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TAX FLASH NEWS

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By applying Rule 10 of the Income-tax Rules, 30 per cent of profits have been attributed to branch for conducting marketing activities relatable to direct sales made by head office in India

Background

The Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Nipro Asia Pte Ltd.[1] (the taxpayer) held that the Assessing Officer (AO) had rightly sought to apply Rule 10 of the Income-tax Rules, 1962 (the Rules) for determination of profits attributable to the branch in respect of the marketing activities relatable to direct sales made by the Head Office (HO) in absence of correct transfer pricing study report. The Tribunal held that 30 per cent of profits were attributable to the branch for its marketing activities in India.

Facts of the case

- The taxpayer is a Singapore-based company having its branch in India. The taxpayer is engaged in the business of trading of medical equipments to and from India. The Indian branch apart from providing marketing, sales warehousing, after sales services on behalf of the HO also marketed Nipro brands in India.

- The Indian branch recorded in its accounts only value of goods sold through it and did not account for sales made directly by HO in India or through distributors. However, all the activities of marketing, after sales, etc. on sales made by HO whether directly or through the distributors were undertaken by the Indian Branch.

- The AO held that the branch office constituted Permanent Establishment (PE) of the taxpayer in India and sough to compute the profit attributable to the PE. The AO observed that the Indian branch did not receive any income in lieu of the services rendered in selling products directly by the HO and that the Transfer Pricing Study Report (TP Report) was not reliable on account of various deficiencies.

- The AO invoked provisions of Rule 10 of the Rules, for determining the income of the taxpayer. In doing so, the AO computed the gross profit margin [28.60 per cent] of Nipro Corporation (Ultimate parent company) and its consolidated subsidiaries from its website and applied the same to sales made by the taxpayer in India. 40 per cent of such determined profit was attributed to sales activity in India through PE and arrived at a profit rate from activities in India at 11.44 per cent [being 40 per cent of 28.60 per cent].

- Upon appeal, the Commissioner of Income-tax (Appeals) (CIT-A) computed the attribution by applying the profit rate from the TP Report for the subsequent years at the rate of 15 per cent on costs and provided some relief to the taxpayer.

- The tax department filed an appeal before the Tribunal.

[1] DDIT v. Nipror Asia Pte Ltd. (ITA No. 4078/Del/2013 order dated 16 February 2017) – Taxsutra.com

- The issues that the Indian branch constituted a PE in India and the correctness of rejecting the TP Report was not disputed between the parties. The dispute merely revolves around the quantification of income attributable to such PE.

- The arguments on behalf of both the tax department and the taxpayer were restricted only to the working done by the AO and CIT-A, and neither argued upon the determination of income attributable in any other manner. Hence the appeal is restricted to the scope of the arguments.

Tribunal's decision

- The 'force of attraction' rule is said to be applied when income from activities directly undertaken by HO in India, *de hors* the involvement of the Indian Branch is included in the total income.

- However, in the instant case, where the income attribution is a *quid pro quo* to the Indian Branch for rendering marketing services relatable to the direct sales made by the HO falls within the ambit of 'profit attribution'.

- The application of Rule 10 by the AO is upheld on account of the following:

  - The Indian Branch was not receiving any income in lieu of services rendered in selling the products directly by the HO

  - The TP Report was not reliable and stands rejected

  - There was no alternative but to determine income attributable on some reasonable basis.

- The quantum of attribution (cost plus 15 per cent) as computed by the CIT-A cannot be upheld on account of the following:

  - The CIT-A had considered the profit margin relating to the subsequent years. The margins undergo a change from year to year and cannot be extrapolated to another year.

  - The taxpayer had applied Transactional Net Margin Method (TNMM) with OP/TC as the Profit level indicator (PLI) which is different from Cost Plus Method (CPM) adopted by the CIT-A. The same disturbs the entire calculation for the current year on such basis.

- The quantum of attribution arrived at by the AO (40 per cent of the gross profit margin of 28.60 per cent) cannot be upheld on account of the following:

  - The gross profit margins were computed from the accounts of Nipro Corporation and its consolidated subsidiaries. Also since such figures were adopted from the website of that entity and not from full-fledged annual accounts of the taxpayer, computation based on selective figures is not acceptable.

  - Also, the adoption of the base as gross profit ratio instead of Net profit ratio does not lend credence to the computation.

- The Delhi Bench of the Tribunal in the case of GE Energy Parts Inc[2] had attributed 26 per cent of profits attributable to marketing activities in India while the case of ZTE Corporation[3] 35 per cent of profits were held attributable to marketing activities. Also the Delhi High Court in case of Rolls Royce Plc[4] affirmed a 35 per cent of 10 per cent of total profits attributable to marketing activities.

- Drawing strength from prescription under Section 44BB and 44BBB of the Income-tax Act, 1961 (the Act) which provide for a profit rate of 10 per cent, the profits of the taxpayer are to be computed under Rule 10 at 10 per cent of sales. In view of all the above, holistically, profits attributable would be 3 per cent (ie. 30 per cent of 10 per cent) on the total amount of sales made by taxpayer (whether directly or through branch) in India.

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[2] GE Energy Parts Inc v. ADIT [2017] 78 taxmann.com 2 (Del)
[3] ZTE Corporation v. A DIT [2016] 159 ITD 696 (Del)
[4] Rolls Royce PLC v. DIT(IT) (2011) 339 ITR 147 (Del)

Our comments

Attribution of profits to a PE has been a subject matter of litigation before the courts. Whether any profits need to be attributed to the PE and if so, how much is attributable is a fact driven exercise.

If all the transactions between the parties are remunerated at an arm's length then whether anything further remains to be attributed to the PE? This can be established having regard to the functions performed, assets employed and risks undertaken (typically known as the FAR analysis) by the parties. If the remuneration is not commensurate to the FAR, then the further attribution of profits to the PE may become necessary.

As observed by the Tribunal, there is no hard and fast rule for attributing profits. Much depends on the factual matrix of each case. A detailed and robust transfer pricing study would be thus essential to support ones transfer prices.

Action Plan 7 on Attribution of Profits to PE issued by the Organisation for Economic Co-operation and Development under the Base Erosion and Profit Shifting (BEPS) project has tried to address certain issues and has also provided additional guidance in this regard and provides for changes to be made to Article 5 of the Model Tax Convention. India as part of its G20, commits to implement the guidelines issued under the Action Plans of the BEPS.

In the backdrop of such changing global scenarios where jurisdictions have tightened up their ropes to get in a fair share to taxes allocated to their economies, it would be apt to have some structured guidance in the domestic regulations to curb the inconsistencies and arbitrariness in the tax administration leading to unwarranted litigation.

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Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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