Tax Hotline

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INDIAN REVENUE AUTHORITIES GETTING MORE AGGRESSIVE ON ATTRIBUTION OF PROFITS: ROLLS ROYCE HELD TO HAVE A PE IN INDIA

In a recent decision in the case of Rolls Royce Plc.[1] (**"RRPLC"**), the Delhi Bench of the Income Tax Appellate Tribunal (**ITAT**), has held that RRPLC has a business connection as well as a permanent establishment (**"PE"**) in India on account of the marketing activities and support services carried on by its subsidiary in India and has attributed 35% of its profits to the Indian PE constituted in India.

FACTS OF THE CASE

RRPLC, is incorporated in the UK, and is in the business of supplying aero-engines and spare parts to a number of Indian customers mainly to Hindustan Aeronautics Limited, Indian Navy and Indian Air Force. RRPLC has a wholly owned subsidiary, M/s Rolls Royce India Ltd. ("**RRIL**") incorporated in the UK but having an office in India. RRIL was engaged in the business of marketing and liaising with the customers and providing administrative and technical support in India.

Decision

The ITAT held that a business connection clearly existed under the Income Tax Act, 1961 since RRIL facilitated the business and the earning of profits of the taxpayer and there was a real and intimate connection in their dealings. Further, the ITAT noted that:

- RRIL is a fixed place of business at the disposal of RRPLC and its group companies in India through which their business is carried on;
- The activity of this fixed place is not a preparatory or auxiliary but is a core activity of marketing, negotiating and selling of the product;
- RRIL acts almost like a sales office of RRPLC and its group companies;
- RRIL and its employees work wholly and exclusively for RRPLC and the group;
- RRIL and its employees are soliciting and receiving orders wholly and exclusively on behalf of the Rolls Royce group;
- The personnel working from the premises of RRIL are in fact employees of RRPLC.

All the above factors led the ITAT to conclude that RRPLC had a PE in India within the meaning of Articles 5(1), 5(2) and 5(4) of the Indo-UK Tax Treaty.

With respect to attribution of profits, the ITAT rejected the plea that since RRIL was remunerated on an arm's length basis, no further profits could be attributed to the PE in India. Instead, the ITAT held that Article 7(3) of the India UK Treaty provides for direct as well as indirect income attribution to the PE involved in negotiating, concluding or fulfilling contracts, and hence observed the following:

- the total profits of the enterprise have to be apportioned on the basis of various factors affecting accrual of income
- a functional and factual analysis of the activities of the PE has to be undertaken
- the economically significant activities and responsibilities undertaken through the PE have to be identified
- due consideration is to be given to the activities and responsibilities undertaken through the PE in the enterprise's overall operations
- the attributable income has to be determined by due application of the arm's length principle by reference to the functions performed, assets used and risk assumed by the enterprise through the PE and through the rest of the enterprise.

Based on the above, the ITAT held that since the taxpayer undertook all manufacturing and research and development activity outside India and the PE was only engaged in marketing activities, the attribution of profits was reduced from 75% (as held by the Assessing Officer) to 35% of the global profits of the taxpayer with respect to sales made in India.

OBSERVATIONS

The above decision comes in stark contrast to the recent decision of the Supreme Court in the case of Morgan Stanley[2] wherein the apex Court had held that in the event that the Indian entity was remunerated on arm's length basis, no further profits could be attributed to the PE constituted in India. Further, the Supreme Court in the Morgan Stanley ruling had also held that even the office of an Indian subsidiary could not be held to be a PE of the foreign

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entity in India. While Supreme Court judgments are considered to be law of the land, this decision has been completely ignored by the ITAT while delivering its judgment.

It may be noted that this ruling follows the Mumbai ITAT decision in the case of SET Satellite (Singapore) Pte Ltd.[3] where the ITAT had upheld the dual entity approach while analyzing the attribution of profits in India on account of an agency PE being formed in India. It may also be interesting to note that following the Vodafone tax controversy, the revenue authorities have reopened about 400 cases of private equity transactions including transactions where shares of an offshore entity holding shares of the Indian entity have been transferred outside India. This continuing aggressiveness of tax authorities in India could result in new challenges for multinationals investing into India, or doing business in India.:

- Parul Jain & Shefali Goradia

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1 - ITA Nos. 1496 to 1501/DEL of 2007, 26 October 2007

2 - Civil Appeal No. 2914 of 2007 (Arising out of S.L.P. (C) No. 12907 of 2006) and Civil Appeal No. 2915 of 2007 (Arising out of S.L.P. (C) No. 16163 of 2006) decided on: 09.07.2007.

3 - ITA No. 535/Mum/04, Assessment year 1999-2000

Source: *Rolls Royce PLC vs DDIT*

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business

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