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Principles of Transfer Pricing critical for determining the arm's length nature of profits attributable to a PE

In Brief

In a recent ruling, the Delhi High Court (“HC”) in the case of Rolls Royce Singapore Pvt. Ltd.¹ held that a transfer pricing study based on a functions performed, assets employed and risks assumed (“FAR”) analysis of parties would be important to establish that remuneration paid to an Indian agent by a foreign principal is an arm’s length remuneration.

Furthermore, in the absence of such transfer pricing study, the HC upheld a specified percentage of profits as attributable to the Permanent Establishment (“PE”) in India.

¹ Rolls Royce Singapore Pvt Ltd. v. A DIT [TS-515-HC-2011(DEL)]

However, on the issue of whether the agent formed a dependent agent PE of the assessee in India under Article 5 of the India-Singapore Double Taxation Avoidance Agreement (the “tax treaty”), the HC remanded the case to the Assessing Officer (“AO”) for fresh adjudication.

Facts of the case

- Rolls Royce Singapore Ltd (“RRS” or the “assessee” or “Company”), a non-resident company, had two business activities in India, namely rendering repairs and maintenance services and supplying spare parts to its customers in India.
- RRS offered its service income to tax as fees for technical services.

- RRS conducted its activity of supply of spares through an Indian entity i.e. ANR Associates (“ANR”). ANR, under a contractual agreement with RRS, solicited the orders from Indian customers and passed them to RRS for execution.
- RRS did not offer income from supply of spares to tax in India, on the ground that it had no PE in India.
- The AO contended that RRS has a business connection/PE in India. Furthermore, the supplies and services are intricately and inextricably linked with each other.
- Accordingly, the AO taxed business profits from supplies by attributing profits (100 percent of the profit for AY 2000-01 to AY 2003-04 and 75 percent profit for AY 2004-05) of RRS to the business connection/PE in India.
- Aggrieved with the assessment order, the Company filed an appeal before the Commissioner of Income Tax (“CIT(A)”).
- The CIT(A) while accepting AO’s contention that RRS has a dependent agent PE in India, granted partial relief to RRS in terms of attribution of profits to PE in the following manner:
 - For AY 2000-01 and 2001-02 at 10 percent of net profit, and,
 - For AY 2002-03 to 2004-05 at 25 percent of net profit of RRS should be attributed to the PE in India.
- RRS, as well as the Revenue, challenged the order of the CIT(A) before the Income-tax Appellate Tribunal, Delhi (the “Tribunal”).
- The Tribunal held as follows:
 - RRS has not been able to substantiate that the remuneration paid to ANR was arm’s length remuneration;

- In the absence of a transfer pricing study, 10 percent of profits should be attributed to the PE for all the years.

- Not convinced with the order of the Tribunal, RRS, as well as the Revenue, approached the HC.

Issues before the HC

- Whether ANR constituted a dependent agent PE under Article 5(8) of the tax treaty.
- Whether ANR has been compensated at an arm’s length price.
- Whether it is correct to attribute 10 percent of profits to the PE in India.

Issue 1 - Whether ANR constituted a dependent agent PE under Article 5 of the tax treaty

Assessee’s contentions

- The assessee contended that ANR was an independent agent in view of the following:
 - ANR was an independent entity and was not related to RRS;
 - ANR had various other clients from whom it was earning its revenues and RRS was not the sole client;
 - ANR did not have the power to negotiate and conclude contracts on behalf of RRS;
 - the transactions between ANR and RRS were on a principal-to-principal basis;
 - ANR was already an existing company and was not created by RRS; and
 - ANR had its own infrastructure and its own business before it entered into the agreement with RRS.

- Merely because ANR was prohibited from promoting the products of competitors of RRS would not mean that it was not an agent of independent status.
- Activities of ANR were not devoted “wholly or almost wholly” (as required by Article 5(9) of tax treaty) on behalf of RRS, as ANR had many other activities and was doing business for various other parties. Agency of RRS held by ANR was only one of those many activities.
- There was no requisition made to RRS by Revenue authorities to furnish details of services rendered by ANR to other clients and commission earned from them to substantiate that activities of ANR were not devoted “wholly or almost wholly” on behalf of RRS.
- RRS had filed a letter with the AO confirming that ANR had rendered services and earned commission from other parties and income from RRS was not the only source of income for ANR. To substantiate this, RRS produced returns of income filed by ANR for certain relevant years.

HC ruling

- The HC accepted the plea of the assessee that no requisition was made to RRS by Revenue authorities to substantiate that activities performed by ANR for RRS were not the only source of income.
- The HC held that the question as to whether ANR has any income from other clients and the extent of such income is very relevant to decide whether ANR is an agent of independent status.
- Therefore, the HC, while putting the onus on the assessee to substantiate this, remanded this issue to the AO for fresh adjudication on the following questions:

- Whether ANR was providing services to clients other than RRS and had substantial income from other client’s and
- Whether ANR was wholly or almost wholly working on behalf of RRS.

Issue 2 - Whether ANR has been compensated at arm’s length price

Assessee’s contentions

- Even if ANR is to be treated as a PE of RRS in India, as per Article 7(2) of the tax treaty, only that income which is reasonably attributed to the PE is to be treated as business profits i.e. the profits which the PE might make if it were a distinct and separate enterprise.
- The question of arm’s length price could arise only when there was a connection between RRS and ANR.
- Even if ANR was a PE of the assessee, this had no bearing on the fixation of commission to be paid by RRS to ANR.
- There was no way RRS could dictate the commission to be charged by ANR, as ANR was negotiating as a third party in the market place.
- Fixed commission agreed between RRS and ANR was at arm’s length and can be treated as reasonable.
- In the case of an associated enterprise which constitutes a PE, once a transfer pricing study is undertaken (taking into account the FAR analysis of the enterprise), there is no further need to attribute profits to the PE.²

² DIT(IT) v. Morgan Stanley and Co. Inc. [2007] 292 ITR 416 (SC)

- The situation would be different if the transfer pricing study does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.
- In each case, the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis of the taxpayer based on the functional and factual analysis is exhaustive for attribution of profits.
- Taxing corporates on the basis of the concept of ‘economic nexus’ is an important feature of attribution of profits.
- When an agent in India has been taxed on the fair value of activities in India, this could not be taxed again in the hands of the assessee as income attributable to the PE.³
- The profits attributable to the PE has to be estimated on a reasonable basis.
- The reasonable profits attributable to the PE could be justified by a transfer pricing study undertaken as mentioned in section 92 of the Income-tax Act, 1961 (the “Act”).

HC ruling

- The HC accepted the assessee’s plea that in cases where the activities of the PE in India are remunerated at fair value and this has been taxed in India, there is no question of taxing the assessee again on the same deemed income;

- The HC held that remuneration paid to an agent could be reasonable and fulfilling the arm’s length price criteria if it is justified by a transfer pricing study. However, in RRS’s case, no such transfer pricing study was carried out.
- In the judicial precedents relied on by the assessee, a transfer pricing study was undertaken to justify the remuneration paid. Accordingly, reliance on such cases by the assessee is misplaced.
- The commission payable to ANR was fixed at 5 percent of invoice value, which was later changed to USD 40,000 per annum with no plausible or justified reason. This manner of fixing of remuneration between RRS and ANR is usually not practiced by two independent parties. Therefore, this seems to be a transaction controlled by RRS and cannot be considered to be carried out at arm’s length basis.
- Furthermore, the assessee has not submitted any record of such type of comparable transactions of fixation of remuneration between two independent parties.
- In the absence of FAR analysis, RRS has not been able to establish that the remuneration paid to ANR was equal to an arm’s length remuneration.

Issue 3 - Whether it is correct to attribute 10 percent of profits to the PE in India.

The HC, based on the following considerations held that 10 percent of profits represents the “reasonable profits” attributable to the PE in India:

- As the remuneration paid to ANR does not represent the arm’s length price, it is difficult to find fault in the order of CIT(A), as well as that of the Tribunal, in attribution of 10 percent profits (10 percent of the invoice value) to PE.

³ Set Satellite (Singapore) Pte Ltd. v. DDIT, (IT) [2008] 307 ITR 205 (Bom)

- The risk assumed by ANR is limited since it has no authority to negotiate, accept any order or vary any contract or to make any warranty representations. Furthermore, there is nothing on record to show that ANR has performed or assumed any responsibility for anything beyond what is written in the agreement between RRS and ANR.
- The HC relied on the rulings of the Supreme Court and the Mumbai Tribunal⁴ to hold that 10 percent profit attribution in trading operations is justified where only the agreement is signed in India and other substantial activities are carried outside India.

Conclusion

The HC has followed and reiterated the pragmatic view expressed by the Supreme Court in the case of Morgan Stanley and Co. Inc. and the Bombay High Court in the case of Set Satellite (Singapore) Pte Ltd. that if a PE is remunerated at arm's length by its foreign principal, then no further profits need to be attributed.

Moreover, the HC has proceeded to clearly articulate a long awaited and much needed diktat that whether or not the attribution is at arm's length can only be determined by applying the fundamentals of transfer pricing. This is a critical verdict and in effect completes the chain of events that should follow post identification of a PE, i.e., starting from identification of a PE, to attribution of profits to the PE, to arm's length attribution, and finally to application of the fundamentals of transfer pricing to ensure arm's length attribution.

Notably, this decree of the HC coincides with the views of the OECD as well as the Australian Tax Office. In fact, the Indian Income-tax Act also requires transfer pricing regulations to be applied for attribution of profits to PEs. The definition of "enterprise" for the purposes of sections 92 to 92F of the Act, includes a PE

(section 92F(iii)), thereby clearly requiring application of the fundamentals of transfer pricing for computing profits attributable to PEs.

In the present case, owing to the absence of a transfer pricing study, the HC could not apply transfer pricing principles and had to accept the arbitrary approach for attribution. Surely, the relevance and significance of a transfer pricing study when attributing profits to a PE cannot be made more evident than this. Therefore, a properly undertaken transfer pricing study is the only key to resolving a profit attribution dispute, the onus of which lies on the taxpayer. In the absence of a transfer pricing study the risk of arbitrary attribution is likely as Revenue officers and also Tribunals as well as Courts may be compelled to rely upon the formulatory approach provided in Rule 10 of the Income-tax Rules, unless they specifically direct for a TP study to be undertaken.

⁴ Annamali Timber Trust Co. v. CIT [1961] 41 ITR 781 (SC) and Ingersoll Rand Co v. ITO [1983] 4 ITD 654 (Bom)

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