

Delhi ITAT upholds Indian subsidiary as PE and attributes profit for functions/risks not considered for TP analysis

Summary

The Delhi Bench of the Income-tax Appellate Tribunal (ITAT) in a recent case¹ ruled that an Indian subsidiary of the taxpayer undertaking critical functions such as negotiation and finalisation of prices and payment terms is a 'Dependent Agent Permanent Establishment' (DAPE) of the taxpayer. The ITAT also held that profits are to be attributed to the DAPE where the taxpayer's Transfer Pricing (TP) analysis does not consider the additional functions undertaken. Laying down the guidelines for calculation of profit attributable to the DAPE, the ITAT remitted the matter back to the tax officer for computation.

Facts of the case

- The taxpayer, a tax resident of Japan, is engaged in the development, manufacture, assembly and supply of air-conditioning and refrigeration equipment.
- During Financial Year (FY) 2005-06, the taxpayer sold goods to its Indian subsidiary and also made direct sales to customers in India.
- The taxpayer availed marketing-support services from its Indian subsidiary in respect of the direct sales made in India and paid a commission at the rate of 10% for it. The marketing-support services were in the nature of receipt of customer request and forwarding of the taxpayer's quotations and contractual proposals to customers in India.
- The Indian subsidiary reported the international transaction of 'commission income' in Form 3CEB² and the transaction price was accepted to be at arm's length at the time of TP assessment.

¹Daikin Industries Limited v ACIT (ITA No. 1623/DEL/2015)

² As per Section 92E of the Income-tax Act, 1961

- The taxpayer did not file TP documentation in respect of the said commission expense. However, it relied on the TP study filed by the Indian subsidiary to demonstrate that the commission payment was at arm's length.
- In the absence of substantial evidence to demonstrate that the functions undertaken by the Indian subsidiary were limited to provision of marketing-support services, the tax officer held that the Indian subsidiary was a DAPE of the taxpayer and attributed profits to the DAPE under the India-Japan Double Taxation Avoidance Agreement (DTAA).

Taxpayer's contention

- In respect of the taxpayer's direct sales, the Indian subsidiary was merely restricted to forwarding the customers' request to the taxpayer and passing on the quotations and proposal received from the taxpayer to the customers.
- Reliance was placed on the Delhi High Court judgment in the case of Adobe Systems³, which had rejected the constitution of a DAPE on similar facts.
- Without prejudice, reliance was placed on the landmark judgement of Hon'ble Supreme Court in the case of Morgan Stanley & Co Inc⁴, which had held that *"Once the transfer pricing analysis is undertaken, there is no further need to attribute profits to PE which is an associated enterprise and has been remunerated on an arm's length basis taking into account all the risk taking functions of the multinational enterprise."*
- Without prejudice, the taxpayer submitted that its global profit margin should be applied for attributing further profits to the DAPE instead of the method applied by the tax officer.

Revenue's contention

- The Revenue presented the following arguments to support the determination of PE and profit attribution to it:
 - No evidence or documents were furnished by the taxpayer to prove its direct communication from Japan with customers in India.
 - On the other hand, email evidence proved that the Indian subsidiary was involved in negotiating and finalising the prices, payment terms, delivery

³ Adobe Systems Inc v ADIT [W.P.(C) 2384/2013 & CM 4515/2013, W.P.(C) 2385/2013 & CM 4517/2013, W.P.(C) 2390/2013 & CM 4523/2013]

⁴ Director of Income Tax (IT) v Morgan Stanley & Co Inc (2007) 292 ITR 416 (SC)

schedule and other contractual terms with the customers in India not just for its business as distributor but also for the taxpayer's direct sales in India.

- The Indian subsidiary was engaged in concluding contracts and habitually securing orders in India. Accordingly, as per the terms of the India-Japan DTAA, it constituted a PE.
- The commission agreement did not take into account the aforementioned functions undertaken by the Indian subsidiary. Accordingly, separate Arm's Length Price (ALP) for the additional functions had to be determined.

ITAT's finding and ruling

- The ITAT recorded the following findings after hearing the rival contentions:
 - The Indian subsidiary was negotiating and finalising the contracts of sale and the taxpayer was only engaged in formally signing the contracts entered with the customers in India.
 - No evidence was placed on record to demonstrate that the customers in India were approaching the taxpayer to finalise their contracts.
 - The Indian subsidiary's huge spend on selling and distribution did not validate the taxpayer's argument that the subsidiary was only a communication channel between the taxpayer and customers in India.
 - Reliance by the taxpayer on the case of Adobe Systems (supra) was misplaced as in the present case, the Indian subsidiary was factually exercising an authority to conclude contracts and secure orders.
 - The TP analysis undertaken by the Indian subsidiary did not cover the additional functions performed in respect of contract negotiation and pricing. Accordingly, the taxpayer's case was covered under exception to the general rule of profit attribution in the case of Morgan Stanley (supra).
 - The methodology followed by the tax officer for determination of attributable profit to the DAPE was unique and suffered from infirmities.
- Based on the above findings, the ITAT ruled the following:
 - The Indian subsidiary is a DAPE of the taxpayer and attribution of profit is to be made to it.
 - Profits earned by the taxpayer should be determined using a step-by-step methodology and attributed to the DAPE as under:

- Based on the provisions⁵ of the Act, the net profit relatable to direct sales in India was estimated at 10% of the taxpayer's total profits.
 - The ITAT estimated that 30% of the above-mentioned profits were attributable to the operations carried out by the DAPE in India.
 - It also ruled that the net profit earned through commission income should be reduced for ascertaining the taxability of the DAPE.
- The actual computation of the attributable profits was remitted back to the files of the tax officer.

Our comments

Similar to other conventional cases involving PE issues, this matter also involved adjudication of two essential questions of determination of PE and attribution of profits to it. The determination of PE is a very fact-specific exercise and hence correct determination of the functions performed, assets used and risk assumed by the parties, supported by cogent evidence, is important. Due to non-availability of transaction-specific data or the taxpayer's TP documentation, general parameters were adopted to determine the percentage of attribution as has been done in several earlier rulings.

⁵ Rule 10 of the Income-tax Rules 1962, which deals with determination of income in case of non-residents in cases where the same cannot be definitely ascertained, allows the tax officer to determine the income at such percentage of turnover as the tax officer may consider reasonable. The tax officer relied on sections 44BB and 44BBB of the Act, which prescribe 10% as the rate of net profit deemed to be chargeable in India.

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