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The Supreme Court* has held there cannot be attribution of profits even if there is a PE in India, if arm's length principle has been satisfied

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Facts

- The assessee is a company incorporated under the laws of Japan and entered into certain transactions with its subsidiary in India relating to royalty, fees for technical services, sale of raw materials, finished goods etc.
- The assessee did not file its return of income in India. Therefore, the Assessing Officer [AO] initiated re-audit proceedings (beyond four years) under sections 147 and 148 of the Income-tax Act, 1961, on the belief that the Indian subsidiary constituted a permanent establishment [PE] of the assessee and thus profits were required to be attributed to the PE in India in terms of the functions performed, risks assumed and assets deployed by the PE.
- The assessee company filed a writ petition against the re-audit proceedings before the Allahabad High Court, which was rejected by the Hon'ble High Court in its combined order where the lead petitioner was LG Electronics Inc.

Ruling of the High Court

- The High Court held there were tangible material to form a belief that income has escaped assessment and consequently, the AO rightly issued the notice for re-audit. Further, the assessee's contention that there was no fresh material before the AO to come to a belief that income had escaped assessment and that there was no application of mind, is patently erroneous.
- The High Court further observed that once the AO is satisfied that a PE of the assessee exists in India and business is being conducted from this PE, the attribution of profits is a necessary consequence. The order of Transfer Pricing Officer [TPO] will not come in the way for the reason that the TPO's order is in relation to the transactions between the subsidiary company and the assessee. The situation becomes different when the subsidiary company also works as a PE of the assessee.
- The High Court has accordingly held that the transfer pricing analysis is to be undertaken between the assessee and its PE which has not taken place as yet. Once a transfer pricing analysis is done, keeping in mind the principle of arm's length price, then there is no need to attribute profits to a PE.
- However, the High Court has further observed that where the transfer pricing analysis does not take into account all the risk taking functions of the enterprise and it does not adequately reflect the function performed and the risk assumed by the assessee, there would be a need to attribute profits to the PE for those functions/risk that have not been considered. In this regard, the High Court has also relied on the decision of the Supreme Court in the case of Morgan Stanley and Co.
- Aggrieved by the High Court's decision, the assessee filed a special leave petition before the Supreme Court.

Issue before the Supreme Court

- Whether the re-assessment proceedings can be sustained when the arm's length principle has already been satisfied.

Ruling of the Supreme Court

- The Hon'ble Supreme Court has allowed the leave petition and has decided the appeals in favour of the assessee.
- The Supreme Court has relied on its decision in the case of E-Funds IT Solutions Inc. wherein it had held that once arm's length principle has been satisfied, there can be no further profits attributable to a person even if it has a PE in India.
- Based on the same, the Supreme Court held that since the notice for the re-assessment is based only on the allegation that the assessee has a PE in India, the notice cannot be sustained once the arm's length price procedure has been followed.
- Accordingly, the Supreme Court has set aside the order of the High Court.
- The Supreme Court has however, given the liberty to the Revenue to approach this Court in case it disputes the factual position with regard to the arm's length principle.

Conclusion

The Supreme Court has been consistently taking a position that where an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise, then nothing further may be left to be attributed to PE. However, the situation could be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise.

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