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No taxes on commission earned by non-resident agents outside India, in absence of 'territorial nexus' with India

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Facts of the case

Background

- The assessee, Fox International Channel Asia Pacific Ltd., is a foreign company (resident of Hong Kong) engaged in distribution of satellite television channels and sale of advertisement air time for the channel companies at global level.
- The assessee is not a channel owner but a service provider who was appointed as an agent by the channel companies to sell the advertisement air time on the channels, to distribute the channels in the territories where the channels are being broadcast and to procure syndication revenues in respect of the contents of the channels.
- Towards the aforesaid services, the assessee earned income by way of agency commission, management fees and other income in the nature of royalty.

Order of the Transfer pricing officer (TPO)

- Since the assessee had earned income from international transactions from its Associated Enterprise (AE) in India, the Assessing Officer (AO) made a reference to the TPO for determining the arm's length price (ALP) of such international transactions.
- After examining the transfer pricing study report, which had adopted the profit split method (PSM) for determining ALP, the TPO accepted PSM as the most appropriate method and concluded that no adjustment is required to be made to the value of the international transaction entered into by the assessee.
- However, w.r.t the agency commission, the TPO noted that, although in the transfer pricing study the assessee had arrived at a margin of 28.17% of global revenue (i.e., INR 252.59 crores) as ALP profit, only INR 227.80 crores was offered to tax in India.
- Accordingly, the TPO held that the differential amount of INR 24.79 crores should be treated as adjustment to the ALP.

DRP Directions

- The assessee filed the following objections before the Dispute Resolution Panel (DRP):
  - The transfer pricing adjustment of INR 24.79 crores represents agency commission fee towards services provided outside India and hence is not chargeable to tax in India.
  - Not only were such services provided outside India but the payment was also received outside India and hence, it cannot be treated as income either under section 7 nor section 9 of the Act.
  - Further, since the agency commission fee is not an income chargeable to tax under the provisions of the Act, it cannot be considered as an international transaction under section 92B(1) of the Act and hence, the TPO had no jurisdiction to make any adjustments.
- DRP upheld TPO’s adjustments by observing that, in view of the Explanation below section 9(2) of the Act, income of a non-resident shall be deemed to accrue or arise in India whether or not the non-resident has a residence or place of business or business connection in India or has rendered services in India.

Assessee’ s contentions:

- The assessee submitted that ALP of the international transaction has to be determined purely on the basis of income sourced from India.
- The TPO had found the margin of 28.17% to be at ALP and has not proposed any changes. However, the same represents the global profit ratio of the assessee.
- Once the TPO had concluded that the margin shown by the assessee at 28.17% is at arms’ length and no adjustment to the ALP is required, no further adjustments should have been recommended on the basis of global income.
- Latching on to a mistake committed in Annexure–1 to the transfer pricing study report while mentioning "arm's length profit attributable to India", the TPO has actually considered the global profit of the assessee amounting to INR 252.59 crores.
- The income of INR 227.80 crores offered by the assessee represents the ALP profit attributable to India. The observations of the DRP that the assessee has admitted the amount of INR 252.59 crores as the profit attributable to India is a total misconception of fact and on a wholly wrong reading of the transfer pricing study report.
- The revenue did not dispute the fact that the agency commission of INR 24.79 crores, is towards services rendered outside India and the payment was also received outside India and hence it cannot be brought to tax in India.
- The assessee has submitted various judicial precedents and drawn ITAT’s attention to CBDT circulars to support its contentions that where the agency fee commission is earned towards company’s operations outside India, it is not taxable in India.

Ruling of the ITAT

- It was observed that the TPO made an adjustment INR 24.79 crores on the profits attributable to India under PSM without any basis and by solely relying on Annexure-1 of the transfer pricing study, wherein the global profit amounting to INR 252.59 crores had been inadvertently disclosed as arm’s length profit attributable to India.
- The ITAT dismissed the contention of the DRP that, section 9 of the Act can bring to tax net any such income accruing or arising through or from a business connection in India, although such income accrues or arises outside India.
- It was held that, as per Explanation 1 to section 9(1)(i) of the Act, **where an assessee does not carry out business operations exclusively in India, only such part of the income as is reasonably attributable to the operations carried out in India shall be deemed to accrue or arise in India. Therefore, the income which is deemed to accrue or arise in India must have a territorial nexus**.
- The ITAT also clarified that on careful reading of the provision contained in Explanation below section 9(2) of the Act, it would be clear that it will not be applicable to the agency commission earned by the assessee.

- Accordingly, the ITAT directed the AO to not make any adjustment in the ALP if the attribution of INR 227.80 crores is found to be factually correct, thereby ruling in favour of the assessee.

Comments

Post incorporation of 'significant economic presence' in the definition of business connection, the scope of taxation of income earned by a foreign company has widened, thereby leaving room for interpretation. The recent decision of the Mumbai ITAT in the case of Fox International Channel Asia Pacific Ltd has given some clarity by adding the requirement of 'territorial nexus'.

In light of the said case, only such profits of the foreign company which is attributable to India can be brought under the tax net by the revenue authorities. However, the assessee should be advised to maintain sufficient documentation to substantiate the basis for attribution of income to India.

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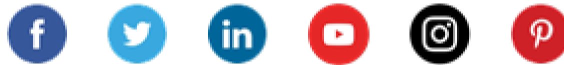

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