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Profit Attribution to PE under EPC Contracts – A Different Perspective”

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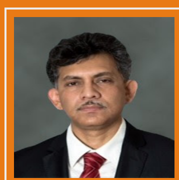

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The issue of attribution of profits to permanent establishments (PEs) is under active consideration of the Indian Revenue Board, which has recently tabled a public consultation paper, prepared by a Committee, proposing rules for a formulary approach by giving a go-buy to the arm’s length principles under transfer pricing (TP), not only for the digital economy, on which the world at large is in active discussion to find a solution, but even for the existing or traditional business models in the brick and motor space.

Given that G-20 countries, as part of the initiative under BEPS Action 1, would in due course, come up with necessary solutions, both with respect to the nexus issue and allocation of profits, for the digital economy, it would be important for the moment, to concentrate more on the issue around attribution of profits to PEs for the traditional business models in the brick and motor space. Representations have been made from various quarters before the Indian Revenue Board for accepting the arm’s length principles under TP for the purposes of attributing profits to PEs under traditional business models, as such principles are enshrined within the texture of Indian model tax treaties; and also the domestic tax laws of India.

While the country waits with baited breath on how the Indian Revenue Board would finally introduce the rules with respect to attribution of profits to PEs interalia for the traditional business model, it is very important for taxpayers, Revenue Officers and the judiciary for adopting correct stands in this regard, which unfortunately has seldom been the case in the last couple of decades of jurisprudence in the country. It is perhaps the arbitrary and inconsistent manner of dealing with the relevant issue by the said three constituents, namely taxpayers, Revenue Officers and the judiciary, that creates the entire confusion in the minds of people.

Honestly, the traditional business model under the brick and motor space does not actually require any specific rules for attribution of profits to PEs, as the arm’s length principles under TP are very much enshrined within the deemed separate entity approach incorporated in the Indian model tax treaties, barring some minor exceptions, namely the presence of force of attraction clause in some tax treaties; and also the express or implied prohibition for the deductibility of payments for royalties, fees, etc. by the PE to its head-office (HO) or other parts of the enterprise of which it is a PE in India, beyond actual costs incurred for such intangibles or rendition of services, as the case may be. It is not the application of arm’s length principles under TP for the purposes of attribution of profits to PEs interalia for the traditional business model, which should be raising concerns for the Indian Revenue Board; or for that matter anybody, however, it is the faulty implementation of such principles by taxpayers, Revenue Officers and the judiciary, that convolutes the entire subject.

In a recent case, the Tax Tribunal was dealing with a project office PE of a foreign enterprise in the context of an EPC contract, which reported loss with respect to the onshore leg of the contract entered into by the foreign enterprise with an Indian customer. The foreign enterprise had assigned the entire value of the onshore leg of the contract as revenue for the project PE; and after deducting necessary expenses therefrom, reported a loss for the purposes of books of account and also income tax, being attribution of profits (in this case, loss) to the PE.

The Revenue Officer had contended during the course of the assessment proceedings that since, as per the provisions of the TP regulations of India, the HO of the foreign enterprise and the PE were “associated enterprises”, an “international transaction” was to be read to be existing between the HO and PE; and thereafter proceeded to adopt the transactional net margin method (TNMM) under TP, where he chose one comparable company, whose profit margin was applied as the arm’s length profit margin for the PE, which resulted in a significant amount being attributed as profits attributable to the PE, in place of the loss reported by the foreign enterprise in its return of income, as being attributable to the PE.

The taxpayer had refuted such attempt of the Revenue Officer on various counts, namely that – (1) TP provisions did not apply in the instant case, as the PE and HO of the foreign enterprise were part of the same enterprise; and accordingly did not constitute AEs; (2) there were no “international transactions” entered into between the HO and PE for the purposes of TP; and (3) in any event, the price paid by the third party

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customer to the foreign enterprise for the onshore leg of the contract executed by the PE could be taken as an internal comparable under the comparable uncontrolled price (CUP) method, such that any "international transaction", even if found to exist between the HO and the PE, were to be held as having been executed at arm's length price.

The Tax Tribunal decided the case in favour of the taxpayer. Without laying down an expansive and reasoned ruling, the Tribunal held that TNMM could not be applied in the case of the taxpayer; and further, in any event, the single comparable chosen by the Revenue Officer under TNMM was not a proper comparable vis-à-vis the taxpayer. The Tribunal also accepted the contentions relating to CUP method, as broached by the taxpayer, again without assigning a detailed reasoning behind such dictum.

Now, the final decision could have gone either in favour of the Revenue or the taxpayer, however, most importantly, not by following the logic of either of the litigants, as highlighted above. The Revenue Officer never has a right to adopt a TNMM to decide the profitability of a PE in any and every case under the pretext that since dealings between the HO and PE are covered by the principles of TP, the PE should in every case report a profit with reference to arm's length profit margins of comparable companies selected under TNMM. At the same time, the taxpayer also cannot be allowed to get away with the sort of arguments, which it had made in the aforesaid case. The Tribunal, in such situation, needs to reject the arguments of both the taxpayer and the Revenue; and proceed to lay down correct principles in consonance with the provisions of Article 7 and 9 of the relevant tax treaty, namely the ones dealing with attribution of profits to PE and TP respectively.

There is no doubt that the exercise of attribution of profits to PE needs to be carried out by applying the arm's length principles under TP, as per the deemed separate entity approach conceived interalia by the Indian model tax treaties. There is also no doubt that the domestic tax laws of India also subject dealings between a PE in India and the HO and other parts of a foreign enterprise, to the provisions of TP. Thus, the Indian model tax treaties and the domestic tax laws of India unwaveringly converge on the above aspect. Having said that, where taxpayers and Revenue Officers often go wrong, as in the instant case, is to try and apply legal definitions of "AEs" and "international transactions" for the purposes of applying the principles of TP, by making the proverbial fortress of the dictionary.

In the instant case, the simple enquiry, which needed to have been carried out by the taxpayer, Revenue Officer and the Tribunal, through proper functional, asset and risk (FAR) analysis, was whether the project PE, being a hypothesised or deemed separate entity as compared to the HO of the foreign enterprise, was entrepreneurial in nature; or a mere service provider of the HO ? The solution to the issue of attribution of profits to the PE would have automatically flowed from the answer to such simple and basic question.

In case the project PE was actually involved in some key or strategic entrepreneurial functions, namely – (a) pricing of the onshore leg of the contract; or the split of the overall contract price between offshore and onshore elements; (b) conceptualisation of the work actually required to be carried out for the onshore leg of the contract; (c) deciding on mobilisation of resources for executing the project; (d) identification of and negotiation with third party contractors for the supply of materials for the onshore leg of the contract, etc., then the project PE could be said to have possessed the characteristics of an entrepreneur under the concept of deemed separate entity approach under the arm's length principles of TP, as enshrined in the Indian model tax treaties, read with the domestic tax laws of India.

On the other hand, in case all such key or strategic decisions were actually taken at the level of the HO of the foreign enterprise; and the project PE merely executed the onshore leg of the contract as per the directions of the HO, then the project PE could not be said to be an entrepreneur, but a service provider of the HO, in its characterisation under the concept of deemed separate entity approach under the arm's length principles of TP, as enshrined in the Indian model tax treaties, read with the domestic tax laws of India.

If the project PE's characterisation was that of a service provider of the HO for the onshore leg of the contract, then it would not have been capable of bearing the entrepreneurial risk of the business; and would have been entitled to a routine return, most probably as an arm's length mark up on its costs, with reference to third party comparable companies under the TNMM approach. Such routine but positive arm's length return on its costs would have been the profits attributable to the project PE; and any entrepreneurial profit/ loss, if any, arising out of the onshore leg of the contract, would have resided at the level of the HO of the foreign enterprise; and not in the hands of the PE.

This is how the principles of arm's length price under TP would have applied while determining the profits attributable to the PE, by hypothesising the same as a separate entity as compared to the HO of the foreign enterprise, in the form of a service provider.

On the other hand, if the FAR analysis would have suggested that the project PE was an entrepreneur, then

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the risk of the business relating to the onshore leg of the contract would have resided with; and been borne by such PE under the hypothesis of a separate entity as compared to its HO. In such case, the contract price for the onshore leg, as receivable from the third party customer, would have needed to be assigned as the revenue of the PE; and from there, several expenditures and allowances would have needed to be deducted for arriving at the profits attributable to the PE. This is a simple case of revenue attribution, having nothing to do with the CUP method, as propounded by the taxpayer in the case deliberated upon in this article.

The interesting part would arise in the context of recognising dealings, if any, between the project PE and the HO or other parts of the foreign enterprise, of which it was a PE in India, in the case of an entrepreneurial PE. Such dealings may typically be conceived as services rendered by the HO in favour of the PE; or intangibles developed at the level of the HO, which might have been exploited by the PE in executing the onshore leg of the project. Ideally, as per the arm's length principles under TP, as understood under the deemed separate entity approach, such internal dealings would have needed to be recognised at arm's length price, namely not necessarily at cost in the hands of the HO.

Now, Article 7 of some of the tax treaties signed by India contain an express embargo on similar lines as that contained in Article 7 of the UN model tax treaties, upon the allowability of deductions in the hands of the PE for payments made to the HO or other parts of the foreign enterprise, of which it is a PE, for receipt of services, intangibles, etc., beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc.

On the other hand, Article 7 of the other tax treaties signed by India do not contain any such embargo, being in line with the erstwhile version of Article 7 of the OCED model tax treaties, i.e. prior to the amendments brought about in the year 2010, which however, carried sufficient ambiguity as to whether such embargo would have needed to be read into the provisions of such erstwhile version of Article 7 of the OECD model tax treaties.

Given that Article 7 of the UN model tax treaties contains such express embargo; and so do some of the tax treaties signed by India, it is likely that India, being a developing economy, may prefer to read such embargo as existing in Article 7 of all tax treaties signed by it, even in absence of any such express prohibition. Thus, to the extent of recognising such dealings between the HO and the PE in India, the arm's length principles under TP might have had to yield to such express/ implied prohibition contained in Article 7 of the Indian model of tax treaties, in limiting deductions with respect to payments made to the HO or other parts of the foreign enterprise, for receipt of services, usage of intangibles, etc., up to the costs incurred by the foreign enterprise on such services, intangibles, etc.

The above discussions provide guidance on how the principles of arm's length price under TP would have applied while determining the profits attributable to the PE, by hypothesising the same as a separate entity as compared to the HO of the foreign enterprise, in the form of an entrepreneur.

However, no discussions/ deliberations on the aforesaid lines were made by either the taxpayer or the Revenue before the Tax Tribunal, while arguing their respective cases. Further, the Tax Tribunal, while simply agreeing with the taxpayer's view, without providing any detailed reasoning, had also left the matter in doubt as to what was the characterisation of the project PE in reality; and accordingly, how profits should have been attributed to such PE. It is recommended that going forward, the exercise of attribution of profits to a project PE, needs to be carried out with reference to the touchstone of arm's length principles under TP on the lines discussed above.