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EY Tax Alert

Tax Tribunal Special Bench upholds applicability of transfer pricing rules to transactions between foreign enterprise and its Indian permanent establishment

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Executive summary

This Tax Alert summarizes a recent decision of the Special Bench (SB) of the Ahmedabad Income-tax Appellate Tribunal (ITAT), in the case of TBEA Shenyang Transformer Group Company Limited[1] (Taxpayer or the Head Office or HO). The question before the SB was whether transactions between a foreign enterprise and its Indian permanent establishment (PE) can be considered an international transaction for the purpose of section 92 of the Income-tax Act, 1961 (the Act) and accordingly subject to the transfer pricing (TP) provisions of the Act. The SB ruled that a PE is a separate enterprise distinct from the HO for the purpose of the Act as well as under Article 7 of the applicable Double Taxation Avoidance Agreement (DTAA). The SB thereafter concluded that transactions between a foreign enterprise and its PE in India can be considered an international transaction and be subject to transfer pricing provisions. The SB however left the questions on whether the HO and its Indian PE are Associated Enterprises (AE) as defined in section 92A(2) of the Act and whether the transactions of the PE could be deemed international transactions under section 92B(2) of the Act for the Division Bench of the ITAT to decide based on the facts and circumstances of the case and the provisions of applicable law.

[1] [TS-508-ITAT-2024(Ahd)-TP]

Key observations of the SB

- TP provisions apply if there is an international transaction as defined in section 92B of the Act and if such transaction is between AEs as defined in section 92A of the Act. Income arising from such international transaction shall be computed as per arm's length principles (ALP) laid down in Rule 10A to 10E of Income-tax Rules, 1962 (the Rules).

- Section 92F(iii) the Act defines an enterprise as "a person including a PE of such person". Accordingly, the Taxpayer and its PE would constitute separate enterprises for the purpose of this section.

- Sections 92A(1) and Section 92A(2) are to be construed conjointly, rather than in isolation for determining if the enterprises would qualify as associated enterprises (AEs) under the Act. In this context, the SB directed the Division Bench of the ITAT to analyze if any clause of section 92A(2) of the Act are satisfied in the instant case.

- An "international transaction" as defined in section 92B of the Act is categorized under either subsection (1) or subsection (2) of the said section. Section 92B(2) of the Act outlines the circumstances under which a transaction between two persons would be deemed to be between AEs. SB has held that the PE has undertaken the obligation of rendering onshore services on behalf of HO and at same terms and conditions which the HO agreed with the third party customer. Further, the PE incurred substantial losses in executing such services. In these circumstances, if it is the fact that the PE was made to accept the term of onerous contract by the HO, provisions of section 92B(2) of the Act may be applicable. The SB directed the Division Bench to analyze the applicability of section 92B(2) of the Act in accordance with law.

- In summary, the SB held that transaction between foreign enterprise and its PE in India can be considered as an international transaction, subject to evaluation of certain conditions viz., such enterprises fall under the definition of AE under section 92A(2) and there is a transaction under section 92B(1) or section 92B(2) of the Act. The SB also held that application of Article 7(2) of the DTAA leads to the conclusion that determination of profits under the hypothesis of the PE being a distinct and separate enterprise, dealing wholly independently with the enterprise of which it is a PE, is nothing but adherence with the arm's length principles.

  P.S. – It may be noted that for transaction between Indian company and its PE in a foreign country, the SB ruled that such transactions will not be subject to TP considering that the HO and PE are residents of India and their global income is taxable in India.

Main Alert

- TBEA Shenyang Transformer Group Company Ltd., a company resident in China, set up a Project Office (PO) in India to fulfil a contract with Power Grid Corporation of India Ltd (PGCIL). The PO was regarded as a PE of the Taxpayer as defined in Article 5 of the India-China DTAA. The contract included offshore supply, onshore supply, and onshore services, with the PO established to provide onshore services. It is stated that the HO in China had made/ received certain payments on behalf of the PO as the PO did not have a bank account in India at the relevant time. This was regarded as 'reimbursement' by the Assessing Officer (AO) and termed as 'international transaction' for the purpose of reference to Transfer Pricing Officer (TPO).

- The TPO found that the rates received from PGCIL for civil work were lower than those paid to subcontractors, suggesting that the PO was not adequately compensated, leading to losses. Consequently, the TPO applied TP provisions to the transactions between the PO and its HO, considering them as international transactions.

- A SB was constituted on a reference made by the Division Bench, on account of apparently conflicting views on the issue of applicability of TP provisions to the transactions between an enterprise and its PE. The question before the SB was below:

  "Whether or not the transactions between a foreign enterprise outside India and its Indian permanent establishment can be considered as an international transactions for the purpose of section 92B of the Act, and accordingly can be subjected to the 'arm's length price' adjustment?"

- The SB highlighted that for TP provisions to apply, certain criteria must be met. These include the presence of ***multiple enterprises***, the classification of these enterprises as ***AEs***, the existence of an ***international transaction*** between such AEs, and the transaction's effect on ***taxable income*** under the Act. The SB's assessment of these conditions in the current case is summarized as follows:

- ***Permanent establishment – a separate enterprise?***

  - Taxpayer contented that definition of 'enterprise' under section 92F(iii) of the Act deems PE as an enterprise, but it does not treat PE separate from foreign company. Accordingly, it was contended that TP provisions cannot apply for transactions between PE and its HO or between other units of HO.

  - Rejecting the Taxpayer's argument, the SB held that applicability of TP provisions

and computation of ALP is linked to being qualified as 'enterprise' and is not linked to being a 'person'. From reading of TP provisions, it is clear that distinction is maintained between an enterprise and a person. Treating 'enterprise as equivalent to 'person' for the purpose of TP provisions, will make some provisions otiose and such interpretation should be avoided.

- The SB also referenced Article 7(2) of the DTAA, which requires that a PE be treated as a distinct and separate enterprise for profit attribution, to conclude that HO and PE are separate enterprises.

- ***Associated Enterprises under section 92A***

  - The SB opined that sections 92A(1) and (2) are required to be read together and not independently. SB also held that *"As long as the provisions of one of the clauses in section 92A(2) of the Act are not satisfied, even if an enterprise has a de facto participation capital, management or control over the other enterprises, the two enterprises cannot be said to be associated enterprises. Once condition of any clauses in section 92A(2) of the Act are satisfied, the AE relationship is triggered. Nothing more is required."*

  - The SB noted that in cases involving a PE, traditional tests like holding voting power through shares or appointment of directors may not apply, as a PE does not have its own share capital or directors. The SB however indicated that the clauses of the AE definition that refer to the control by one enterprise over the other enterprise on account of certain commercial relationships (e.g. dependence on intangible property or substantial supplier or customer relationships etc.) may apply in HO-PE situations. The SB directed the Division Bench of the ITAT to analyze whether any clauses of section 92A(2) are satisfied in this case based on the facts and circumstances without concluding on this aspect.

- ***Impact on taxable income***

  - The Taxpayer contended that there is no income arising out of international transactions in the current case as there is only fund movement between HO and PE.

  - The SB emphasized that income for TP purposes should be interpreted from a commercial and business perspective. The fundamental question arises whether an independent entity would permit to route its receipts and payments via third party. The SB concluded that in the current case, transactions do affect taxable income, particularly considering that the HO retains full control over the PE funds and the PE's revenue is dictated by agreements executed by the HO.

- ***International transaction under section 92B***

  - The SB also questioned whether the PO's obligation to render onshore services on behalf of the HO, which resulted in substantial losses, could be seen as a transaction influenced by the HO, potentially making it a deemed international transaction under section 92B(2) of the Act. This section outlines that a transaction with a non-AEs can be deemed to be between AEs if there is a prior agreement or if the terms are determined in substance between the other person and the AE.

  - The SB specifically noted that there is a difference between section 92B(1) and section 92B(2) of the Act. As per section 92B(1), enterprises once determined as AEs will remain AEs throughout the year. Whereas enterprises determined as AEs as per section 92B(2) will be AEs only for the specific transaction. In this regard, the TPO has to demonstrate as to which specific transaction qualifies as deemed international transaction.

  - The SB, without concluding on this issue, directed the Division Bench of the ITAT to determine application of section 92B(2) to the transactions.

- ***Tax treaty override***

  - The Taxpayer argued that under section 90 of the Act, the DTAA provisions, to the extent they are beneficial to the taxpayer, override the Act. In this context, Article 9 of the DTAA was cited, which stipulates that TP adjustments are applicable only when one of the enterprises involved is a resident of the other contracting state. Since, neither the HO nor the PE is considered a resident, the Taxpayer contended that transactions between them should not be subject to TP adjustments as per the DTAA.

  - The SB clarified that Article 9 simply reaffirms rules similar to domestic law and does not independently alter existing domestic rules. Article 9(1) does not bar adjustment of profit under the domestic law even if the conditions differ from those of Article 9(1). Even if the DTAA is assumed to prevail, profits must be attributed to the PE as if it were an independent enterprise, in line with Article 7 of the DTAA. The SB concluded that this approach aligns with the arm's length principle and found no conflict between

Article 9 of the DTAA and TP regulations of the Act, rejecting the taxpayer's argument.

Comments

Approach to attribution of profits to a PE has been a subject matter of intense debate in the international as well Indian context. The international consensus has been that the profits should be attributed to a PE on the basis of the "separate enterprise" concept, and the application of the arm's length principle. This is currently encapsulated in Article 7(2) of the OECD Model Tax Convention (MTC) with similar provisions found in a most of India's DTAAs. The key challenge however has been the correct interpretation and application of the provisions of Article 7(2) of the MTC, and in domestic legislation which draws on this wording or on the separate enterprise concept. The SB ruling affirms that the underlying philosophy of TP provisions and Article 7(2) is same wherein both try to analyze as to how third parties would have dealt with each other under uncontrolled conditions.

While the SB has affirmed the concept of treating a PE as a separate enterprise, careful consideration of the AE definition in section 92A(2) is also crucial to determine if the PE should be considered as an AE of the HO. Additionally, arrangements the PE has with third-parties would need to be evaluated to determine if the same could come with the scope of deemed international transactions.

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