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What's New

Tax Insights

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No profits could be attributed to PE in India, when contract for supply of goods (at offshore level) was incurring loss at global operational level – Delhi bench of the Tribunal

In brief

The taxpayer, a tax resident of Japan, earned revenues from technical collaboration agreements and from execution of projects in India for customers in the railway and power sectors through project and branch offices (which were admitted permanent establishments [PEs]) in India. Revenue alleged that the profits earned from offshore supply of equipment would also be attributed to the PEs in India, and accordingly attributed a portion of the overall revenues to the PE in India. Upon perusal of all facts and the relevant provisions of the India–Japan Double Taxation Avoidance Agreement (DTAA), the Delhi bench of the Income-tax Appellate Tribunal (Tribunal)[1] was of the view that, when the contract for supply of goods (at an offshore level) was incurring losses at an operational level, no profit could be attributed to the PE in India.

In detail

Facts

- The taxpayer is a Japanese company and the parent entity of a multinational engineering and electronics conglomerate. It has project offices and a branch office in India for performance of onshore activities relating to projects with Indian customers. The income earned by the project and branch offices were being offered to tax in India.
- During the years under consideration, the taxpayer entered into contracts with X Limited, which entailed manufacture and offshore supply of equipment from Japan and an onshore portion for indigenous procurements and other services in India.

Revenue's contentions

- Revenue alleged that the profits earned from offshore supply of equipment would also be attributed to the PEs in India given the involvement of the project offices in relation to customs duty clearances for these supplies.

[1] ITA Nos. 2259 & 2260/Del/2022

- The tax officer (TO) has applied the taxpayer's global profit rate of 6.87%, pertaining to one of the years, on offshore supply of goods, and attributed 35% thereof to the PE in India.

Taxpayer's contentions

- Post manufacturing, the taxpayer hands over the equipment to another entity in Japan that ships it to India. The entity is directly paid by X Limited for the shipping and transporting activities.
- The Indian project offices of the taxpayer play a limited role for supporting the customs clearance of the equipment, costs of which are charged back to the taxpayer. Thus, the goods pass through the project office only for customs duty clearance.
- The India–Japan DTAA protocol clarifies that the term 'directly or indirectly attributable to the permanent establishment' will mean only that part played by a PE in transactions in which the PE is involved. As the project office is not involved in the manufacturing and supply of goods, there is no question of attribution of profits.
- Without prejudice, the taxpayer also argued that it has incurred loss from the contract at operational level owing to changes in product specification leading to rejection and rework and owing to increased cost arising from increased labour rates and project delay on account of the COVID-19 pandemic. In this regard, the taxpayer relied on the jurisdictional High Court decision,[2] which held that no profit could be attributed when there is a loss to the foreign entity. In the referred case, the High Court upheld the finding of the Tribunal that the taxpayer recorded a global net loss in the relevant year and as per Article 7(1) of the DTAA, having a profit is a precursor for profit attribution.
- Without prejudice, the TO has adopted a notional profit of 6.87% and an arbitrary attribution of 35% without any basis.

Tribunal's observations and ruling

- The facts relating to manufacturing and shipment of equipment to India were not disputed by Revenue.
- The role of the project office in the offshore supply and the basis for attributing 35% were not discussed by the TO.
- The Tribunal upheld the taxpayer's reliance in the decision of the jurisdictional High Court[2].
- Accordingly, the Tribunal allowed the grounds raised by the taxpayer and deleted the addition made by the TO.

The takeaways

The Tribunal has in a welcome ruling, upheld the principle laid down by the Delhi High Court that no attribution is required if there is a global net loss. The approach of the Tribunal in holding that no attribution is needed considering the limited functions performed by the PE, is also in line with the generally accepted principles of attribution based on a proper functional evaluation. It also emphasises the responsibility of the lower authorities to evaluate the role of a PE in the light of particular facts, prior to profit attribution. It would be interesting to see how this principle would play out in a scenario where there is a global net profit, but the underlying contract for which a PE is alleged has a net loss at the operating level.

[2] CIT (International Taxation) *v.* Nokia Solutions and Networks OY [2023] 147 taxmann.com 165 (Delhi)

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