Attribution of Profits to Permanent Establishment – The Indian Experience

Globalisation has created a controversy between the tax payers and tax authorities on the emergence of Permanent Establishment ('PE') as well as the attribution of profits to PE. The PE concept is used in international taxation to determine whether the particular income shall or shall not be taxed in the state from which the income originates. In a recent decision of *Rolls Royce Singapore Pvt Ltd Vs. ADIT,* the Delhi High Court, while dealing with the issue of attribution of profits to PE, *inter alia*, held that the Transfer Pricing analysis to determine the "arm's length" price has to be done by taking the "Functions, Assets used and Risk involved" (FAR) and in case the same has not been done, the argument on 'arm's length' price would not be acceptable. The purpose of this article is to highlight the importance of complying with the arm's length principle when remunerating the enterprise constituting the PE and the issues in relation to the same. However, readers would need to also analyse the taxability under the Income-tax Act, 1961 ('Act') before arriving at a conclusion.

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD model tax treaty, which forms the basis of the extensive network of tax treaties between OECD countries and also between several OECD and non-OECD countries. Variations in domestic tax laws regarding taxation of PEs and lack of consensus as regards correct interpretation of Article 7 may result in double taxation for such foreign entity. In a recent decision of *Rolls Royce Singapore Pvt Ltd Vs. ADIT,* the Delhi High Court, while dealing with the issue of attribution of profits to PE, *inter alia,* held that the Transfer Pricing analysis to determine the "arm's length" price has to be done by taking the "Functions,

Assets used and Risk involved" (FAR) and in case the same has not been done, the argument on 'arm's length' price would not be acceptable.

Concept of Attribution of Profits

Under the provisions of the tax treaties, if a foreign enterprise carries on business in India through a PE, then the profits of such enterprise may be taxed in India but only so much of them as are directly or indirectly attributable to such PE.

As per Article 7(2) of the OECD Model Convention 2010, the profits to be attributed to the PE would be the profits which the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the Functions performed, Assets used and Risks assumed (FAR) through the PE and other parts of the enterprise.

Para 16 of the OECD commentary on Article 7 further provides that profits that are attributable to the PE are to be determined under the fiction that PE is a separate enterprise and that such an enterprise is independent from rest of the enterprise of which it is a part as well as from any other person. The second part of the fiction corresponds to the arm's length principle.

OECD 2010 report on the attribution of profits to PE provides for a two-step process to apply an arm's length separate enterprise principle in attributing profits to a PE:

- *Step 1:* Undertake a functional analysis and factual analysis, which attributes to the PE the Functions performed, Assets used and Risks assumed (FAR) by the enterprise in respect of the business it carries on through the PE.
- *Step 2:* Determine the pricing on an arm's length basis, which determines an arm's length return for the FAR attributed to the PE.

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Thus, the OECD has developed a working hypothesis as regards the approach for attribution. It has examined the feasibility of treating a PE as a hypothetical distinct and separate enterprise and has reviewed ways in which transfer pricing principles could be applied by analogy in order to attribute profits to a PE in accordance with the arm's length principle.

Thus, method of attribution of profits to the PE has become one of the major concerns for the global multinational enterprises. The attribution has been a matter of dispute over a period of years and there are various judicial precedents which have tried to relate the attribution of profits and the arm's length principles. Accordingly, we have discussed below some of the decisions which have dealt with the issue of profit attribution:

- ***Rolls Royce Singapore Pte Ltd Vs. ADIT (Delhi High Court)***

Facts:

Rolls Royce Singapore Pte Ltd ('assessee' or 'RRSL'), a tax resident of Singapore, was engaged in the business of supply of spare parts for oil field equipment and rendering repairs/overhauling services of certain equipment. Furthermore, the assessee had obtained the services of ANR Associates (ANR) in India, which was engaged in receiving/ soliciting orders.

The assessee argued that ANR should be treated as a person working in an independent capacity and, therefore, should not constitute a Dependent Agent in India. Alternatively, even if ANR is treated as a Dependent Agent of RRSL, the payment of US$40,000 per annum that was paid, being an arm's length price, no further income was attributable in India in the hands of RRSL for the reason that ANR was already liable to tax in India.

The AO, CIT (A) and tribunal took the view that the assessee had a "permanent establishment" on the basis that it had a "dependent agent" in India under Article 5(9) of the India-Singapore DTAA and that the income earned from supplying spare parts was taxable in India. The AO held that 25% of the profits on sales of spare parts were chargeable to tax which was reduced to 10% by the CIT (A) and the tribunal. Aggrieved by the ITAT's order, RRSL appealed before the

Bombay High Court, in case of *SET Satellite (Singapore) Pte Ltd (218 CTR 452)*, has held that if the correct arm's length price is applied and paid, then nothing further would be left to be taxed in the hands of the foreign enterprise. The Bombay High Court restored the CIT(A) order in the taxpayer's case and held that in case the agent is remunerated at arm's length by the foreign principal, the tax liability of the foreign principal (which would arise in case it is regarded to have a PE in India) would stand extinguished.

Delhi HC with respect to existence or otherwise of a PE in India on account of the activities of ANR and the subsequent income attribution in India.

Ruling:

The High Court, while dealing with the above issue, *inter alia* held that while in principle it is correct that if a fair price is paid by the assessee to the agent for the activities of the assessee in India through the Dependent Agent PE and the said price is taxed in India at the hands of the agent, then no question of taxing the assessee again would arise; this is subject to a Transfer Pricing Analysis being undertaken under Section 92. The facts showed that the manner in which the commission/remuneration had been fixed was usually not done between independent parties in an uncontrolled transaction. The assessee was in a position to dictate terms to the agent and so it could not be said that the commission was at "arm's length" within the meaning of Article 7 (2) of the DTAA. The Transfer Pricing analysis to determine the "arm's length" price has to be done by taking the "Functions, Assets used and Risk involved". As this has not been done, the assessee's argument on "arm's length" price is not acceptable [*(Morgan Stanley 292 ITR 416 (SC) & Set Satellite (Singapore) 307 ITR 205 (Bom) distinguished*].

As the commission paid by the agent to the DAPE is not at "arm's length," the estimation that 10% of the profits on sales of spare parts were attributable to the activities carried out by the agent in India and taxable, is reasonable.

- ***Supreme Court judgement in case of DIT (Intl Taxation) Vs. Morgan Stanley and Co Inc (292 ITR 416)***

Facts:

Morgan Stanley & Co. Inc., United States (MSCO) was engaged in the investment banking (MSAS) to support its main office functions in equity and fixed income research, account reconciliation and provision of information technology (IT) enabled services. MSCO outsourced some of its activities to MSAS. MSCO sought a ruling from the AAR on issues, *inter alia,* whether it had a PE in India and if so, the amount of profits attributable to such PE. MSCO contended that if MSAS was remunerated for its services at arm's length, no further income should be attributed in the hands of the PE (i.e. MSAS). The important issue in this case related to the taxability of the MSCO in India is that whether MSAS had been remunerated for its services at arm's length. The AAR ruled that "so long as MSAS was remunerated for its services at arm's length, no further income could be attributed in the hands of the PE of the applicant." This decision was challenged by the tax authorities in the Supreme Court.

Ruling:

Supreme Court held that the AAR was correct in principle in its ruling in as much as there was no need to attribute further profits to the PE of the foreign company where the transaction between the two was held to be at arm's length, taking into account all the risk-taking functions of the enterprise. The Supreme Court further held that the situation would be different if transfer pricing analysis did not adequately reflect the functions and risks assumed by the enterprise. In such a case, there would be need to attribute profits to the PE for those functions/risks that have not been considered. It also held that the entire exercise was to ascertain whether the service charges payable or paid to the service provider fully represented the value of profit attributable to its services. In each case, the data placed by the taxpayer had to be examined as to whether the transfer pricing analysis was exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case.

- Relying on the above Supreme Court decision, Bombay High Court, in case of *SET Satellite (Singapore) Pte Ltd (218 CTR 452),* has held that if the correct arm's length price is applied and paid, then nothing further would be left to be taxed in the hands of the foreign enterprise. The Bombay High Court has

restored the CIT(A) order in the taxpayer's case and held that in case the agent is remunerated at arm's length by the foreign principal, the tax liability of the foreign principal (which would arise in case it is regarded to have a PE in India) would stand extinguished.

- In the case of BBC *Worldwide Ltd Vs. DDIT (2010-TIOL-59-ITAT-DEL),* the Delhi ITAT applying the principles laid down in the decisions of Supreme Court in the case of Morgan Stanley *(supra)* and decision of the Bombay High Court in the case of SET Satellite *(Singapore)* Pvt Ltd *(supra)* held that where an agent is compensated on an arm's length basis for its agency services in India, there should be no additional income attribution in the hands of the Taxpayer which is a foreign enterprise. It may be pertinent to note that in the facts of this case, the agent received a commission of 15% of the revenues as compensation for services.

- Delhi ITAT in the case of *eFunds Corporation Vs. ADIT (134 TTJ 1)* has adopted the dual taxpayer approach whereby the Indian subsidiary and the PE of Foreign enterprise were regarded as two separate assessable entities. The ITAT, referring to SC decision in case of Morgan Stanley, observed as under:

"From perusal of these observations of Hon'ble Supreme Court, it is clear that the assessment of PE gets extinguished only if following two conditions are cumulatively met-

1. *The associate enterprise has been remunerated on arm's length basis, and*
2. *By FAR (Functions performed, Assets used and Risks assumed) analysis, nothing more can be attributed to PE."*

The ITAT further held that as eFunds India is not remunerated for functions performed, risks assumed and assets utilised by the foreign enterprise, attribution to PE is called for, which takes these factors into account. The relevant observations are as under:

In the case of *BBC Worldwide Ltd Vs. DDIT (2010-TIOL-59-ITAT-DEL),* the Delhi ITAT, applying the principles laid down in the decisions of Supreme Court in the case of Morgan Stanley (supra) and decision of the Bombay High Court in the case of SET Satellite (Singapore) Pvt Ltd (supra) held that where an agent is compensated on an arm's length basis for its agency services in India, there should be no additional income attribution in the hands of the taxpayer which is a foreign enterprise. It may be pertinent to note that in the facts of this case, the agent received a commission of 15% of the revenues as compensation for services.

"Indian entity and Indian PE are two separately assessable entities. Indian entity, i.e., eFunds India is assessable with reference to incomes it received from foreign enterprises, i.e., eFunds Corporation and eFunds IT Solution Inc. and any other income it might have earned. This assessment will be in the status of 'resident' and as per 'domestic tax law'. The foreign enterprise is taxable in India as PE with reference to profits, which are attributable to Indian PE. This assessment will be in the status of 'non-resident' and as per 'Article 7 of Indo-USA DTAA' where the assessable income will be determined after FAR analysis as per provisions of Article 7(2).

In these cases, Indian entity eFunds India is having either nil or minimal risk and all the relevant assets required for carrying out business activities are provided by eFunds Corporation, USA. Whatever payments it gets from foreign enterprise, represent the price of services provided by it to the foreign enterprise and it will not get any remuneration for the functions performed, risks assumed and assets utilised by the foreign enterprise in India. Clearly, the second limb of judgement of Supreme Court referred to supra is applicable in this case, which says that something has to be attributed to PE if risk and assets belong to foreign enterprise as a whole."

Landmark Principles Laid Down in Relation to Profit Attribution

Thus, the crux of all the decisions discussed above is that where the transactions are held to be at

arm's length, nothing further can be attributed to the PE, provided that the transfer price takes into account all the risk-taking functions of the foreign enterprise. Thus, assessment of PE gets extinguished only if following two conditions are cumulatively met:

- The associate enterprise has been remunerated on arm's length basis, and
- By FAR (Functions performed, Assets utilised and Risks assumed) analysis of Indian and foreign enterprise, nothing more can be attributed to PE.

Possible Income Attribution Scenarios

As may be discerned from the above discussion, while there is a general consensus in the judicial decisions on the need to apply transfer pricing principles for income attribution, there is some ambiguity on how these principles should be applied. Hence, depending on the facts of the case, the following possible scenarios could exist on income attribution in case foreign enterprise is regarded as having a PE in India:

Alternate Situations	Possible Scenarios	Judicial Precedents/Other Guidance/ Comments
Situation 1 Indian entity is compensated on arm's length basis taking into consideration only functions performed assets owned and risks assumed by Indian entity.	**Scenario 1** As compensation to Indian entity does not take into account functions/risks of PE, additional income needs to be attributed to the PE based on arm's length principles.	■ Based on OECD's dual taxpayer approach ■ SC decision in Morgan Stanley ■ Delhi High Court in case of Rolls Royce
	Scenario 2 Tax Authorities could attempt to apply formulary apportionment (either apply foreign enterprise's worldwide profit margin to India revenues and attribute part of it to PE or apportion a percentage of India revenues to PE)	■ Even though most case laws support application of transfer pricing principles, the ultimate determination has often been based on a formulary apportionment (could result in a arbitrary apportionment, say, 10% or 15% of profits, depending upon activities performed in India) ■ *Motorola Inc Vs. Deputy Commissioner of Income Tax*[1] ■ *Galileo International Inc. Vs. DCIT*[2]
Situation 2 Indian entities arm's length compensation considers its own functions/risks as well as functions/risks of foreign enterprise that relate to the PE	**Scenario 1** No additional Income Attribution	■ Consistent with OECD's dual taxpayer approach as all functions/risks of the PE have been compensated in the transfer price ■ *DIT Vs. Morgan Stanley* ■ Practical risk of tax authorities seeking to apply formulary apportionment does exist

Way Forward

There is a high risk that the tax authority could attempt to attribute profits to a PE in the absence of adequate documentation to apply arm's length principles for attribution. Given the same, it is imperative that the transfer pricing between two associates takes into account the FAR analysis of the foreign principal as well. In other words, liability of foreign company in India may not be extinguished unless the transfer pricing takes into account the FAR analysis of Indian Company as well as foreign company.

Thus, it is advisable that robust transfer pricing documentation should be maintained and benchmarking should be done in a manner whereby the Functions performed, Assets utilised and Risk assumed (FAR) of both the foreign entity and Indian entity are taken into account. ■

[1] *95 ITD 269 (Delhi ITAT)*
[2] *19 SOT 257 (Delhi ITAT)*