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TAX FLASH NEWS

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40 per cent of the global profit to Indian PE is attributed based on the functions performed, assets deployed and risk assumed

Background

The Bengaluru Bench of Income-tax Appellate Tribunal (the Tribunal), in the case of Arrow Electronic India Limited[1] (Liaison office) (the taxpayer), has held that where the Liaison Office (LO) of the multinational company carries out activities which are not in the nature of 'preparatory and auxiliary' constitutes a Permanent Establishment (PE). The Tribunal ruled in favour of the Revenue on 40 per cent profit attribution to Indian operations of the taxpayer, however, restricts the Transfer Pricing (TP) adjustment to 40 per cent of net sales, so attributed.

Noting that taxpayer had filed returns u/s 148 for its LO, declaring income on the basis of cost + mark-up basis, the Tribunal holds that taxpayer itself has admitted to income having arisen in India from LO operations and the indirect existence of PE. The Tribunal upheld the attribution of profits (40 per cent) undertaken by the Assessing Officer (AO) by considering sectoral weightage of 50:25:25 for functions performed, assets employed and risks involved and a further intra-sectoral ratio of 70:30 for functions and 10:90 each towards assets and risks between Head Office (HO) and LO. In addition, by acknowledging the requirement for working capital adjustment while arriving at the arm's length price the Tribunal upheld the grant of working capital adjustment by CIT (Appeals).

Facts of the case

- Arrow Asia Pac Limited, Hong Kong, (Arrow HK) had set up a branch in Singapore in the name of Arrow Electronics India Private Limited (Arrow Singapore) to service the customers in India. In 1994, after receiving necessary approvals from Reserve Bank of India (RBI), the Singapore Branch had opened LOs in multiple cities of India (main operations and control based in Bengaluru).

- In December 2002, a fully owned subsidiary of Arrow HK was set up as Arrow Electronic India Private Limited (Indian Subsidiary) in India and till July 2003 operations were carried on by LO as no effective operations were carried on by the Indian subsidiary. Subsequently LO became inoperative. Few of the employees of LO were later moved to the Indian subsidiary.

- Indian subsidiary started showing sales from July 2003 and filed its return for the period starting from July 2003. In 2006, survey was conducted on the LO premises (Bangalore) where the office of the Indian subsidiary was also located. Details pertaining to LO were found and impounded under Section 133A. Statements of former employees of LO, who were later working for the subsidiary were recorded by AO.

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[1] Arrow Electronics India Ltd v. ADIT [I.T (TP).A Nos.209 & 210/Bang/2011] - AY 2000-01 & AY 2001-02 and ADIT v. Arrow Electronics India Ltd [I.T (TP).A Nos.617 to 619/Bang/2011 & 31-33/Bang/2011 AY 2002-03, 2003-04 & 2004-05]

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- Post survey, reassessment notices were issued under Section 148 on AY 2000-01 to AY 2004-05 to the taxpayer and complying with the notice, the taxpayer filed the returns declaring an income on the basis of cost plus 6 per cent mark-up.

- The AO concluded that the taxpayer/ LO was carrying out income earning activities in India based on the statements recorded from the employees and concluded that the activities are not preparatory and auxiliary in nature and LO is a PE of Arrow Singapore.

- Having established PE, AO, had then computed 40 per cent of the global profits of Arrow Singapore and attributed to the LO's India operations. 40:60 ratio was determined by fixing a relative weightage to the functions, assets and risk (in this case 50:25:25) as there was no mathematical formula to work out the profits of Indian and Singapore operations separately.

- In order to arrive at the abovementioned rate of attribution (40:60) between LO and HO, the AO first identified 8 different functions and assigned weightage to LO and HO on a scale of 800 and concluded 70:30 ratio on functions performed (methodology tabulated below).

Parameters	Functions	Assets	Risks	Total
Sectoral weightage	50%	25%	25%	100%
Intra sectoral ratio(LO:HO)	70:30	10:90	10:90	100
Weighted average	35:15	2.5:22.5	2.5:22.5	40:60

- The AO identified the following eight key functions to undertake the contribution analysis in assigning under sectoral weightage identifying new customers, customer pursuits and follow up, supplier coordination, price negotiations and finalisation, securing orders, processing of orders, dispatching materials and payment for materials.

- For AY 2002-03 to AY 2004-05, AO determined the profit attributable to LO (40:60 attribution ratio) as determined for AY 2000-01 and AY 2001-02 based on findings that the Singapore entity had business connections in India. Subsequently, the cases were referred to Transfer Pricing Officer (TPO) for evaluation of the arm's length nature of the transactions between the associated enterprises.

- While determining TP adjustment, TPO held that the entire sales were as a result of the taxpayer's function as a trader and the amount of the entire sales for the year represented the international transaction made during the year.

- The profit as determined by TPO was much higher than the profit attributed by AO, on account of the fact that the TPO has not considered applying 40 per cent of global sales as attributed to the taxpayer even though the department itself has upheld the 40:60 apportionment. Further, TPO rejected the claim of the taxpayer for granting the benefit of working capital adjustment.

- The TPO determined adjustment under Section 92CA and AO substituted the above attributed profits with adjustment proposed by TPO. Aggrieved by the adjustments made by AO/TPO, the taxpayer filed appeal before CIT (Appeals) against the final order issued by the AO for AY 2000-01 to AY 2004-05.

First level appeal – CIT(Appeals) - The taxpayer appealed the following issues before the first level of appeal:

- Whether the Arrow Singapore had business connection in India and thereby existence of a PE;

- Whether the arm's length margin is to be applied on the total turnover by the taxpayer or the 40 per cent turnover as determined by AO for the purpose of attribution of profits; and

- Whether the benefit of working capital adjustment can be provided while determining the arm's length price.

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Order of the CIT(A)

- With respect to the grounds of objections of the taxpayer, CIT(A) upheld the decision of AO for AY 2000-01 to AY 2001-02 confirming the existence of PE in India through LO and noted that LO clearly overridden the permitted activities (by RBI) in India.
- The CIT(A) further held that the taxpayer could not lay any material to dislodge the findings by AO and hence the decision of AO to be upheld. By filing returns in response to the notice u/s 148 the taxpayer has admitted that a portion of income was earned in India and this indicates their case is covered under section 9(1)(i).
- CIT(A), consistent with the Revenue earlier stand for AY 2000-01 and 2001-02, held that only 40 per cent of the total sales should be attributed to LO while determining the arm's length price. Accordingly restricted the adjustment undertaken by TPO to the 40 per cent of the sale of PE and not on the total turnover from India.
- With respect to allowability of working capital adjustment, the CIT(A) observed that, there is no standard guidance on application of the interest rate (i.e. rates based on CMIE, RBI or the SBI PLR) while undertaking the working capital adjustment. However, acknowledged that the taxpayer is right in claiming for the benefit of working capital adjustment and hence allowed in favour of the taxpayer.
- The CIT(A) held that, considering AO has independently determined the profit attributable to LO, the working capital adjustment should also have been computed. Accordingly AO was directed to adopt the working capital adjusted arm's length price. Accordingly, CIT(A) allowed a partial relief on the adjustment made by TPO.

Key issues raised before Tribunal - Taxpayer's Grounds of Appeal

- The CIT(A) erred in upholding the actions of AO in establishing business connection of Arrow Singapore in India and PE and CIT(A) erred in upholding the arbitrary method of attribution of profit by AO.

Key issues raised before Tribunal - Revenue's Grounds of Appeal

- The CIT(A) erred in providing partial relief by holding that the percentage of arm's length price as determined by TPO should have been applied only on 40 per cent of the total sales and not on the total sales; and
- The CIT(A) erred in providing for working capital adjustment of 0.906 per cent and 1.459 per cent for AYs 2002-03 and 2003-04 considering the fact that AO had independently determined the profit attributable to the LO. For AY 2004-05, CIT(A) directed the AO to allow an adhoc figure of 1.25 per cent towards working capital adjustment.

The taxpayer filed cross objections against the appeal by the revenue before the Tribunal.

Tribunal's Ruling– Taxpayer's appeal

On PE and attribution of profits to the LO in India: The Tribunal observed that the taxpayer itself had admitted that the activities of LO were taxable in India by showing income at cost + 6 per cent basis in return of income. Thus, the taxpayer has indirectly accepted the fact that the Company had business connection in India and also the Indian LO as PE of Arrow Singapore. Stating that the taxpayer could not lay any material to dislodge CIT(A)'s findings, Tribunal upheld CIT(A) orders for AY 2000-01 to 2001-02.

On attribution of profits: Upheld CIT(A)s view on AO's consideration of sectoral weightage at 50:25:25 for functions performed, assets employed and risks involved, 10:90 towards assets and risks in the intra sectoral ratio pertaining to LO and HO and the final quantification of profits attributable to LO and HO at 40:60.

Tribunal's Ruling – Revenue's appeal

Whether TP adjustment should be on the total turnover value of the Singapore Company or to be restricted on the revenue attributed: the Tribunal held that, to be consistent with the Revenue's own stand for AY 2000-01 and AY 2001-02, the arm's length price to be determined based on the 40 per cent of the turnover of the Singapore entity as attributable to LO and not on the total turnover.

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Whether working capital adjustment to be allowed or not: Without specifically commenting on the allowability of working capital and methodology followed by CIT(A), the Tribunal has merely upheld the decision of CIT(A) in this regard.

Our comments

Establishment of PE and profit attribution has been a matter of debate before the Courts/Tribunals over a period of time. Due to own set of facts on each case, constrained by the paucity or limitation of facts and analysis, formulary approach has been adopted as thumb rule by various Tribunals and Courts in most of the cases.

Once the existence of PE is confirmed, Article 7 of the tax treaty provides for tax sharing rights over the profits earned by an enterprise that carries on business through a PE in source country. Article 7 of tax treaties provides for theorising PE as a separate entity, as compared to other parts of the enterprise, as a result of which, the principles of TP apply by analogy, as per the 'functionally separate legal entity approach' advocated by the OECD[2], in preference over the formulary approach. This is mainly due to the fact that, the lack of a common interpretation among countries and inconsistent application of Article 7 can lead to double taxation and non-taxation situations.

Although the basis for attribution of profits is debatable in the instant case, it is a positive move that AO adopted allocation of weights basis Functions undertaken, Asset deployed and Risk assumed by LO and the enterprise that carried on business through LO in India. Similarly, the Tribunal's acceptance of the principle that once transfer pricing adequately takes into account functions and risks, no further profits are attributable is appreciated.

The case re-iterates that taxpayers should always eye the defense mechanism relating to attribution of profits to PE having regard to its FAR profile so as to determine the level of remuneration. While attributing the profit, the taxpayer may apply prescribed methods under the relevant TP regulations.

The case highlights the importance for the basic principle of maintaining uniformity between the actual functions undertaken by the entity in the host country and functions as per the inter-company contractual arrangement/requirements as per the applicable regulatory approvals. i.e. in the said case, the entity in question failed prove that LO in the host country did not undertake functions beyond the perimeters of 'preparatory and auxiliary functions' as specified by RBI regulations on LOs and this itself turned out to be the prime reason for establishment of PE in India.

Therefore, it is critical for the multinational enterprises to analyse, document and update the roles and responsibilities of associated enterprises within the business value chain of the group and re-visit remuneration policies on a regular basis. In addition, taxpayers to exercise utmost care to ensure uniformity in actual functions undertaken and risks assumed by entities and documentation maintained and filed before various regulatory authorities in their respective jurisdictions.

[2] OECD - Organisation for Economic Development and Co-operation

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