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News Alert
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For attribution of profits to PE, AO cannot simply apply Rule 10 without rejecting TP study for proper reasons

In brief

The taxpayer, a project office of Hyundai Rotem Company[1], Korea (the taxpayer), provided liaisoning, co-ordination, and administrative support services to its head office (HO), in connection with a contract being executed in India. The income of the project office was computed on a cost plus 9% basis, and this was supported by a transfer pricing (TP) study. In this regard, in a recent ruling, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) ruled in favour of the taxpayer, and primarily held the following:

- For the purpose of computing income of a permanent establishment (PE), the methodology provided under TP Regulations[2] is preferred over the procedure provided under Rule 10 of the Income-tax Rules, 1962, read with section 9 of Income-tax Act, 1961 (the Act).

- Rule 10 can be applied in cases where the income of the PE cannot be definitely ascertained, and the assessing officer (AO) has to demonstrate this. AO cannot simply proceed to apply Rule 10 without rejecting the TP study undertaken by the taxpayer. For rejecting the TP study, the AO must provide reasons and evidence.

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[1] Hyundai Rotem Company *v.* Ass. DIT [TS-612-ITAT-2012 (DEL)]

[2] Sections 92 to 92F of the Income-tax Act, 1961 read with Rules 10A to 10E of the Income-tax Rules, 1962.

- Profits attributable to a PE shall be determined by the same method each year unless there is sufficient reason to not do so [reliance placed on Article 7(5) of the Double Taxation Avoidance Agreement (tax treaty) between India and Korea and the fact that the Revenue itself had accepted the taxpayer's methodology in subsequent assessment years].

Facts

The taxpayer is a project office of Hyundai Rotem Company, Korea, and had formed a consortium with Mitsubishi Corporation (M.C.), Japan and Mitsubishi Electric Corporation, Japan to bid for the Mass Rapid Transport System Contract from Delhi Metro Rail Corporation for a design, manufacture and supply, test, commissioning, training and transfer of technology of passenger rolling stock. The contract was awarded to this consortium. The project office provided liaisoning, co-ordination, administrative support services to its HO in connection with the contract being executed in India. In its tax return, the income of the project office was computed on a cost plus 9% basis, and this was supported by a TP study.

There are three years under consideration, i.e., AY 2002-03, 2003-04 and 2004-05. A TP study was undertaken for each of these years. For AY 2004-05, the transfer pricing officer (TPO) accepted the TP study carried out by the taxpayer and found the international transactions to be at arm's length. However, in case of AY 2002-03 and AY 2003-04, the case was not referred by the AO to the TPO. The AO did not accept the cost plus methodology adopted by the taxpayer and instead determined the income by applying Rule 10. The AO adopted a global formulary apportionment approach in order to determine the income attributable to the project office.

Aggrieved, the taxpayer appealed to the Commissioner of Income-tax Appeals (CIT(A)) who upheld the AO's approach. Aggrieved, the taxpayer appealed before the Tribunal.

Taxpayer's contentions

- As far as existence of PE is concerned, there is no dispute. The dispute relates to the income attributable to such PE in India. The issue is whether income has to be determined on the basis of Rule 10 or on the basis of the TP Regulations, wherein a mechanism for determination of arm's length price (ALP) is provided. There is nothing in the statute to suggest that the AO has any discretion in this matter, and if the Revenue contends that the AO does, then that would negate the mandatory nature of application of the TP regulations.

- As per Article 7(2) of the India-Korea tax treaty, the income of a PE has to be determined on an arm's length basis and as if it was a distinct and separate enterprise.

- The mechanism to determine ALP was available in a limited way in erstwhile section 92 of the Act and in old Rule 11. With the introduction of the TP Regulations and the consequent substitution of section 92 and omission of Rule 11, Rule 10 has lost its application in cases where the treaty provides a separate entity and arm's length approach for the determination of a PE's income.

- Determination of income on the basis of Rule 10 is totally unscientific and contrary to the procedure provided in the TP Regulations. Further, the language of Rule 10 itself suggests that it is a rule of last resort and is not available to the AO as first or the alternate option particularly when the matters are governed by Article 7(2) of the DTA read with section 92 of the Act.

- Except for AY 2002-03 and AY 2003-04, in all other subsequent AYs, the Revenue had accepted the cost plus 9% methodology adopted by the taxpayer.

- Reliance was placed on the Supreme Court (SC) decisions in the cases of Morgan Stanley and Co.[3] and Hyundai Heavy Industries Co. Ltd.[4].
- CBDT circular No.14 dated 12 December 2001 also contemplates that transactions between foreign enterprises and its PE are subject to transfer pricing.

Revenue's contentions

- Discretion lies with the AO to either resort to Rule 10 or to the TP Regulations. Both provide a methodology to determine the income of a non-resident. They are not mutually exclusive and are not in conflict with each other, but rather provide a parallel mechanism.
- Article 7(2) of the India-Korea tax treaty does not speak of application of TP Regulations. In fact, earlier, when no specific TP Regulations existed, Article 7(2) of the tax treaty was applied by resorting to Rule 10. Since Rule 10 is still there even after introduction of the TP Regulations, the AO can resort to this rule for attribution of profits to a PE.
- Article 7(4) of the UN Model Convention recognises that profit attribution can be done on the basis of apportionment of the total profits (Rule 10).
- Revised Article 7 of the OECD Model Convention which speaks of the two-step analysis has not been accepted by India, and is anyway not applicable to the years under consideration in the instant case.

[3] DIT *v.* Morgan Stanley and Co, [2007] 292 ITR 416 (SC)
[4] CIT *v.* Hyundai Heavy Industries Co Ltd [2007] 291 ITR 482 (SC)

Tribunal ruling

- Rule 10 does provide a mechanism for taxing the income of a PE. Further, once a rule is provided in the statute, its existence cannot be denied. However, one has to determine whether the conditions enumerated in the rule are available for its application or not.
- A plain reading of Rule 10 suggests that it can be applied in cases where income accruing or arising to any non-resident from any business connection is such which cannot be definitely ascertained. However, the AO had not demonstrated or pointed out that income cannot be definitely ascertained on the basis of the TP study or other material on record. The CIT(A) had also simply observed that no prejudice is caused to the taxpayer by determining its income under Rule 10.
- If a reference to the TPO has not been made, the AO can independently undertake a transfer pricing analysis. However, in the instant case, the AO simply proceeded to apply Rule 10 without rejecting the TP study undertaken by the taxpayer. The AO had not pointed out any error in the TP study, nor did the AO put forth any evidence or provided any reason for why the TP study may not have been proper, or why the transactions with the HO may not have been at arm's length.
- For the purpose of computing a PE's income, if one weighs the procedure provided in Rule 10 read with section 9, *vis-à-vis* the procedure provided in the TP Regulations, in light of TP study carried out by the taxpayer and its consistent position of showing income under a particular method, then the scale would tilt towards the detailed method provided under the TP Regulations.
- The Revenue itself has accepted the methodology adopted by the taxpayer in subsequent assessment years. Article 7(5) of the India-Korea tax treaty

provides that profits attributable to a PE shall be determined by the same method year by year unless there is good and sufficient reason to the contrary. However, in the instant case, no reasons have been provided by the AO for adopting a different method in different years.

Therefore, the income of the taxpayer should be computed at cost 9% as declared by it, and as also accepted by the Revenue in subsequent years.

PwC observations

In the context of transfer pricing, until the recent landmark ruling in the case of Rolls Royce Singapore Pvt. Ltd.[5], judicial precedents[6] on attribution of profits to PEs had mostly held that no further attribution is required if the PE is compensated at arm's length. In the case of Rolls Royce Singapore Pvt. Ltd., the High Court (HC), not only reiterated this view, but also held that whether or not the attribution is at arm's length can only be determined by applying the fundamentals of transfer pricing. In the case of Rolls Royce Singapore Pvt. Ltd., since there was no TP study, TP principles could not be applied and the HC had to thus accept the approach of attributing profits as per Rule 10.

In the instant case, the Tribunal has gone a step further and ruled upon another vital aspect, i.e., the applicability of Rule 10 for the purpose of attributing profits to a PE (in a situation where a TP study exists, even if no TP assessment has been undertaken).

For the purpose of computing a PE's income, Rule 10 is typically considered to be a method of last resort, and particularly so after the introduction of TP Regulations. By articulating a clear preference for the methodology provided under the TP Regulations, over the procedure provided under Rule 10 (read with section 9), the Tribunal seems to have reinforced this.

In a welcome decision, the Tribunal has held that Rule 10 can be applied in cases where the income of the PE cannot be definitely ascertained, and the AO is required to demonstrate the same before proceeding to apply Rule 10. Where a TP study exists, it is warranted that the AO first reject the TP study based on sufficient evidence and for proper reasons.

The Tribunal has objected to the AO simply proceeding to apply Rule 10 without rejecting the TP study undertaken by the taxpayer. Accordingly, the significance ascribed to a TP study by the Tribunal is quite apparent, and this is clearly a message for taxpayers who have PEs in India, i.e., to undertake a detailed transfer pricing analysis for the purpose of attribution of profits to their PEs in India, and to put together all the corresponding underlying transfer pricing documentation.

5 Rolls Royce Singapore Pvt. Ltd. *v.* ADIT [2011] 202 Taxman 45 (Del)

6 Such as in the cases of Morgan Stanley (above) , SET Satellite (Singapore) Pte. Ltd *v.* DDIT [2008] 3071 ITR 205 (Bom), and DIT *v.* BBC Worldwide Ltd. [2011] 203 Taxman 554 (Bom).

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