

LO held to constitute PE in India; upholds FAR analysis as a reasonable basis for profit attribution

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In brief

The Bangalore bench of the Income-tax Appellate Tribunal (Tribunal), on the facts of the case has held that the activities of the liaison office (LO) of a Singapore based entity constituted profit-earning activity for the Singapore entity. Filing of the return of income by the taxpayer, pursuant to notice issued under section 148 of the Income-tax Act, 1961 (the Act), declaring income on the basis of cost plus 6%, was considered as an indirect admission by the taxpayer that income arose from the operations of the LO in India. Further, with respect to the method of attribution of income to Indian operations, the Tribunal was of the view that in the absence of a mathematical formula, Function, Asset and Risk (FAR) analysis could be taken as a reasonable method.

In detail

Background

- In this case¹, the taxpayer was an India LO of an entity (HO) based out of Singapore. The taxpayer and its HO were a part of a group of companies based out of the United States.
- Until July 2003, the Indian operations were being carried out by the taxpayer. Subsequently, the operations were transferred to another Indian group company.
- A survey was conducted on the premises of the taxpayer, shared with the Indian group Company, wherein the sale and expense details and other accounts pertaining to the LO were found and impounded. In addition, the statement of the employees of the LO was recorded.
- After the survey, notices under section 148 were issued for assessment years (AY) 2000-01 to 2004-05.
- In response to such notices, the taxpayer filed its return of income, declaring income on the basis of cost plus 6%².
- According to the Tax Officer (TO), the LO was carrying on income earning activities in India, which was also substantiated by the statements of the employees of the LO.
- The TO held that a portion out of the total profits earned, by the Singapore taxpayer, was attributable to the Indian operations. Accordingly, the TO considered 40% of the net profits as attributable to the LO.
- Before deciding the 40:60 ratio, the TO undertook the functional analysis after fixing the relative weightage of 50:25:25 to FAR and finally determined the weighted average after taking into consideration the intra sectional ratio between the LO and the HO.

¹ I.T.(TP). A Nos. 209 & 210/ Bang/ 2011 and I.T.(TP).A Nos 617 to 619/ Bang/ 2011 (Bangalore ITAT)

² Although it is not expressly stated in the ruling; however, from the reading of the ruling it appears that the

taxpayer had filed the return on cost plus basis on a without-prejudice basis.

- A reference was made to the Transfer Pricing Officer (TPO), who applied the Transactional Net Margin Method as the most appropriate method, and determined arm's length margin at 4.78%, 5.18% and 5.58% as mean PLI for the three years which was accepted by the TO
- The taxpayer carried the appeal to the Tribunal

Issues before the Tribunal

The following **key** issues arose before Tribunal:

- Whether the activities of the taxpayer constituted a business connection/ PE in India?
- Whether the profits, as attributed by the TO to the Indian operations, were reasonable and fair?

Taxpayer's contention

- The taxpayer contended that it was engaged only in preparatory and auxiliary activities, and accordingly, the case was covered under Article 5(7) of the Double Taxation Avoidance Agreement between India and Singapore.
- The LO was restricted to perform activities in India in

accordance with the guidelines issued by the Reserve Bank of India. Accordingly, the LO had not conducted any business operations in India.

Revenue's contention

- Although the LO was not doing any trading activity in the conventional sense, it was involved in income earning operations by employing technically qualified persons for marketing, sales, administration, accounts, etc.
- The LO was involved in finding potential customers, price negotiations, concluding contracts, etc.
- In the absence of any mathematical formula for working out the profits of Indian operations, the FAR analysis is the best way to arrive at the profits.

Tribunal's ruling

- That by filing the return of income on cost plus 6%, the taxpayer itself indirectly accepted that they had a business connection in India and the Indian LO was the PE of the Singapore based entity.
- Upheld the TO's consideration of sectoral weightage at

50:25:25 for functions performed, assets employed and risks involved, 10:90 towards assets and risks in the intra sectoral ratio pertaining to LO and HO and the final quantification of profits attributable to the LO and the HO at 40:60.

The takeaways

- The Bangalore Tribunal in the matter of the taxpayer has primarily relied on the order of the lower authorities and has not given detailed findings as to how the activities carried out by the LO of the Singapore entity contributed to the profit generating activities of the enterprise.
- The filing of tax return on a cost plus basis has been considered as acceptance of business connection in India.
- Due consideration should be given to the ruling before filing the return of income on a without-prejudice basis.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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