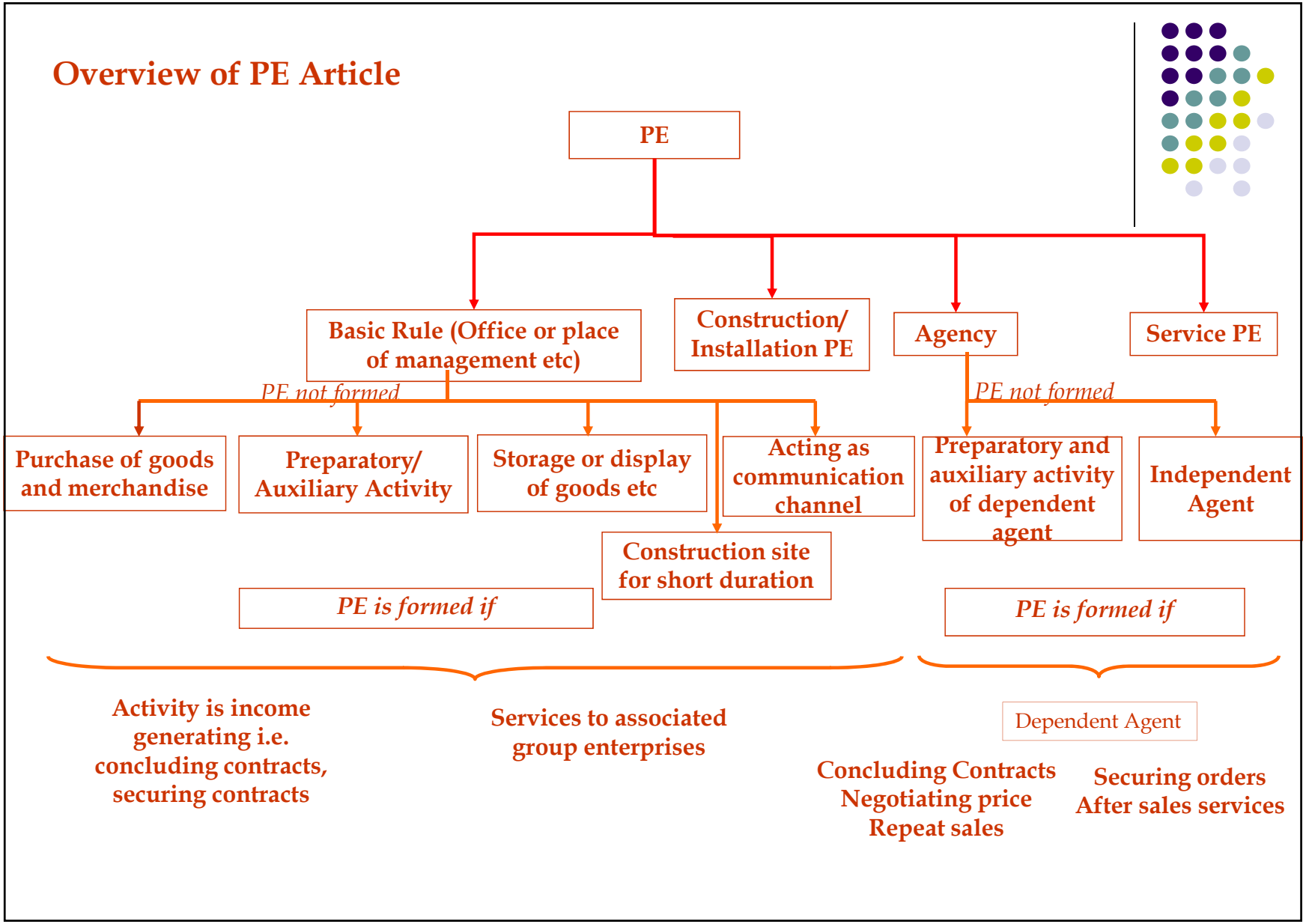
Overview of PE Article



DIT (International Taxation) v Morgan Stanley and Co Inc (2007) 292 ITR 416 (SC)

Morgan Stanley, US (MSCo)

Engaged in the business of providing financial advisory services, corporate lending and securities underwriting

Deputation of Employees

Stewardship Activities of employees

Service Agreement [Cost plus mark up (29%) received by MSAS

Group Company

Deputation on request based on need for such knowledge and skills

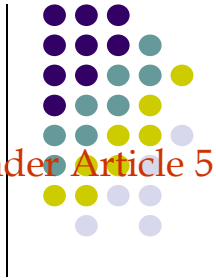
Lien on overseas employment

For ensuring quality and confidentially

Morgan Stanley Advantage Services India Pvt Limited (MSAS)

Provides support to the group's front office functions such as statistical and financial analysis, market gathering, account reconciliation, etc

Morgan Stanley & Co - Issues



- Whether the services to be rendered by MSAS constitute a PE of the applicant under Article 5 of the India-US tax treaty?
- Whether MSAS would be regarded as constituting a fixed PE under article 5 (1) or an agency PE of the Applicant under Article 5 (4) of the Treaty?
- Whether the Applicant would be regarded as having a PE in India under Article 5(2)(l) of the Treaty if it were to send some of its employees to India for undertaking certain Stewardship Activities or on deputation?
- Issues relating to transfer pricing.
- As long as MSAS is remunerated for its services at arm's length, whether any further income can be attributed in the hands of the PE of the Applicant?

Ruling given by the AAR

- The AAR gave its ruling on 13th February, 2006.
- It held that MS will neither have a 'basic rule' PE under Article 5(1) nor it will have an Agency PE under Article 5(4) of the DTAA between India and USA nevertheless holding that there was virtual projection of MS.
- The AAR, however, ruled that the provision of services by the employees of MS would constitute a 'Service PE' under Article 5(2)(l) of the DTAA if the employees render service for more than 90 days.
- The AAR also ruled that if an Arm's length remuneration is paid to an Agency PE, then no further profits can be attributed to the Agency PE.
- AAR declined to give any ruling on transfer pricing issues.
- As long as MSAS, being the PE of the applicant in India, is remunerated for its services at arm's length by the applicant/Morgan Group and as long as all its actual income is brought to tax, no further income can be attributed in the hands of the PE of the applicant.

After the AAR ruling…

- **Since substantial questions of law were involved and the ruling of the AAR would have a bearing on similar other cases with significant revenue implications, the 'Revenue' decided to file a Special Leave Petition (Civil) under Article 136 of the Constitution of India.**

- **Subsequently, the assessee also filed a SLP on issues decided against it by the AAR.**

Revenue's Appeal (SLP No. 12907 of 2006)

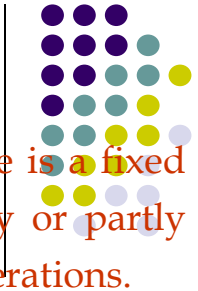
1. Whether Permanent Establishment under Article 5(1) of the Treaty exists and whether the activities of MSAS are preparatory or auxiliary in nature?

   - There are two basic requirements for having a PE, i.e., the enterprise having a place at its disposal and the carrying out of business activities from that place. Since MS has unrestricted access to the premises of MSAS as per clause 9 of the service agreement, the first requirement is satisfied.

   - MSAS is doing the core business functions of MS. MSAS is working under the total control and supervision of the MS. Even the AAR observed that MSAS is nothing but a virtual projection of MS in India. Therefore MSAS gets hypothesized as PE. The hypothesized PE is not exactly the same as the subsidiary.

     An analogy of a "Toll Manufacturer" and "Independent Contractor" is most appropriate to understand this distinction.

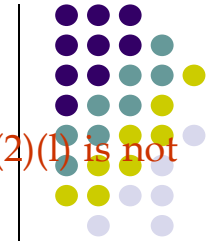
Ruling by the Apex Court



- Under Article 5 (1) of the DTAA between India and US, there exists a PE if there is a fixed place through which the business of an enterprise, which is an MNE, is wholly or partly carried on. Article 5(1) is not applicable to MSAS as it performs only back office operations.

- There is no agency PE as the PE in India has no authority to enter into or conclude the contracts. The contracts would be entered in the US. They would be concluded in US.

Ruling by the Apex Court(Contd..)



- The ruling of the AAR that the stewardship activity would fall under Article 5(2)(l) is not accepted by the SC.
- On the other hand, persons on deputation have lien on employment with MS and MS retains control over the deputationists' terms and employment. The employees continue to be on the payroll of the MNE. In such a case, a service PE can emerge.
- As the above conditions are satisfied in this case, there exists a Service PE in India (MSAS).

Ruling by the Apex Court(Contd..)

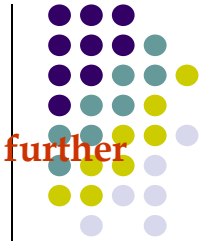
- Agreed with the AAR in principle that if an associated enterprise, which also constitutes a PE, has been remunerated at arm's length basis taking into account all the risk-taking functions of the enterprise, then no further income could be attributed to the PE (MSAS).

- The Transactional Net Margin Method (TNNM) is the most appropriate method for determination of arms' length price in the case of a 'service PE'.

Morgan Stanley - Ruling by AAR and SC – A snapshot

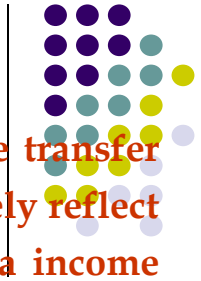
Grounds	AAR	SC
Fixed Place PE	No	Upheld
Agency PE	No	Upheld
Service PE (Stewardship)	Yes	Disallowed
Service PE (Deputation)	Yes	Upheld
Appropriateness of TNMM	No adjudication	Yes
Attribution of further profits	No	Upheld

Interpretation of Apex Court Ruling



- **One possible interpretation is that if a transfer pricing analysis is done, no further profits can be charged in the hands of MS and**
- **if any adjustment has been made by the transfer pricing officer, then further profits can be charged only in the hands of MSAS i.e the Indian company.**
- **Nothing can be taxed in the hands of the foreign company, the MS, and it is not required to file a return of income even if transfer pricing officer determines a higher arms' length price.**
- **This is suggestive of a single point taxation.**

Interpretation of Apex Court Ruling



- **The other possible view and which appears to be more correct, is that if the transfer pricing officer determines that the transfer pricing analysis does not adequately reflect the functions performed and risks assumed by the enterprise, then the extra income attributable to India should be taxed in the hands of the foreign company, that is, MS.**

- **MS has to file its return of income in India.**

- **In the present case, since the transfer pricing analysis has not taken into consideration the functions performed by the 'deputationists' and the risks assumed by the enterprise MS on account of those functions, MS may be required to file its return of income in India.**

Summary

- **The functions of MSAS in India are substantive and core functions of the Morgan Stanley Group and are not just 'back office functions'. The MSAS is, therefore, a PE of MS under Article 5(1) of the DTAA.**

- **The functions performed by MSAS in India clearly indicate that in substance they have an authority to conclude contracts and thus MSAS is a PE of MS under Article 5(4) of the DTAA.**

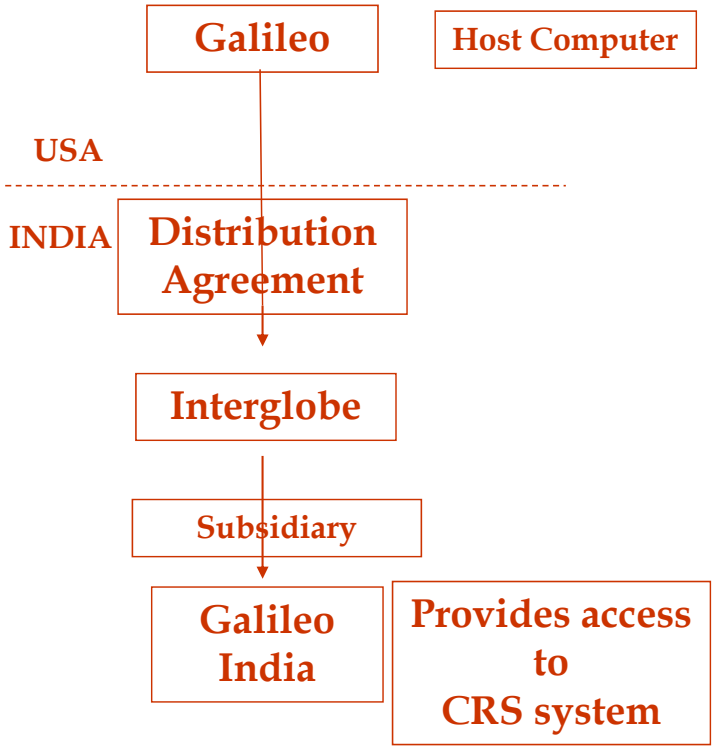
Summary(Contd..)

- **The functions of MSAS in India are substantive and core functions of the Morgan Stanley Group and are not preparatory or auxiliary in nature and thus the exclusion clause of Article 5(3)(e) of the DTAA will not be applicable.**

- **The 'deputationists' working on behalf of MSCo. constitute a service PE of MS in India.**

- **Payment of an arm's length remuneration to a dependant agent PE or to a service PE does not extinguish the tax liability of the principal in India .**

GALILEO INTERNATIONAL (DELHI TRIBUNAL)



Facts

- Galileo International Inc (Galileo) operates in India through its subsidiary, Interglobe
- Galileo provides electronic global distribution services to airlines, hotels tour and cab operators through Travel Agents (TA) using Computer Reservation System (CRS)
- CRS is connected with host computer in US through telecommunications facilities situated within and outside India
- Interglobe to act as sole and exclusive distributor of Galileo's CRS services
- Interglobe to provide CRS services to TAs and enter into contracts with them

GALILEO INTERNATIONAL (DELHI TRIBUNAL)

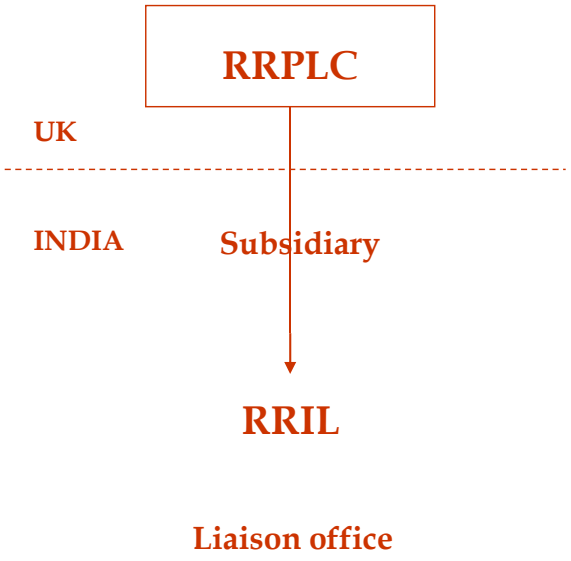
Tribunal Ruling

Existence of Business Connection / PE	Yes
Income attributable to PE	15 percent
Whether any profit was attributable to PE	Nil (since expenses of PE exceeded 15 percent of Income)

Principles

- **Income attributable to PE based on functions, assets and risks**
- **Principle enunciated in Morgan Stanley in the context of Service PE applied to DAPE**

ROLLS ROYCE (DELHI TRIBUNAL)



Facts

- Rolls Royce Private Ltd Company (RRPLC), is engaged in manufacture of aircraft engines
- RRPLC operates a liaison office (RRIL) in India
- RRPLC did not file a return in India as it did not earn any income in India
- Based on findings of survey operations, Revenue held that Liaison Office constitutes a PE (Fixed place PE and DAPE)
- Revenue attributed 75 percent of profits arising from sales in India to PE

ROLLS ROYCE (DELHI TRIBUNAL)

Tribunal Ruling

Existence of Business Connection / PE	Yes
Extent of profit attribution to PE	Manufacturing – 50 percent R &D – 15 percent Remainder 35 percent profit for marketing attributed to PE

Comments

- Since separate accounts for PE were not available, Rule 10 of the Income-tax Rules (Rules) applied
- No reference to transfer pricing principles for attribution of profits (Morgan Stanley)
- Rule of thumb applied for attribution

SONY TRIBUNAL DECISION

- A dependent agent (DA)PE is distinct from the DA and can be taxed separately
- In addition to ALP to a DA, additional tax can be imposed on the foreign company's revenues from India under source rules
- In case of DA, commission payable is to computed with reference to domestic laws
- While attributing profits to DAPE, commission paid to the DA is deductible cost
- Morgan Stanley principles distiguished
- OECD Report on 'Attribution of Profits to PE' applied

Question

The question is not how to determine the profits but is what are the profits of an enterprise for the purpose of Article 7(1)

CORRESPONDING TAX PROVISIONS UNDER INDIAN TAX LAW

RELEVANT BUSINESS ACTIVITY APPROACH

- Rule 10 attributing proportionate worldwide profits

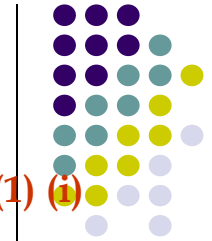
FUNCTIONALLY SEPARATE ENTITY APPROACH

- Transfer pricing Regulations providing Arms Length Price determination to determine the profit attributable.

Separate Entity Approach - India

- **Whether India has accepted the approach**
  - **Not explicit in the rules and regulations**
- **Indirectly accepted in International Conventions in 1969 and 1976.**
- **CBDT circular no 740 specifies that the branch of a foreign company/concern in India is a separate entity for the purpose of taxation (specifically provided for Banks)**
  - **But this circular is on the applicability of withholding tax on remittance of Interest by Branch to its Parent**
  - **Not directly on taxation of branch/PE**

Separate Entity Approach
Business Models

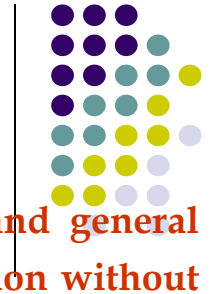


- **Tax Implications for non-resident due to Business Connection under Section 9(1) (i)**
  - **Agency PE**
  - **PE compensated at ALP**
  - **Does the foreign company is liable to be taxed in India**
  - **DTA vs Income-tax Act**
- **International precedents support the view that**
  - **PE is required to be compensated at ALP**
  - **No exposure for non-residents**
- **UK/Australian tax laws provides for compensation at ALP**

Attribution of Profits – R&D center

- **Attributing assets : the "place of use" test. Recognition and characterisation of dealings. Special considerations for intangible assets.**
- **Permanent Establishment engaged in Research and Development activities leading to the development of intangible property rights.**
- **How should profit be recognised and characterised?**
  - **Contract Research?**
  - **Cost Contribution Arrangement?**
  - **Economic ownership of the intangible- new OECD draft commentary provides which part of the enterprise undertakes "active decision making"**

PAYMENT BY BRANCH TO HO
EXTRACT FROM CIRCULAR 649 DATED 31ST MARCH 1993



- **PARA 2: Technical fees that are not covered under head office executive and general administrative expenditure specified in section 44C are to be allowed deduction without any limit while computing the business profit of the branch office - permanent establishment - in India. However, the technical fees received by the head office will be taxable in accordance with the DTAA read with the Act. XXX**

- **PARA 3: The above position will hold good when the technical services are provided by a third party and the payment is made by the permanent establishment in India to the head office directly by way of reimbursement or through the head office to the third party in respect of such services.**

- **CONCEPT OF SEPARATE ENTITY**

Attribution of Profits

- **Payment for FTS to HO- Is it allowable**
  - **Circular no 649 dated 31st March 1993**
  - **Indo-USA DTA Article 7(3) restricts such deduction**
  - **India-Singapore or Germany DTA does not have clause similar to that**

- **Payment of Interest to HO**
  - **Specific restriction for Banking Companies under the DTA**
  - **Is it part of HO expenditure u/s 44C**
  - **CBDT circular no 740 dated 17/04/1996 allows deduction of tax**