



Permanent Establishment - A Recent Development

Galileo International Inc Vs. DCIT

FACTS OF THE CASE

Galileo International Inc ('Galileo' or 'assessee') a resident of USA is engaged in the provision of services to hotels, airlines etc pertaining to reservations, booking etc through its Computerized Reservation System ('CRS'). The services provided by it are as follows:

- Receipt of requests from Travel Agents of airlines etc (or TA) for information display (as stored in CRS), ticket booking etc;
- Forwarding the aforesaid requests from TA's to Airline servers, receiving responses thereupon from Airlines Server, forwarding the same to TA's etc;
- Generating reports on booking status for Airlines in set format etc.
- Display of real time status qua flight schedules, fares etc.

For this purpose, it maintains and operates a huge master computer system (MCS) consisting of 18 mainframe computers with its main server located in USA. This main computer is connected to the airline servers' to/from which data is continuously sent and obtained. All the input processing and output is managed, processed and stored by the appellant through the MCS in USA.

In aforesaid connection, the appellant has entered into agreements (referred as participating carrier agreements or PCA) with various airlines etc. (referred to as 'participants' in the ruling) to provide them with the CRS services. The appellant earns booking fees from Airlines for services listed in relevant agreement including the above-mentioned services.

The appellant in order to market and distribute the CRS services to the TAs appoints distributors and pays a distribution fees to them for their services. In India the appellant has entered into a distribution agreement (DA) dated 25th February 1995 with Interglobe

Address:



Enterprises Pvt. Ltd., an unrelated party to market and distribute CRS services to the TAs in India.

The appellant is also responsible for securing the telecommunication network to enable the TAs to access the CRS.

In the course assessment and first level appellate proceeding it was decided that Galileo has a business connection in India and income chargeable to tax as per income tax act 1961, as well as a PE under Article 5 of the DTAA with USA. Galileo has decided to file an appeal with second level appellate authority against the aggrieved order of first level appellate authority.

GROUND FOR APPEAL

The appellant filed its return of income for 4 years for the AY 1995-96 to 1998-99, pursuant to a notice issued by the income tax department and contended as follows:

- No income accrued or arose to it in India nor could any such income be deemed to accrue or arise in India under section 5(2) or 9(1)(i) of the Income Tax Act, 1961 and so it did not have any taxable income in India.
- It did not have any permanent establishment (PE) in India within the meaning of Article 5 of the DTAA between India and USA (treaty) and so the booking fees which is in the nature of the 'business profits' are not liable to tax in India under article 7(1) of the treaty.

ISSUES BEFORE THE ITAT

- 1) Whether Galileo had a Business Connection (BC) in India under section 9(1)(i) of the Act ?
- 2) Whether the appellant has any taxable income under section 5(2) of the act?

Address:



- 3) As regards DTAA, whether Galileo had a PE in India (fixed place or agency PE etc) as per article 5 of the DTAA entered between India and USA? As regards agency PE under DTAA, whether appellant is eligible to immunity provided under Para 5 of Article 5 thereof?
- 4) How much attribution of the income earned by the Galileo is chargeable to tax in India?

DECISION OF THE ITAT

- 1) Business connection under section 9(1)(i) of the Income Tax Act.
 - The meaning of the word business connection is not exhaustive in nature in fact it includes some of the activities to be termed as business connection. It has a wide though uncertain meaning. thus in order to determine the business connection the facts of each particular case need to be analyzed.
 - As regards accrual of income to assessee under the Act, ITAT ruled that income accrued to assessee in India and there existed a business connection for that in India, in view of the following:
 - Computer/hardware as well as connectivity via nodes etc. (hired from SITA) was provided to TA's etc in India by assessee (which were not dumb or in nature of Kiosk);
 - Booking takes place in India through seamless CRS system of assessee;
 - Booking constituted important limb of assessee's overall operations and without the same, no income could have accrued to assessee.
 - So income which is pertaining to bookings which takes place from the equipment in India can be deemed to accrue or arises in India and hence taxable in India.
- 2) Income accruing or arising under section 5(2) of the Income Tax Act.

Address:



- In the case of the business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be such part of the income as is reasonably attributable to the operations carried out in India.
- In the given case a majority of work which generates revenue (income) for the Galileo is carried outside the India. In India only generations of request and receiving of end results activities is carried on.
- Thus in the case of Galileo lion's share of the appellants operations took place outside India, only miniscule portion, adjudicated at 15% of the appellants income, was held to have accrued in Indian territories. The extent of work carried out in India is in relation to generating requests and receiving the end result of the process in India.
- The ITAT held all the expenses in the form of the remuneration to the Interglobe are held as an allowable deduction and shall be reduced while computing the income of the appellant and since the payment to the agent in India is more than what is the income attributable to the PE in India, it extinguishes the assessment as no further income is taxable in India.. In this connection, ITAT placed reliance on SC ruling in Morgan Stanley (supra) and CBDT Circular No. 23 of 1969 (supra).

3) Permanent establishment under DTAA.

➤ Fixed place rule which is stated in article 5(1)

Article 5(1) gives a general definition of the permanent establishment i.e. it is a fixed place of business through which the business of an enterprise is partly or wholly carried on.

The ITAT held that Galileo has a fixed place of business in the form of the computers installed in the premises of the subscribers (travel agents) through

Address:



which it carries its business partially. The justification for this ruling is as under: -

1. In the case of Galileo, CRS is the main source of revenue, which is partially existent in the various computers installed at the premises of the subscribers. These computers perform the functions of reservation and ticketing and form an integral part of the entire CRS.
2. The computers so installed cannot be shifted from one place to another even within the premises of the subscriber. Thus the appellant exercises complete control over the computers installed at the premises of the subscribers.
3. In some cases the appellant itself has placed those computers and in all the cases the appellant through its agent installs the telecommunication network.
4. The ITAT ruled that appellant did have fixed place PE in India, which comes in existence on operation being performed through computers in India. Thus the computers/hardware installed at TA's premises gave rise to appellant's fixed place of business in India (as it exercised complete continuous control over the same).

➤ Exceptions to the above rule which is stated in article 5(3)

1. Article 5(3) lists a number of activities, which are preparatory and auxiliary in nature, these activities act as exceptions to the general definition laid in article 5(1) and which are not regarded as PE's even when the activity is carried through a fixed place of business.
2. The activity of the appellant is developing and maintaining a fully automatic reservation and distribution system with the ability to perform comprehensive information, reservation, communication, ticketing, distribution and related function on a world wide basis.

Address:

Thus, ITAT ruled that since appellant's activities in India contributed directly to revenue generation, it do not fall in umbrella of 'preparatory or auxiliary' clause of subject DTAA. .

➤ Agency rule stated in Article 5(4)

1. Under the said article, an agent is a person employed to do any act for another or to represent another in the dealing with the third person. Thus, any agent can be considered PE only and only if when a person other than agent of independent status,
 - i) Has and habitually exercise in that state an authority to conclude contract, or
 - ii) Though it has no such authority but habitually maintains stock of goods from which he regularly deliver goods on the behalf of the enterprise.
2. In the present case Interglobe is completely dependant on the appellant in respect of rendering services to the subscribers. Thus that part of the income, which earns its revenue by rendering services to the subscribers, is carried on solely by the appellant. Even though the distributor may have other business activities, in respect of the CRS business the distributor acts only for the appellant and not for any other person. Thus the tribunal said that Interglobe is a dependant agent (DA) of the appellant.
3. Also, although the distributor is responsible for entering into the contracts with the subscribers, yet the appellant through the PCA ensures that the subscribers are authorized to use the 'Galileo system'. Therefore, Interglobe is a DA of the appellant who has habitually exercised the authority to conclude contracts on the behalf of the appellant.

Address:



4. In the case of Galileo, if the agent is to deliver the goods either the goods should be such in which the enterprise deals in or which are regularly hired out which may be considered as given on bailment from which the revenue is generated.

But in the present case the computers supplied by Interglobe to the subscribers are not dealt with by the appellant or which is by itself is the source of revenue. Thus clause (b) of paragraph 4 of article 5 does not apply to consider the dependant agent as PE of the appellant in India.

5. In a nutshell, the ITAT held that the distributor is a DA of the appellant to the extent that it exercises the authority to conclude contracts on behalf of the appellant.

➤ Attribution of profits under article 7 of the DTAA.

- Having considered that the appellant had a PE in India under two forms- fixed place PE and agency PE the ITAT examined as to what is the profit attributable to the PE under the said article.
- Article 7 of the treaty postulates that only that much of profit as are arising due to assets and activities of the PE can be brought to tax and if the whole of the business activities are not apportioned between that arising in India and outside India.
- Since the entire activity of Galileo is not carried out in India where the PE is situated so, only that much of the profit is attributable to the functions carried through the PE, and only this much of the attributed profit can be taxable in India.
- On attribution front under subject DTAA, ITAT after deliberating upon Para 5 of Article 7 thereof (supra) reiterated its findings that 15% of 'booking' revenue generated to assessee is taxable in India and

Address:



since assessee remunerated Interglobe (agent in India) more than what is attributable to PE in India, it extinguishes any further assessment.

Conclusion

This ruling enhances the possibility of identified as a PE for the companies using internet and information technology in the business. This ruling creates difficulties for the MNC's for managing the risk of PE. It also needs to review the importance of this ruling and its effects.

S.R. Dinodia & Co.
S.R. Dinodia & Co.

Address:

K-39, Connaught Place, New Delhi- 110001 India Phone: 91-11-23418016, 23416214,
Fax: 91-11-41513666 E-mail: srdinodia@srdinodia.com