



## Use of global network and infrastructure for processing card payment transactions constitutes a Permanent Establishment (AAR)

Litigation on when a non-resident has a Permanent Establishment (PE) in India has always been a contentious issue. Despite over twenty years of jurisprudence on the subject, the gap between the taxpayers' and the Revenue's position on this subject is still quite wide. This is reflected in a recent ruling of the Authority for Advance Rulings (AAR) on certain questions raised by MasterCard Asia Pacific Pte. Ltd. (MAPL or Applicant)<sup>1</sup>. The ruling addresses several important issues around the constitution of a PE and on the characterisation of certain income streams associated with the processing of credit card payment transactions under the India-Singapore Tax Treaty (Treaty).

### Background & Summary

MAPL (a Singapore resident) carried out transaction processing and payment related activities for customers in the Asia Pacific, Middle East and Africa (APMEA) regions through a worldwide network. It *inter alia* entered into agreements with Banks and Financial Institutions in India (Customers) pursuant to which it received transaction processing fees, assessment fees for building and maintaining a network and additional revenue for services ancillary to the transaction processing activities. Additionally, it also had a subsidiary in India called MasterCard India Services Private Limited (MISPL).

The key factors considered in the ruling, and the conclusions drawn by the AAR on account of such factors is briefly summarised below:

Factors	Conclusions
<b>Fixed Place PE</b>	
<ul style="list-style-type: none"> <li>• 'MasterCard Equipment Processors' (MIPs) owned by MISPL were placed at the Customers location.</li> <li>• The processing of transactions took place through the 'MasterCard</li> </ul>	<ul style="list-style-type: none"> <li>• MAPL has a fixed place PE in India because of the presence of MIPs</li> <li>• The MasterCard network constitutes a fixed place PE for MAPL in India.</li> </ul>

<sup>1</sup> See MasterCard Asia Pacific Pte. Ltd. Singapore (A.A.R. No. 1573 of 2014, 6 June 2018)



<p>Worldwide Network' which comprises MIPs, transmission towers, leased lines, cables, nodes, internet and application software.</p> <ul style="list-style-type: none"> <li>• Certain functions in relation to the processing of transactions were undertaken by Bank of India.</li> <li>• Functions and risks that were earlier conducted directly by a non-resident group company of the Applicant are now conducted by MISPL.</li> </ul>	<ul style="list-style-type: none"> <li>• The premises of Bank of India constitute a fixed place PE for MAPL in India.</li> <li>• MISPL (i.e. the Indian subsidiary) constitutes a PE for MAPL in India.</li> </ul>
<b>Service PE</b>	
<ul style="list-style-type: none"> <li>• MAPL's employees visited India from time to time.</li> <li>• Certain activities were also performed by employees of Bank of India.</li> </ul>	<ul style="list-style-type: none"> <li>• Employees of MAPL visiting India to provide services constitute a service PE in India.</li> <li>• Activities performed by Bank of India's employees do not result in the formation of a Service PE.</li> </ul>
<b>Dependent Agent PE (DAPE)</b>	
<ul style="list-style-type: none"> <li>• Marketing support activities were performed by MISPL for MAPL.</li> </ul>	<ul style="list-style-type: none"> <li>• MISPL constitutes a DAPE of MAPL in India on account of habitually securing orders wholly for MAPL.</li> </ul>
<b>Income classification</b>	
<ul style="list-style-type: none"> <li>• A license to use trademarks and marks was granted by MAPL to its customers in India. Customers were also using software as well as intellectual property in MIPs and the network.</li> </ul>	<ul style="list-style-type: none"> <li>• A portion of the fees received by MAPL would be classified as 'royalty' under the Treaty.</li> </ul>

## AAR's Findings

### *PE in India*

#### Fixed Place PE

The AAR concluded that MAPL had a fixed place PE in India on account of:

- a) the presence of MIPs;
- b) the MasterCard Network; and
- c) Bank of India's premises.

Each of these aspects is discussed below:

#### a) MIPs

MIPs situated at the Customer's locations were described as special purpose equipment used for carrying out preliminary examination of information such as PIN processing, validation of card codes, verification of names and addresses of cardholders, sending alerts in case of errors and encryption of data for transmission. The AAR held that the



requirements of permanency, fixed place and disposal enumerated by the Supreme Court in the case of *Formula One World Championships Limited<sup>2</sup>* (FOWC) and the OECD commentary were satisfied with respect to these MIPs. It was held that the MIPs triggered a fixed place PE of the Applicant as they remained placed at the customer locations and were at the disposal of the Applicant.

The AAR noted that affixation of the equipment to the ground was not mandatory as these MIPs remained placed at the site of customer banks itself throughout the year. On the question of whether they were at the disposal of the Applicant, the AAR observed that all decisions related to the MIPs for risk mitigation, maintenance and upgradation were taken by the Applicant itself without any role of the customers. Accordingly, ownership of the MIPs was an irrelevant factor when the Applicant had a certain amount of space at its disposal (customer locations) and the right to use the MIPs for its business activities. The fact that the Applicant also charged one-time license fee for installation and storage of MIPs also suggested that the MIP's were in fact in control of the Applicant.

The AAR also held that functions performed by these MIPs were significant in nature and could not be considered as preparatory and auxiliary [within the meaning of Article 5(7)(e) of the Treaty].

#### b) the MasterCard Network

It was contended that the MasterCard Network that was involved in all three phases of transaction processing, i.e. authorisation, clearance and settlement would constitute a fixed place PE of the Applicant. The Network consisted of MIPs present in India, the Application Software which was owned by the Applicant as well as transmission towers, leased lines, fibre optic cable, nodes, internet, etc. which were provided by third parties.

The AAR ruled that the Network also met the requirements of permanency and fixed place. As regards the disposal test, the AAR concluded that this test was satisfied since:

- The responsibility for management and maintenance of the Network was with a Group Company in the US;
- Application software in the Network was owned and controlled by the Applicant;
- The MIPs and the part of the Network provided by third party service providers was also at the disposal of the Applicant; and
- The Network was secured by MasterCard to prevent fraud and to enhance security.

In the case of the MasterCard Network too, the AAR held that the functions performed by it were significant and not preparatory and auxiliary in nature.

#### c) Bank of India Premises

The Applicants had entered into an agreement with Bank of India for performing certain activities relating to clearing and settlement of transactions. The AAR was of the view that the settlement activity (movement of actual funds between banks) was an integral part of the whole transaction, and was carried out by the employees of Bank of India through its own premises in India. It concluded that the Bank of India premises constituted a fixed place PE of the Applicant. This conclusion was based, inter alia, on the following factors:

- Bank of India carries out settlement activity as an agent of the Applicant and under its instructions and responsibility;
- The employees of Bank of India who carry out this work are under the direction and

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<sup>2</sup> [2017] 394 ITR 80 (SC)



control of the Applicant, and the space occupied by them in Bank of India is at the disposal of the Applicant; and

- The fact that the premises are not exclusively used by the Applicant was not relevant in determining whether a fixed place PE existed.

#### d) Subsidiary as a PE

The AAR held that MISPL would constitute a PE of the Applicant in India on account of the following factors:

- Functions and risks that were earlier conducted directly by a non-resident group company of the Applicant are now conducted by MISPL in India, but not shown in the Functions, Assets and Risks (FAR) of MISPL.
- Since MISPL is carrying on work of the Applicant, to that extent the facilities, services and premises of MISPL are at the disposal of the Applicant.

### Service PE

#### a) Employee visits

The employees of MAPL visited India for conducting business meetings with Customers. The employees visited India for obtaining an understanding of future requirements, providing information on new products, obtaining customer feedback and to monitor efficiency of operations. The visits by the employees exceed the 90-day Service PE threshold provided under the Treaty.

The AAR held that the visits by employees constitutes a Service PE on account of the following factors:

- Relying on the decision of *e-Funds IT Solutions Inc*<sup>3</sup>, the first test for creating a Service PE is satisfied since service is provided to Indian customers;
- Even if a part of the process is automated, employees are needed to check; if the process is working in order; to interact with customers; to meet clients and take feedback, etc. All these activities are a part of the services that MAPL renders to its Customers. Thus, the employees visiting India are providing services to Indian Customers and constitute a Service PE in India; and
- Visits by the employees cannot be considered as 'stewardship activities' (as held as not constituting a Service PE by the Supreme Court in case of *Morgan Stanley & Co*<sup>4</sup>).

#### b) Bank of India employees

As mentioned earlier, MAPL had entered into an agreement with Bank of India for performing certain activities relating to clearing and settlement of transactions. The tax authorities contended that there is a Service PE in India, as services are rendered by the Applicant through the employees of Bank of India.

The AAR held that a Service PE under the Treaty cannot be constituted through Bank of India employees on account of the following reasons:

- The employees of the Bank are neither employees of MAPL nor are they 'other

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<sup>3</sup> [2017] 399 ITR 34

<sup>4</sup> [2007] 292 ITR 416



personnel' engaged by MAPL to render services; and

- The employees render services to the Bank in lieu of salaries they receive from the Bank. As such, the employees of the Bank rendered services on behalf of the Bank to MAPL.

### DAPE

The Indian subsidiary, MISPL was involved in rendering marketing support services to MAPL. MISPL provides the proposals to the Indian banks that are prepared, validated and approved by MAPL. The proposal contains rates at which MAPL proposes to provide services to the Customers. In case the Customer makes a counter proposal, the same is uploaded on the portal of MAPL outside India by the employees of MISPL. MAPL contended that MISPL cannot be considered as a DAPE in India under the Treaty.

The AAR held that the MISPL was involved in '*habitually securing orders*' on behalf of MAPL and constitutes a DAPE for MAPL under the Treaty. This was based on the following factors/observations:

- MISPL is legally and economically dependent on MAPL being a 100 percent subsidiary. It gets its instructions and remuneration from MAPL;
- Though the contracts were finalised by MAPL, the contracts were routed through MISPL. While this does not satisfy the requirement for 'conclusion of contracts', it certainly satisfied the requirement of 'securing orders' to constitute a DAPE; and
- The term 'habitually' is to be interpreted in the context of business of MAPL. In this context, the process followed for entering into contracts (even if undertaken for two or three new contracts within a year) satisfied the requirement of 'habitually' securing orders.

### *Nature of payments received by the Applicant – Whether taxable as Royalty or Fees for Technical Services (FTS)*

#### Taxability as Royalty

The next issue for consideration was whether the payments received by MAPL from the Customers such as transaction processing fees, assessment fees and transaction related miscellaneous fees would be taxable as 'royalty' or 'FTS' under Article 12 of the Treaty. MasterCard Internal Incorporated, USA (MCI) had entered into a MasterCard Electronic License Agreement with the Customers for granting a license towards use of trademarks. This agreement was subsequently assigned to MAPL. MAPL contended that the fees received from the Customers was for transaction processing and the licensing of trademarks was purely incidental. Accordingly, MAPL contended that fees received from the Customers cannot be considered as royalty.

The AAR observed that the taxability of income streams is to be determined based on the real nature of the transaction and not on the classification made by MAPL or the Customers. The AAR distinguished the Delhi High Court ruling in case *FOWC*<sup>5</sup> and held that the dominant purpose of the agreement is to license trademarks based on the following factors:

- Unlike FOWC, the use of trademarks is not for a limited period and not for use in a restricted manner;
- There seems to be no justification for MAPL to license trademarks/logo to Customers

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<sup>5</sup> [2017] 390 ITR 199 (Del)





who are receiving services and not providing services;

- MAPL is paying royalty under the licensing agreement with MCI US [the real owner of the Intellectual Property (IP)];
- MAPL further licensed these IPs to the Customers so that it can be used by the Customers for selling cards which in turn would increase the transaction processing activity of MAPL;
- If MAPL is paying royalty to MCI US for use of intangibles and these intangibles are used by the Customers in India, then the fees charged by MAPL to the Customers is nothing but a consideration for use of intangibles in India.
- The trademark/brand is needed by the Customers for attracting people to buy their cards and not for transaction processing.
- If the use of the trademarks/brand was purely incidental, there was no need for MAPL to incur significant amount of expenditure on advertisement and promotion.
- It is the final consumers who are ultimately making a payment for using the intangibles of MasterCard in the form of brand, reputation trust reliability, logo etc. The Customers i.e. the Banks in only a medium for the fee to be paid by the consumer to MAPL.

Based on the above, the AAR held that the licensing of various IPs in the form of trademarks/brand, etc is not incidental to the activity of transaction processing. The payment made by various Customers in India to MAPL is for the use of these IPs and hence is royalty. Such royalty is effectively connected with various types of PEs (discussed above which would be taxable under Article 7 and not under Article 12).

Additionally, the AAR held that a portion of the fees received by MAPL would be classified as 'royalty' under the Treaty based on the following factors/observations:

#### a) Use of equipment

The AAR held that MAPL is the *de facto* owner of the MIPs, as it *inter-alia* recovered the cost of installation of the MIP in the one-time on boarding fee. The payment for use of MIPs constitutes royalty and is effectively connected with the PE created on account of MIPs as well as other PEs.

#### b) Use of process

Relying upon the decision of Madras High Court in *Verizon Communication*<sup>6</sup>, the AAR held that since both the equipment and processing was undertaken in India, there was a use of 'process' taxable as royalty under the Treaty. The AAR held that the process need not be secret.

Even otherwise, the AAR held transaction processing involved use of 'secret process' considering the technology involved in transaction processing, technology hubs of the Group in India and acquisitions undertaken towards technological developments by the Group (irrespective of whether such process is patented or not).

#### c) Use of software

MAPL contended that there is no standalone provision of MIP and application software and that the transaction is rendering of transaction processing service. However, the AAR

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<sup>6</sup> [2014] 361 ITR 575 (Mad)



observed that the use of software embedded in the MIP, and cards in the application software are essential part of the transaction without which no transaction can be completed. Thus, the AAR held that the use of software is royalty and is effectively connected to the PE.

### Taxability as FTS

As far as taxability of receipts as FTS is concerned, the AAR held that as the payments received by MAPL are for use of a 'standard facility' which is provided to the ultimate consumers, the same cannot be treated as FTS by virtue of several judgements laid down by the Courts. While determining whether the payment constitutes FTS or not, the AAR has viewed the transaction from the perspective of the final consumer and not from the perspective of Customer i.e. Banks as they are regarded only as a medium for payment of fees to MAPL.

The payments for other services which are not in nature of a standard facility are also not held to be in the nature of FTS as they do not 'make available' any technical knowledge or skill or know-how to the recipient.

### *Would arm's length remuneration to the PE absolve any further attribution of profits to the PE?*

Reliance was placed by MAPL on the decision of Supreme Court in the case of *Morgan Stanley* (supra) to contend that no further profit attribution needs to be made to a PE, once it is remunerated on an arm's length basis.

The AAR held that the aforesaid decision of the Supreme Court was in the context of an Agency PE and cannot apply to the facts of this case where existence of a Fixed Place PE is upheld. The AAR also held that functions performed and risks undertaken by MAPL through its Indian subsidiary is not fully captured in the FAR profile of the Indian subsidiary and hence a further profit attribution may be considered by the Assessing Officer.

Even in the case of DAPE, the AAR held that the FAR profile of its PE in India, is different from FAR of the dependent agent (Indian subsidiary). It is only when both FARs are identical, one can say that there cannot be any further profit attribution.

### *Tax withholding at source*

The AAR held that the payments made to MAPL constitutes royalty which is effectively connected to the PE in India and hence tax should be deducted at the applicable rate on a net income basis. In respect of services rendered outside India, as they are not effectively connected to the PE in India, there is no requirement to withhold tax; however, attribution exercise needs to be done by the Assessing Officer.

### **Dhruva Comments**

While determination of a PE is a factual exercise, the ruling throws light on critical aspects to be considered for evaluating the existence of a PE. This ruling may have far reaching implications for business models/arrangements where substantial part of business is carried through digital/e-commerce platforms without any significant human intervention. One may also expect this ruling to be taken in further appeal to the High Court. While the ruling of the AAR is binding only on the Applicant, nonetheless, the taxpayers would need to critically assess the impact of this ruling on their business models/arrangements.



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