

MASTERCARD HAS A PERMANENT ESTABLISHMENT IN INDIA: AAR

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- MasterCard's Indian operations resulted in the constitution of a fixed place and dependent agent PE in India under the India Singapore DTAA
- Employees of MasterCard visiting India constituted a service PE of MasterCard in India
- Fees paid to MasterCard by Indian customers (primarily banks and other financial institutions) for payment processing services offered by MasterCard would be classified as royalty income

India's tax authority has won a sweeping victory before India's Authority for Advance Rulings (AAR), convincing the tribunal on 6 June 2018 that MasterCard's activities in India created a permanent establishment in India under several different theories. The tribunal also concluded that processing fees paid to MasterCard's regional headquarters by Indian banks and other financial institutions were royalty income.

In its decision, the AAR appears to have unreasonably lowered the threshold for the formation of a PE in India, making it likely that the decision will be appealed to the High Court. The decision also appears to call into question the well-established understanding on profit attribution, which is likely to be of significant concern to MNEs deriving revenues from Indian operations.

Background

An advance ruling was sought from the AAR by MasterCard Asia Pacific Pte Limited (MasterCard Asia Pacific), MasterCard's regional headquarters for the Asia Pacific, Middle East, and Africa and a wholly owned indirect Singapore subsidiary of MasterCard USA, regarding the taxability in India of fees received from Indian banks and other financial institutions for its payment processing services.

The service involved electronically processing payments between a cardholder's bank and a merchant's bank using the MasterCard network.

Under royalty agreements signed by Indian financial institutions, MasterCard Asia Pacific received transaction processing fees in exchange for authorization, clearing, and settlement of card-based transactions, and additional fees for incidental services.

Each financial institution was provided with a MasterCard Interface Processor (MIP) – an electronic device the same size as a standard personal computer – to be placed in the institution's premises, which connected the financial institution to the MasterCard network.

MasterCard Asia Pacific's Indian subsidiary, MasterCard India Services Private Limited (MasterCard India), owned and maintained the MIPs placed in Indian financial institutions and also provided support services.

Ruling of the AAR

After hearing both parties, the AAR arrived at the following conclusions:

1. MIPs constitute a fixed place PE

The AAR ruled that all material decisions relating to the operation and maintenance of the MIPs were made by MasterCard Asia Pacific even though MasterCard India had legal ownership of MIPs. This demonstrated that the MIPs were at the disposal of MasterCard Asia Pacific for the duration of the licence agreement.

The AAR also rejected MasterCard's contention that the functions performed by MIPs fell within the preparatory or auxiliary exception in the India-Singapore tax treaty.

The AAR noted that MIPs provided several key elements of the payment authorization process, such as PIN processing, validation of card codes, address and name verification, fraud alerts, and data encryption.

MIPs were therefore responsible for preliminary examination and verification of the transaction, failing which the transaction would not be authorized. This was held to be a significant activity, and not merely a preparatory or auxiliary one.

For this reason, the AAR held that MIPs created a fixed place PE of MasterCard Asia Pacific in India.

2. MasterCard Network constitutes a fixed place PE

The AAR noted that the actual settlement of moving funds between banks was undertaken in India by the Bank of India, on behalf of MasterCard Asia Pacific.

The AAR understood the MasterCard network to include MIPs and MasterCard's application software, as well as transmission towers, leased lines, fibre optic cables, and transmission nodes (all owned by third parties).

The AAR concluded that although several functions were performed outside India, significant activities relating to clearance and settlement took place in India. Relying on the prior rulings holding computerised reservation systems to be PEs (*Amadeus Global v. DCIT*, (2008) 113 TTJ 767 and *Galileo International v. DCIT*, (2008) 114 TTJ 289), the AAR held that just like MIPs, the MasterCard network also passed the tests of permanency and "fixed place."

Regarding the disposal test, the AAR observed that since a sister company of MasterCard Asia Pacific was responsible for management and maintenance of the MasterCard Network, and since the application software used to access the MasterCard network was owned and controlled by the MasterCard Asia Pacific, the MasterCard network was at the disposal of MasterCard Asia Pacific.

On that basis, the AAR ruled that the MasterCard network also constituted a fixed place PE of the MasterCard Asia Pacific in India.

3. Bank of India constitutes a fixed place PE

The AAR observed that since the employees of the Bank of India (the designated settlement bank in India) carried out their functions in accordance with the instructions given by the MasterCard Asia Pacific, such employees were under the control and supervision of MasterCard Asia Pacific, and hence the space occupied by them in the Bank of India was effectively at the disposal of MasterCard Asia Pacific.

On that basis, the AAR ruled that Bank of India also constituted a fixed place PE of MasterCard Asia Pacific in India.

4. MasterCard India constitutes a fixed place PE

For ten financial years prior to FY 2014-15, MasterCard USA had voluntarily declared it had a PE in India and had agreed to Indian taxation on 100% of the income arising from its Indian operations.

In FY 2014-15, the group restructured and Indian activities and employees of MasterCard USA were transferred to newly formed MasterCard India.

MasterCard argued that it had admitted to the existence of a PE in prior tax years only under a tax treaty mutual agreement procedure (MAP) settlement process to avoid protracted litigation with Indian tax authorities.

The AAR disagreed with MasterCard's contention that it had admitted to the existence of the PE only under MAP settlement.

Relying on income tax returns for prior years, the AAR observed that MasterCard had admitted to the existence of a PE under MAP settlement only for years prior to FY 2004-05.

For subsequent years (up to FY 2013-14), the MasterCard had voluntarily admitted to carrying on transaction processing activities resulting in the creation of a PE in India. In such a situation, MasterCard Asia Pacific was precluded from now stating that MasterCard India was only carrying on support activities, which could not result in a PE.

The fact that MasterCard India was carrying on the business of MasterCard Asia Pacific, to the extent that all facilities, service, personnel, and personnel of Mastercard India were at the disposal of the Mastercard Asia Pacific, meant that the MasterCard India constituted a fixed place PE of the MasterCard Asia Pacific in India.

The AAR also concluded that MasterCard Asia Pacific's analysis of the functions, assets, and risks of MasterCard India did not accurately reflect the nature of activities performed by it, since the very same activities that were previously classified as transaction processing activities were now sought to be classified as support activities.

5. Visiting employees constitute a service PE

The AAR further held that the services performed by visiting employees of MasterCard, such as taking customer feedback, providing information about new products, and monitoring the efficiency of operations were an integral part of the transaction processing services provided by the MasterCard Asia Pacific to Indian customers.

These services could not constitute stewardship activities, the AAR said. Accordingly, the AAR held that a service PE of the MasterCard Asia Pacific was constituted in India.

6. MasterCard India constitutes a dependent agent PE

The AAR noted that MasterCard India habitually secured orders for the MasterCard Asia Pacific in India. Based on the narration of the MasterCard Asia Pacific, the AAR observed that all agreements entered with Indian customers after the incorporation of MasterCard India were in fact routed through MasterCard India.

In the AAR's view, this showed that MasterCard India was habitually securing orders for MasterCard Asia Pacific, thereby resulting in the constitution of a dependent agent PE of MasterCard Asia Pacific in India.

7. Payments to MasterCard Asia Pacific amount to royalty

The AAR noted that under a license agreement between MasterCard USA (which owned all MasterCard intellectual property (IP) and MasterCard Asia Pacific, MasterCard Asia Pacific was granted a license to use MasterCard IP in connection with MasterCard's transaction processing services.

This IP was subsequently sub-licensed to Indian banks and financial institutions by MasterCard Asia Pacific. In the AAR's view, this meant that the dominant purpose of the agreements executed between MasterCard Asia Pacific and Indian financial institutions was to allow the institutions to use MasterCard Asia Pacific's IP for their payment card programs, and therefore constituted royalty payments.

However, since such payments were effectively connected with a PE of MasterCard Asia Pacific in India, they would be taxed as business profits under Article 7 of the India-Singapore tax treaty, and not as royalty.

Independent of this finding, the AAR held that such payments would also be classified as payments for the use of equipment (being the MIPs), or as payments for use of a secret process (being the workings of the MIPs), or as payments for use of software (being the application software of Mastercard Asia Pacific used for accessing the Mastercard network) and would therefore amount to royalty payments, but would be taxable as business profits under Article 7 for being effectively connected with a PE of Mastercard Asia Pacific in India

8. Attribution of profits

AAR relied on its previous finding on the functions performed, assets employed, and risks assumed by MasterCard India on behalf of the MasterCard Asia Pacific, to conclude that the remuneration paid by the MasterCard Asia Pacific to MasterCard India was not arm's length.

Relying on the decision of the Supreme Court in *DIT v. Morgan Stanley & Co*, [2007] 292 ITR 416, the AAR concluded that there would be a need to attribute further profits. On this basis, the AAR observed that the tax authorities may consider a further attribution of profits to MasterCard India.

Key takeaways

The AAR has made sweeping remarks on the taxability of MasterCard in India on several counts – holding that MIPs, MasterCard network, and MasterCard India constitute a PE of MasterCard Asia Pacific in India.

In respect of the transaction processing fees, the AAR has ruled the fees to be royalties, and not business income.

The AAR seems to have lowered the thresholds for formation of a PE in India, and not considered the dominant nature of transactions, to determine the characterization and effect of a transaction.

While the AAR has acknowledged that significant functions of the business were carried outside India, the AAR has adopted a somewhat narrow approach, holding that certain Indian participants and digital equipment would nonetheless constitute a PE of MasterCard Asia Pacific in India.

In light of this approach, it would be interesting to see the profit attribution in such cases where Indian functions, although relevant from a PE perspective, form a small portion of the global functions of the business.

In fact, the AAR has also gone on to reject the well-established rule in *Morgan Stanley*, namely, that there can be no further attribution in case of arm's length transactions. The reason is that the functions, assets, and risks analysis was inadequate, and the ratio in *Morgan Stanley* is inapplicable to fixed place PE.

Interestingly, the AAR has held an Indian subsidiary of a foreign parent to be a PE; however, the AAR's findings on this point are fact driven and also based on prior conduct of MasterCard with respect to its tax position.

Setting up Indian subsidiaries and transacting on an arm's length basis with such entities has been a standard process for foreign MNEs looking to establish presence in India. The ruling will have an impact on such structures, and MNEs will need to evaluate the value attributed to their Indian entities vis-à-vis the functions performed.

Considering recent rulings, it appears that tax tribunals are moving towards a liberal interpretation of current tax laws to accommodate digitized transactions. Digital business models are especially vulnerable to the changing tax landscape, given the lack of clear jurisprudence in this space.

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You can direct your queries or comments to the authors.