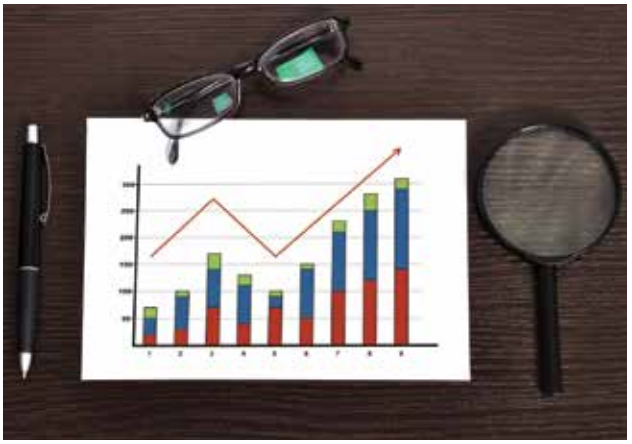
Attribution of Profits to Permanent Establishment – Formulary Apportionment vs. Arms Length Principle Approach



There has been a growing trend of MNCs (Indian and Overseas) entering other countries to carry on business or perform services. This trend raises multiple issues surrounding the concept 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. The purpose of this article is to highlight the methodology prescribed by OECD Model Convention 2010 and also the methodology adopted by various Tribunals to attribute profits in cases where arms length principles are not met. However, readers would need to also analyse the taxability under the Income-tax Act, 1961 ('Act') before arriving at a conclusion.

(Contributed by International Taxation Committee of the ICAI. Comments can be sent at citax@icai.in)

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 Convergys Customer Management Group Inc vs ADIT[1], the Delhi Tribunal, while dealing with the issue of attribution of profits to PE, inter alia, held that attribution of profits to PE should be made by transfer pricing principles as laid down by Hon'ble Supreme Court in case of Morgan Stanley (292 ITR 416). Further, in respect of free of cost assets and software provided by the Taxpayer, the Hon'ble Tribunal has prescribed a four-step process to arrive at profit attribution, starting with applying global profit percentage to end customer revenue from Indian operations.

Concept of Attribution of Profits – As Prescribed by OECD

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 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

[1] *ITA No 1443/Del/2012 and 5243/Del/2011*

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 arms 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.

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.

Background - The Indian Experience

The method of attribution of profits to the PE has become one of the major concerns for 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 and the same are briefly discussed below:

- Supreme Court judgment in case of *DIT (Intl Taxation) vs. Morgan Stanley and Co Inc* (292 ITR 416) held that 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 a 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.

Supreme Court judgment in case of *DIT (Intl Taxation) vs. Morgan Stanley and Co Inc* (292 ITR 416) held that 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.

  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.

- Delhi High Court in case of *Rolls Royce Singapore Pte Ltd. vs. ADIT* also 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 u/s 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. 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.

- The Hon'ble Bombay High Court, in case of *SET Satellite (Singapore) Pte Ltd.* (218 CTR 452), had 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 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 Experience - Landmark Principles

Thus, the crux of all the decisions discussed above is that if the transactions are held to be at arm's length and the transfer price takes into account all the risk-taking functions of the foreign enterprise, then, nothing further can be attributed to the PE. Thus, no further attribution of profits 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.

Recent Ruling --- Delhi Tribunal in Case of Convergys Customer Management Group Inc vs ADIT[2]

Background and facts

- The assessee i.e. Convergys Customer Management Group Inc. is a US tax resident. It provides IT enabled customer management services by utilising its advanced information system capabilities, human resource management skills and industry experience. The assessee has a subsidiary in India viz. Convergys India Services Pvt. Ltd. ("CIS"). CIS provides IT enabled call centre/back office support services to the assessee.
- After confirming the existence of a PE, the AO had computed profits attributable to Indian PE by estimating revenue from Indian operations. AO had arrived at such revenue by allocating the global revenue in proportion of number of employees. The AO also allocated expenses (excluding direct expenses) in proportion of number of employees.
- The learned CIT(A) held that no further profits can be attributed to the Assessee's PE to the extent that the transfer pricing analysis of CIS has already captured such functions, assets and risks. However, further profit was required to be attributed on account of:
  - Certain assets of the Assessee being deployed in India.
  - Entrepreneurial services to manage risk related to the service delivery are performed by the Assessee in India.
- In computing the profits to be attributed, the learned CIT(A) considered total revenue of Assessee pertaining to contracts/projects in respect of which services were procured from CIS. However, while computing profits, the learned CIT(A) did not allow deduction for expenses such as research and development, depreciation, amortisation etc. It also considered only 50% of selling, general and administrative expenses and limited the quantum of deduction for "head office" expenses to the ceiling prescribed under domestic tax law.

Tribunal's ruling

- As a general principle, the Tribunal recognised that attribution of profits to the PE is a transfer pricing issue and no further profits can be attributed to a PE once an arm's length price has been determined for the Indian affiliate, if the transfer pricing analysis subsumes the risk profile of the PE.
- Hon'ble Tribunal rejected Revenue's attribution methodology. Hon'ble Tribunal held that the methodology adopted by the AO and the ld. CIT(A) cannot be accepted as they have considered revenue of the assessee company (Convergys Customer Management Group Inc as a multinational enterprise) as the starting point for arriving at the profits attributable to the PE of assessee in India.
- The revenue of the assessee company cannot be considered as the revenue of the PE by any stretch of imagination. Furthermore the expenses incurred outside India are linked with the business activities of the assessee undertaken outside India for the functions performed outside India and are not linked to the PE of the assessee in India.
- ITAT also rejected CIT(A)'s stand on further profit attribution to PE for risks. ITAT held that

Despite the recognition of arm's length principles for profit attribution, while concluding on the extent of profits attributable to the PE, the Delhi Tribunal appears to have adopted a formulary apportionment approach. This method employed by the Tribunal does not take into account the transfer pricing principle of function, asset and risk analysis that determine profit attribution.

[2] *While the ruling deals with a number of other issues such as existence of PE, characterization of payments as royalty etc, this Article covers the aspects relating to profit attribution to a PE.*

no attribution of profits can be made on account of management of risk as risk resides outside India.

- However, attribution can be made on account of free of cost assets and software provided by the Assessee. As the Assessee has submitted that it does not prepare India specific accounts, the attribution of profits on the basis as disclosed in the transfer pricing study for assets and software cannot be accepted.
- Based on the facts, the Tribunal accordingly worked following methodology to compute profit attribution to PE in India –

  Step 1 - Compute Global operating Income percentage (Operating Income/Total Revenue) as per annual report/10K of the company.

  Step 2 - Apply this percentage to End-customer revenue from Indian operations. The amount arrived at is the Operating Income from Indian operations.

  Step 3 - The operating income from India operations is to be reduced by the profit before tax of CIS (i.e. Indian subsidiary). The residual is attributable between US and India.

  Step 4 - The profit attributable to the PE should be estimated percentage of residual profits.
- To arrive at the estimated percentage of residual profits, Tribunal relied upon SC ruling in *Anglo French Textile Company Ltd. vs. CIT* (23 ITR 101) and Hukum Chand Mills Ltd. vs. CIT 103 ITR 548. In Anglo French, 10% attribution was held as reasonable and in the latter, 15% attribution was accepted.

  In this regard, ITAT held as under:

  "These cases decided by the Apex Court though are old, but they still hold the field as they have not been tinkered with. In our considered view, the adoption of higher figure of 15% as held by Hon'ble Supreme Court in the Hukum Chand Mills Ltd. (supra), for attribution of assessee's Indian PE operations will meet the ends of justice. Thus, the attribution of Indian PE income should be made at 15% of profit retained by CMG in the US."
- Accordingly, Tribunal concluded that 15% of the amount determined in Step 4 would be the income attributable to PE in India.

Conclusion of Tribunal and the Controversy

Despite the recognition of arm's length principles for profit attribution, while concluding on the extent of profits attributable to the PE, the Delhi Tribunal appears to have adopted a formulary apportionment approach. This method employed by the Tribunal does not take into account the transfer pricing principle of function, asset and risk analysis that determine profit attribution.

Further, the rationale for attributing a part of the "residual profits" to the PE does not appear to be very clear from the facts of the case. Under general transfer pricing principles, residual profits are typically allocated to an enterprise that owns valuable intangible property or makes other non-routine contributions. There is no finding in the order to suggest that the PE was making any non-routine contributions to the value chain or was the "economic owner" of intangibles.

The ruling also does not seem to have explicitly addressed the issue of possible economic double taxation which could potentially arise in a situation where the residual profit that is sought to be attributed to the PE is also taxed in the hands of the Indian company by way of a transfer pricing adjustment.

While there is a general consensus in the judicial decisions on the need to apply transfer pricing principles for income attribution, there is also some ambiguity on how these principles should be applied. 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.

Way Forward

Accordingly, 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.

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 ie transfer pricing takes into account the FAR analysis of Indian Company as well as Foreign Company. ■