A Primer on Attribution of Profits to Dependent Agent Permanent Establishment

The globalisation and growth of technology have resulted into novel ways of doing business across the globe. With the surge in e-commerce and increasing cross-broader transactions, taxation of income earned by the foreign enterprises has attracted the attention of the Indian tax authorities. This has created high exposure of constituting a Permanent Establishment (PE) in the country where the foreign enterprise carries on its business. In earlier articles in this column, we analysed 'basic concepts of Agency Permanent Establishment and circumstances in which a person can be considered as an agent of foreign enterprise' and 'concept of Dependent Agent PE'. In this final article in the series of three articles, we have discussed 'basic concept of attribution of profits to a dependent agent PE and discussed some of the landmark rulings on the subject'. The attribution of profits to PEs has recently been the focus of attention of the Indian tax authorities because of increasing globalisation, innovative ways of doing business and use of advanced technology in almost every facet of business environment. Further, realising the need to have consistent approach to the attribution of profits, OECD has made several efforts in developing a standard approach to attribution of profits resulting in The OECD Discussion Drafts of 2001, 2004 and "2008 Report on Attribution of Profits to Permanent Establishments".

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Basic International Taxation

In order to appreciate the subject of attribution of profits, it would be apt to discuss some of the basic aspects of international taxation.

The Double Tax Avoidance Agreements (DTAA) governs allocation of taxing rights of two countries, signing the DTAA, in respect of various streams of income. The allocation of taxing rights broadly provides for determining

- the nature of the income (income from house property, business income, income from capital gains etc.),
- the jurisdiction (country) in which the concerned income should be taxed (the country of residence of tax payer or the country of source of income of the tax payer or both),
- at what point of time, the concerned income should be taxed (at the time of generation of income, at the time of credit of such income, at the time of payment of such income etc.); and
- the quantum of such income to be taxed in the state of source of income, if the source country has the right to tax it.

For example, in case of income earned/generated from house property, entire income in the nature of rental income, transfer or exploitation of house property, is liable to be taxed in the source state, if the property is located in the source state. Similarly, as regards income from capital gains, dividend, royalty, technical services and interest, the DTAA provides for the exact quantum of amount to be taxed in the source country without any subjectivity being involved either for the residence country or the source country to tax the particular income.

As discussed in the first article of this series, a permanent establishment needs to be constituted in order to trigger taxability of business income in the source country, unless these profits fall into special categories of income for which other Articles of the DTAA give taxing rights to the source state. The DTAA does not provide for what kind of receipt or receivable is considered as business income. The same is determined on the basis of the domestic tax rules of the source and residence country. The DTAA, however, provides for rules of how much business income may be taxed in the source country. Generally, all the DTAAs provide that only so much of income as is attributable to the activities of the PE may be taxed in the source country.

Further, Section 9 of the Income-tax Act, 1961 (the Act) also mandates to tax only that part of the income as is reasonably attributable to the operations carried out in India. Accordingly, in situations where the foreign enterprise is a tax resident of a country or a jurisdiction with which India has not signed a DTAA, income should be attributed as per provisions of Section 9 of the Act.

It would be difficult to determine the contribution of each activity into the overall profit of the enterprise. The importance of each of the activities of the enterprise varies in terms of the entire chain of activities within the enterprise. The significance of any particular activity within the enterprise depends on the nature of the product dealt with by the enterprise, long term and short term business strategy adopted, the period since when the enterprise is in existence and so on.

Principles of Attribution of Profits to PE under DTAA

An enterprise earns profit by carrying on many activities in its business. The quantum of profit (or loss) is a factor of many activities of the business. Collective efforts of the assets and personnel of the enterprise result in the profit of the enterprise. Generally, in case of a manufacturing enterprise, the enterprise carries out functions of purchasing raw material, converting raw material into finished goods, holding the inventory, undertaking marketing activities and carrying out promotion activities, selling price negotiation and finally collecting receivables. Thus, profit is, broadly, combination of all these activities.

From the above discussion, it follows that it would be difficult to determine the contribution of each activity into the overall profit of the enterprise. The importance of each of the activities of the enterprise varies in terms of the entire chain of activities within the enterprise. The significance of any particular activity within the enterprise depends on the nature of the product dealt with by the enterprise, long term and short term business strategy adopted, the period since when the enterprise is in existence and so on. The amount of profit earned by an enterprise through its various activities depends on various commercial reasons.

Accordingly, understanding the business of the enterprise is of extreme importance while dealing with the situation of attribution of the profits to its PE in the source country.

A Attribution of profits to dependent agent permanent establishment (DAPE) under the Act

1 Circular No. 23 dated 23rd July 1969

Circular states that only that portion of profit which can reasonably be attributed to the operations of the business carried out in India, is liable to Income Tax. The relevant extract of the circular is reproduced below:

"7. Extent of the profit assessable under Section 9 – Section 9 does not seek to bring into the tax-net the profits of a non-resident which can reasonably be attributed to the operations carried out in India. Even if there be a business connection in India, the whole of the profit accruing or arising from the business connection is not deemed to accrue or arise in India. It is only that portion of the profit which can reasonably be attributed to the operations of the business carried out in India, which is liable to Income tax."

The above circular has been withdrawn by CBDT with effect from 22nd October 2009. The said circular has been relied upon in several important judgements including Morgan Stanley 292 ITR 416 (SC), SET Satellite (Singapore) 11 DTR 313 (Bom) / 173 TM 475, Amadeus Global 113 TTJ 767 (Del.) etc.

2 Rule 10 of Income Tax Rules, 1962

Rule 10 of the Income Tax Rules, 1962 provides, where the actual amount of income accruing or arising to a non-resident cannot be definitely ascertained, the amount of such income may be calculated:

a. at such percentage of turnover as the tax officer may deem reasonable.
b. on any amount which bears the same proportion to the total profits and gains of the business of such person, as the receipt so accruing bear to the total receipt of the business.
c. in such other manner as the Tax Officer may deem fit.

It can be seen from the above that there is not much guidance on the attribution of the profits in the Act. The foreign enterprises having DAPE in India have to mainly rely on the judicial precedents available on the subject.

B Attribution of profits to DAPE under DTAA

1 Attribution methodology differs from one type of PE to other type of PE

In case of foreign companies having distributors in India, generally, the terms of the arrangements are reduced in writing by way of contracts. Hence, it is relatively easier to understand the division of activities, risks and assets between a foreign company and the Indian distributor. The problem arises in case where there is only one entity in the residence country and the source country. If there is no other legal entity to carry out the activities but the activities are carried on fictionally by the PE, the enterprise has to ascertain and carry out factual analysis to decide what activities are deemed to be carried out by the PE.

Since in case of dependent agent PE, there would not be any formal agreement between the foreign enterprise and fictional entity being PE, it is pertinent to ascertain the functions, assets and risks (FAR) attributable to the PE.

2 Trends in OECD

Over the years, there have been considerable variations in the language and general principles of article 7 of the OECD MC. Further, OECD acknowledged that there is a need to provide more certainty to taxpayers in respect of the principles of attribution of the profits in its report - *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. It was indicated that further work would address the application of the arm's length principle to permanent establishments. Accordingly, in 2008, a report entitled Attribution of Profits to Permanent Establishments was published by the OECD.

Further, in order to provide certainty on how profits should be attributed to permanent establishments, 2008 Report's full conclusions are reflected in a new version of Article 7, together with accompanying Commentary.

3 Structure of Article 7 of the OECD model

Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State.

Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent 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 through the permanent establishment and through other parts of the enterprise.

Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a

permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

Paragraph 3 ensures that there is no double taxation of the same income. Paragraph 4 provides that Article 7 will be applicable to business profits which do not belong to special categories of income covered by other Articles of DTAA.

Principles of attribution under the Act are similar to the principles provided in the DTAA. Explanation 1 to Section 9(1)(i) also states that where in case of a business of which all the operations are not carried out in India, only such part of the income which is reasonably attributable to operations in India shall be chargeable to Income tax.

4 Approaches to allocate profits

There are broadly two methodologies followed to attribute profits to a PE

- Relevant Business Activity Approach
- Functionally Separate Entity Approach

4.1 Relevant Business Activity Approach

Under this approach, it is presumed that there is a fixed quantity of profits made by the foreign enterprise as a result of various activities carried out in the residence country and the source country. In other words, the amount of profits is first determined. The profits earned by the enterprise as a whole would then be attributed to the PE situated in the source country.

Thus, there is a limit on attribution of profits to the PE. Loss from the other parts of the business would reduce profits attributable to PE. This approach disregards activities actually carried out by the PE in the source country, as it first derives the total profit that can be attributed to the PE.

4.2 Functionally Separate Entity Approach

Approved by OECD and popularly called as Authorised OECD approach (AOA), this approach does not restrict attribution of profits to the PE. The approach is essentially a bottom-up approach and suggests that activities of PE need to be compensated appropriately as PE is a separate entity. PE is deemed to perform various functions independent of the foreign enterprise.

Thus, this approach does not impose overall limit on the profits that can be attributed to the PE. Attribution of the profits can exceed the profits of the enterprise as a whole or from a particular business activity. Further, loss from the other part of the activities would not reduce the profits of the PE.

Rationale behind "Dual taxpayer" approach being more appropriate:

- DA would be awarded for its service, taking into account its assets/risk
- Profits to be attributed towards assets and risks of non-residents in relation to functions performed by DA on its behalf
- AOA attributes profit to DAPE based on such assests/risks/functions
- Remuneration to DA does not include remuneration related to risks assumed by non-resident through DA
- Profits attributable to DAPE must reflect these risks

5 Basics of Authorised OECD Approach

Under the Authorised OECD Approach, following steps are to be followed:

Hypothesising the PE as a distinct & separate enterprise

- Perform functional & factual analysis
- Attribute rights & obligations to PE arising out of external transactions of enterprise
- Attribute risks based on significant people function
- Attribute economic ownership of assets based on significant people function
- Attribute capital (free & debt) based on assets & risks attributed to PE
- Recognise & determine nature of dealings between PE & HO

Since, in case of DAPE, there is no contractual agreement between the HO and DA, one needs to visualilse what all functions are performed by the PE. In case of the attribution methodology, more importance is given on functions which will determine risk and assets assumed by the PE, unlike in case of two separate legal entities, where risks and assets are assumed by the PE independent of the foreign enterprise. Accordingly, in case of agency PE, functions are determined based on the conduct of the DAPE and risks and assets are attributed as per the functions performed by the

DAPE. The functions of the PE and people of the PE determine the asset and risks of the PE.

Similarly capital and debt and nature of dealing between PE and the HO i.e. interdivision transactions need to be factored into, to hypothesise the character of PE.

Step two: Determining pricing on arm's length basis in respect of transactions between PE and rest of hypothesised enterprise.

Based on the FAR of the DAPE, based on the transfer pricing regulations, one needs to ascertain the comparables of the DAPE and compute the profitability of the comparables. Same principles are to be applied for attribution of losses as well.

6 If profits are attributed at arm's length, no further attribution

Arm's length remuneration to the DAPE extinguishes the liability of the foreign principal enterprise. This proposition has been upheld by various judicial pronouncements including the Supreme Court judgment in the case of Morgan Stanley (292 ITR 416). Further circular no. 23 of 1969 also supports the requirement of arm's length payment.

However, one needs to be careful to ensure that the arm's length remuneration considers not only functions performed, assets employed and risks assumed by the DAPE but also functions performed, assets employed and risks assumed by the foreign principal enterprise to avoid any further attribution of profits.

7 Jurisprudence on the Attribution of profits

Though, there are several judicial precedents on the attribution of profits, following three landmark judicial precedents on the subject of attribution of profits have been discussed, being leading judgments in the context of the agency PE.

7.1 Galileo International Inc (19 SOT 257)

Facts

Assessee-company was incorporated under laws of US and carried on business of maintaining and operating system for providing electronic global distribution of services to airlines, hotels and tour and cab operators by connecting them to travel agents utilising a Computerised Reservation System (CRS) - On their behalf, assessee had entered into an agreement with various participants known as 'participating carrier agreement' - It had also entered into a separate agreement known as distribution agreement with travel agent in India - For services rendered by said agent under agreement, assessee was paying to it 1 Euro for each booking from airlines, etc. - Assessee was, however, paid 3 Euro for each booking –

Principles of attribution under the Act are similar to the principles provided in the DTAA. Explanation 1 to Section 9(1)(i) also states that where in case of a business of which all the operations are not carried out in India, only such part of the income which is reasonably attributable to operations in India shall be chargeable to Income tax.

Held

AO held that assessee's income generated in India was chargeable to tax in India under Section 5(2), read with Section 9(1). The Commissioner (Appeals) upheld order of AO. On second appeal, Tribunal upheld findings of lower authorities that assessee's income was chargeable to tax in India, but held that only 15% of revenue accruing to assessee in respect of bookings made in India should be treated as income accruing or arising in India. The Tribunal further held that since assessee was charging 3 Euro per booking, 15% thereof would come to 0.45 Euro and after paying commission of 1 Euro per booking to travel agent, there was no income or profit which was chargeable to tax in India since there was no additional income attribution as payment to distributor exceeded attributable income. The Delhi HC upheld the findings of the Tribunal.

Apparently, no particular approach i.e. Relevant Business Activity Approach or Functionally Separate Entity Approach was followed by the tribunal or the high court.

7.2 Rolls Royce Plc (113 TTJ 446)

Facts

The assessee was a Singaporean company. Its principal activities were sale of spare parts for oil-field equipments and engines and turbine compressor systems and electronic retrofit projects and services rendered in connection with repair and overhauling of such equipments. The major

clients of the assessee in India included ONGC, GAIL, etc. Though in the Income-tax return filed by the assessee-company, it had shown income from maintenance services as fee for technical services (FTS) and paid tax at the rate of 20%. Thereupon as per the provisions of the Act, it had not declared any income for supply of equipments made to the Indian clients on the ground that it had no PE in India and, therefore, its business income from supply of spare parts was not chargeable to tax in India.

Held

PE was determined under "fixed place" as well as "agency" PE rules. It was also held that activities carried out outside India was not taxable and accordingly, 50% of profits was allocated towards manufacturing activities and 15% of profits allocated towards R&D activities carried outside India. Further, activities carried out in India was held taxable and 35% of profits allocated towards marketing activities. Following the principles laid down by the SC in the case of Morgan Stanley, it was also held that attribution of Profits to PE is extinguished when the remuneration to the Agent takes care of risks assumed by the Principal in India. In other words, the profits attributable to the PE in India will have to be computed, taking into consideration the functions performed and risks assumed not only by the dependent agent but also the Principal in India. The ruling further emphasised the importance of performing a robust factual and functional analysis.

7.3 SET Satellite (307 ITR 205)

Facts

The taxpayer, a company incorporated in Netherlands was a wholly owned subsidiary of Satellite Television Asia Region Limited (STAR Limited) based in Hong Kong, which in turn was a subsidiary of Star Television Limited, a company incorporated in British Virgin Island.

The taxpayer was granted the exclusive right for sale of advertising time, in India, on the channels of the STAR TV network, which were owned by STAR Limited. Consequently, the taxpayer engaged an Indian Company, Star India Pvt. Ltd. (SIPL), to procure business from Indian advertisers, on a commission of 15% of receipts from such business. The taxpayer offered to tax @10% of the revenue so earned on the basis of CBDT circular no.742.3.

However, the Assessing Officer (AO), after considering the taxpayer as a conduit company, held that the taxpayer company was floated only for the purposes of tax planning and avoidance and therefore, the income earned by the taxpayer actually belonged to STAR Limited. However, as a protective measure the AO assessed the taxpayer at the rate of 20% of the gross revenue as income earned in India.

The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO and held that income from advertisement revenue be taxed in the hands of Star Limited as per the provision of CBDT Circular No. 742.

Held

Mumbai Tribunal held that Dependent Agent ('DA') and DAPE are two distinct taxable entities. The Arm's length remuneration paid to DA is for FAR assumed by him and not by the foreign entity for earning profits. The profits need to be attributed based on FAR assumed by the foreign entity in respect of the business carried on through the PE. Such FAR of the DA would depend on the facts/functions/activities carried on by the DAPE. Further, remunerating the DA at arm's length does not extinguish the tax liability of the DA in respect of the DAPE in India.

The HC accepted the finding that DAPE existed and that the income attribution limited to profit attributable to the DA's services. Further, if correct ALP is applied for compensating the agent, nothing further is taxable. The HC held the same by relying on the Morgan Stanley ruling and CBDT Circular No 23 of 1969. Such a ruling upholds the "single taxpayer" approach.

Conclusion

The subject of attribution of profits to agency PE involves understanding of the business of the foreign enterprise, understanding of the concepts and application thereof. In the Indian context, since the jurisprudence is still being developed, the subject is marked with the huge subjectivity and prolonged litigation. Accordingly, the taxpayer needs to constantly review their cross broader arrangements and ensure that the payments made by it are backed by the robust transfer pricing documentations reflecting the FAR of the foreign enterprise as well. ■