35 per cent of net global profits are attributed to Indian PE of a Chinese company in respect of both hardware and software supplied to Indian customers – Delhi Tribunal

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal), in the case of ZTE Corporation1 (the taxpayer), held that almost entire sales functions, including marketing, banking and after sales, were carried out by taxpayers’ Permanent Establishment (PE) in India and, therefore, 35 per cent of net global profits as per published accounts are attributed to the PE in India in respect of hardware and software supplied to Indian customers. The Tribunal observed that for the purpose of attribution of profits to the PE, the most important aspect to be kept in mind is the level of PE’s participation in the economic life of source country. It is primarily nexus between the source country and PE’s activities which produce the taxable income to the taxpayer.

In the present case, since the taxpayer has not maintained books of accounts relating to PE in India, the indirect method prescribed in Rule 10 of the Income-tax Rules, 1962 (the Rules) for attribution of profits resorted. The Tribunal observed that the issue of attribution of profits depends on the facts of the case and is fully dependent on the level of operations of the activities carried out in India.

Facts of the case

- The taxpayer is a Chinese company engaged in the business of providing telecom equipment. The taxpayer was engaged in the supply of telecom equipment to Indian telecom operators. The taxpayer was also engaged in the supply of mobile handsets to various customers in India. During the year under consideration, the taxpayer did not file its return of income in India on the ground that it did not have PE in India under the India-China tax treaty (tax treaty).

- The Assessing Officer (AO) held that the taxpayer had a business connection in India, and its business had been carried through its PE in India. The AO held that the taxpayer had a fixed place PE, an installation PE and dependent agent PE in India and therefore, the revenues from the supply of telecom equipment and mobile handsets were to be taxed in India as business profits. He held that the profits of the PE in India had to be computed separately in respect of hardware and software components of the telecom equipment and the mobile handsets. The payments for the supply of software embedded in the telecom equipment should be treated as royalty under Section 9(1)(vi) of the Income-tax Act, 1961 (the Act) and also under Article 12(3) of the tax treaty. As regards the attribution of profits to the PE in India in respect of hardware component, the AO invoked Rule 10 of the Rules and determined the income of the taxpayer’s PE at 20 per cent of the net global profits from Assessment Year (AYs) 2004-05 to 2008-09. However, for AY2009-10, the AO has attributed 45 per cent of the operating profit.

- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the taxpayer had a fixed place PE and dependent agent PE in India. However, he did not accept the AO’s plea of having installation PE in India. The CIT(A) held that software embedded in the telecom equipment was taxable as business profits, and not royalty. As regards the computation of profits attributable to the PE, 2.5 per cent of total sales made by a foreign company in India were held to be attributed as business profits of the PE (including the value of software).

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1 ZTE Corporation v. ADIT (ITA No.5870/Del/2012) – Taxsutra.com
Tribunal’s ruling

- The taxpayer has agreed for attribution of profits to PE without prejudice to its claim that there was no PE in India. The fundamental principle governing the attribution of profits is that once the domestic law has determined that business income has a source in the country, the mechanics of law then apply to calculate the amount of taxable profit.

- This involves the determination of gross assessable income derived from the country, from which allowable expenditure and past years losses carried forward are deducted to arrive at the net amount of income. This is a direct method for attribution of profit to a PE. However, the taxpayer has not maintained any books of accounts relating to its PE in India and, therefore, the indirect method as prescribed in Rule 10 of the Rules for attribution of profits has been resorted to.

- For the purpose of attribution of profits to a PE, one of the most important aspects to be kept in mind is the level of PE’s participation in the economic life of the source country. It is primarily the nexus between source country and the PE’s activities which produce the taxable income to the taxpayer.

- Rule 10 of the Rules prescribes a method of determination of income in the case of non-residents where exact profits cannot be calculated for want of sufficient information. In the present case, since the taxpayer did not maintain separate books of account, the AO had invoked Rule 10(ii) of the Rules and attributed 20 per cent of net global profits arising out of revenues realised from India. However, the CIT(A) attributed 2.5 per cent of entire sales revenue as per Rule 10(i) primarily relying on the decision in the case of Alcatel-Lucent, France⁷, inter alia, observing that Alcatel-Lucent France, which was in the same line of business as the taxpayer, had accepted and not contested the same in appeal.

- The issue of attribution of profits depends on the facts of the case and is fully dependent on the level of operations of the activities carried out in India. This is evident from Article 7 of the tax treaty and Explanation ¹ to Section 9(1)(i) of the Act.

- The Tribunal relied on various case laws⁴ dealing with profit attribution which was relied upon by both sides. In the case of Motorola⁵, the Tribunal has referred to the decision of the Supreme Court in the case of Ahmedbhai Umarbai & Co.⁶ wherein it has been held that the income attributable to the manufacturing activity should be more than the income attributable to the activity of sale.

- Each case has to be considered on its own merits, depending upon the level of operations carried out by PE in India. The CIT(A)’s and AO’s findings for AY2009-10 provide a clear picture of the level of operations carried out by the taxpayer’s PE. The CIT(A) has pointed out that ZTE India (a wholly-owned subsidiary of the taxpayer) is doing preparatory work, negotiating the contract and price and answering specified queries of the customers on behalf of the taxpayer. These are all vital functions which are revenue generating.

- It has been observed that the CIT(A) has adopted the reasoning in the case of Alcatel-Lucent, France. In this decision CIT(A) himself noted that taxpayer had accepted and not contested in appeal attribution at 2.5 per cent of total sales revenue. Therefore, this decision, considered by CIT(A), cannot be the basis for arriving at the conclusion that 2.5 per cent of entire sales revenue should be attributable to Indian PE, which is primarily as per Rule 10(i) methodology provided. The Tribunal was not inclined to accept this plea of the tax department and therefore, attribution is to be done as per Rule 10(ii) of the Rules.

The taxpayer was trying to distinguish the decision in the case of Rolls Royce PLC⁷ by referring to the absence of provisions of Article 7(3) of India-U.K. tax treaty being present in the India-China tax treaty. This is not of much significance because it only considers the involvement of taxpayer’s representatives in negotiations. We have to consider the overall operations carried out by the PE in India. Mere involvement of expatriates in the activities of PE for assisting the Indian team cannot substantially affect the revenue generating capacity of the PE.

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³ Motorola Inc. v. DCIT [2005] 95 ITR 269 (Del) (SB)
⁴ CIT v. Ahmedbhai Umarbai & Co. [1950] 18 ITR 472 (SC)
⁵ Rolls Royce Plc v. DDIT [2011] 339 ITR 147 (Del)
• In the case of Nortel Networks India International Inc., the Tribunal has noted that hardware supply contract was a part of the turnkey contract which involved supply, installation, testing, and commissioning, etc. as is in the present case. Activities of Nortel India and that of LO of Nortel Canada and services of expatriate workers had also been taken as part of the operation of the work by the PE. Thus, the level of operation carried out in India was extensive and under such circumstances, the Tribunal had attributed 50 per cent of the net profit arising out of Indian transactions as taxpayer’s income.

• The Tribunal held that the level of operations carried out by taxpayer through its PE in India is considerable enough to conclude that almost entire sales functions including marketing, banking and after sales were carried out by PE in India and, therefore, keeping in view the decision of the Supreme Court in the case of Ahmedbhai Umarbhai & Co., and the decision in the case of Rolls Royce and of Nortel Networks India International Inc., it has been held that it would meet the ends of justice if 35 per cent of net global profits as per published accounts out of transactions of the taxpayer with India are attributed to the taxpayer’s PE in India in respect of both hardware and software supplied by it to the Indian customers. The Tribunal, following the decision of the jurisdictional High Court/Tribunal in the case of Ericsson A.B., Nokia Networks OY and Alcatel-Lucent, France rejected the tax department’s argument that the embedded software is taxable as royalty.

• In the context of the taxpayer’s plea that since it has paid marketing support services to ZTE India which is at arm’s length and hence, no attribution should be made, the Tribunal rejected the same. The Tribunal observed that the AO, in his findings for AY2009-10, has rightly pointed out that the functions performed in respect of transactions on account of supply of equipment and handsets with customers in India were not the subject matter of TP analysis before the TPO. Since all the functions were not the part of TP study, the taxpayer’s contention that if a correct arm’s length is applied then nothing further will be left to be taxed in the hands of foreign enterprise, in light of the decision in the case of Morgan Stanley, cannot be accepted. This is because in that decision itself Supreme Court has, inter alia, observed that if the TP analysis does not adequately reflect the functions performed and risks assumed by the enterprise, then in such a case there would be a need to attribute profit to the PE for those functions/risks that have not been considered.

Our comments

Determination of profit attribution has been a matter of debate before Courts/Tribunal over a period of time. It is important to note that when the existence of a PE is confirmed, Article 7 of a tax treaty provides for tax-sharing rights over the profits earned by an enterprise that carries on business through a PE in source country.

The Delhi Tribunal in the case of Nortel Networks India International Inc has held that since the accounts of the taxpayer have no sanctity and same were not audited, resorting to Rule 10 of the Rules would be justified. Accordingly, an attribution of 50 per cent of profits to the activities of PE in India would be a reasonable attribution. Similarly, the Delhi Tribunal in the case of Convergys Customer Management Group Inc. has prescribed a methodical approach for profit attribution by applying the percentage of global income to end-customer revenue from India operations. Further, the Tribunal attributed 15 per cent of profit to the activities of PE in India.

In the present case the Tribunal has laying emphasis on the level of PEs participation in the economic life of source country attributed 35 per cent of net global profits as per published accounts. It was observed that it is primarily the nexus between source country and the PE’s activities which produce the taxable income to the taxpayer. The issue of attribution of profits depends on the facts of the case and is fully dependent on the level of operations of the activities carried out in India.

Further, relying on the observations of the Supreme Court in the case of Morgan Stanley, the Tribunal noted that if the TP analysis does not adequately reflect the functions performed and risks assumed by the enterprise, then in such a case there would be need to attribute profit to the PE for those functions/risks that have not been considered.

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8 Nortel Networks India International Inc. [2014] 65 SOT 158 (Del)
9 DIT v. Ericsson A.B. [2012] 343 ITR 470 (Del)
10 DIT v. Nokia Networks OY [2013] 358 ITR 259 (Del)
11 Alcatel-Lucent, France v. ACIT [2014] 151 ITD 534 (Del)
13 Convergys Customer Management Group Inc. [2013] 58 SOT 69 (Del) (URO)
In light of the present ruling of the Tribunal, it is important for multinational enterprises doing business in India to review their PE and related profit attribution risk periodically. The ruling also emphasises the importance of a robust transfer pricing analysis as a tool managing PE profit attribution risk.
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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