IN THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment delivered on: 16.05.2016

\+ **W.P.(C) 2384/2013 & CM 4515/2013**

ADOBE SYSTEMS INCORPORATED ..... Petitioner
Through: Mr R.P. Bhat, Senior Advocate with Mr Prakash Kumar, Mr Vishal Kalra and Mr Vivek Bansal, Advocates.

versus

ASSISTANT DIRECTOR OF INCOME TAX AND ANR ..... Respondents
Through: Mr Dileep Shivpuri, Senior Standing Counsel with Mr Sanjay Kumar, Advocate.

WITH

\+ **W.P.(C) 2385/2013 & CM 4517/2013**

ADOBE SYSTEMS INCORPORATED ..... Petitioner
Through: Mr R.P. Bhat, Senior Advocate with Mr Prakash Kumar, Mr Vishal Kalra and Mr Vivek Bansal, Advocates.

versus

ASSISTANT DIRECTOR OF INCOME TAX AND ANR ..... Respondents
Through: Mr Dileep Shivpuri, Senior Standing Counsel with Mr Sanjay Kumar, Advocate.

WITH

\+ **W.P.(C) 2390/2013 & CM 4523/2013**

ADOBE SYSTEMS INCORPORATED ..... Petitioner
Through: Mr R.P. Bhat, Senior Advocate with Mr Prakash Kumar, Mr Vishal Kalra and Mr Vivek Bansal, Advocates.

versus

ASSISTANT DIRECTOR OF INCOME TAX AND ANR ..... Respondents

Through: Mr Dileep Shivpuri, Senior Standing Counsel with Mr Sanjay Kumar, Advocate.

CORAM:
JUSTICE S.MURALIDHAR
JUSTICE VIBHU BAKHRU

JUDGMENT

VIBHU BAKHRU, J

1. The Petitioner, Adobe Systems Incorporated (hereafter the 'Assessee'), has preferred the present petitions under Article 226 and 227 of the Constitution of India, impugning three separate notices dated 30th March, 2011 (hereafter 'the impugned notices') issued under Section 148 of the Income Tax Act, 1961 (hereafter the 'Act') for Assessment Years (AYs) 2004-05, 2005-06 and 2006-07 respectively. The Assessee further impugns three separate orders dated 8th March, 2013 (hereafter 'impugned orders') passed by the Assessing Officer (hereafter 'the AO') rejecting the objections raised by the Assessee against the assumption of jurisdiction under Section 148 of the Act.

2. Briefly stated, the controversy in these petitions involves the question whether Adobe Systems India Private Limited (an Indian

subsidiary of the Assessee and hereafter referred to as 'Adobe India') could be considered as its Permanent Establishment (PE). And if so, whether any part of the Assessee's income, could be attributed to such PE in respect of the activities carried out by Adobe India, income from which had been subjected to transfer pricing scrutiny/adjustment.

2.1 The Assessee disputes that it has a PE in India. It further contends that since the income of Adobe India has been assessed at Arm's Length Prices (ALP), no part of Assessee's income could be attributed to Adobe India even if it was assumed to be the Assessee's PE in India. On the other hand, it is the Revenue's case that the activities carried out by the Adobe India are the core business activities of the Assessee; Adobe India is the Assessee's PE in India; the cost plus basis on which Adobe India is remunerated by the Assessee does not capture the fair share of Assessee's income attributable to its PE; and that a part of the Assessee's income, computed on profit split method, is chargeable to tax under the Act.

2.2 Whilst the Assessee claims that there is no tangible material for the AO to have any reason to believe that the Assessee's income has escaped assessment, the Revenue contends that the transfer pricing report as submitted by Adobe India provides sufficient reason to form a belief that the Assessee's income had escaped assessment.

Factual Background

3. The Assessee is a company incorporated under the laws of Delaware in USA. The Assessee provides software solutions for network publishing which includes web, print, video, wireless and broadband applications. The Assessee has a wholly owned subsidiary in India, namely, Adobe India. It is stated by the Assessee that Adobe India provides software related Research and Development (R&D) services to the Assessee and the Assessee does not have any business operations in India. The R&D services rendered by Adobe India, are paid for by the Assessee on cost plus basis in terms of an agreement entered into between the Assessee and Adobe India. Whilst the Assessee claims that such agreement is on principal to principal basis, the Revenue disputes the same.

4. The Assessee claims that during the Previous Years relevant to the AYs in question, it was not assessable under the Act in respect of any of its income other than interest on advance fees paid to Adobe India. And since, Adobe India had withheld the applicable taxes (TDS) on such interest, the Assessee was not obliged to file its return of income under the Act by virtue of Section 115A(5) of the Act.

5. Adobe India is assessed to tax in India in respect of its income. As stated earlier, Adobe India is mainly engaged in the business of providing software related R&D services to the Assessee. It is stated by the Assessee that R&D activities carried out by Adobe India are on assignment basis and does not entail end to end software development. Since Adobe India provides R&D services to its holding company, an Associated Enterprise (AE), its transaction with the Assessee have been subjected to examination by the Transfer Pricing Officer (TPO). It is stated that for AYs 2004-05 and 2005-06, the AO and the TPO accepted the fees paid by the Assessee on cost plus 15% basis as being on ALP and Adobe India's assessment was made accordingly. The assessment orders for AYs 2004-05 and 2005-06 have become final and are not subject matter of any further proceedings. It is stated that in Adobe India's assessment for AY 2006-07, the TPO/AO did not accept the Transfer Pricing Study submitted by the Assessee therein as he did not accept the set of comparables used by the Adobe India to determine the ALP. However, Adobe India succeeded in its appeal before the Income Tax Appellate Tribunal and this Court is informed that the Revenue has assailed the Tribunal's order in this Court which as yet is pending. The Assessee further informs that for AY 2007-08, the Transfer Pricing Study furnished by Adobe India was not accepted by the TPO, who sought to

apply Profit Split Method (PSM) for determining the ALP instead of Transactional Net Marginal Method (TNMM) used in the preceding years. Adobe India successfully challenged the TPO's order for AY 2007-08 before the Dispute Resolution Panel (DRP) and the DRP has held that ALP be determined by applying TNMM as in the preceding years.

6. The AO issued the impugned notices under Section 148 of the Act on 30th March, 2011. In response to the aforesaid notice for AY 2004-05, the Assessee sent a letter dated 9th May, 2011 stating that it did not conduct any business activity in India and had not earned any taxable income except the interest on advances received from Adobe India, tax on which was duly withheld and deposited by Adobe India. The Assessee also referred to Section 115A (5) of the Act to contend that by virtue of the said provision, it was not liable to file its return of income under Section 139(1) of the Act, for the relevant year. The Assessee also sought reasons for reopening of the assessment for the AY's in question. Thereafter, AO issued show cause notices dated 27th July, 2011 for AY 2004-05 and 1st August, 2011 for AYs 2005-06 and 2006-07 alleging non-compliance of the impugned notices dated 30th March, 2011. The Assessee responded to the show cause notice for AY 2004-05 on 9th

August, 2011 and to the show cause notices for AYs 2005-06 and 2006-07 on 24th August, 2011, by reiterating its earlier stand that it had earned only interest income from Adobe India in respect of which tax was withheld by Adobe India in terms of Article 11 of the DTAA between USA and India.

7. Reasons recorded for initiation of reassessment proceedings were furnished by the AO under cover of a letter on 17th October, 2011. After the receipt of aforesaid reasons, Assessee requested for inspection of records in order to file objections against the reasons recorded.

8. The Assessee filed its objections through a letter dated 23rd August, 2012 while reserving its right to make further objections on inspection of the files.

9. On 4th January, 2013, the AO issued notices under Section 142(1) of the Act directing the Petitioner to submit the returns of income in response to the impugned notices dated 30th March, 2011. The Assessee, on 4th February, 2013, without prejudice to its rights and contentions, filed the returns of income for AYs 2004-05, 2005-06 and 2006-07.

10. Thereafter, on 22nd February, 2013, the Assessee filed additional objections after inspecting the records. By an order dated 8th March,

2013, the AO disposed of the objections filed by the Assessee for the relevant AYs.

11. In the aforesaid backdrop, the limited controversy to be addressed is whether the AO had any reason to believe that the Assessee's income for the AYs in question had escaped assessment. Before proceeding to address the issues involved, it would be necessary to refer to the reasons recorded by the AO for forming the belief that the Assessee's income for the relevant AYs had escaped assessment.

Reasons to believe that income had escaped assessment.

12. In the reasons recorded by the AO for issuance of the impugned notices, the AO had recorded that: (a) Adobe India develops software for the Assessee for which Adobe India has been compensated on a 'cost plus profit basis'; (b) the ownership of the software developed by Adobe India is the sole property of the Assessee and Adobe India does not retain any intellectual property rights in respect of the software developed by it; (c) the Assessee makes substantial profits by selling the software developed in India abroad for which no taxes have been paid by the Assessee in India; (d) Adobe India has been working wholly and exclusively for the Assessee and does not develop software for any other concern; and (e) the Assessee's transaction with Adobe India are not isolated transactions "*but*

a continuous business connection as Adobe India is connected to the Assessee through a network of lease lines and other technological means".

13. On the basis of the above, the AO concluded that activities carried out by Adobe India were a part of the Assessee's core business activities and, consequently, Adobe India constituted the Assessee's PE under Article 5(1) of the Indo-US Double Taxation Avoidance Agreement (DTAA). He also observed that in terms of the agreement between Adobe India and the Assessee, the Assessee was obliged to provide assistance, specifications and supervision and was further entitled to audit the facilities of Adobe India for maintenance of the requisite standards. This, according to the AO, indicated that the Assessee had a Service PE in India in terms of Article 5(2)(l) of the Indo-US DTAA. According to the AO, Adobe India was also a dependent agent of the Assessee and thus, constituted its PE in terms of Article 5(5) of the Indo-US DTAA.

14. The AO reasoned that since the Assessee had a PE in India, a part of the profit accruing to the Assessee which is attributable to the activities in India was chargeable to tax under the Act.

15. The AO further observed that the transaction between the Assessee and Adobe India involved transfer of intangibles and multiple inter-related transactions which could not be evaluated separately for the purposes of determining ALP by any one transaction. The AO also recorded that development and customisation of software was a highly technical job and the same could not be restricted to computation on cost plus basis. In his view, cost plus basis was not a suitable method for intangibles like software services and the Profit Split Method was applicable in terms of Rule 10B of the Income Tax Rules. Finally, the AO took note of the global profits reported by the Assessee and held that the same should be apportioned in the ratio of the R&D expenses incurred by the Assessee. On the aforesaid basis, the AO computed Assessee's taxable profits for AY 2006-07 as under:

> "From the above facts it's clear that the assessee has business connection as well as permanent establishment in India and its income has escaped assessment as per the provisions of Section 147 r.w.s. 148 of the Income-tax Act, 1961. The total value of the transactions is Rs1094766837/-. These are R&D expenses of the assessee's Co.
>
> As per global B/S of the assessee company the total R&D expenses are $365328000 and profit is $728434000 applying the same ratio the profit attributable to India R&D which is Rs.1094766837 come to Rs2080056990 which is more than Rs.1 lakh. Although the figures are for calendar year but same has been taken on pro-rata basis.

> From the above paras, it is clear that the income of the assessee escaping assessment is Rs2080056990/- which is more than Rs.1 lacs and therefore I have reason to believe that income of the assessee has escape assessment as per section 151 r.w.s. 148 of the Income-tax Act, 1961."

The taxable profits for AYs 2004-05 and 2005-06 were also computed in a similar manner.

Reasoning and Conclusion

16. It is apparent from the plain reading of the reasons recorded by the AO that his belief that the income of the Assessee had escaped assessment stems from his understanding that the activities pertaining to R&D services rendered by Adobe India were conducted by the Assessee. He has, therefore, concluded that the Assessee must surrender a part of his income, which is attributable to those activities in India, to tax under the Act. It is not disputed that Adobe India has been assessed to tax on the very same activities priced on Arm's Length basis. In the circumstances, the first and foremost question to be considered is whether such activities of a subsidiary company could by itself provide a reason to believe that any income relating thereto has escaped assessment in the hands of foreign holding company.

17. Chapter X of the Act contains special provisions relating to avoidance of tax. Section 92 of the Act, which falls under Chapter X of the Act, mandates that any income arising from international transactions shall be computed having regard to the ALP. The purpose of enacting the transfer pricing regulations is to ensure that income from transactions between the related parties are not shifted out of India so as to escape or mitigate the incidence of tax payable under the Act. Thus, the transfer pricing regulations are to be read as providing the framework, to tax the real income of an assessee derived from international transactions with a related party; they cannot be read as provisions to impute any hypothetical income in the hands of an assessee. Thus, the transfer pricing scrutiny/adjustments in respect of the activities of Adobe India must be read to have resulted in capturing the entire income from the said activities in the net of tax.

18. In ***Sony Ericsson Mobile Communications India Pvt. Ltd. and Ors. v. Commissioner of Income Tax-III and Ors.*: (2015) 374 ITR 118 (Del)**, a Division Bench of this Court explained the context of Chapter X of the Act in the following words:-

> "77. As a concept and principle Chapter X does not artificially broaden, expand or deviate from the concept of "real income". "Real income", as held by the Supreme

> Court in ***Poona Electricity Supply Company Limited versus CIT, : [1965] 57 ITR 521 (SC),*** means profits arrived at on commercial principles, subject to the provisions of the Act. Profits and gains should be true and correct profits and gains, neither under nor over stated. Arm's length price seeks to correct distortion and shifting of profits to tax the actual income earned by a resident/domestic AE. The profit which would have accrued had arm's length conditions prevailed is brought to tax. Misreporting, if any, on account of non-arm's length conditions resulting in lower profits, is corrected."

19. Services provided by Adobe India to the Assessee have been remunerated by the Assessee on cost plus basis and the same has been accepted in AYs 2004-05 and 2005-06. The method of determining the ALP for the said transaction, that is, TNMM, has been accepted for AYs 2004-05, 2005-06, 2006-07; although for AY 2007-08, the TPO has sought to use the PSM, the same was not upheld by the DRP. Thus, undisputedly, the real income of Adobe India, which is related to the activities carried out by Adobe India has been brought to tax in its hands. And even if there is any dispute relating to the same, it is liable to be resolved in proceedings relating to Adobe India.

20. We may now refer to the provisions of Article 7 of the Indo-US DTAA which read as under:-

"ARTICLE 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. 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 them as is attributable to (a) that permanent establishment ; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment ; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and

development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprises, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment as provided in paragraph 1(a) of this Article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the

> provisions of those Articles shall not be affected by the provisions of this Article.
>
> 7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business including income from the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services) and including income from the rental of tangible personal property other than property described in paragraph 3(b) of Article 12 (Royalties and Fees for Included Services)."

21. Paragraph 1 of Article 7 makes it amply clear that only so much of the profits as are attributable to a PE or could be attributed by using the principle of Force of Attraction would be taxable in the contracting state of the PE. In other words, in addition to the business profits attributable to a PE, profits attributable to sale of goods or merchandise which are similar to those sold through the PE or other business activities which are similar to those effected through the PE, can also be taxed in the state where the PE is situated.

22. Further, paragraph 2 of Article 7 of the Indo-US DTAA also stipulates that profits attributable to a PE would be such profits which a PE might be expected to make if it were a distinct and an independent enterprise engaged in the same or similar activities and dealing wholly at arm's length with the enterprise of which it is a PE.

23. In view of the above, even if the subsidiary of a foreign company is considered as its PE, only such income as is attributable in terms of paragraphs 1 and 2 of Article 7 can be brought to tax. In the present case, there is no dispute that Adobe India - which according to the AO is the Assessee's PE - has been independently taxed on income from R&D services and such tax has been computed on the basis that its dealings with the Assessee are at arm's length (that is, at ALP). Therefore, even if Adobe India is considered to be the Assessee's PE, the entire income which could be brought in the net of tax in the hands of the Assessee has already been so taxed in the hands of Adobe India. There is no material that would even remotely suggest that the Assessee has undertaken any activity in India other than services which have already been subjected to ALP scrutiny/adjustment in the hands of Adobe India. Thus, in our view, even if the AO is correct in its assumption that Adobe India constituted the Assessee's PE in terms of Article 5(1), 5(2)(l) or 5(5) of the Indo-US DTAA, the facts in this case do not provide the AO any reason to believe that any part of the Assessee's income had escaped assessment under the Act.

24. In the case of ***DIT (International Taxation) v. Morgan Stanley & Company Inc.***: **(2007) 292 ITR 416 (SC)**, the Supreme Court had explained the above in the following manner:-

> "32. The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not all profits of MSCO would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry-forward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the

> functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporate on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE)."

25. We may also mention that according to the AO, the profits attributable to the activities carried out by Adobe India are to be ascertained by PSM as, according to him, the Cost Plus method used by Adobe India for determining the ALP does not fairly capture the profits which could legitimately be taxed under the Act. In our view, the question as to which is the correct method of determining the ALP can only be debated in proceedings relating to the assessment of Adobe India. The fact that the AO has not succeeded in persuading the DRP to accept his point of view, cannot possibly provide him a reason to now try and assess profits calculated on PSM in the hands of the Assessee.

26. In view of the aforesaid, the impugned notices and the proceedings initiated by the AO are liable to be set aside.

27. In view of our above conclusion, it is not necessary for us to examine whether the Assessee had a PE in India in terms of Article 5(1), 5(2)(l) or Article 5(5) of the Indo-US DTAA. However for the sake of completeness, we consider it appropriate to also examine the question

whether the AO's opinion that the Assessee has a PE in India is informed by reason.

28. A subsidiary company is an independent tax entity and is separately taxed for its income in the country of its domicile. In the present case, Adobe India is a separate assessee and is liable to pay tax on its income. The fact that a holding company in another contracting state exercises certain control and management over a subsidiary would not render the subsidiary as a PE of the holding company. This is expressly spelt out in paragraph 6 of Article 5 of the Indo-US DTAA, which reads as under:-

> "(6) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

29. The aforesaid principle is also stated in Klaus Vogel on Double Taxation Conventions, Third Edition in the following words:-

> "40. [Principle] 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 follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes

> an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company."

30. Having stated the above, we must also clarify that the fact that a subsidiary company is a separate tax entity does not mean that it could never constitute a PE of its holding company. In certain circumstances, where the specified parameters defining PE - in the present case Article 5 of the Indo-US DTAA - are met, a subsidiary would constitute a PE of its holding company. However, in determining whether the requisite parameters are met, it is necessary to bear in mind that a subsidiary is a separate legal entity and its activities, the income from which are assessed in its hands at arm's length pricing, cannot be the sole basis for the purposes of imputing the subsidiary to be a PE of its holding company. This is so because, a subsidiary is liable to pay tax on its income and a foreign holding company is liable to pay tax on its income and the same set of activities cannot be construed as that of a holding company through its PE and that of the subsidiary as its own activity resulting in income from the same activities being taxed twice over; once in the hands of the subsidiary and again in the hands of the holding company. In cases where a subsidiary acts as an agent of its holding company, the income from the

activities conducted by the subsidiary for and on behalf of its principal would be assessed in the hands of the principal - that is, the holding company - and not in the hands of the subsidiary. The subsidiary would only be liable to pay tax on the remuneration receivable as an agent and such remuneration would clearly be deductable while computing the income in the hands of the holding company.

31. Keeping the aforesaid principles in mind, we may now examine whether the AO had any reason to hold that the Assessee has a PE in India in terms of Article 5(1), 5(2)(l) or Article 5(5) of the Indo-US DTAA. Article 5 of the Indo-US DTAA which defines Permanent Establishment reads as under:-

"ARTICLE 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory ;

e) a workshop ;

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources ;

g) a warehouse, in relation to a person providing storage facilities for others ;

h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

i) a store or premises used as a sales outlet;

j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve-month period ;

k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve-month period;

l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period ; or

(ii) the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of Article 9 (Associated Enterprises)].

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise ;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise ;

e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 5 applies - is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State, if:

a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed

place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in the State on behalf of the enterprise have contributed to the sale of the goods or merchandise ; or

c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

32. Para (1) of Article 5 defines a PE to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term 'fixed place of business' includes premises, facilities, offices which are used by an enterprise for carrying on its business. The fixed place must be at the disposal of an enterprise through which it carries on its business wholly or partly. Although, the word 'through' has been interpreted liberally but the very least, it indicates that the particular location should be at the disposal of an Assessee for it to carry on its business through it. These attributes of a PE under Article 5(1) of the Indo-US DTAA were elucidated by the Supreme Court in ***Morgan Stanley*** (*supra*). In a recent decision, a Division Bench of this Court in ***Director of Income Tax v. E-Funds IT Solution*****: [2014] 364 ITR 256 (Delhi)** reiterated the above-stated attributes; after quoting from various authors, this Court held that "*The term 'through' postulates that the taxpayer should have the power or liberty to control the place and, hence, the right to determine the conditions according to its needs*". In the present case, there is no allegation that the Assessee has any Branch Office or any other office or establishment through which it is carrying on any business other than simply stating that Adobe India's constitutes the Assessee's PE. There is no evidence that the Assessee has any right to use the premises or any fixed place at its disposal. The AO has simply

proceeded on the basis that the R&D services performed by Adobe India are an integral part of the business of the Assessee and therefore, the offices of Adobe India represent the Assessee's fixed place of business. Thus, clearly the right to use test or the disposal test is not satisfied for holding that the Assessee has a PE in India in terms of Article 5(1) of the Indo-US DTAA.

33. In ***E-Funds IT Solution*** (*supra*), this Court had expressly negated that an assignment or a sub-contract of any work to a subsidiary in India could be a factor for determining the applicability of Article 5(1) of the Indo-US DTAA. The Court had further expressly held that :

> "Even if the foreign entities have saved and reduced their expenditure by transferring business or back office operations to the Indian subsidiary, it would not by itself create a fixed place or location permanent establishment. The manner and mode of the payment of royalty or associated transactions is not a test which can be applied to determine, whether fixed place permanent establishment exists.
>
> Reference to core of auxiliary or preliminary activity is relevant when we apply paragraph 3 of Article 5 or when sub-clause (a) to paragraph 4 to Article 5 is under consideration. The fact that the subsidiary company was carrying on core activities as performed by the foreign assessee does not create a fixed place permanent establishment."

34. Thus, the AO's view that Adobe India constituted the Assessee's PE in terms of paragraph 1 of Article 5 of the Indo-US DTAA is palpably erroneous and not sustainable on the basis of the facts as recorded by him.

35. We also find that there is no material to hold that the Assessee's employees constitute a Service PE in terms of Article 5(2)(l) of the Indo-US DTAA. The Assessee has denied that any of its employees has rendered any service in India. There is no material available with the AO that would contradict the same. The AO has concluded that the Assessee has a PE in India in terms of Article 5(2)(l) of the Indo-US DTAA, only on the basis that the Assessee has a right to audit Adobe India and that the agreement between the Assessee and Adobe India entails that the Assessee would provide specifications, assistance and supervision for the R&D services procured by the Assessee. The said terms of the agreement do not in any manner indicate that the Assessee has been providing services in India. Clause 5.5 of the agreement referred to by the AO indicates that the Assessee is authorized to audit the Indian subsidiary (Adobe India), so as to ensure that Adobe India adheres to the standards required by the Assessee. The same cannot possibly lead to the inference that the Assessee has been rendering services to Adobe India. The stipulation as to provide specification and further assistance is only for

the purpose of ensuring that the Assessee procures the service that it has contracted for from Adobe India. Such clauses in the agreement cannot lead to an inference that the Assessee has a PE in India for rendering services, that is, a Service PE in terms of Article 5(2)(l) of the Indo-US DTAA. This has also been authoritatively held by Supreme Court in ***Morgan Stanley*** (*supra*).

36. It is also noteworthy that the AO while computing the income that is alleged to have escaped assessment has also not alluded or attributed any income to the services alleged to have been rendered by the Assessee to Adobe India. In terms of Article 7(1) of the Indo-US DTAA, only such income as is attributable to the PE can be taxed in the State where the PE is located.

37. The AO's view that Adobe India constitutes the Assessee's PE under Article 5(5) of the Indo-US DTAA is also wholly unsustainable. Article 5(5) of the Indo-US DTAA provides for an exclusion to Article 5(4) of the Indo-US DTAA. In terms of Article 5(4), where a person acts in a contracting state on behalf of an enterprise of the other contracting state, the enterprise shall be deemed to have a Permanent Establishment in the first mentioned state. In other words, a dependent agent of an enterprise would constitute its PE. In the present case, there is no material

to form a view that Adobe India acts as an agent for and on behalf of the Assessee. Further, there is no allegation that any of the other conditions specified under clauses (a), (b) or (c) of paragraph 4 of Article 5 of the Indo-US DTAA are applicable to Adobe India. One of the necessary conditions for holding that an agent constitutes a PE of an enterprise is that the agent must have an authority to conclude contracts or should have been found to be habitually entering into or concluding contracts on behalf of the enterprise. In the present case, there is no allegation that Adobe India is authorised to conclude contracts on behalf of the Assessee or has been habitually doing so.

38. Insofar as Article 5(5) of the Indo-US DTAA is concerned, the same postulates that any business carried through a broker, commission agent or any other agent of an independent status acting in its normal course would not constitute a PE of an enterprise. The exception to this being that if activities of such agent are devoted wholly or almost wholly on behalf of the enterprise and the transactions between enterprise and the agent are not made under arm's length conditions. In such case, the agent would not be considered as an agent of independent status. In the present case, apart from the AO stating so, there is no reason to assume that Adobe India is an agent of the Assessee; there is neither any agreement

which states so nor any material which indicates that Adobe India acts as such. More importantly, it is not disputed that Adobe India is assessed on its income determined at ALP and, therefore, there is no occasion for the AO to assume that Adobe India constitutes the Assessee's PE under Article 5(5) of the Indo-US DTAA.

39. In view of the aforesaid, the impugned notices and impugned orders are set aside. The petitions are allowed and the pending applications are disposed of. However, in the given circumstances, parties are left to bear their own costs.

VIBHU BAKHRU, J

S.MURALIDHAR, J

MAY 16, 2016
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