

Tax Flash News

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The Supreme Court holds profit attribution issue as a question of fact and the attribution of profit to PE of CRS companies based on FAR analysis as fair and reasonable

Executive Summary

The Supreme Court recently dismissed the batch of revenue appeals¹ in cases of non-resident taxpayers engaged in providing electronic global distribution services to Airlines through the Computerized Reservation System (CRS). In these cases, the taxpayers constituted Permanent Establishment (PE)² in India and the debate was around how much profit should be attributed to the PE in India. The Supreme Court took a view that the issue of what portion of the income can be reasonably attributed to the operations carried out in India is a question of fact. It also concurred with the orders of the Tribunal on the profit attribution to PE, wherein relevant factors based on FAR analysis (Functions performed, Assets used, and Risks undertaken) were considered.

Facts of the case

- Non-resident taxpayers are in the business of providing electronic global distribution services to Airlines through CRS. The taxpayers maintain and operate mainframe computers and servers located in other countries, which are connected to airline servers, to and from which data is continuously sent and obtained regarding flight schedules, seat availability, etc.
- In order to market and distribute the CRS services to travel agents in India, the taxpayers appointed and entered into distribution agreements with Indian entities. The taxpayers earned revenue of USD/EURO 3 per booking made in India and the amount paid to the Indian entities ranges from USD/EURO 1 - 1.8 per booking, which is in the range of 33.33 percent to about 60 percent of the total earning.

- During the assessment proceedings, the tax department alleged that the taxpayers had a PE/business connection in India and the entire income earned by them out of India was taxable in India.
- The Delhi bench of Tribunal confirmed the existence of a PE in the form of fixed place PE and dependent agent PE. However, noted that the major share of activities was processed in USA / Europe and the activities in India were only minuscule. Basis the FAR analysis, the Tribunal assessed 15 percent of revenue as accruing or arising in India. Since the payment made to distribution agents in India was more than the said percentage, the Tribunal held that no further income was taxable in India³.
- The High Court dismissed the appeals filed by the tax department by noting that the Tribunal had adopted a reasonable approach with respect to attribution.

Supreme Court Decision

- The Supreme Court observed that the Tribunal arrived at the quantum of revenue attributed to the activities carried out in India based on FAR analysis. Moreover, the commission paid to the distribution agents (which has already been taxed in India) by the taxpayers was more than twice the amount of attribution. Therefore, the Tribunal rightly concluded that the same extinguished any further assessment in the hands of the taxpayers.

¹ DIT v. Travelport Inc. & Others [CIVIL APPEAL NOS. 6511-6518/2010] (Taxsutra)

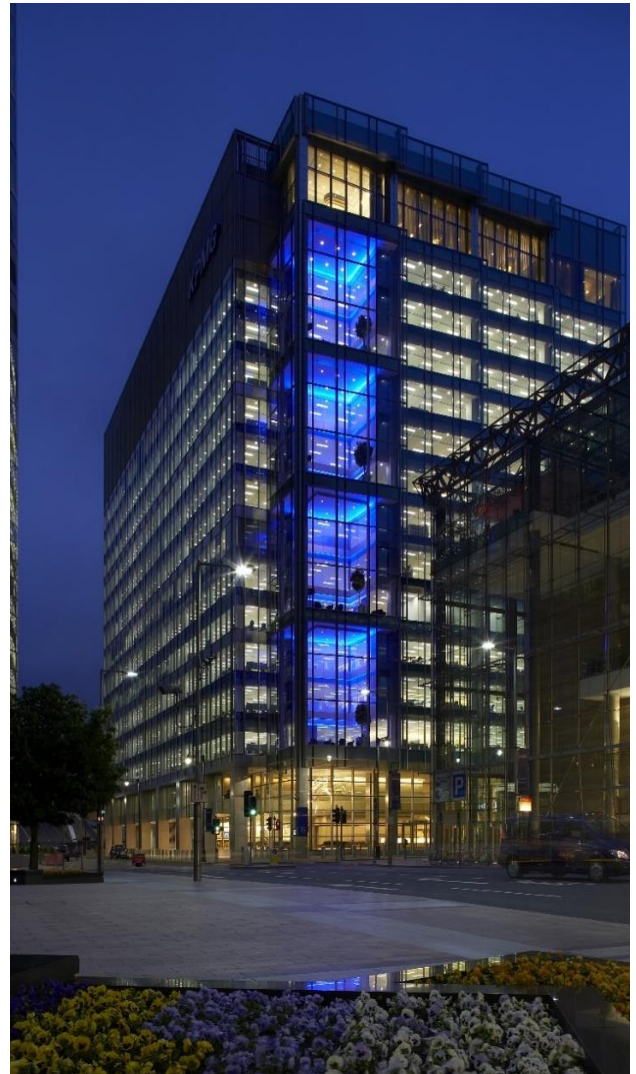
² Fixed Place and Dependent Agent PE

³ The Tribunal had referred to CBDT Circular no. 23 of 23 July 1969 and the Supreme Court's decision in the case DIT v. Morgan Stanley & Co. [2007] 292 ITR 416 (SC).

- The approach of the Tribunal and High Court on the question of attribution appears to be fair and reasonable, taking into account relevant factors.
- What portion of the income can be reasonably attributed to the operations carried out in India is obviously a question of fact.

Our comments

The concept of PE and the issues concerning the attribution of profits to a PE has been one of the most debatable issues in international tax as any inappropriate attribution of profit could lead to double taxation. The Supreme Court in this ruling by upholding the approach of the Tribunal around the profit attribution based on FAR analysis provides further strength to this approach. A committee constituted by the Central Board of Direct Taxes (CBDT), to bring clarity, objectivity, and predictability in the manner of attribution of profits to PE, submitted a detailed proposal to the Finance Ministry in April 2019. One of the observations was that the FAR analysis is considered insufficient for PE attribution as it does not consider demand-side factors and market contributions to overall profits. Till we see any change in the profit attribution rules in India, taxpayers would be guided by such relevant judicial precedents and focus on maintaining robust FAR and economic analysis. APA and MAP options could also be explored to achieve certainty, provided the existence of a PE is accepted by the taxpayer



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