is a virtual projection of the latter even if the tests explicitly stipulated in the permanent establishment Article of a tax treaty are not met? This was one of the main questions that recently came up for consideration before India's Income Tax Appellate Tribunal, New Delhi in the case of *Nokia Networks OY vs. ICIT* (June 2018). But hasn't the OECD already answered this question in its Commentary to Article 5(7) of the Model Convention in the following words: "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 is not the OECD view alone – it is a cardinal principle of corporate tax law that a subsidiary has separate legal existence from that of its parent and must be treated as a separate legal entity for most purposes, including for tax purposes, except only in limited circumstances.

The majority judgment in *Nokia Networks* concurs with this view, but a dissenting member of the bench reached a completely different conclusion (grounded on a sound, powerful reasoning). I will come to the dissenting judgment later in the article, but first let me discuss the approach taken by the majority members. According to the majority judgment, under Article 5 of the India-Finland tax treaty, an Indian subsidiary cannot be treated as a permanent establishment of its foreign parent unless it met the physical or representative presence test set out in the tax treaty. The majority view was that, based on the facts and circumstances of the cases as well as an examination of judicial precedents on permanent establishment, especially the law as laid down by the Supreme Court of India in the celebrated case of *Formula One World Championship Ltd* (which I discussed in an earlier blog here), Nokia's Indian subsidiary cannot be said to be a permanent establishment of Nokia Finland.

No physical or representative presence

Specifically, the majority ruled that the Indian subsidiary was not a fixed permanent establishment of Nokia Finland because the subsidiary merely provided administrative support services (such as telephone or fax or conveyance services) to Nokia Finland's employees. The majority members rejected the Revenue's contention that the subsidiary was a dependent agent permanent establishment of Nokia Finland (as it exercised full control over the management and other activities of the subsidiary). Again, this is an obvious reiteration of the cardinal principle that the mere fact that the activities of a subsidiary are controlled by its parent does not make the former a dependent agent permanent establishment of the latter. Not only does Article 5 of the tax treaty not say that a subsidiary can by default be the permanent establishment of its parent, the Article also explicitly states that for a representative presence to exist, the dependent agent must routinely conclude contracts on behalf of the foreign enterprise.

Specifically, the majority observed that the subsidiary did not have any authority to habitually conclude supply contracts on behalf of Nokia Finland because the entire transaction relating to supply of off-shore equipment was undertaken by Nokia Finland outside India. The subsidiary was an independent legal entity which entered into independent marketing agreements with Nokia Finland and installation and technical support agreements with Indian customers and was taxed in India on profits arising from such activities. Furthermore, the off-shore supply of equipment by Nokia Finland had no correlation with the services rendered by the subsidiary because supply contracts were entered between Nokia Finland and the Indian customers.

Importantly, the India-Finland tax treaty does not contain a service permanent establishment Article so the fact that the parent deputed its employees to provide technical assistance to its Indian subsidiary in relation to certain installation works carried out in India (on a principal to principal basis) did not add much substance to the Revenue's case. In any event, in the majority's view, the activities carried out by Nokia Finland in India constituted preparatory and auxiliary services and, therefore, fell outside the definition of permanent establishment.

Virtual projection and permanent establishment

Now, I come to that one important aspect of this case that left the bench divided (resulting into a dissenting opinion by one of the members): can a subsidiary be said to be a permanent establishment of the foreign parent because the former is a virtual projection of the latter (even if other conditions of Article 5 are not met)? The Revenue's position was that the subsidiary was nothing but a "virtual projection" of Nokia Finland and the legal identity between the subsidiary and Nokia Finland was somewhat blurred.

The dissenting opinion – while one may disagree with it – provides forceful reasons that merit appreciation. The dissenting opinion notes that a subsidiary should be treated as a permanent establishment of its foreign parent for the reason that "the way and manner in which it carries out its business activities, it is nothing but an avatar of, a virtual projection of, or an extension of, its foreign parent." According the dissenting member, a subsidiary should be termed as "unassociated" or "indirect" permanent establishment (as against "associated" or "direct" permanent establishment comprising office, branch etc.) and the fixed place of business test and disposal test are not relevant to cases of "unassociated" or "indirect" permanent establishments.

This reasoning throws an important question: can the concepts of direct or indirect permanent establishments be read into the tax treaty? The question is not whether a subsidiary can be said to be a virtual projection of its foreign parent. The question is whether a permanent establishment can be said to exist in vacuum (using the concept of virtual projection) if the tests of permanent establishment as contained in the tax treaty (and as universally applied) are not met? The majority view was that the concept of virtual projection is not a standalone concept and for any foreign company to have a virtual projection in India, the foreign company must meet the requirements of Article 5. In other words, the concept of virtual projection does not mean that even without meeting the definition in Article 5, virtual projection itself will lead to an inference of a permanent establishment.

No doubt, the OECD provides clear guidance on these issue. However, according to the dissenting member, the OECD guidance cannot guide Indian courts – at least, not always! As I noted in my earlier blog here, foreign businesses who make profits out of business activities carried out in India must pay income tax in the country. But any tax collected must be in accordance with the provisions of the tax treaty. The tax authorities will naturally seek to interpret and apply the permanent establishment principle in future using the dissenting opinion as tool, which is scarcely in line with settled principles of international tax law and past judicial precedents. Would this mean increased uncertainty, riskier investments, and an increase in tax disputes? Time will tell.