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Tax alert: Special bench of ITAT analysed applicability of TP between HO and PO

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The Special bench of Ahmedabad Tribunal has held that a transaction between an Indian project office ('PO, Branch, PE') and a foreign head office ('HO') is a transaction between two distinct non-resident enterprises and, therefore, constitutes an 'international transaction' within the meaning of section 92B of the I-T Act.

In a nutshell

Two separate judgements analysed the issue relating to applicability of TP provisions to HO and PO. The conclusion in two judgements being different, a special bench of ITAT was constituted to analyse the issue in detail.

Special bench analysed the facts of the case and concluded that the facts of the two cases are different and hence there is no conflict in the two judgements.

Special bench analysed in detail the relationship between HO and PO and the applicability of various provisions of transfer pricing in case of transactions between the HO and PO.

The Special bench also clearly carved out the difference in applicability of TP provisions in case of India branch of foreign HO and foreign branch of Indian HO.

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Facts

The taxpayer[1], an Indian project office (hereinafter referred to as 'PO'), was established by its head office, a Chinese non-resident company (hereinafter referred to as 'Foreign Company' or 'HO') in connection with a power project, to provide certain onshore services within India.

As per the arrangement between HO and PO, the PO was responsible to provide onshore services to third-party customer in India. Further, the PO outsourced a portion of the services to independent sub-contractor(s). However, since the PO did not have any operational bank account in India, the HO directly made payments to such sub-contractors and collected money from customers on behalf of the PO.

Dispute

The transfer pricing officer (TPO) took a view that, since the original onshore service contract was entered into by HO with the third party, but the contract was executed by the PO on behalf of the HO, it considered the contract to be an 'international transaction.' Hence, TP provisions are applicable to international transactions between PO and its HO in China.

Additionally, the TPO observed that the per unit rate received for the work done by PO is lower than the rate paid to sub-contractor. Therefore, it held that the PO is not adequately compensated for the onshore activity and has incurred losses.

Taxpayer's arguments

- The taxpayer contended that the transaction with self or between two branches of the same person cannot trigger any income and in the absence of any income, the provisions of Chapter X are not applicable.
- That PE is only a subset of foreign company and has no separate standing. Hence, under normal parlance, it can never be considered or assumed to be a separate person.

Tribunal's Observations

- ***Conflicting precedent on issue*** - The Tribunal analysed the conflict in the earlier Division bench's decisions in case of Aithent Technologies and Fujifilm Corporation owing to which the Special bench was constituted.
  - In the case of Aithent Technologies[2], an Indian HO entered into transactions with its Canadian branch. The Division bench of the Tribunal observed that as per section 92B of the Act, for a transaction to be an international transaction, it is *sine qua non* that there should be two or more AEs. In the given case, since the branch in Canada is not a separate entity from the Indian HO, the transactions between the Indian HO and the foreign Branch cannot be said to be an international transaction. Same reasoning was taken by the Division bench of the Tribunal while disposing the issue in appeal for different assessment year.
  - In the third round[3], when the issue reached to the Division bench of Tribunal, the facts remained the same. However, the Division bench of Tribunal referred to the definition of 'Enterprise' under Section 92F(iii), which states that *"an enterprise means a person (including the permanent establishment of that person)..."*. Taking a conjoint reading of the definition of 'international transaction' and 'enterprise' the Division bench of Tribunal observed that since the transaction is between two separate enterprises, such transactions between an HO and PO can be subject to transfer pricing. **However, it further held that this observation loses substance when the HO is an Indian entity, and the branch/PO is outside India.** It explained that a resident of India is taxable in India on its global income as per section 5(1) of the I-T Act. The accounts of a branch of an Indian HO are consolidated with the HO and the taxable income of the branch is also offered

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[1] TBEA Shenyang Transformer Group Company Limited [TS-508-ITAT-2024(Ahd)-TP]

[2] Aithent Technologies Pvt Ltd v ITO in ITA Nos. 3512/Del/2010 &1923/Del/2013

[3] Aithent Technologies Pvt Ltd vs DCIT reported in [2016] 74 taxmann.com

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for tax with the income tax return of the HO.

- — It was also noted by the Division bench of Tribunal that the object of introducing transfer pricing provisions in India is to prevent tax base erosion to ensure reasonable, fair and equitable profits to the country. In case of a transaction between the Indian HO and foreign branch, the intercompany transactions are nullified in the consolidated accounts/return of Income of the HO and hence there is no scope of tax base erosion.
- — It further held that as per section 5(2) of the Act, in case of an Indian branch of a foreign company, only the income of Indian branch is taxable in India. Hence, there is a potential in this case to manipulate the profits of Indian branch qua transactions between foreign HO and the Indian branch.

- The Tribunal pointed out that in the case of Fujifilm Corporation[4], the transactions were between an Indian branch and its Japanese Head Office. Therefore, considering different facts, there is no conflict between the decision of Aithent and Fujifilm Corporation.
- ***Residential status of transacting entities*** - The Tribunal further observed that the residential status of the branch is that of its head office. In case of Indian enterprise and its foreign branch, both are residents in India. Thus, the condition, as per the definition of international transaction, that at least one party should be non-resident does not get fulfilled in the case of Indian enterprise and its foreign branch. But in the case of India branch of a foreign company, both branch and the HO are non-resident entities for the purpose of Income-tax Act, and a transaction between two non-residents is covered as an international transaction.
- ***Difference between person and enterprise*** - On the taxpayer's argument that the definition of 'enterprise' deems a PE as an enterprise but does not treat the PE as separate from the foreign company, the Tribunal analysed that *'the applicability of TP provisions and computation of ALP are linked to qualifying as an "enterprise" and not to being a "person.* A Sole proprietorship of non-resident person in USA may have transaction with Sole proprietorship of same person in India. Both the Sole proprietorships are separate enterprises of same person.
- ***Profit attribution to PE*** - As per article 7(2)[5] of the India -China treaty, when business is carried on through a PE, appropriate profits should be attributed to such PE for its activities as if it were a distinct and separate enterprise. Therefore, the Tribunal held that the transfer pricing provisions are applicable on transactions between an Indian branch and its foreign HO.
- Additionally, it held that in the given case, the arrangement between Chinese HO and Indian Branch have resulted into losses in the hands of the branch and accordingly, the transaction is subject to transfer pricing law.
- ***AE relation between HO and PO*** - The Tribunal also analysed the AE relationship of the PO and HO and pointed out that "*To find the meaning of the expression 'participation in management or capital or control', one has to take recourse to section 92A(2) of the Act which gives practical illustrations. Sections 92A(1) and (2) of the Act, are thus* ***required to be read together and both the subsections cannot be read independently***". Considering the applicability of different clauses of section 92A(2), it held that Division bench of the ITAT need to analyse the clauses of section 92A(2) of the Act which are satisfied in the instant case to establish AE relationship. Generally, PO is dependent on HO for its operations and may get covered under section 92A(2) under one or the other sub-clause such as sub-clause (g)(h) or (i) of section 92A(2) of the Act.

[4] Fujifilm Corporation India reported in (2018) 193 TTJ 716 (Del)

[5] "Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

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- ***Deemed international transaction*** - While concluding the decision, the Tribunal made reference to the two limbs of section 92B[6] which defines 'international transaction' and 'deemed international transaction' and held that the PO has rendered the services to third party on behalf of the HO under the same terms as agreed between HO and the third party. This arrangement has resulted into a loss to the PO. In case PO's contract with third party is influenced by the terms and conditions agreed by the HO with third party, it may get covered under deemed international transaction.
- In light of aforesaid reasoning, the special bench concluded that *"transaction between foreign enterprise and its PE in India can be considered as an international transaction and be subject to ALP adjustment*."

Conclusion

The controversy regarding applicability of TP provisions to the transactions between HO and its PE, have been a point of debate and interpretation. This issue was dealt by the Division bench of Tribunal in case of Aithnet, but the controversy and ambiguity still persisted. The Special bench in the present judgement analysed variance in facts and the applicability of transfer pricing law under different circumstances to remove the ambiguity. Thereby necessitating adherence with arm's length principle for transactions between a foreign HO and its Indian PE.

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[6] (1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be an international transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not.

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