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GENERAL ANTI-AVOIDANCE (ABUSE) RULES

- UK GAAR consultation document vis-a-vis Indian GAAR as enacted by Finance Act, 2012
- GAAR Guidelines : Haste & Caught in between
- GAAR in the UK - A carefully planned approach
- Framework for UK GAAR Unveiled

WITHHOLDING TAX

- Dichotomy between reimbursement of expenses and payment for services
- The Grand PAN League - Karnataka High Court hits a Sixer!
- A silver lining for software industries after the extended royalty regime

PERMANENT ESTABLISHMENT

- Aramex Ruling: The AAR Redefines Permanent Establishment
- Liaison Office - Taxability in India

SAFE HARBOUR

- OECD's Revisions in the Frontier of Safe Harbour

MFN CONCEPT

- Most Favoured Nation Clause - A hidden treasure!

INTEREST vs BILL DISCOUNTING CHARGES

- Interesting ruling on taxation of interest and bill discounting

ROYALTY/FTS

- B4U International Holdings Limited - Will aiming the tax net skyward help tax authorities expand their horizons

+

- Boston IFA, 2012
- World Tax Review
- US Updates
- Mauritius Updates
- Case Laws

TOTAL NO. OF PAGES WITH COVER : 100 • SINGLE COPY ₹ 700

Rano Jain*

Liaison Office - Taxability in India

MEANING

A Liaison Office (LO) is primarily in the nature of a representative entity set up in India by an overseas entity. Most of the times, it is set up in order to test the suitability of local conditions before starting a full fledged operation.

Any entity intending to open a liaison office in India has to first take the permission from the Reserve Bank of India.

A liaison office may be subject to certain restrictions, which may include, among others:

1. It cannot carry any commercial operation in India.
2. It has to open a special account in a bank, which only allows inflow from the foreign countries.
3. It can neither borrow, nor lend money.
4. All expenses must be met through inward remittances from abroad.
5. It must file regular returns to the RBI, with audited annual accounts and an activity report for the year.

At the time of closure of the liaison office, RBI grants permission to repatriate the balance in Indian bank account to the parent company.

As per Foreign Exchange Management (Establishment in India of a Branch or Other Places of Business) Regulations, 2000, pursuant to which the RBI issues notifications setting out guidelines concerning the establishment in India any place of business, an LO shall not carry on any activity other then the ones for which approval has been granted by the RBI.

2. Controversy

Since the liaison office is not permitted to earn any income, normally it should not constitute a taxable entity in India. However, under the Income-tax Act, nomenclature is not always conclusive, one has to look for the substance behind a particular transaction. There may be cases where in the guise of a liaison office an entity may be doing certain transaction which in substance may lead to taxability in India. This fact has led to a large amount of litigation, whereby the Income-tax Department alleges the liaison office of a foreign entity to be indulging in transactions leading to taxability in India.

3. Relevant provisions

In order to understand the controversy and the arguments of both the sides, one should first understand the relevant provisions leading to the controversy:

3.1 Section 5 of the Income-tax Act

Section 5 of the Act deals with the scope of the total income. Sub-section (1) relates to total income of a resident. Sub-section (2) is attracted in the case of a non-resident. It says that the total income of a non-resident shall include all income from whatever source

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derived, which is received or deemed to have been received in India in any previous year by or on behalf of such person. Clause (b) of sub-section (2) provides that the total income of a non-resident includes all income, from whatever source, which accrues or arises or is deemed to accrue in India during such year.

3.2 Section 9 of the Income-tax Act

As per section 9 of the Act, all incomes accruing or arising whether directly or indirectly through or from any business connection in India or from any property in India or through any assets or source of income in India or through transfer of a capital asset situated in India, shall be deemed to accrue in India. The mandate contained in the *Explanation* to the section is that for the purpose of the said clause, where the business of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only that part of the income as is reasonably attributable to the operations carried out in India.

To attract the provisions as referred above, it must be shown that

(*i*) The assessee has 'business connection' in India; and

(*ii*) The income of the business can be deemed to accrue or arise in India from such operations as are carried out in India.

The *Explanation* limits the quantum of taxable income so deemed to accrue or arise only to such part of income as is reasonably attributable to the operations carried out in India.

The expression 'business connection' was not defined for the purpose of the above provision, before 31st March, 2003. By Finance Act, 2003, two *Explanations* were inserted, after the then existing *Explanation*, which is numbered as *Explanation* 1 of sub-section (1) of section 9, w.e.f. 1st April, 2004. *Explanation* 2 contains an inclusive definition; it brings in the business activities specified in cls. (*a*) to (*c*), within the fold of "business connection" which has to be understood in its ordinary meaning.

In view of the above provisions, the essential features of "business connection" may be summed up as follows:

(*a*) Habitual exercise of an authority to conclude contracts on behalf of the non-residence, except in cases this activity is limited to purchase of goods and merchandise on his behalf.

(*b*) Having no authority as aforesaid, keeping and maintaining and also delivering out of, the stock on behalf of the non-resident.

(*c*) Habitually securing orders or being subject to the same control.

(*d*) A real and intimate relation must exist between the trading activities by a non-resident carried on outside India and the activities within India

(*e*) The relation contributes directly or indirectly to the earning of income by the non-resident in his business

(*f*) A course of dealing or continuity of relationship and not a mere isolated or stray nexus between the business of the non-resident outside India and the activity in India, would furnish a strong indication of business connection.

3.3 Section 90 of the Income-tax Act

The provisions of section 90 of the Act empower the Central Government to enter into an agreement with the government outside India for the purpose of granting certain reliefs. It is well settled that where India has entered into a treaty for avoidance of double taxation as also in respect of aspects referred to in section 90 of the Act, the contracting states are governed by the provisions of the treaty. The treaty overrides the provisions of the Act. In case an agreement is entered into by the government of India, which is notified under section 90 of the Act, the same will govern the liability to tax, in respect of those to whom the treaty applies.

Here it is evident to mention the Apex Court in the case of ***CIT* v. *P.V.A.L. Kulandagan Chettiar* [2004] 267 ITR 654/137 Taxman 460**,whereby it was held that where liability to tax arises under the local enactment, the provisions of sections 4 and 5 of the Act provide for taxation of global income of an assessee chargeable to tax thereunder, then it is subject to the provisions of an agreement

entered into between the Central Government and the government of a foreign country for avoidance of double taxation as envisaged under section 90 to the contrary. If any, and such an agreement will act as an exception to or modification of sections 4 and 5 of the Income-tax Act.

The provision has been very categorically held favour by the Delhi High Court in the case of *UAE Exchange Control* (*supra*).

3.4 Provisions of DTAA

The liability to tax under the DTAA is governed by Art.7 in almost all the treaties with various nations. Art.7 of the DTAA categorically provides that profits of an enterprise of a contracting state shall be taxable only in that state, unless the enterprise carries on business, in the other state, through a Permanent Establishment (PE) situated thereof. 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 that, as is attributable to the PE. Therefore liability on account of tax, of an enterprise of either of the contracting states, in India would arise if the enterprise in issue had a PE in India. The provisions of sections 5 and 9 would have no applicability.

A conjoint understanding of all the other provisions makes it very clear that in cases of entities from the states with whom India has entered into a Double Taxation Avoidance Agreement, the liability to tax would arise only if it has a PE in India, the provisions of sections 5 and 9 have no applicability, discussion on 'business connection' as provided in section 9 is unnecessary.

4. Meaning of PE

The **CBDT Circular No.14 of 2001[(2002)172 CTR (St.)13]** mentions that the term PE though not defined under the Act but its meaning may be understood with reference to the tax treaties entered into by India.

As per the various treaties entered into by India:

A PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on and includes within its ambit places such as a place of management, a branch, an office etc.; but

Excludes places enumerated in clauses (*a*) to (*e*) of Article 5, clause (e), which is relevant for a liaison office being;

> *"The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character."*

Thus to come out of the tax net, by coming in the saving clause of the meaning of PE, one has to prove that the LO is carrying on the activities which are in the nature of preparatory or auxiliary to the main enterprise.

5. Questions to be answered

In view of all the above referred provisions, while deciding the true nature of a liaison office for the purposes of taxation, one has to answer the following questions:

(*i*) Whether looking to the nature of activities carried on by the liaison office, can it be said to have earned any income?

(*ii*) Whether, in case answer to the above is affirmative, such income can be said to have accrued or deemed to have accrued and arisen in India, so as to be taxable under the IT Act, 1961?

(*iii*) Whether the principal concern outside India can be said to have any "business connection" within the meaning of section 9 of the Act in India by virtue of its setting up a liaison office.

(*iv*) In case the entity is governed by the DTAA, in view of the saving clause as contained in art. 5 of DTAA, the activity of the liaison office are liable to be treated as outside the purview of "Permanent Establishment" and accordingly no income can be deemed to accrue or arise in India ?

6. Issues arising

A. LO does not earn any income

The very basic issue while taxing any entity is to find out whether actually the entity has earned some income or not. In case of a liaison office

it has to be seen that the LO earns some income in India, independent of its parent company abroad or not. The logic behind all these provisions related to 'business connection' are to exclude entities which are not exclusively earning any independent income to be excluded from the tax net. In the case of ***Nike Inc.* v. *Asstt. CIT* [2010] 125 ITD 35 (Bang.),** it has been held that before going into the jargon of various other provision, the A.O. has to first give a finding that the assessee has received any income, other than from its Head Office in US for meeting its various expenses in India.

B. Business connection

Hon'ble Apex Court in the case of ***CIT* v. *R.D. Aggarwal & Co.* [1965] 56 ITR 20** defines 'Business Connection' involving a relation between a business carried on by a non resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those gains. It predicates an element of continuity between the business of the non-resident and the activity in the taxable territory, a stray or isolated transaction not being normally regarded as a business connection.

The Supreme Court in the case of ***Anglo French Textile Co. Ltd.* v. *CIT* [1953] 23 ITR 101** held that where there was a continuity of business relationship between the person in India who helps to make the profits and the person outside India who receives the profits, business connection exists.

Hon'ble Andhra Pradesh High Court in the case of ***G.V.K.Industries Ltd.* v. *ITO* [1997] 228 ITR 564/[1998] 96 Taxman 179** enumerated the following principles to decide 'business connection'

(*i*) To be determined on the facts of each case

(*ii*) The expression is too wide to have a definition

(*iii*) The essence is close, real, intimate relationship and commonness of interest

(*iv*) Where there is control of management or finances or substantial holding of equity shares or sharing of profits

(*v*) There must be continuity of activities or operation

C. Facilitating the purchase of goods - Explanation to section 9(1)(i)

Clause (b) of *Explanation* 1 of section 9(1)(i) acts as an embargo against attributing any income to the purchase operation carried out in India, if such purchases are for the purpose of exports. In other words, while arriving at the deemed income accruing or arising directly or indirectly through a business connection in India, no part of that income shall be attributable to the operation limited to the purchase of goods for the purpose of exports.

However there have been arguments on the line that any purchase may pull the entity out of tax net.

In this context, Hon'ble Supreme Court in the case of ***Anglo French Textile Co. Ltd.* (*supra*)** says:

> *"In our judgment the contention of the learned counsel of the applicant and on which the whole argument is founded- that it is the act of sale alone from which the profits accrue or arise can no longer be sustained and has to be repelled in view of decision of this court in* **CIT *v.* Ahmedbhai Umarbhai & Co. *[1950] 18 ITR 472 (SC)*** *.....it was held by this court that the profit of that part of the business, viz., the manufacture of oil in the mill at Raichur accrued or arose in Raichur even though the manufactured oil was sold in Bombay and the price was received there, and, accordingly that part of the profits derived from sales in Bombay which are attributable to the manufacture of the oil in Raichur was exempt from excess profit tax under the proviso to section 5 of the Act. Their Lordships quoted the following observation of* **Lord Davy In Re Cors. Of Taxation v. Krik *1900 AC 588*,** *"It appears to their lordships that there are four processes in the earning or production of this income: (1) The extraction of ore from oil soil; (2) the conversion of crude ore into a merchandisable product, which is a manufacturing process; (3) the sale of the merchandisable product; (4) the receipt of the moneys arising from the sale.*
>
> *All these processes are necessary stages which terminate in money, and the income is the*

money resulting less the expenses attendant on all the stages. The first process seems to their Lordships clearly within sub-section (3), and the second or manufacturing process, if not within the meaning of 'trade' in sub-sec. (1) is certainly include in the words 'any other source whatever' in sub-section (4). So far as relates to these two processes, therefore, their Lordships think that the income was earned and arising and accruing in New South Wales."

Department's argument in many of the cases has been that the case of *Anglo French* (*supra*) does not now govern the situation in view of the addition of Exp. 1(b) to section 9(1) of the Act, taking out activities of purchase while deeming the accrual of income. However, it seems that the said principle is not affected by the *Explanation*. The principle laid down in the decision is that in a business of sale and purchase, the activity of the purchase cannot be totally divorced from the activity of sale leading to income. The *Explanation* only seeks to exclude income from activities limited to purchase of goods in India for the purpose of export. The principle is that a purchase of raw material, getting goods manufactured and selling the product from an integral activity remains unshaken. This has also been affirmed by the **Authority for Advance Ruling** in the case of ***Columbia Sportswear Company, In re*** **[2011] 337 ITR 407/201 Taxman 214/12 taxmann.com 349 (AAR-New Delhi)**.

In ***Mustaq Ahmed, In re*** **[2008] 307 ITR 401/ [2009] 176 Taxman 69 (AAR-New Delhi),** AAR held as under:

"That means, there can be no attribution of notional income to the operation of non-residents, insofar as they are confined to the purchase of goods in India for the purposes of export….. The deemed accrual envisaged by section 9(1)(i) will become ineffective to the limited extent of purchase operations undertaken by non-resident in India for the purpose of export….. One cannot get out of the net of taxation altogether by invoking Expl. 1(b)."

Thus, it is very clear that the purchases are to be for the purpose of exports only. However this a matter of facts only and has to be judged on the basis of facts and circumstances of each individual case.

D. Exclusionary clause-'Preparatory and auxiliary nature'

The dictionary meaning of auxiliary is *"providing extra help and support"* while the dictionary meaning of preparatory is *"done in order to prepare for something"*

The **OECD Commentary** on article 5 at para 23 reads as under:

'To a considerable extent it limits that definition and excludes from its rather wide scope a number of forms of organizations which, although they are carried on through a fixed place of business, should not be treated as PEs. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the service it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know how contract, if such activity has a preparatory or auxiliary character.'

At para 24 it says, *'It is often difficult to distinguish between activities which have auxiliary or preparatory character and those who have not. The decisive criterion is whether or not the activity of the fixed pace of business in itself forms an essential and significant part of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the whole enterprise, does not exercise a preparatory or auxiliary activity.'*

In the case of ***Inspecting Assistant Commissioner v. Mitsui & Co.*** **[1991] 39 ITD 59 (Delhi)(SB),** the Special Bench of the tribunal made a detailed analysis of the same as under:

"Clause (iiia) of the Double Taxation Avoidance Agreement provides that supply of information which is preparatory or auxiliary to the formation of the contract between the contracting states does not amount to having a fixed place of business, and, therefore, permanent establishment. What is important to note is that supply of

information must only be preparatory or auxiliary to the formation of the ultimate contract. In contracts of this type which deal with the import export policy of the country involving several public institutions, supply of information can be on variety of points which cannot be visualized. Supply of information is meant to clear the doubts in the minds of the contracting parties, so that ad idem *is established before a final contract is concluded. In international trade and commerce, there are several aspects on which information has to be gathered and supplied to the contracting parties. It can start with the negotiations from the very nascent stage to the final conclusion of the contract and also removal of doubts on various points relating to supply of material, transportation, payment schedule, mode of transport, freight and charges, bank guarantee, interest payable, commission payable, etc. etc. It is difficult to specify the areas to which the supply of information can be limited. That was why the clause (iiia) was so widely worded as to include extensively and intensively all areas of supply of information, the only limited factor being that supply of information should be either preparatory or auxiliary to the formation of the final contract. Any information conveyed even after the conclusion of the contract say, for example, delay in the payment by the party in one contracting state to the party in another contracting state may also fall within the broad spectrum of supply of information. Information can be elicited or gathered only by negotiations or questions and answers and communication of these answers to the questions raised cannot but be treated as supply of information."*

E. Activities as per RBI permission

Any liaison office opened in India is obliged to do only those activities for which the permission from the RBI has been granted and RBI does not allow such entities to carry on any business. As a natural corollery to this, a liaison office set up by the permission of RBI, being able to carry only demarcated activities, would not constitute a PE. This view has also been affirmed by the Authority for Advanced Ruling in the case of ***Angel Garments* (*supra*) and Educational *Institute of American Hotel and Motel Association, In re* [1996] 219 ITR 183/85 Taxman 666 (Delhi).**

However the **Karnataka High Court** in the case of ***Jebon Corporation India* v. *CIT* [2012] 206 Taxman 7/19 taxmann.com 119** held that, 'Once the material on record clearly establishes that the liaison office is undertaking an activity of trading and therefore entering into business contracts, fixing price for sale of goods and merely because RBI had not taken any action, such inference is not justified'

Therefore, the facts of the case, for the purposes of taxation are to be analyzed irrespective of the fact whether there is violation of RBI guidelines or not.

F. Part of income

The liability to tax under the DTAA is governed by article 7, clause (1) Art. 7 of the DTAA categorically provides that profits of an enterprise of a contracting state shall be taxable only in that state, unless the enterprise carries on business, in the other state, through a PE situated thereof. 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 that, as is attributable to the PE.

7. A matter of facts

In an organisation, to ascertain as to whether or not an activity is of a preparatory or auxiliary nature, the same has to be seen and appreciated in the context of overall activities of the organization.

It is to be seen whether the office in the other contracting state is carrying out the same activities, which constitute the core activity of the enterprise. If that office is carrying on the same activities as that of the enterprise itself, it will be the PE of that enterprise.

It should also be appreciated that an activity can be core activity of one enterprise, at the same time it can be preparatory or auxiliary for the other.

If the assessee is engaged in the business of earning income from the advertising of products of the other companies worldwide and in any contracting state it has an office for advertising, that office will be treated as PE of the enterprise in that contracting state. However, for a manufacturing enterprise, the activities of its

office located in the other contracting state for advertising of its products will be viewed as merely doing a preparatory or auxiliary nature of work and may not constitute a PE.

Likewise an information collecting entity which earns income from dissemination of information so collected would be a PE in the other contracting state if it opens an office for collection of information in that contracting state.

Some instances on the basis of various judicial pronouncements are:

(*i*) ***K.T. Corporation, In re*** **[2009 181 Taxman 94 (AAR-New Delhi)**: Holding seminars, conferences etc., preparation of reports, dealing with India's market scenario in mobile as well as broadband segment, held to be of preparatory and auxiliary in nature.

(*ii*) ***Motorolla Inc.*** **v.** ***Dy. CIT*** **[2005] 95 ITD 269 (Delhi): advertising activity held to be so.** No income accrued to the assessee on its sale of cellular equipment to cellular operators in India even if it had a 'business connection' in India since the sale itself had not been effected in India. The assessee's Indian subsidiary could not be considered as a permanent establishment or a fixed place of business. The Indian subsidiary only carried out activities of an auxiliary or preparatory nature, before the assessee could commence its actual business in India.

The assessee's liaison office in India did not carry on any business activity for the assessee. It only carried on the assessee's advertising activities and assisted the assessee in its preliminary and preparatory work. Therefore, the liaison office would not afford a 'business connection' to the assessee. However, the assessee's Indian subsidiary, which engaged itself in activities that supported the assessee's main activity, would be considered as the assessee's permanent establishment in India. Also, there were marketing agreements between the assessee and its subsidiary that amounted to a 'business connection'. Therefore, 20 per cent of the assessee's net profits on its sale of cellular equipment in India would be treated as income earned through its permanent establishment.

(*iii*) ***Western Union Financial Services Inc.*** **v.** ***Asstt. DIT*** **[2007] 104 ITD 34 (Delhi)** money transfer business across international borders for which it appointed agents in India for rendering its services against payment of commission. The agents were provided software without any copyright to enable them to access its mainframe computer in USA. It also had a liaison office in India, which was not involved in trading activity. Although there was a 'business connection', yet neither its office nor its agents were its permanent establishments or fixed places of business in India. Moreover, the assessee retained the property in software to itself and the commission paid to agents were uniform in all countries. Also, the contracts were not executed in India. Only the payments were made in India. Therefore, no taxable income arose to the assessee in India.

(*iv*) ***Dy. DIT (International Taxation)*** **v.** ***Jebon Corporation India*** **[2010] 125 ITD 340/1 ITR (Trib.) 655 (Mag.) :** Identifying buyers, negotiating with buyers, agreeing to the price, procuring purchase orders and forwarding the same to the head office and follow up activities relating to realization of payments and after sale support is held to be a PE.

(*v*) ***Rolls Royce PLC*** **v.** ***Dy. DIT*** **[2008] 19 SOT 42 (Delhi) P**rocuring orders, organising events, media relations and administrative support. The orders by customers in India were routed through Rolls Royce India Limited only. Thus it had a permanent establishment and a business connection in India. Therefore, income arising from operations in India accrued in India and was taxable in India.

(*vi*) ***DIT(International Taxation)*** **v.** ***Morgan Stanley & Co. Inc.*** **[2007] 292 ITR 416/162 Taxman 165 (SC)** An Indian company provided support for main office functions in equity and fixed income research, accounts reconciliation and also IT enabled services such as back office operations, data processing, etc. to the applicant. For that purpose, the applicant sent its staff for stewardship for ensuring high quality services by the Indian company. Since the stewardship in-

cluded monitoring outsourced operations by the Indian company and the staff would be in India for a short period and was not involved in day-to-day management of services by the Indian company, the Indian company was a service PE of the applicant in India under article 5(2)(i) of DTAA with USA in respect of services performed by the deputed staff, but not on account of stewardship activities.

(*vii*) ***Mitsui & Co. Ltd.* v. *Asstt. CIT* [2008] 114 TTJ 903 (Delhi)** LO was engaged in providing support services, hence no PE.

(*viii*) ***Gutal Trading Est., In re* [2005] 278 ITR 643/149 Taxman 498 (AAR-New Delhi)**: providing information about the technology being used by the principal company and to receive and reply trade enquiries of customers with no right to enter into negotiations by with customers, does not constitute business connection.

(*ix*) ***U.A.E. Exchange Centre Ltd.* v. *Union of India* [2009] 313 ITR 94/183 Taxman 495 (Delhi) : D**ownloading of information from the main servers located in UAE for drawing cheques on banks in India and dispatching the same to the beneficiaries as per the instructions of NRI, termed as being in the nature of preparatory and auxiliary.

(*x*) ***Sojitz Corporation* v. *Asstt. DIT (International Taxation)* [2008] 117 TTJ 792 (Kol.):** Collecting and sending of information from India to Japan; held not to be a PE.

(*xi*) ***Columbia Sportswear Company, In re* [2011] 337 ITR 407/201 Taxman 214/12 taxmann.com 349 :** identifying a competent manufacturer negotiating a competitive price, help in choosing the materials etc. cannot be excluded from the definition of the PE.

(*xii*) ***Nike Inc.* v. *Asstt. CIT* [2009] 125 ITD 35 (Bang.):** Placing orders with local manufacturer specifying the quantity, price, the affiliate with address on whom the bill is to be raised and the destination and in not any way communicating with the manufacturers other then supervising to ensure quality as per approved samples, no income deemed to accrue or arise.

(*xiii*) ***Ikea Trading (Hong Kong) Ltd., In re* [2009] 308 ITR 122/176 Taxman 344 (AAR-New Delhi):** The assessee was a company incorporated in Hong Kong. It set up a liaison office in India for purposes of purchase of goods in India for purposes of exports from India. It received the sale price in Hong Kong. The activities of liaison office were confined to only purchase of goods. There were no sales in India. No income accrued in India.

(*xiv*) ***Dy. DIT* v. *M. Fabricant & Sons Inc.* [2011] 48 SOT 576/15 taxmann.com 358 (Mum.)** The assessee was a non-resident. It opened a liaison office in India for purchase of good. The liaison office was not it's PE. The income attributed to liaison office did not accrue in India.

8. Conclusion

We are living in an era where the world is euphemistically described as a global village. Organisations and companies operate transnationally. There is an eagerness to bring to tax by states, the income, by employing deeming fictions so that income which ordinarily do not accrue or arise within the taxing state are brought within the states' tax net. It is in this context that the expression 'PE' appearing in the DTAA has to be viewed. In the model treaty under article 5 read with article 7, profits of an enterprise are liable to tax in India if an enterprise were to carry on business through PE, meaning thereby fixed place of business through which the business of an enterprise is wholly or partly carried on. Under article 5(2)(c), amongst others, PE includes an office. However article 5(3) which opens with a *non-obstante* clause, is illustrative of instances whereunder the DTAA various activities have been deemed as ones which would not fall within the ambit of the expression 'PE'. However, in case of an entity of a state with whom India does not have a treaty, one has to go to sections 5 and 9 of the Income-tax Act and interpret the provisions of the same on the facts and circumstances of the particular case.