New dimension of PE Taxation- Substance Over Form

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1.0 Introduction:

In International Taxation Landscape, Permanent Establishment (PE) taxation has always been a topic of evolving dimensions. Article 5 of OECD MC deals with PE and its different shades, the prominent being fixed PE under sub article (1). Recent classic judgement of the Hon'ble Supreme Court of India (SC) in the case of Hyatt international[1] examined the facts of the case of a so-called consultancy service arrangement and finally approved the High Court's finding that there is fixed PE of the non-resident Hyatt UAE in India. It is a classic example of substance over form scenario dealing with the PE taxation.

2.0 Factual Matrix:

Hyatt International Southwest Asia Ltd. is a Company incorporated in Dubai and is tax resident of UAE (hereafter referred to as Hyatt UAE). Hyatt UAE is a globally renowned hotel and hospitality corporate group. It is an established brand in the global hotel industry. In 2008 Hyatt UAE entered into a 20-year Strategic Oversight Service Agreement (SOSA) with Asian Hotel Ltd.(AHL) a resident company of India. AHL owns and operates two hotel properties in Delhi and Mumbai in India. Hyatt UAE provided the strategic services from Dubia to AHL in promoting AHL's hotel business in terms of formulating and establishing strategic plans relating to branding, marketing, product development and other key operations as per SOSA mentioned above. One of its group companies Hyatt India Pvt. Ltd. is a resident Indian company which managed the daily hotel operations of AHL on the basis of a separate Hotel Operating Service Agreement (HOSA) entered into between the two entities. Hyatt UAE had full control and discretion in formulating and establishing strategic plans relating to branding, marketing, product development and other key operations in the form of appointing and supervising key personnel like General Manager (GM) etc., implement Human Resource (HR) and procurement policies, control pricing , branding, marketing strategies and manage operational bank accounts. It is empowered to assign personnel to the hotel without the owner's consent.

The most important fact is that Hyatt UAE receives its fee calculated as a percentage of hotel's revenue as well as cumulative gross operating profits. Under the SOSA, Hyatt UAE agreed to provide strategic planning services and know how to ensure that the hotel was developed and operated as an efficient and high-quality full-service hotel. On examination of the entire arrangement and looking beyond the covenants of the agreements, Assessing Officer (AO) held that Hyatt UAE had a fixed PE in India under Article 5(1) of the OECD MC. On account of Hyatt UAE carrying out its business through the hotel premises in India, the income received from SOSA by Hyatt UAE was held to be attributable income of the PE to be taxed in India. Dispute Resolution Panel (DRP) endorsed AO's findings. Hyatt UAE filed an appeal before the Income Tax Appellate Tribunal (ITAT). The ITAT rejected the appellant's contention and held that it had a fixed PE in India and SOSA fee was held to be taxed in India. The Delhi High Court endorsed the findings of the ITAT. The appellant Hyatt UAE contested before the SC.

3.0 Rival Arguments:

3.1 Taxpayer's Arguments

It was argued that the SOSA fee received by Hyatt UAE cannot be categorized as fee for technical services (FTS) in the absence of the FTS clause in India-UAE DTAA. Once the receipt of income cannot be categorized as FTS then the same would be treated as business profits that becomes taxable only when Hyatt UAE has a PE in India. It was argued that there was no designated place for Hyatt UAE to operate in both the hotels in Delhi and Mumbai so as to constitute fixed place PE. It was further explained that employees of Hyatt UAE travelled to India for a period less than the threshold stipulated for a service PE under Article 5 of OECD MC. It was mentioned that day to day operations of the hotel were carried out by Hyatt India under a separate agreement HOSA. It was argued that Hyatt UAE rendered only consultancy services and nothing beyond the same and accordingly argued that it was not taxable in India for the years under consideration.

3.2 Revenue's Arguments:

It was argued by the Revenue that Hyatt UAE had enjoyed full and unconditional disposal of the entire hotel premises and thereby the argument of the taxpayer of a "specific designated place" has no relevance. Hyatt UAE had unfettered rights under the SOSA to depute senior level employees at their own discretion and involve in implementation of Human Resource and procurement policies, and exercised full control on pricing, branding and marketing strategies. It managed and operated bank accounts. So, all these facts were demonstrated to argue that Hyatt UAE's role extended much beyond high level policy formulation and in real carried the business activity on its own. Another clinching issue raised by the Revenue is that Hyatt UAE received its fee calculated as a percentage of hotel's revenue as well as that of cumulative gross operating profit. It was argued that SOSA satisfied three important criteria –

i) Stability -as the same is for a 20-year term,

ii) Productivity- as the fee is linked to business revenues and profit and

iii) Dependence- as it relied on the entire hotel infrastructure.

Thereby it was vociferously argued that Hyatt UAE constituted a fixed PE under Article 5(1) of DTAA in India and accordingly the entire SOSA fee is to be taxed in India as attributable to the PE.

Revenue placed reliance on the decision of the SC in *Formula One World Championship Ltd.*[2]wherein, racing circuit which was under the control of Formula One World Champions (FOWC) was held to be a fixed PE in India. In the decision of *Formula One (supra)* the Hon'ble Court referred to the decision of *Visakhapatnam Port Trust*[3] where a PE is explained to be of such nature that it would amount to a virtual projection of a foreign entity of one country into the soil of another country.

4.0 Decision of the Court:

The Hon'ble Court examined the covenants of SOSA as extracted in the impugned HC judgement and observed that Hyatt UAE enjoys the discretion in formulating and establishing the strategic planning in all aspects of hotel operations, including branding, product development etc. Hyatt UAE is empowered to depute key personnel like General Manager and members of the executive committee. The hotel owners' consent in this process is not mandatory. Another important ingredient of the agreement in respect of the strategic fee received by Hyatt UAE is not a fixed fee; instead, it is calculated as a percentage of hotel revenue as well as percentage of cumulative gross operating profit.

The Hon'ble Court observed that the degree of control and supervision exercised by the appellant clearly transcends much beyond the advisory service and aligns with criteria for a fixed PE under Article 5(1) of India-UAE DTAA. The Court relied on *Formula One's (supra)* decision and also of commentaries of Klaus Vogel and Phillip Baker and held that it is a fit case of fixed PE under Article 5(1) of the DTAA. It was observed that Hyatt UAE performed core and essential functions by deputing key personnel and engaged itself in implementation of various strategic policies. In the process the entire hotel premises was at the disposal of Hyatt UAE and satisfied the criteria required under Article 5(1) of the DTAA to be the fixed place of business. It was held in *Formula One Case (Supra)* the exclusive position is not essential- temporary or shared use of space is sufficient, provided business is carried on through that space. In view of the same assessee's argument that there is no designated place at the disposal of Hyatt UAE is found to be without any force.

The Court agreed with the Revenue's argument that SOSA being for a term of 20 years coupled with Hyatt UAE's continuous and functional presence satisfies the tests of stability, productivity and dependence. Hyatt UAE's argument that daily operation was handled by Hyatt India a separate legal entity did not help in any way as the core functions and strategic decision making were all influenced by Hyatt UAE in respect of the hotel business.

4.1 Attribution of Profits:

The HC order which is contested before SC in this case had referred the issue of attribution of profits to PE to a larger Bench of Delhi HC . Delhi HC in its Full Bench decision held that in case of a PE of a non-resident, if constituted in India the attribution of profits is based on the functions carried out, assets employed and risks assumed (FAR) in respect of activity carried out in India by the PE. The overall performance of the entity at the global level though it results in a loss has no bearing on the PE attribution and should be computed as per the FAR analysis of PE in the source state. This Full Bench decision of the HC overruled its own division bench decision in the case of *Nokia Solutions*[4] wherein a contrary decision was rendered that there would be no attribution of profits to PE in case the entity's performance at a global level resulted in loss.

Hon'ble SC affirmed the finding of the HC in respect of Hyatt UAE constituting a fixed place in India under Article 5(1)and further held that income received from SOSA is attributable to such PE and is therefore taxable in India. Thereby, though the issue of attribution of profits to PE is not an issue of contest before the SC the Full Bench decision of Delhi HC in respect of PE attribution has been indirectly endorsed.

5.0 Article 5(1)-OECD MC- Court Findings:

Article 5(1) of OCED Model Convention states *"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."*

As per the fixed PE definition there are two limbs as under:

a. There must be a specific, fixed, identifiable physical location in the source country; and

b. Such location must be at the disposal of the foreign enterprise for carrying out its business wholly or partly.

Hon'ble SC agreed with the finding of HC that the entire hotel premises were at the disposal of Hyatt UAE and thereby satisfied the disposal test. The second test is in respect of carrying out the business either wholly or partly through such premises at the disposal. It is to be examined whose business is required to be carried out from such place in the present case so as to constitute a fixed PE. It is obvious that the non-resident, i.e. Hyatt UAE has to carry on its own business from the said hotel premises either wholly or partly. It is therefore relevant to examine what business activity has been pursued by Hyatt UAE from the said hotel premises in India. SOSA provides that Hyatt UAE is obliged to provide strategic consultancy services to AHL the owner of the hotel property. As per the observations of the Court Hyatt UAE travelled beyond the scope of advisory role and participated in implementation of policies of brand building, marketing and pricing strategies etc. In pursuing these objects whether Hyatt UAE carried out its own business or is it the business of AHL? If the business of AHL is promoted on account of Hyatt UAE's advisory role and also on account of extended implementation role, is it not just a support given to AHL and nothing beyond that? In other words, Hyatt UAE's advisory role and its involvement in implementation of policies only promoted AHL's business then the second condition that non-resident should carry out its own business through the premises at disposal is not satisfied. Accordingly, can it be said that the fixed PE of Hyatt UAE did not pursue its own business which is a mandatory condition under Article 5(1)?

Or, looking at the facts of the case, is it to be construed that Hyatt UAE being eligible to receive fee as a percentage of the hotel revenue and gross operating profit promoted its own business by running the hotel of AHL. This can be inferred from the Hon'ble SC observation in para 12.3 *"The consideration is not a fixed fee; instead, it is calculated as a percentage of room revenue and other revenues and income – whether directly or indirectly derived from the hotel's operations – as well as cumulative gross operating profit. This remuneration structure clearly reflects an active commercial involvement, linking the assessee's income to the financial and operational performance of the hotel."*

Para 16 - *"In the present case, a detailed review of the SOSA executed between the appellant and AHL demonstrates that the appellant exercised pervasive and enforceable control over the hotel's strategic, operational, and financial dimensions. Specifically, the agreement vested the appellant with powers to:*

- Appoint and supervise the General Manager and other key personnel,

- Implement human resource and procurement policies,

- Control pricing, branding, and marketing strategies,

- Manage operational bank accounts,

- Assign personnel to the hotel without requiring the owner's consent.

These rights go well beyond mere consultancy and indicate that the appellant was an active participant in the core operational activities of the hotel."

This judgement is a classic example of examining facts relating to the actual conduct in comparison with the documentation etc., thereby looking at substance over the form.

6.0 Conclusion- Key Takeaways:

This decision of the SC is a trendsetting classic ruling laying emphasis on substance over form. It is no more possible for the corporate world to shield themselves under the guise of clever documentation, thereby artificially avoiding the trigger of PE in the source country. In this present case though, Hyatt UAE projected itself as rendering consultancy services but ended itself in virtually conducting the hotel business of service recipient i.e. AHL and getting rewarded in a revenue sharing arrangement. In respect of looking at this decision as a precedent, one needs to carefully note that this would act as a precedent only in a set of specific facts that exactly exist as in this present ruling. Thereby this ruling may not be a precedent in every normal case of non-resident rendering consultancy services to a resident in India and strictly confining himself to the advisory role. The issue of attribution of profits to PE, though not disputed before the Hon'ble SC in this case, the ratio laid down by Full Bench of Delhi HC attains the sanctity on account of affirmation by the SC as an *obiter dicta* in this decision. Thereby attribution of profits to PE should be on the basis of FAR analysis of PE's activity in the source country irrespective of entity as a whole incurring loss globally. However, contrary erudite view is that attribution issue is not adjudicated by the SC and is open for adjudication by the SC on a specific question of law that may be disputed in the future.

This decision unfolds a new dimension to the PE taxation in the International Taxation landscape.

1 *Hyatt International Southwest Asia Ltd [TS-954- SC-2025]*

2 *Formula One World Championship Ltd. [TS-361 -SC-2017]*

3 *Visakhapatnam Port Trust [1983] 144 ITR 146 AP HC*

4 *Nokia Solutions and Networks OY [TS-960 -HC-2022 (DEL)]*