Amicus Tax Alert

Delhi High Court Explains Profit Attribution to PE

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Hyatt International: Profit Attribution to PE

In a significant ruling, Delhi High Court in *Hyatt International*[1] has clarified the principles of profit attribution to a Permanent Establishment (PE) under Article 7 of Double Taxation Avoidance Agreement (DTAA). The ruling has crucial implications for multinational enterprises (MNEs) operating in India, particularly on how profits are attributed to PEs in situations where parent company incurs global losses.

Background Facts

Hyatt International Southwest Asia Ltd., a UAE-based company with PE in India, filed its tax return in India, declaring nil income, arguing that no profits could be attributed to its PE in India since the global entity had incurred losses.

The key issue for consideration was whether profits should be attributed to PE in India despite the parent entity suffering losses at the global level.

The assessee primarily relied on Nokia case (2023)[2], wherein Delhi High Court held that no profits could be attributed to PE if the global entity had incurred losses.

However, the Division Bench of the High Court expressed reservations on the correctness of this view, leading to a referral to the Full Bench of Delhi High Court.

Key Aspects of the Judgment

- **PE as an Independent Taxable Entity:** The Court held that Article 7(1) establishes a clear dichotomy between global profits earned by an enterprise and those attributable to a PE in a Contracting State. This distinction is reinforced by Article 7(2), which requires profits attributed to the PE to be treated as if it were a separate and independent entity conducting similar activities. The phrase "dealing wholly independently" in Article 7(2)[3] further amplifies that the PE operates separately from the parent enterprise, making it incorrect to combine the income of the entire group with that of the PE in the Contracting State.

  In other words, PE's tax liability should be determined by its own activities within the source state, not by the overall profitability of the parent company.

- **Global Losses do no Impact PE Taxation:** The Court unequivocally rejected the argument that global losses at enterprise level could prevent profit attribution to PE. It asserted that even if global entity incurs a loss, PE's profits from its local activities are taxable in India based on the 'separate entity' approach.

  The Court ruled that accepting taxpayer's submission would allow the Revenue to tax the PE even when the global entity is profitable but the PE itself incurs a loss. Conversely, it would imply that a Contracting State could only tax the PE if the global entity earns a profit, which contradicts the purpose of Article 7. The profits attributable to the PE in the source state are the only profits subject to tax, as clarified in Article 7(2).

  The Court also relied on Supreme Court decisions of Morgan Stanley[4] and Ishikawajama[5] to hold that profits attributable to a PE cannot be ignored on the basis of the performance of group as a whole.

- **OECD Commentary on Article 7:** In reaching its conclusion, Delhi High Court heavily relied on OECD Commentary on Article 7(2). According to OECD, Paragraph 2 establishes that profits attributable to a PE must be determined as if the PE were a separate and independent enterprise. ***This requires reliance on arm's length principle premised upon functions performed, assets used, and risks assumed by the PE and other parts of the enterprise, similar to the treatment of associated enterprises under Article 9.***[6]

> The Court further highlighted that Article 7(2) does not seek to allocate the overall profits of the enterprise to the PE. Instead, it requires determining profits that can be attributed to the PE based solely on its activities, regardless of the enterprise's global profitability. This means that a PE may be attributed profits even when the enterprise as a whole makes no profit, or vice versa.[7]
>
> Additionally, the Court stressed that the correct application of Article 7(2) was crucial to avoid double taxation. If the State where the PE is located taxes profits not attributable to the PE, it may result in double taxation contrary to the objectives of tax treaty.[8]

Conclusion

In an era where Transfer Pricing is widely acknowledged as a scientific tool for profit attribution, one wonders why any ad-hoc apportionment principle at all should be resorted to for purpose of profit attribution. To seek an answer to this question one has to deep-dive into taxpayer's arguments in support of the global formulary approach. In *Hyatt* case, taxpayer primarily relied on the following arguments:

Reliance on *Motorola* case***[9]*** - In attributing profits to the PE, the Special bench of Tribunal in the *Motorola* case***[10]*** ascertained the global sales and global net profit of the Group and allocated 20% of that global net profit to Indian PE.

Reliance on *Nokia* case[11] - Relying on the *Motorola* case, the Tribunal ruled that no profit or income could be attributed to PE in India when foreign entity incurs a net loss at the entity level.

In Hyatt Ruling, the Court has held that reliance on *Motorola* case has been misinterpreted and read wholly out of context by later cases as establishing a standard practice of attributing PE profits based on the global profits or losses of the enterprise. In *Motorola* case no independent accounts and profitability statement of the PE were presented leaving the Tax Authorities and Courts with no option other than to determine profit attribution on apportionment principle. Accordingly, allocation of global net profit in *Motorola* case was as a case-specific remedy due to unsubstantiated financial records of the PE.

The Court also took cognizance of the Authorized OECD Approach (AOA)[12] to profit attribution for PEs which provides a two-step approach for profit attribution —a functional and factual analysis to identify significant people functions, and determining arm's length remuneration for those functions. The Court in *Hyatt* Case relies on AOA to accurately attribute profits based on the specific contributions of local entities.

Incidentally, the definition of AE under the Indian TP Regulations categorically includes PE.[13] This inclusion reinforces the requirement that profits must be attributed to the PE, based on the arm's length principle. This aspect however was not examined or argued before the Court in *Hyatt* case as the case was being argued with reference to treaty provisions.

In conclusion, if there was any doubt whatsoever, Hyatt Ruling affirms reliance on Transfer Pricing based on the 'separate entity' approach as the correct approach for profit attribution under Indian treaties and regulations, with apportionment of profits being an exception rather than the norm.

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[1]*Hyatt International Southwest Asia Ltd. v. Additional Director of Income-tax* [2024] 166 taxmann.com 466.

[2]*CIT (International Taxation) v. Nokia Solutions and Networks OY* [2023] 147 taxmann.com 165/455 ITR 157 (Delhi).

[3] Art. 7(2) of India-UAE DTAA: "*Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

[4] Refer *DIT (International Taxation) v. Morgan Stanley & Co.* [2007] 162 Taxman 165/292 ITR 416 (SC) (para 35).

[5] Refer *Ishikawajma-Harima Heavy Industries Ltd. v. DIT* [2007] 158 Taxman 259/288 ITR 408 (SC) (para 49).

[6] Refer P.15, 16 of *OECD MTC Commentary on A.7(2)*.

[7] Refer P.17 of *OECD MTC Commentary on A.7(2)*.

[8] Refer P.18 of *OECD MTC Commentary on A.7(2).*

[9]*Motorola Inc. v. DY. CIT* [2005] 147 Taxman 39/95 ITD 269 (Delhi) (SB).

[10] Ibid

[11]*Nokia Solutions and Networks OY v. ACIT* [2022] 97 ITR(T) 79 (Delhi Tribunal).

[12] Refer P. 20-22 of *OECD MTC Commentary on A.7(2*) for Authorized OECD approach (AOA), introduced by *Report on Attributions of Profits to Permanent Establishments, OECD, 2010.*

[13] Refer Section 92F(iii) of the *Income-tax Act, 1961*, which defines "*enterprise*" to include a Permanent Establishment for the purpose of determining an Associated Enterprise under Section 92A of the *Act*.

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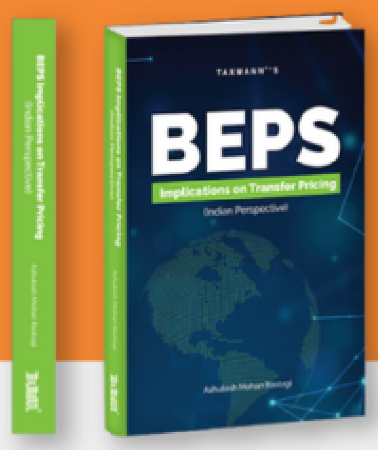

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