

## Profit attribution to a Permanent Establishment in India – A vexed issue

By: Ravi S. Raghavan, Partner, Tax and Private Client Group, Majmudar & Partners, India

### Background

Foreign companies in India are often subjected to a tax audit scrutiny by the Indian tax authorities to check if they have a Permanent Establishment (“PE”) in India and what will be the profits attributable to such a PE. The issue of attribution of business profits to a PE is a highly litigated issue.

In the *Motorola* case, the books of accounts of the India PE had huge losses although Motorola, at a global level, was making big profits. The Commissioner of Income-tax (the “CIT(A)”), in this case, rejected the accounts of the taxpayer and invoked Rule 10 of the Income-tax Rules, 1962 to calculate the profits attributable to the PE. The Special Bench of the Delhi Income-tax Appellate Tribunal upheld the profit attribution method applied by the CIT(A) under which the profit percentage was calculated based on global accounts and applied to the Indian revenue to determine the profits attributable to PE in India.

Relying on the methodology used in the *Motorola* case, in the *Nokia Solutions* case, the division bench of the Delhi Income-tax Appellate Tribunal held that the net margins at the global level are to be applied to calculate income attributable to a PE in India. However, in the *Nokia Solutions* case, given that the taxpayer had incurred a global net loss as per its audited accounts, no profit or income was attributed to the PE in India.

An appeal was filed in the *Nokia Solutions* case in the Delhi High Court (the “DHC”), and the DHC accepted the ruling of the division bench of the Delhi Income-tax Appellate Tribunal upholding the principle that if a multinational company has a net loss in its global accounts, no income can be attributed to its Indian PE.

However, in the *Hyatt International Southwest Asia* case, the DHC took a contra view to the *Nokia Solutions* decision. The DHC held that the Indian PE is an independent taxable entity, and profits must be computed on the basis of the India operations. Given this, the issue of attribution of profits was referred a larger bench of the DHC.

### Facts and arguments

Hyatt International Southwest Asia Ltd (the “Taxpayer”), is a UAE-based entity, and it had a PE in India under the India-UAE Double Tax Avoidance Agreement (the “UAE DTAA”). During the relevant assessment year, the Taxpayer incurred losses from its global operations and, therefore, took the position that no profit should be attributed to the Taxpayer’s Indian PE. The Taxpayer relied on Article 7 of the UAE DTAA, which deals with profit attributable to a PE. Article 7 (1) of the UAE DTAA provides that the profits of an enterprise of a Contracting State will be taxable only in that State (i.e., in the UAE) unless the enterprise carries on business in the other Contracting State through a PE situated therein (i.e., in India). In such a case, the profits can be taxed in the other State (i.e., in India) but only so

much of them as are attributable to that PE. Article 7(2) of the UAE DTAA, *inter alia*, clarifies that where an enterprise of a Contracting State (i.e., the UAE) carries on business in the other Contracting State (i.e., India) through a PE situated therein, then the profits must be determined keeping in mind that the PE is a distinct, separate and wholly independent enterprise.

The Taxpayer argued before the larger bench of the DHC that for a foreign enterprise to be taxed in India, the following three (3) conditions must be satisfied:

1. The foreign enterprise must have a PE in India;
2. The foreign enterprise must be making a profit; and
3. At least a part of the profit made by the foreign enterprise should be attributable to its PE in India and only that part is liable to be taxed.

Based on the above conditions, if a foreign enterprise is making a loss, the question of attributing profit to the Indian PE cannot arise and, consequently, that enterprise should have no tax liability in India.

## **The ruling of the larger bench of the DHC**

The larger bench of the DHC assessed Article 7 of the UAE DTAA in great detail and came up with the below listed findings:

- Article 7 of the UAE DTAA restricts the taxation of profits of an enterprise in the State of which it is a tax resident (i.e., in the UAE). However, the scope is expanded by taking into consideration the activities that may be undertaken by such an enterprise in the other Contracting State (i.e., India) through a PE situated therein.
- Article 7(1) of the UAE DTAA prescribes that if a PE exists in the other Contracting State (i.e., India), the PE will be taxed only on the attributable profits. Article 7(1) of the DTAA creates a dichotomy between the profits that may be earned by an enterprise on a global scale and those attributable to a PE situated in the Contracting State (i.e., India), which is a distinct and independent enterprise.
- As a PE constitutes a “separate source of profit,” the profit attribution to the PE must be based on the activities conducted in India and not on the foreign entity’s global financial performance. As such, not taking into account the income generated by activities undertaken by the Indian PE and making the attribution dependent on the overall profits or income earned by the global entity is not the correct approach.
- Profits can be attributed to an Indian PE even if the global entity has never made profits, and conversely, no profits may be attributed to a PE even if the global entity has made profits.

## Our comments

The *Hyatt International Southwest Asia* and the *Nokia Solutions* cases have rekindled the debate of profit attribution to a PE in a situation where the foreign company has reported a net loss. Article 7 of the UAE DTAA does not restrict the right of the source State (i.e., India) to attribute income to the PE and whether the foreign company has a global profit or loss is irrelevant. This is also well recognized in the OECD commentary.

In our view, it is likely that the Taxpayer (Hyatt International Southwest Asia) may appeal to the Supreme Court. However, considering the well-drafted and reasoned 59-page order passed by the DHC, it remains to be seen what the Supreme Court will do.