

Bombay Chamber of Commerce

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Presentation on

Attribution of Profits to Permanent Establishment

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Short Forms:

ALP Arm's Length Price.

COR Country of Residence.

COS Country of Source.

HO Head Office.

PE Permanent Establishment.

TP Transfer Pricing.

TPO Transfer Pricing Officer.

Attribution of Profits to Permanent Establishment (PE).

Preface:

Conceptual Issues Vs. Interpretation Issues.

1. Tax issues arise when the head office or main Enterprise is situated in one country (COR) & PE is situated in another country (COS). Before calculating the tax, one has to consider the amount of profits that is taxable in both the countries. Hence we have to calculate the profits earned by different parts of the enterprise - Head Office (HO) & Permanent Establishment (PE).

2. Logical Arguments

- (i) A Vedanti can prove taking support from the Vedas that

God the ultimate is Infinite.

At the same time

God is also Shunya or "NIL".

Hence Infinite is equal to Shunya.

- (ii) We may realise that a tax commissioner & a tax consultant can logically prove just about anything. The argument at each stage would be logical and correct. And yet the total result (macro level) may be absurd.

Moral is to look at the macro level.

(For those who may be interested: The philosophical truth in the 1st point above has been also proved by American author Neale Donald Walsch in his series of books - "Conversations with God". He has not relied on the Vedant.)

3. Attribution of Profits to Permanent Establishment (PE).

- (i) Let us understand the issues involved from pure **accounting** and businessman's view point.
- (ii) Consider Indian **Income-tax Act**,
- (iii) Indian **Case Law**,

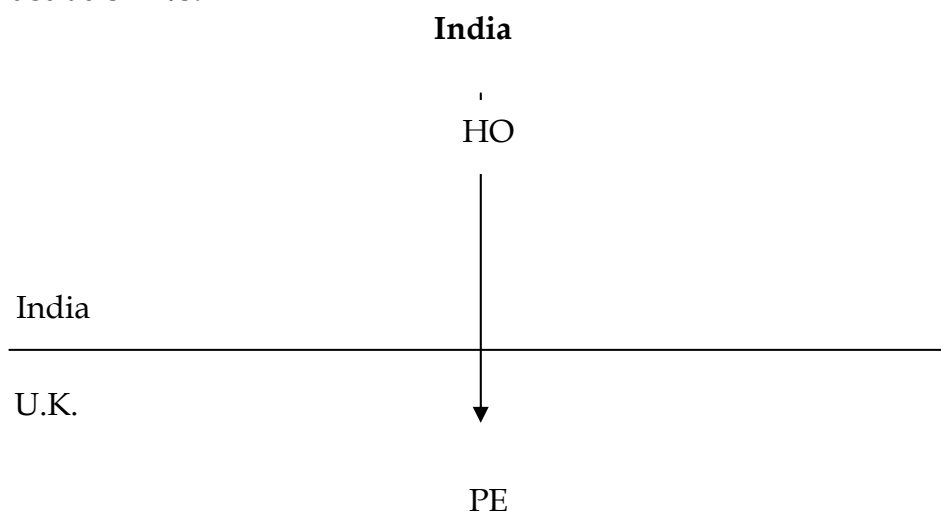
- (iv) **Direct Taxes Code (DTC) &**
- (v) **OECD Convention & Commentary.**

Not necessarily in this order. These five view points may be considered for all the issues relevant to the matter.

4. **Draftsmen's Behaviour**

Let us consider illustration. Indian company has a PE abroad. Now apply circular 23 of 1969 & Indian case law.

Illustration No. 1



What are the legal provisions!

- (i) From circular 23 of 1969 to DTC, the provisions are for the situation when HO is abroad and PE is situated in India. Not for the situation described above.
Why!
Draftsmen draft the law based on circumstances prevalent at the time of drafting. (Observation one on draftsmen's behaviour.)
- (ii) When the **circumstances reverse** themselves, they are confused. They stubbornly refuse to change the law. This is my second observation of human behaviour. We will see real life illustrations as we proceed further. Thankfully, OECD Model Convention Article 7 has a neutral language.
- (iii) Third Observation: When the draftsman drafts the law, he drafts in a manner that is more beneficial to himself. Consider Indian Income-tax Act:

Indian Government Draftsman drafted **Transfer Pricing (TP)** provisions. Then clarified that business between HO & PE is also covered under TP. PE definition has been added.

Consider (**Illustration No. 2**) that foreign HO has given loan to Indian PE and interest is charged on ECB @ 7%. TPO claims that in U.S.A. interest rates are near zero. Hence 7% interest on a \$ ECB is excessive. So he adjusts the interest rate to 2%. In the assessment of PE, while allowing interest expenditure, only 2% will be allowed.

However, on payment of interest to Non-Resident HO, the PE is supposed to deduct income-tax at source (Section 195). That interest is considered @ 7%.

Where the draftsmen are fair human beings, they would provide for automatic adjustment on TDS. Indian draftsman has gone ahead and made provision that such Compensatory Adjustment shall not be made!!! (Income tax Act Section 92C, last proviso. DTC - Section 106(6).)

It is not just tax payers who are greedy.
Even Government of India is greedy.

No surprise.
Philosophers say, "World is driven by Greed & Fear."
And Government draftsmen are also men of this world.

_____ Preface Completed _____

I. OECD Discussion draft dated 24th November, 2009:

1. Business Income to be taxed only in the Country of Residence (COR). Article 7 (1).
2. However, if a Non-Resident (NR) has economic presence in another country beyond a **threshold**, the host country, or the Country of Source (COS) can also tax the assessee. Article 7 (1).
3. The threshold is called Permanent Establishment (PE).

There can be different forms of PE

Fixed Base PE	Article 5 (1)
Illustrations of PE	Article 5 (2)
Construction of PE	Article 5 (3)
Exclusions from PE	Article 5 (4)

Dependent Agent PE	Article 5 (5)
Independent Agent – Not a PE	Article 5 (6)
Controlled Company	
Not necessarily a PE	Article 5 (7)

Essence: A PE will be constituted only if there is a physical presence in the COS or actual operations are carried out within the COS. **Geographical location of** the functions in the COS is very important.

4. COS will levy **normal tax** on the net profit of the PE. **Computation of income** will be as per the domestic law- as far as principles of Articles 7 are complied with.

Expenditure incurred by the Enterprise for the PE – should be allowed full deduction irrespective of the country where it is incurred.

5. COS taxes PE's profit – **COR has inherent jurisdiction** to tax PE's profits. COR will calculate PE's profits as per its own domestic law. (SC decision in Chettiar's case is, with respect, incorrect.)

From this tax on PE's profits, COR will give relief under Article 23A (exemption method) or Article 23B (credit method).

6. If one country makes an adjustment to the profits of the PE (under TP rules) than the other country must make **corresponding adjustment**. It should be the endeavour of both the countries to ensure that there is no double tax.

7. What may be taxed in the COS is only the **profits attributable** to the PE.

8. The fact that the PE is part of the main enterprise will be forgotten. It shall be deemed that the PE is a separate & independent entity. Hence the principle that an assessee can not make profits out of itself is given a go-bye as far as attribution of profits to PE is concerned.

9. PE's profits shall be computed by applying **Functions, Assets & Risks analysis**.

10. PE may make profits by **dealing with** outside customers. (e.g. State Bank of India's London branch lending funds to customers in London,)

PE may make profits by dealing with HO as well as other PEs of the same enterprise. (e.g. SBI London branch lending funds or providing

services to SBI - Mumbai HO + New York branch + Singapore branch.)
All these profits are to be calculated at ALP. (**Cost plus profits.**)

11. OECD does not approve of the "**Force of Attraction**" principle.
12. If an enterprise has several sources of income in COS, for **each source** it should be **separately examined** whether that activity becomes a PE or not.
13. It is possible that HO makes losses while PE makes profits. And vice versa.
14. For transactions between PE & HO, **documentation** has no legal implications. For example, it is not necessary for either party to raise an invoice for the services rendered. However, for the purposes of attribution of profits, they should raise all the documents as if they are dealing with third parties.
15. When any unit of an assessee does a function for another unit - PE or HO - the services should be charged at ALP. Not just cost. What will be charged will be cost plus profits.
16. Article 7 (5) is being deleted.

_____(**Brief view of the OECD Commentary completed.**)_____

II. **Accounts:**

II.1 **Attribution within Department:**

It is well settled that a business enterprise may make **profit or loss** from **many of its functions**. Sales is not the only function that contributes to profits. During college days, in the subject of "costing" we have studied standard illustrations of textile mills and sugar mills.

So, an enterprise can make profits in purchase function, production or sales. And it can make profits at the head office and at any of its branches.

Some companies give **bonus** to all their employees depending upon the profits. Each department's employees get bonus based on the **profits** made by the particular **department** or unit.

When one department transfers its product to the next department, it adds a mark-up, a profit margin. **Inter departmental transfer pricing** is not a difficult issue. The head office may allocate different common costs

(indirect overheads) to each department and attribute the profits to each department. It is all a matter that can be resolved without much problem.

So attribution of profits to a department or a PE is essentially a **simple matter for cost accountants**. When the same issue is considered under **International Taxation**, it becomes an **insurmountably complex** issue. Why!

Within the company, there is hardly any **conflict of interest**.
In International taxation, there are six parties involved:

1. The Assessee – HO.
2. HO tax consultant in COR.
3. Permanent Establishment.
4. Permanent Establishment tax consultant in COS.
5. Government of COR &
6. Government of COS.

Each has its/ his vested interest. And there is more than one conflict of interest. Hence the matter is bound to be complex.

II.2 Simple Illustration (No. 3)

A Chinese company sells electronic products in India.

Let us say, manufacturing cost of a mobile phone as per company's records is Rs. 2,000. It is selling the phones (comparable to Black Berry) at Rs. 5,000 – in Indian retail market.

	Rs.
Ex-factory cost	2,000
Transport, insurance & customs duties	500
Chinese HO profit	500
Transferred to Indian PE at	3,000
Indian PE's expenses	200
Indian PE sells to retailers at	3,500
PE Net profit	300
Retailer sells to consumer at	5,000

An alternative may be that the HO transports the product to the Indian PE but does not pass any financial **accounting entry**. It only makes quantitative records.

Whether the company transfers at a mark-up or not, does not make any difference. Chinese and Indian Income-tax departments will apply **Transfer Pricing** rules and will try to determine what should be the

correct profit attributable to the Chinese HO & the Indian PE. The profit has to be determined at **Arm's Length Price (ALP)**.

The principle that an assessee **cannot make profits from itself** is ignored & in fact contradicted for the purposes of PE taxation. This is as per OECD model convention & Commentary.

It is quite likely that the Chinese TPO will say that the transfer price between HO & PE should be Rs. 3,100 and the Indian TPO will say that it should be Rs. 2,900.

OECD revised discussion draft dated 24th November, 2009 - for new Article 7; says that the two Governments should resolve the issue and the assessee should not be made liable to pay double tax. In practice, there is hardly any mechanism. MAP has its limitations.

II.3 **What should be the real profits attributable to the PE is the issue.**

Let us see the attribution issues: Limitations of FAR analysis.

1. **Government Subsidies:** Chinese Government gives huge **subsidies** to Chinese manufacturers. Hence they can sell the product at Rs. 2,000 and make a profit. In the absence of the subsidies, the price could be Rs. 15,000 - or - there would be no manufacturer, and no PE in India. Can it be said that the PE's entire profit is due to Chinese subsidy and hence taxable only in China!
2. **Under Valuation of Yuan:** It is alleged that Chinese Yuan has been deliberately kept **under valued**. Hence the Chinese company can make profits. **Where is the source of this profit!**
3. **Exchange Rate Fluctuation:** For this illustration, we have taken figures in Indian rupees. In reality, the Chinese company's records are maintained in Yuans. After the goods have been received in India and HO account is credited in terms of Yuan; rupee appreciated by 10% vis-a-vis Yuan. The PE received more money on sales in India and has to pay less to the HO for import of goods. It makes a profit of 12%. (On 31st March, 2009 one Yuan was equal to INR 7.56. On 19th March, 2010 it was Rs. 6.65.)

None of these profits can be attributed to functions or assets of either the HO or the PE. These are simply fortuitous profits. Who had taken the risk of exchange rate fluctuation!

4. **Agent:** Now assume that the Chinese company, instead of setting up its own PE in India, appoints an agent. The agent is dependent

on Chinese company and constitutes a PE. All price figures given in paragraph _____ are same in this case also.

Now how much profits are to be attributed to the HO & how much to the PE!

Under TP rules, no invoice or voucher is sacrosanct. Everything can be examined – whether it is at ALP or not!

From pure TP point of view, it makes no difference whether the PE is a branch of the assessee or a separate company owned by totally separate owners. HO made a profit of Rs. 500 and PE made a profit of Rs. 300 – totally Rs. 800. How much of the profit may be attributed to whom!

Functions & Assets Analysis

Assume that the Chinese company has an investment in assets of Rs. 100 crores and employs 1000 persons. The Indian PE has taken a sales depot on rent. Total fixed assets are less than Rs. 10 lakhs and employs five persons. If function and assets analysis is applied, probably Rs. 790 of the profits may be attributed to HO and Rs. 10 may be attributed to the PE.

At the same time, it is normal for similar distributors in India to earn @ 10% over their purchase price. Hence at ALP, the PE should earn Rs. 300.

If the CUP prices are different from FAR analysis prices; which price should prevail!

Assuming that Rs. 790 profits attributed to HO is a fair attribution, can the Chinese Government tax Indian PE's profits in China!

_____ **(Brief view of the accounting issues completed.)** _____

III. Income-tax Act:

S.4 - Charge of income-tax

U/s. 5 (2) Scope of Total Income: A non-resident's income is taxable in India only if he has an income - received / accrued in India or deemed to be received/ accrued in India.

When a NR does business in India through a PE, it can be said that the profits accrue in India. Hence the PE's profits are taxable in India u/s. 5.

S.6 - Residential Status:

When a foreign company is Non-Resident of India u/s. 6 (3), just because it has a PE in India, it does not become an Indian resident. Hence all income of the NR earned otherwise than through a PE in India, remain beyond the Scope of Total Income taxable in India.

S.9 Deemed Income: 9 (1) (i) Business Connection.

Explanation 1 (a) - Only profits attributable to operations carried out in India are taxable in India.

Explanation 2- Concept of Business Connection has been expanded to cover dependent agents.

Explanation 3- Only profits attributable to operations carried out in India are taxable under this provision.

Note- OECD in its FAR analysis considers functions, assets & risks. Income-tax Act considers only functions - for this specific provision.

S.9 (v), (vi) & (vii)

Interest, royalty & FTS are taxable in India if they are paid by an Indian resident. Hence the concept of receipt or accrual in India; or operations carried out in India - are not relevant.

Can India tax Non-Resident's income out of operations carried out abroad! (Ishikawajma - SC decision. Current budget 2010 explanation inserted in S.9. Government of India has taken a view that when services are utilised in India, the FTS is taxable in India. Parliamentary jurisdiction - US tax on Infosys, WIPRO & Satyam. This is applicable only to FTS, royalty & interest. Not applicable to business income. CBDT stand is necessary because the world is taxing in this manner.)

S. 90 Double Tax Avoidance Agreements.
Treaty overrides the Income tax law.

S.195 TDS from payments to Non-residents - if such payments are chargeable to tax under the Act.

S. 115A Royalty & FTS taxable @10% on gross payment to non-resident.

Chapter X sections 92 to 92F. Transfer Pricing.

Section 92F (iii) “Enterprise” includes a PE.

Section 92F (iii) (a) defines PE to include only fixed place PE.

This probably means that Service PE, Agency PE, etc. are not included.

Summary: If a NR has a PE in India, the PE’s income is taxable in India u/s. 5 itself.

Transactions between a PE & the HO are covered under Transfer Pricing regulations.

_____ **(Brief view of the Indian Income tax Act completed.)** _____

IV. Case Law:

Morgan Stanley. S.C. 292 ITR 416.

Once the PE has been paid arm’s length price, no further profits can be attributed to it.

Set Satellite Bombay HC 307 ITR 205.

HO not liable to tax once the PE has been paid at ALP.

Government of India has taken a view that when services are utilised in India, the FTS is taxable in India.

Ishikawajma – Parliamentary jurisdiction – US tax on Infosys, WIPRO & Satyam. This is applicable only to FTS, royalty & interest. Not applicable to business income. CBDT stand is necessary because the world is taxing in this manner.

_____ **(Very brief view on Indian Case law completed.)** _____

V. Direct Taxes Code:

Section 2 - Liability to pay income-tax.

Section 3 - Non-Resident’s income taxable in India if received or accrued/ deemed to be received or accrued in India.

Section 5 - Deemed income, interest, royalty & FTS taxable in India if received/accrued from an Indian resident.

S. 5 (3) Only profits attributable to operations carried out in India are taxable in India.

- S. 5 (5) Ishikawajma case overruled.
- Section 113 (12) Enterprise includes PE.
- Section 112 GAAR
- Section 258 Double Tax Avoidance Agreements.
- Section 206 Foreign Tax Credit.
- 284 Definitions
- 284 (43) Business Connection

Section 4 (3) Residential Status of company

If a company's control and management is situated- even partly in India; that company becomes Indian resident. Hence ALL the companies which have a PE in India will become Indian Residents. Hence u/s. 3 their global income will be taxable in India.

This of course, is an absurd proposal under DTC. It is understood that in the 2nd draft of the DTC, this provision will be dropped.

A separate sub-committee has been appointed to draft CFC rules.

S. 258 (8) Treaty Override

Under the 1st draft, the DTC or the DTA **whichever is later** shall prevail. Even this provision from the 1st draft will be dropped. Appropriate provisions to avoid treaty abuse may be proposed in the 2nd draft of DTC.

__(Brief view of Direct Taxes Code on Attribution issues completed.)__

Illustration No. 4:

Foreign Television Channel (FTC) company appoints a marketing agent in India. Let us assume, the agent is dependent on the HO, has authority to conclude contracts & does conclude contracts on behalf of HO. Hence the agent is a PE.

PE gets advertisement orders, collects revenue & after deducting 15% commission remits the balance to HO.

Let us assume that the FTC earns 25% net profit on the advertisement revenue received from India. What amount can be taxed in India!

1. **Department** may make following claims: Taxing HO itself.
 - (i) Advertisement revenue has been **received in India**. Receipt in India by the agent amounts to receipt by the principal. Hence u/s. 5 the net profit on the whole of the revenue is taxable in India.
 - (ii) U/s. 9(1)(i), the assessee has a **business connection** in India. Net profits on all receipts through the business connection are taxable in India.
 - (iii) The **foot print** of the TV channel is in India. Hence it is doing business in India. Hence it is taxable in India.
 - (iv) The TV channel is providing two services:
 - (a) To the viewers, the entertainment service;
 - (b) To the advertisers, the advertising service.

Both services are utilised in India. Hence (i) residence of the assessee and (ii) whether there is a PE or not; are irrelevant.

2. **Taxing the PE.**

- (i) PE will of course be taxed on the net profit out of 15% commission.
- (ii) In addition to the 15% commission, there may be some more profits attributable to the PE's operations in India but taxable in the hands of the HO. Of course, at the time of filing the return, there may be only one return. The PE & the HO are only one entity.

OECD Commentary on Article 7 supports this view.

3. Under the Income-tax Act it is a well established principle that **Treaty Overrides the Act**. Under the Treaty, a NR's foreign business income cannot be taxed in India. Only the profits attributable to PE can be taxed in India. Hence the issues raised in I (i),(ii) & (iii) are redundant.

As far as I (iv) is concerned, the FTC is doing a business. The advertisement revenue earned by FTC is a business income, not fees for technical services. Hence Article 7 applies & not Article 14. Hence the result will be same as per issues (i), (ii) & (iii). In other words, foreign company is not taxable in India.

Under the Draft I of the DTC it is proposed that the Treaty may not Override the Act. Whichever is later shall override the earlier. Then the whole tax exposure raises its head again.

It is learned that there has been very stiff opposition to S.258 (8) of the DTC. This provision may be removed. Treaty Overriding the Act will be restored. As far as treaty abuse is concerned, there will be some other provisions like GAAR.

Explanation to Section 9 as proposed by Finance Bill, 2010 establishes the position that if a service is utilised in India, profits attributable to the same will be taxable in India. This is also proposed in DTC.

A tough position lies ahead.

4. PE Taxability.

A series of SC & HC decisions support the view that once the PE has been paid at ALP, no further profit can be attributed to the PE.

5. What is the participants' view!

VI. Some issues beyond the contents page.

Definition of "Country of Source".

FAR Analysis

PE - fixed base is redundant for Global trade.

Some information: CBDT Chairman Shri S.S.N. Moorthy has informed as under:

1. Serious complain about **Treaty Override** will be taken care of. The proposal in DTC S. 258(8) will be dropped. They will find out other means to take care of treaty abuse. GAAR will be available. They will also consider other proposals if necessary.
2. A sub-committee has been appointed to draft **Advance Price Agreement** regime under Transfer Pricing.
3. Another sub-committee has been appointed to draft **Controlled Foreign Company** rules.
4. Government of India has taken a view that when services are utilised in India, the FTS is taxable in India.

Ishikawajma - Parliamentary jurisdiction - US tax on Infosys, WIPRO & Satyam. This is applicable only to FTS, royalty & interest. Not applicable to business income. CBDT stand is necessary because the world is taxing in this manner