

DESAI SAKSENA & ASSOCIATES

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Friday Tax Alert

From:

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Transaction between a foreign enterprise and its Indian PE is an international transaction subject to the application of transfer pricing provisions - Special Bench ITAT, Ahmedabad

FACTS OF THE CASE:

1. TBEA Shenyang Transformer Group Company Limited (TBEA China/HO), **incorporated in and tax resident of China**, was awarded a contract by Power Grid Corporation of India Limited (PGCIL) to build sub-stations in India. The aforesaid contract comprised offshore supply, onshore supply and onshore services covered under separate agreements.
2. As per the agreement pertaining to onshore services, TBEA China was to provide services encompassing **inland transportation and civil work** within India. Pursuant to the same, TBEA China set up a **Project Office (PO/taxpayer)** in India. Thus, the taxpayer constituted a Fixed Place Permanent Establishment (PE) of TBEA China in India as per Article 5(1) of the India-China Double Tax Avoidance Agreement (DTAA).
3. **The HO was responsible for executing the offshore portion of the contract, whereas the taxpayer was responsible for the onshore portion.** The taxpayer subcontracted a portion of the onshore work to independent third-party contractors in India. The HO received payments in relation to all the contracts and it passed on the portion relating to the onshore work to the taxpayer subsequently, as the taxpayer did not have a bank account in India at the relevant time.
4. **India's tax authorities adopted the stance that the act of the taxpayer carrying out the execution of the contract by providing services and thereby incurring expenses, which were subsequently passed on by the HO, was an international transaction between the HO and taxpayer.**
5. Accordingly, the Transfer Pricing Officer (TPO) subjected the transaction under consideration to the arm's length standard and observed that the rate per unit of civil work received by the taxpayer from the HO (which in turn was received by the HO from PGCIL) was lower than the rate paid by the taxpayer to third-party sub-contractors. Hence, the **TPO opined that the taxpayer was not adequately compensated for services rendered by it, resulting in losses.**
6. The pertinent question before the Special Bench (SB) was whether the transactions between a foreign enterprise and its Indian PE are international transactions within the purview of Section 92B of Income Tax Act (the Act) and consequently, would be subject to ALP adjustment under transfer pricing regulations.

OBSERVATION OF THE SPECIAL BENCH OF ITAT, AHMEDABAD:

- ✓ Under the Act as well as the Rules, the **applicability of transfer pricing is dependent upon whether an entity qualifies as an "enterprise" or not** as defined under Section 92F of the Act.
- ✓ "Enterprise" as per Section 92F of the Act is defined as " "enterprise" means a person (including a permanent establishment of such person) who is or has been or is proposed to be

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engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.”

- ✓ Given that the **definition explicitly includes PE**, the ITAT SB adjudicated that PE qualifies as an enterprise.
- ✓ The ITAT SB also observed that as per **Article 7(2) of the India-China DTAA** (which governs attribution of business profits), it is clear that a PE shall be attributed profits which it would be reasonably expected to earn in its capacity as a distinct and separate enterprise.
- ✓ It was further observed that Article 9 of the DTAA, dealing with AEs, is limited to only confirming that broadly similar rules exist in domestic law and Article 9(1) by itself does not fulfil any necessary function as it only formulates rules that may already exist in domestic laws. Hence, **even if the taxpayer’s contention that provisions of DTAA override the Act was to be accepted, as per Article 7 of the DTAA profits need to be attributed to the PE.**
- ✓ The SB specifically held that the taxpayer’s **contention that there are only fund movements between the HO and PO is not acceptable, as in an unrelated scenario an enterprise would not permit its receipts and payments to be routed through a third party.**
- ✓ The revenue of the taxpayer is influenced by the agreement signed by the HO with PGCIL and hence, the taxable income in the hands of the taxpayer is dependent upon the HO.
- ✓ The **definition of transaction under Section 92F(v) of the Act includes arrangement, understanding, or action in concert.** Thus, the **arrangement/understanding between two enterprises giving rise to income or loss may be subject to transfer pricing.**
- ✓ Given this, the **transaction between the HO and the taxpayer would qualify as a transaction between two AEs** which should be subject to ALP determination under transfer pricing regulations.

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

ITAT Mumbai deletes TP adjustment qua management fees payment; holds that whether the business decision was commercially sound or not is not relevant, the only question is whether the transaction, which was entered into, was bona-fide or not or whether it was a sham transaction only for the purpose of diverting profits.

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FACTS OF THE CASE:

1. TBEA Otis Elevator Company (India) Limited (taxpayer) is engaged in the **business of manufacture, erection, installation, and maintenance of elevators, escalators, and other lifting and handling equipment**. During the year under consideration, the taxpayer had entered into several international transactions with its Associated Enterprises (AEs).
2. In the course of assessment proceedings, the matter was referred by the Assessing Officer (AO) to the TPO. The TPO accepted all the international transactions to be at arm's length, except for the **transaction pertaining to payment of management fees to Otis Asia-Pacific (APAC) headquarters, which had been allocated to the taxpayer on a cost plus 5% markup**. In response to the show cause notice (SCN) issued by the TPO, the taxpayer submitted various documentary evidence such as the **rationale for availing services from the AE which houses qualified and experienced personnel, benchmarking analysis and other relevant details**.
3. However, the TPO opined that in the case of the taxpayer, **commercial expediency** of the international transaction relating to management services was not being examined and instead, an exercise was being undertaken to check whether the taxpayer passed the **need-benefit-evidence test**. Accordingly, the TPO concluded that the taxpayer had failed to furnish **evidence in respect of the cost incurred by the AE** for providing the said management services and the transaction was effectively leading to **profit shifting and base erosion**, which was not permissible as per Indian transfer pricing regulations. The TPO made an upward adjustment considering the arm's length price (ALP) of management fees to be nil.
4. The taxpayer filed objections before the Dispute Resolution Panel (DRP), however, the TPO's order was upheld. Aggrieved, the taxpayer filed an appeal before the Income Tax Appellate Tribunal (Hon'ble ITAT).

OBSERVATIONS OF THE HON'BLE ITAT, MUMBAI:

- ✓ It is for the **taxpayer to determine whose services it desires to avail**. Business decisions are at times good and profitable and at times bad and unprofitable. Business decisions, in fact, can result in losses, therefore, whether the decision was commercially sound or not is not relevant.
- ✓ The **only question is whether the transaction entered into was bonafide** or was a sham transaction which is entered only for the purpose of diverting profits.
- ✓ The Hon'ble ITAT drew reference and support from the decision of **Hon'ble Punjab & Haryana High Court in the case of Knorr Bremse India Pvt Ltd {2015} 63 taxmann.com 186 (Punjab & Haryana)**.
- ✓ The Hon'ble ITAT further stated the **Hon'ble High Court of Delhi, in the case of Cushman Wakefield (India) (P.) Ltd. (2014) 46 taxmann.com 317 (Delhi)**, held that the **AO / TPO cannot question the quantum of the fee, but can check if services were actually rendered and if they are genuine and real**.
- ✓ Accordingly, the Hon'ble ITAT **directed the AO/TPO to delete the TP adjustment**.

[Otis Elevator Company (India) Limited [TS- 507-ITAT-2024(Mum)-TP]