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Tax alert: Taxpayer not expected to deduct TDS on notional profit attributed to PE

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The Delhi Bench of the Income-tax Appellate Tribunal, based on facts, has held that the taxpayer cannot be treated as an assessee-in-default for not deducting tax at source (TDS), as it cannot be expected to compute TDS on a notional payment, a part of which, is to be attributed towards profit of permanent establishment (PE) of the payee and there was no tax liability on the payee.

In a nutshell

When the basis of attribution of profit to the PE was a notional income, that too, based on a methodology adopted in the case of payee, the taxpayer could not be expected to perform an impossible act of computing TDS on a notional payment, a part of which, was to be attributed towards profit of PE of parent company.

There being no obligation of the taxpayer to withhold tax under section 195 of the Income-tax Act, 1961 (ITA), the taxpayer cannot be treated as an assessee-in-default under section 201 of the ITA.

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Background:

- The taxpayer[1], an Indian company and a wholly owned subsidiary of a Korean company (K Co), is engaged in trading, assembly, manufacturing, marketing and sales of electronics and home appliances.
- A survey operation under section 133A of the Income-tax Act, 1961 (ITA) was conducted in the business premises of the taxpayer to verify the compliance of tax deducted at source (TDS) provisions. Based on the documents and statements recorded from certain expatriate employees, the Assessing Officer (AO) observed the following:
  - During the Financial Years (FYs) 2004-05 to 2010-11, corresponding to Assessment Years (AYs) 2005-06 to 2011-12, the taxpayer had entered into various international transactions with K Co and other associated non-resident companies for the purchase of raw materials, finished goods, capital goods, etc.
  - The parent company i.e., K Co and other associated companies had a business connection and Permanent Establishment (PE) in India. Hence, the income derived by K Co and other group entities was taxable as business income in India. Therefore, the taxpayer was liable to deduct TDS in terms of section 195(1) [relating to TDS on certain payment to non-residents] of the ITA while making payments to them. Since, the taxpayer had not deducted TDS on such payments, the AO initiated proceedings under section 201 [relating to consequences of failure to deduct or pay] of the ITA.
- While concluding the proceedings under section 201 of the ITA, the AO treated the taxpayer as an assessee-in-default and by considering the payments made by the taxpayer to K Co and other non-resident group entities towards purchase of raw materials, finished goods, capital goods etc., computed the default of the taxpayer and raised demands under section 201(1)/201(1A) of the ITA.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)], who held that the taxpayer's TDS default was to be determined on the basis of income computed on a cost-plus basis, 20% on the payments made as salaries attributed to Indian operations of K Co. The same was on the basis that:
  - In the case of K Co and the group companies, audit proceedings were taken up and orders passed that K Co and other non-resident group entities had a PE in India.
  - When the matter reached before the Dispute Resolution Panel (DRP), it directed that except K Co, no other non-resident group entity had any PE in India. Further, profits from 20% mark-up on certain salary cost of the expatriate employees, were attributed to the PE of K Co.
- Aggrieved, the taxpayer filed an appeal before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

The ITAT noted /observed the following:

- While passing orders under section 201(1)/201(1A) of the ITA, the basis for computation of TDS default was payment to K Co and other non-resident group entities towards purchase of raw materials, capital goods, spare parts, etc. However, subsequently, the position changed substantially as in case of payee entities, the DRP held that only K Co had PE and no other non-resident group entities had any PE in India.
- Even, the method of attribution of profit to the PE of K Co was changed from payment made towards purchase of raw material, finished goods, spare parts, etc., to a notional payment of 20% mark-up on certain salary cost of expatriate employees. As a result of the change in manner of attribution of profit to the PE, the demand raised by the AO got substantially reduced.

[1] LG Electronics India Ltd. vs ITO (TDS) [ITA Nos. 7926 to to 7932/ Del/2018] (Delhi ITAT)

- Thus, the basis of attribution of profit to the payee, K Co, was purely notional, as it was the specific case of the taxpayer that it had not paid any salary cost of expatriate employees to K Co.
- It was the case of the taxpayer that on the salary cost paid to the expatriate employees, the taxpayer had deducted TDS under section 192 [relating to TDS on salary] of the ITA. When the taxpayer had not made any direct payment to the K Co towards the salary cost of expatriate employees, there was no liability on the taxpayer to deduct tax on such notional payment. Moreso, the taxpayer had already deducted tax under section 192 of the ITA in respect of salary cost of expatriate employees.
- When the basis of attribution of profit to the PE was a notional income, that too, based on a methodology adopted by DRP in case of payee, the taxpayer could not be expected to perform an impossible act of computing TDS on a notional payment, a part of which, was to be attributed towards profit of PE of K Co.
- Further, the Delhi Bench of the ITAT in case of payee i.e., K Co quashed the final audit orders for non-implementation of DRP directions. Owing to low tax effect, Revenue had not filed any appeal for AYs 2005- 06 to 2010-11 and for AY 2011-12 no separate assessment was framed in case of K Co. Thus, the factual position was that there was no tax liability on the payee, viz., K Co in the AYs under consideration.

  Thus, on overall consideration of facts and materials on record, there being no obligation of the taxpayer to withhold tax under section 195 of the ITA, the taxpayer could not be treated as an assessee in default under section 201 of the ITA. Reliance was placed on an earlier ruling[2] in this regard.

In view of the above, the ITAT directed the AO to delete the demands raised under section 201(1)/201(1A) of the ITA for the AYs under consideration.

Comments:

The Delhi Bench of the ITAT, in this ruling while holding that the taxpayer is not an assessee-in-default has held / upheld the following principles:

- When the basis of attribution of profit to the PE was a notional income, that too, based on a methodology adopted in the case of payee, the taxpayer could not be expected to perform an impossible act of computing TDS on a notional payment, a part of which, was to be attributed towards profit of PE of parent company.
- There being no obligation of the taxpayer to withhold tax under section 195 of the ITA, the taxpayer cannot be treated as an assessee-in-default under section 201 of the ITA.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

[2] Samsung India Electronics Pvt. Ltd. vs. DCIT [2014] 364 ITR 103 (Delhi HC)

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