Indian subsidiary also negotiating contracts – constitutes DAPE; additional attribution of profits, as such functions not considered in FAR analysis of subsidiary

June 6, 2018

In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal), in a recent ruling[1] held the following:

- The Indian subsidiary of the taxpayer constituted its dependent agent permanent establishment (DAPE), as the Indian subsidiary was identifying customers, negotiating and finalising prices with customers in India to whom the products were sold by the taxpayer.
- Profits are to be attributed to the DAPE even if the taxpayer paid commission to the Indian subsidiary, as the benchmarking of the commission was done without considering all the functions performed by the Indian subsidiary.

In detail

Facts

- The taxpayer was a tax resident of Japan, engaged in the business of developing, manufacturing, assembling and supplying air conditioning and refrigeration equipment.
- The taxpayer had a wholly owned subsidiary in India, to which the taxpayer sold air-conditioners.
- Apart from sales to its Indian subsidiary, the taxpayer also made direct sales to customers in India.
- With regard to direct sales to Indian customers, the taxpayer entered into an agreement with its subsidiary for availing marketing services, i.e., to forward the customers' request of procuring products to the taxpayer and to forward the taxpayer's quotations and contractual proposal to the customers and paid commission for the same.
- During the assessment proceedings, the TO held that the Indian subsidiary was the DAPE of the taxpayer in India, alleging that the activities of the Indian subsidiary were not restricted to marketing services, but also involved identifying customers, negotiating and finalising prices, etc.
- Thereafter, the TO also attributed the profits to the said permanent establishment (PE) in a unique manner, by allowing the deduction of expenses at 5% of sales value from the additional profits earned by the taxpayer on account of PE activities in India.
- Aggrieved, the taxpayer filed an appeal before the Tribunal.

[1] ITA No. 1623/Del/2015

Issue before the Tribunal[2]

- Whether the Indian subsidiary constitutes DAPE of the taxpayer in India?
- If the taxpayer had a PE in India, was there a need for attribution of income, if the commission paid by the taxpayer to its Indian subsidiary was at arm's length price (ALP)?

Taxpayer's contentions

DAPE

- The taxpayer was independently undertaking all the important activities concerning sales transactions, such as negotiation and finalisation of prices, payment terms, delivery schedules and other contractual terms with customers in India.
- The Indian subsidiary was merely a communication channel.
- The taxpayer's employees also visited in India for discussions with customers.
- The Indian subsidiary made sales to individual customers in India and the taxpayer was making sales only to institutional customers in India.
- The Indian subsidiary was economically independent and remunerated for providing marketing support. Thus, its activities could not constitute a PE of the taxpayer in India.

Attribution of profits

- In the Indian subsidiary's case, the transfer pricing officer (TPO) had accepted that the international transaction of commission payment by the taxpayer was at ALP.
- No further profits needed to be attributed to the PE of the taxpayer in India.
- The taxpayer placed reliance on the decision of the Supreme Court[3] in support of its contentions.
- The mechanism of computing profits attributable to PE was not as per law.

Revenue's contentions

- The taxpayer provided no evidence (including emails/ correspondences) to substantiate that it identified customers, approached them, made presentations and demonstrated and negotiated and finalised prices in respect of direct sales made by the taxpayer.
- The employees of the taxpayer who visited India rendered only consultancy services, which were charged separately to the Indian subsidiary.
- Several sales to Indian customers were for amounts less than INR 25,000. Furthermore, there were also direct sales to individual customers, and thus, sales were not restricted to institutional customers.
- The Indian subsidiary constituted DAPE of the taxpayer under the provisions of the India Japan Double Taxation Avoidance Agreement.[4]

Tribunal's ruling

DAPE

- In the highly competitive air-conditioning and refrigeration equipment industry, tremendous efforts were necessary to achieve sales. For selling the same products, in the capacity of a distributor, the Indian subsidiary had incurred huge selling and distribution expenses. The contention of the taxpayer that customers in India were directly approaching it in Japan was not acceptable.
- Although the Indian subsidiary was not vested with the apparent authority to finalise the contracts of direct sales in India, the negotiating and finalising of contracts, etc., constituting the substance of any sale transaction in India were indeed performed in India. The mere fact that the taxpayer was formally signing the contracts would not alter this position.
- It was not the case of the taxpayer that the Indian subsidiary was an independent agent, *qua* the taxpayer.
- The Indian subsidiary was habitually exercising authority in India to conclude contracts on behalf of the taxpayer, though such contracts were formally signed by the taxpayer in Japan. Furthermore, the Indian subsidiary was securing orders in India almost wholly for the taxpayer. Thus, the Indian subsidiary constituted the DAPE of the Indian taxpayer in India.

Attribution of profits

- The applicability of the principle laid down by the Supreme Court[5] in the case cited by the taxpayer was not to be disputed; however, the same was not applicable in the instant case, as it fell within the exception, as laid by the

[2] Another issue with respect to determination of amount of profits attributable to PE restored to the file of TO
[3] Director of Income Tax *v.* Morgan Stanley & Co. [2007] 292 ITR 416 (SC)
[4] No specific averments with regard to attribution of profits are captured in the Tribunal ruling
[5] Director of Income Tax *v.* Morgan Stanley & Co. [2007] 292 ITR 416 (SC)

Supreme Court[5], i.e., if the transfer pricing analysis did not adequately reflect the functions performed and risks assumed by the enterprise.

- Profits were to be attributed to the DAPE, as the commission paid by the taxpayer to its Indian subsidiary had been found at ALP only with regard to the marketing functions. Accordingly, it would be necessary to attribute profits to the PE for functions such as negotiating and finalising contracts, performed by such PE.
- The Tribunal held that the mechanism followed by the TO in computing the amount of profits attributable to the PE was unique in nature and suffered from several infirmities. For the purposes of attributing profits, the Tribunal suggested that the profits earned by the Indian subsidiary from the commission income (and not the entire commission payments) should be reduced from the profits arising from the direct sales. Thereafter, the matter was restored to the TO to determine the amount attributable to the PE in India, as per the directions provided by the Tribunal.

The takeaways

- The decision affirms the position that entities performing significant sales functions involving negotiation and finalisation of contracts on behalf of a foreign enterprise in India may constitute DAPE of the foreign enterprise in India, even if the contracts are signed outside India.
- Further, the ruling has reiterated the principle of the Supreme Court[5] that an exception was carved out for attribution of profits if the transfer pricing analysis does not adequately reflect the functions performed and risks assumed by the enterprise. Accordingly, it is important that taxpayers document a robust functional analysis identifying functions performed, risks assumed and assets deployed both by the Indian entity and also the foreign enterprise for marketing transaction relating to direct sales in India. This analysis will not only be required for TP purposes but also for deciding on whether a DAPE constitutes, and subsequently attribution of profits to a PE, if any.
- The inferences on DAPE and attribution of profits in this ruling by the Tribunal is primarily based on inadequate documentation to substantiate the performance of activities of the Indian entity and foreign enterprise related to direct sales in India and also discrepancy as identified by the TO and Tribunal in the functional analysis, contractual agreement of the Indian entity and foreign enterprise. Therefore, the taxpayers should align the contractual agreements and pricing policy with functional analysis and follow it up with maintenance of backup documentation on contemporaneous basis to support actual conduct of activities.

Let's talk

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

Our Offices

Ahmedabad

1701, 17th Floor, Shapath V,
Opp. Karnavati Club,
S G Highway,
Ahmedabad – 380051
Gujarat
+91-79 3091 7000

Bengaluru

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bengaluru – 560 008
Karnataka
+91-80 4079 7000

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai – 600 006
Tamil Nadu
+91 44 4228 5000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th
Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Telangana
+91-40 44246000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata – 700 091,
West Bengal
+91-033 2357 9101/
4400 1111

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai – 400 050
Maharashtra
+91-22 6689 1000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City,
Gurgaon – 122002
Haryana
+91-124 330 6000

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
Maharashtra
+91-20 4100 4444

For more information

Contact us at
pwctrs.knowledgemanagement@in.pwc.com

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

In India, PwC has offices in these cities: Ahmedabad, Bengaluru, Chennai, Delhi NCR (Gurgaon), Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, visit www.pwc.com/in

PwC refers to the PwC International network and/or one or more of its member firms, each of which is a separate, independent and distinct legal entity. Please see www.pwc.com/structure for further details.

Follow us on: