PERMANENT ESTABLISHMENT AND TRANSFER PRICING

December 13, 2024

Applicability of Transfer Pricing on transactions undertaken by Permanent Establishment (PE) with its Head Office/ Parent Company

Special Bench (SB) of Tribunal in India in a recent decision[1] has dealt with the controversy regarding applicability of transfer pricing law on transactions undertaken by a PE in India with its Head Office/ Parent Entity and held that transfer pricing law will apply to such transactions and can be subjected to an arm's length price adjustment.

BACKGROUND

TBEA Shenyang Transformer Group Company Ltd., (TBEA/ Head Office), a company which is incorporated in China and is a tax resident of China, entered in various supply and service agreement with an Indian customer, Power Grid Corporation of India Ltd., (PGCIL), to build sub-stations in India required for transmission of electricity.

Under the agreement, the equipment was directly supplied by TBEA to PGCIL. However, for providing certain onshore services such as inland transportation and civil work services, within India, TBEA set up a Project Office (PO/ taxpayer) in India. The PO also sub-contracted a part of the work to independent third-party contractors.

During the initial setting up period, HO made certain payments to sub-contractors on behalf of the PO and received service income from PGCIL. The tax officer took a view that since the service agreement was executed between HO and PGCIL, the expenditure incurred by PO for carrying out execution of the contract on behalf of HO, is in the nature of transaction of 'reimbursement' and being an 'international transaction', required to be tested under transfer pricing laws of India.

The tax officer also investigated the facts and observed that the PO is not adequately compensated for the onshore activity and therefore, proposed to make transfer pricing adjustment to the amount of expenditure incurred by HO on behalf of PO and claimed as reimbursement.

CONTROVERSY

The controversy was whether a PE in India will be considered as a separate entity from its HO and transaction undertaken between PE with its HO will be subject to transfer pricing laws of India.

The SB was constituted to answer the above controversy because of divergent views given by Division Bench of Delhi in the case of Aithent Technologies Pvt. Ltd.[2] and Fujifilm Corporation Japan[3].

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[1] TBEA Shenyang Transformer Group Company Limited vs. DCIT [ITA No.581/Ahd/2017]
[2] Reported in [(2015) 155 ITD 266 (Del)
[3] Reported in (2018) 193 TTJ 716 (Del)

In the later decision of Fujifilm Corporation Japan, wherein, Fujifilm Corporation had a Branch Office (PE) in India, the Delhi Tribunal observed that PE is also an 'enterprise' for the purposes of the transfer pricing provisions and hence any transaction between PE with its HO is subject to transfer pricing regulations.

FINDING OF SPECIAL BENCH

The SB held that –

1. The term 'Enterprise' is defined in clause (iii) of section 92F of the Act, which includes a PE and therefore, PO is a separate entity from its HO in China.

2. As per section 92B(1), to qualify as international transaction, at least one party should be non- resident. The residential status of PO is that of its HO, i.e. resident of China and since both are non-residents, they fall in the definition of International Transaction as provided under Section 92B of the Act.

3. Article 7(2) of the India-China DTAA too provides that the profits of PE shall be determined under the hypothesis that it is a distinct and separate enterprise, dealing wholly independently with the enterprise of which it is a PE.

The SB also rightly held that for application of transfer pricing, either –

i. the PO and HO are Associated Enterprise (AE) in terms of sub-section (1) and (2) of Section 92A of the Act or

ii. the transaction between PO and HO passed the condition provided under section 92B(2) of the Act to be termed as 'deemed international transaction'.

However, unfortunately, SB has left the satisfaction of the above conditions for consideration by the Division Bench.

OUR ANALYSIS

A transaction shall be subject to transfer pricing if it involves (i) income, and (ii) is an 'international transaction' as per the definition provided under section 92B of the Act. Section 92B provides two scenarios to define an international transaction (i) when the transaction is entered between two AE or (ii) when the transaction is entered between two independent parties, say A and B, but there exists a prior agreement between AE of A and B or the terms of transaction are determined in substance between them.

In the present case, if PO and HO could not be covered under the definition of Associated Enterprise as provided under section 92A(2) of the Act, which is likely so, one is required to check if the transaction can otherwise be covered under section 92B(2) of the Act to be termed as 'deemed international transaction'. However, here also, the transaction of Reimbursement created by the tax officer is between PO and HO which are not Associated Enterprise as not falling under section 92A(2) of the Act, and since PGCIL is also not an Associated Enterprise of either PO or HO, therefore, it cannot be held that the transaction entered between PO and HO are tainted because of any prior agreement or influence of PGCIL.

It shall be important to see as to how the above two conditions will be dealt by the Division Bench to treat such transaction as 'international transaction'. Nonetheless, in terms of Article 7(2) of the India-China DTAA, the profit of PE is required to be determined considering it as a separate entity dealing wholly independently with its HO and therefore, transfer pricing will apply to such PE.

KEY TAKEAWAYS:

- PE of foreign company operating in India shall comply with all transfer pricing requirements such as maintaining transfer pricing document, filing Accountant Report in Form 3CEB etc. With the above decision of SB in place, the PE in India would not be able to defend levy of penalty for non-complying with transfer pricing requirement of India.

- Companies shall objectively benchmark their transaction of payment of reimbursements made to holding/ group companies. Mere stating that the transaction is supported by payment made by holding/ group companies to third parties will not be held sufficient and the tax officer would investigate whether such reimbursement satisfy the need and benefit test.

Queries?

If you have any queries about this article, please reach out to our experts:

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