Attribution of profits to PE depends upon role played by PE in overall income generation: ITAT

Summary – The Delhi ITAT in a recent case of Nipro Asia Pte Ltd., (the Assessee) held that Attribution of profits to PE in India has to be in line with extent of activities of PE in India and depends upon role played by PE in overall generation of income

Facts

- The assessee a Singapore based company was engaged in business of trading of medical equipments to and from India. The assessee was operating in India through a branch office which undertook all the activities for marketing, selling and after sales services of the products sold by the assessee in India, either directly or through the distributors, apart from making sales to customers in India from the branch office.
- The Assessing Officer held that the branch office constituted permanent establishment in India under article 5 of the Double Taxation Avoidance Agreement with Singapore as well as the business connection in India in terms of section 9(1). Thus, he computed the amount of profit attributable to the business connection/PE. The Assessing Officer observed that the ultimate holding company of the assessee, namely, N Corporation, was having three overseas branch offices including one in India and others in Africa and UAE. He invoked the provisions of rule 10 for determining the income of the assessee. He attributed 40 per cent of gross profit rate to the sales activities in India through the permanent establishment. After applying such profit rate, the taxable income of the assessee was computed at Rs. 80.95 lakhs.
- On appeal, the Commissioner (Appeals) did not agree with the Assessing Officer in taking 40 per cent contribution of selling and marketing functions. Taking note of the TP study report of the assessee for the assessment year 2006-07 in which the assessee had used cost plus of 15 per cent as a mark-up on the total cost incurred by the branch office in India and considering that business model of the assessee for all the years remained the same, held that 15 per cent should be added to the assessee's costs for the purposes of mark-up, which resulted in reducing the total income to Rs.16.75 lakhs.
- On appeal by the revenue to the Tribunal:

Held

- There is no dispute on the fact that the branch office constitutes a permanent establishment of the assessee in India which has been fairly accepted by the assessee as well. Entire controversy revolves only around the attribution of income to such PE. The assessee filed report in Form No. 3CEB and tried to justify the ALP of the international transaction under the 'Cost Plus Method' on the services rendered, 'Comparable Uncontrolled Price' Method on trading of nephrology products and 'Resale Price Method' on other products sold in India. The TP study report, as held by the Commissioner (Appeals) did not give any indication as to the allocation of costs and how these segments were created, which was rejected by the authorities below. On a specific query, the assessee candidly accepted that the TP study report was not available and the same be treated as rightly rejected in view of the deficiencies pointed by the authorities. This finding is approved.

- As a matter of fact, both the sides have focused only on the manner of determination of the quantum of income of the assessee chargeable to tax in India. The Assessing Officer took up total sales made by the assessee in India either directly or through the branch office for the purpose of determination of income. It is not disputed that the branch office in India was not only effecting sales directly, but also undertaking marketing activities in respect of goods sold directly by the head office in India either through distributors or direct customers. Under these circumstances, it is incorrect to argue that the Assessing Officer applied 'force of attraction' rule for determining the income of the assessee. *Au contraire,* it is found that the Assessing Officer has restricted himself to the 'profit attribution' principle, inasmuch as the branch office in India rendered marketing services to its head office for making direct sales and the Assessing Officer has confined the computation of income only to the extent of the contribution made by such marketing services rendered in India. An income which is a *quid pro quo* to the branch office for rendering marketing services directed towards effecting direct sales by the head office in India, falls within the sweep of 'profit attribution'. 'Force of attraction' rule is said to be applied when income from activities directly undertaken by head office in India, *de hors* the involvement of Indian branch office, is also included in the total income. Where, however, the Indian branch office renders some services in respect of the direct sales made by the head office, the determination of income for such services, cannot be brought within the ambit of force of attraction rule. As the Assessing Officer has restricted the computation of total income of the assessee only to the extent of contribution made by the marketing effort done by the Indian branch office in the overall profit from the sales made by the head office in India, the contention of the assessee that the authorities below applied force of attraction rule will have to be rejected.
- It has been noticed that the direct sales made by the head office were not recorded in the books of the branch office. It is further not disputed that the assessee booked all the expenses incurred in marketing activity for such direct sales made by the head office without receiving any corresponding income. In such circumstances, coupled with the absence of any correct transfer pricing study report, the Assessing Officer was left with no alternative but to determine income on some reasonable basis, for which he invoked the provisions of rule 10. The Commissioner (Appeals) noted in the impugned order that the assessee in subsequent assessment years, namely, 2005-06 and 2006-07 has used cost plus 15 per cent as a mark up on total cost incurred by the branch office in India, whereas the branch office was compensated at cost plus 5 per cent. In the Transfer pricing study report for the assessment year 2005-06 the assessee applied Transactional Net Margin Method (TNMM) and not the Cost Plus Method (CPM) as has been taken note of by the Commissioner(Appeals). In this report, the Profit level indicator of OP/TC has been taken at 15 per cent. Be that as it may, the calculation made by the Commissioner(Appeals) for the instant year by

applying the profit rate from the TP study report for the assessment year 2005-06 is unacceptable for the reasons that, firstly, it relates to a later year and the margins undergo a change from year to year and, secondly, the assessee applied TNMM and not the CPM as has been noticed by the Commissioner(Appeals), which disturbs the entire calculation for the current year on such basis.

- The working done by the Assessing Officer is also equally not up to the mark. He computed 'gross profit' margin at 28.60 per cent of N Corporation and its consolidated subsidiaries. Such gross profit rate was applied to all the sales made by the assessee in India, whether directly or through its branch office. 40 per cent of such determined profit was attributed to sales activity in India through PE. That is how, profit rate from the activities in India was determined at 11.44 per cent (*i.e.*, 40 per cent of 28.60 per cent). The view adopted by the Assssing Officer is unacceptable because he took the figures of net sales and cost of sales and computed gross profit at 28.6 per cent from the accounts of N Corporation and its consolidated subsidiaries. The table from which such percentage of 28.6 per cent was worked out, also shows the amount of Selling, general and administrative expenses, which is a little more than 20 per cent of sales value. Adoption of base as gross profit rate by the Assessing Officer, instead of net profit, does not lend credence to his calculation.
- A bare perusal of the rule 10 transpires that where actual amount of income accruing to non-resident from any business connection, etc., in India cannot be definitely ascertained, the amount of such income may be calculated in one of the three ways as given under clauses (*i*) to (*iii*) of rule 10 and the first, being 'at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable' and the third, being 'in such other manner as the Assessing Officer may deem suitable'. In principle, the Assessing Officer has rightly invoked this rule for determining the income of the assessee. As the annual accounts of N Corporation and its consolidated subsidiaries were not made available and the Assessing Officer got some of the important figures from the website of N Corporation, such selective figures cannot be equalized with the full fledged annual accounts of the assessee company, facilitating the precise determination of income accordingly. The working done by the Assessing Officer in considering gross profit margin as a base point from such selective figures, is also not capable of acceptance. Under such circumstances, the profit of the assessee be computed under rule 10 at 10 per cent of the sales consideration to the customers in India, either directly by the head office or through the branch office. In holding so, sections 44BB and 44BBB which provide for profit rate of 10 per cent have been relied upon.
- Then comes the question of attributing income to the activities of marketing and sales carried out by the branch office in India. In this regard, it is seen that there can be no hard and fast rule of attribution of profit to marketing activities carried out in India at a particular level. In fact, attribution of profits to PE in India is fact based, depending upon the role played by the PE in the overall generation of income. Such activities carried out by a PE in India resulting in generation of income, may vary from case to case. Attribution of income has to be in line with the extent of activities of PE in India. Taking all the relevant facts into consideration and on a holistic approach, it was directed that 30 per cent of the profits, namely, 3 per cent (30 per cent of 10 per cent) on the

amount of sales made by the assessee in India either directly or through its branch office be applied as the amount of profit attributable to the PE in India. No further deduction on any account is to be allowed. This will result into determination of total income of the assessee.

- In the result, the appeal is partly allowed.