Supreme Court of India

M/S Dit (International ... vs M/S Morgan Stanley & Co. Inc on 9 July, 2007

Author: Kapadia

Bench: Dr. Arijit Pasayat, S.H. Kapadia

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           CASE NO.:
Appeal (civil)  2914 of 2007

PETITIONER:
M/s DIT (International Taxation), Mumbai

RESPONDENT:
M/s Morgan Stanley & Co. INC

DATE OF JUDGMENT: 09/07/2007

BENCH:
Dr. Arijit Pasayat & S.H. Kapadia

JUDGMENT:
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J U D G M E N T CIVIL APPEAL No. 2914 OF 2007 (arising out of S.L.P. (C) No. 12907 of 2006) with CIVIL APPEAL No. 2915 OF 2007 (arising out of S.L.P. (C) No. 16163 of 2006) M/s Morgan Stanley & Co. INC. □ Appellant versus Director of Income Tax, Mumbai □Respondent KAPADIA, J.

Leave granted.

2. In these civil appeals we are concerned with the articles in Double Tax Avoidance Agreement ("DTAA") between India and United States which have implication on transfer pricing legislation. The said Treaty either advocates application of arm's length principle or provides a mechanism for avoiding double taxation on income.

3. Morgan Stanley Group (MS Group) is one of the world's largest diversifying financial services companies. It is a world wide leader in investment banking and it is ranked amongst the top institutions

in merger and acquisitions, underwriting of equity and equity and related transactions. It has a major presence in major securities market, with traders in numerous countries around the world offering a unique distribution of products. It has three main lines of business, namely securities investment management and investment banking and credit services. Morgan Stanley and Company (for short, 'MSCo') is an investment bank engaged in the business of providing financial advisory services, corporate lending and securities underwriting. One of the group companies of Morgan Stanley, Morgan Stanley Advantages Services Pvt. Ltd. (for short, 'MSAS') entered into an agreement for providing certain support services to MSCo. MSCo outsourced some of its activities to MSAS. The said MSAS was set up to support the main office functions in equity and fixed income research, account reconciliation and providing IT enabled services such as back office operation, data processing and support centre to MSCo.

4. On 19.5.2005 MSCo (Applicant) filed its advance ruling application in Form 34-C inviting its advance ruling on the points enumerated hereinbelow. The basic question relating to the transaction between the applicant and MSAS on which advance ruling was sought was two fold namely, whether the applicant was having a PE in India under Article 5(1) of the DTAA on account of the services rendered by MSAS under the Services Agreement dated April 14, 2005 entered into by MSAS with the applicant and if so, the amount of income attributable to such PE.

5. By the impugned ruling delivered on 13.2.2006 by the Authority for Advance Ruling (for short, 'AAR') it was held, inter alia, that the applicant cannot be regarded as having a fixed place of business PE under Article 5(1) of the DTAA; that MSAS cannot be regarded as an agency PE under Article 5(4) of the DTAA; that the applicant would be regarded as having a PE in India under Article 5(2)(l) if it were to send some of its employees to India as stewards or as deputationists in the employment of MSAS. Against this ruling of the AAR the applicant and the Department have come to this Court in appeal by way of special leave petition. According to the Department the applicant should be regarded as having a fixed place in India under Article 5(1) as the applicant proposes to carry on its business through MSAS in India. According to the Department MSAS was the PE of the MSCo in India. They had a fixed place of business in Mumbai. According to the Department the nature of the activities proposed to be performed by MSAS in Mumbai indicated that the said company represented the business presence of the MSCo in India. The Department also submitted that MSAS was legally and financially dependent upon the applicant and consequently MSAS constituted an agency PE of the applicant under Article 5(4) of the DTAA. Both these contentions were rejected by the AAR vide the above impugned ruling. However, it has been ruled by the AAR that MSAS should be regarded as constituting a service PE under Article 5(2)(l) as it proposed to send its employees to India for undertaking stewardship activities and for undertaking to send some of its employees to India as deputationists in the employment of MSAS. It is against this ruling of the AAR that the applicant has come to this Court by way of appeal. On the second question the AAR ruled that the Transactional Net Margin Method (TNMM) was the most appropriate method for the determination of the Arm's Length Price (ALP) in respect of the service agreement dated 14.4.2005 between the applicant and the MSAS and as the said method meets the test of arm's length as prescribed under Section 92-C of the 1961 Act, no further income was attributable in the hands of MSAS in India. The said ruling of the AAR on the question of income attributable to the PE is the subject matter of challenge by the Department.
EXISTENCE OF P.E. IN INDIA

6. With globalization, many economic activities spread over to several tax jurisdiction. This is where the concept of P.E. becomes important under Article 5(1). There exists a P.E. if there is a fixed place through which the business of an enterprise, which is multinational enterprise (MNE), is wholly or partly carried on. In the present case MSCo is a multi- national entity. As stated above it has outsourced some of its activities to MSAS in India. A general definition of the P.E. in the first part of Article 5(1) postulates the existence of a fixed place of business whereas the second part of Article 5(1) postulates that the business of the MNE is carried out in India through such fixed place. One of the questions which we are called upon to decide is whether the activities to be undertaken by MSAS consists of back office operations of the MSCo and if so whether such operations would fall within the ambit of the expression "the place through which the business of an enterprise is wholly or partly carried out" in Article 5(1).

7. We quote herein below Articles 5 and 7 of the DTAA :

"Article 5 PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

(g) a warehouse, in relation to a person providing storage facilities for others;

(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

(i) a store or premises used as a sales outlet;

(j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve month period;

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve month period;

(l) the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services), within Contracting State by an enterprise through employees or other personnel, but only if;

(i) activities of that nature continue within that State for a period or periods aggregating more than 90 within any twelve-month period; or

(ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprise).

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following :

(a) the use of facilities solely for the purpose of storage, display or occasional delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery;

(c) the maintenance of a stock of goods, or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed base of business solely for the purpose of advertising, for the supply of information, for scientific research, or for other activities which have preparatory or auxiliary

character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 5 applies is acting in a Contracting State on behalf of an enterprise of the other Contracting State other Contracting State, that enterprise shall be deemed to have permanent establishment in the first- mentioned State if:

(a) he has an habitually exercises in that first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

(b) he has no such authority but habitually maintains in the first-

mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

(c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

xxxxx Article 7 BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, 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 independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly at arm's length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as the enterprise, in any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent

establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses, incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or except in the case of banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment as provided in paragraph 1

(a) of this Article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business including income from the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services) and including income from the rental of tangible personal property other than property described in paragraph 3 (b) of Article 12 (Royalties and Fees for Included Services)."

8. In our view, the second requirement of Article 5(1) of DTAA is not satisfied as regards back office functions. We have examined the terms of the Agreement along with the advance ruling application made by MSCo inviting the AAR to give its ruling. It is clear from reading of the above Agreement /application that MSAS in India would be engaged in supporting the front office functions of MSCo in fixed income and equity research and in providing IT enabled services such as data processing support centre and technical services as also reconciliation of accounts. In order to decide whether a P.E. stood constituted one has to undertake what is called as a functional and factual analysis of each of the activities to be undertaken by an establishment. It is from that point of view, we are in agreement with the ruling of the AAR that in the present case Article 5(1) is not applicable as the said MSAS would be performing in India only back office operations. Therefore to the extent of the above back office functions the second part of Article 5(1) is not attracted.

9. Lastly, as rightly held by the AAR there is no agency PE as the PE in India had no authority to enter into or conclude the contracts. The contracts would be entered in the United States. They would be concluded in US. The implementation of those contracts only to the extent of back office functions would be carried out in India, and therefore, MSAS would not constitute an Agency PE as contended on behalf of the Department.

10. In the DTAA, the term P.E. means a fixed place of business through which the business of an MNE is wholly or partly carried out. The definition of the word P.E. in Section 92(F)(iii) is inclusive,

however it is not under Article 5(1) of the Treaty. It is for this reason that Article 5(2) of the DTAA herein refers to places included as P.E. of the MNE. One such place is mentioned in Article 5(2)(l) which deals with furnishing of services.

11. The concept of P.E. was introduced in 1961 Act as part of the statutory provisions of transfer pricing by the Finance Act of 2001. In Section 92-F (iii) the word "enterprise" is defined to mean "a person including a P.E. of such person who is proposed to be engaged in any activity relating to the production□. ". Under the CBDT circular No.14 of 2001 it has been clarified that the term P.E. has not been defined in the Act but its meaning may be understood with reference to the DTAA entered into by India. Thus the intention was to rely on the concept and definition of P.E. in the DTAA. However, vide Finance Act, 2002 the definition of P.E. was inserted in the Income Tax Act, 1961 (for short, 'I.T. Act') vide Section 92-F (iiia) which states that the P.E. shall include a fixed place of business through which the business of the MNE is wholly or partly carried on. This is where the difference lies between the definition of the word P.E. in the inclusive sense under the I.T. Act as against the definition of the word P.E. in the exhaustive sense under the DTAA. This analysis is important because it indicates the intention of the Parliament in adopting an inclusive definition of P.E. so as to cover service P.E., agency P.E., software P.E., Construction PE etc.

12. There is one more aspect which needs to be discussed namely, exclusion of P.E under Article 5(3). Under Article 5(3)

(e) activities which are preparatory or auxiliary in character which are carried out at a fixed place of business will not constitute a P.E. Article 5(3) commences with a non obstante clause. It states that notwithstanding what is stated in Article 5(1) or under Article 5(2) the term P.E. shall not include maintenance of a fixed place of business solely for advertisement, scientific research or for activities which are preparatory or auxiliary in character. In the present case we are of the view that the above mentioned back office functions proposed to be performed by MSAS in India falls under Article 5(3)(e) of the DTAA. Therefore, in our view in the present case MSAS would not constitute a fixed place P.E. under Article 5(1) of the DTAA as regards its back office operations.

13. However, the question which arises for determination in the present case is the nature of activities performed by stewards and deputationists deployed by MSCo to work in India as employees of MSAS. Under Article 5(2)(l) furnishing of services through the fixed place in India can constitute a P.E. The AAR in the impugned ruling has held that the stewards and deputationists are proposed to be sent by the MSCo from U.S. According to the AAR there is a flow of service from the MSCo to the MSAS when the former deputes its own employees to work in India in MSAS. Therefore, according to the AAR the service Agreement between MSCo and MSAS dated 14.4.2005 would fall under Article 5(2)(l) and consequently the transfer pricing regulation would apply for evaluating the charges payable by MSCo to MSAS in India for such service contract. This ruling has been challenged by the applicant.

14. Article 5(2)(l) of the DTAA applies in cases where the MNE furnishes services within India and those services are furnished through its employees. In the present case we are concerned with two activities namely stewardship activities and the work to be performed by deputationists in India as employees of MSAS. A customer like an MSCo who has world wide operations is entitled to insist on quality control and confidentiality from the service provider. For example in the case of software P.E. a server stores the data which may require confidentiality. A service provider may also be required to act according to the quality control specifications imposed by its customer. It may be required to maintain confidentiality. Stewardship activities involve briefing of the MSAS staff to ensure that the output meets the requirements of the MSCo. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of the MSCo. These stewards are not involved in day to day management or in any specific services to be undertaken by MSAS. The stewardship activity is basically to protect the interest of the customer. In the present case as held hereinabove the MSAS is a service P.E. It is in a sense a service provider. A customer is entitled to protect its interest both in terms of confidentiality and in terms of quality control. In such a case it cannot be said that MSCo has been rendering the services to MSAS. In our view MSCo is merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services. We do not agree with

the ruling of the AAR that the stewardship activity would fall under Article 5(2)(l). To this extent we find merit in the civil appeal filed by the appellant (MSCo) and accordingly its appeal to that extent stands partly allowed.

15. As regards the question of deputation, we are of the view that an employee of MSCo when deputed to MSAS does not become an employee of MSAS. A deputationist has a lien on his employment with MSCo. As long as the lien remains with the MSCo the said company retains control over the deputationist's terms and employment. The concept of a service PE finds place in the U.N. Convention. It is constituted if the multinational enterprise renders services through its employees in India provided the services are rendered for a specified period. In this case, it extends to two years on the request of MSAS. It is important to note that where the activities of the multinational enterprise entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE can emerge. Applying the above tests to the facts of this case we find that on request/requisition from MSAS the applicant deputes its staff. The request comes from MSAS depending upon its requirement. Generally, occasions do arise when MSAS needs the expertise of the staff of MSCo. In such circumstances, generally, MSAS makes a request to MSCo. A deputationist under such circumstances is expected to be experienced in banking and finance. On completion of his tenure he is repatriated to his parent job. He retains his lien when he comes to India. He lends his experience to MSAS in India as an employee of MSCo as he retains his lien and in that sense there is a service PE (MSAS) under Article 5(2)(l). We find no infirmity in the ruling of the ARR on this aspect. In the above situation, MSCo is rendering services through its employees to MSAS. Therefore, the Department is right in its contention that under the above situation there exists a Service PE in India (MSAS). Accordingly, the civil appeal filed by the Department stands partly allowed.

Income Attributable to PE

16. Under Article 7, the taxability is of the MNE. What is to be taxed under Article 7 is income of the MNE attributable to the P.E. in India. The income attributable to the said P.E. is the income attributable to foreign company's operations in India, which in term, implies the income attributable to the activities carried on by the MNE through its P.E. in India. Therefore, there is a difference between the taxability of the P.E. in respect of its income earned by it in India which is in accordance with the Income-Tax Act, 1961 and which has nothing to do with the taxability of the MNE, which is also taxable in India under Article 7, in respect of the profits attributable to its P.E.. Under Article 7, the taxability is of the MNE. What is taxable under Article 7 is profits earned by the MNE. Under the said IT Act, the taxable unit is the foreign company, though the quantum of income taxable is income attributable to the P.E. of the said foreign company in India.

17. An important question which arises for determination is whether the AAR is right in its ruling when it says that once the transfer pricing analysis is under taken there is no further need to attribute profits to a PE. Computation of income arising from international transactions has to be done keeping in mind the principle of arm's length price. Charges paid or payable by MSCo to MSAS under the service contract have to be accounted as income at arm's length price. There are different methods for determining appropriate transfer pricing. Under Section 92C(1) of the I.T. Act, arm's length price in relation to international transaction has to be determined by any of the following methods:

(a) Comparable Uncontrolled Price Method (CUPM)

(b) Resale Price Method (RPM)

(c) Cost Plus Method (CPM)

(d) Profit Split Method (PSM)

(e) Transactional Net Margin Method (TNMM)

(f) Such other method as may be prescribed by CBDT

18. The taxpayer is required to compute arm's length price for a transaction(s) using one of the five methods stipulated in the Income Tax Rules. Rule 10C(1) of Income Tax Rules defines the most appropriate method as the method which is best suited to the facts and circumstances of each particular international transaction. As per Rule 10C(2) the most appropriate method has to be selected having regard to number of factors which are enumerated therein. The arm's length price has to be computed by the application of methods mentioned in Section 92C(1) of the I.T. Act.

19. In the present case, the applicant has taken the opinion of Earnest and Young (for short, 'E & Y'), Consultants, as experts who have suggested, keeping in mind the various activities undertaken by MSCo and MSAS in India, TNMM as the most appropriate method for determination of arm's length price in respect of transaction between MSCo and MSAS. The applicant sought a ruling from the ARR on the appropriateness of the said method. On the adequacy of the mark-up the applicant relied upon a transfer pricing review undertaken by E & Y, an independent consultant, for benchmarking the transaction between the applicant and MSAS and as per that review, the average mark-up (on costs) of comparable companies providing similar services, was taken into account at 29%. This was agreed upon by MSAS and the applicant (MSCo). It has been accepted by the Transfer Pricing Officer and by the Assessing Officer. It has not been disputed by T.N. Chopra & Associates, consultants appointed by the Department.

20. Accordingly, the applicant (MSCo) preferred an applicant to the AAR on the following issues:

(i) Appropriateness of TNMM for determination of arm's length in respect of transaction between MSCo and MSAS.

(ii) Adequacy of the mark-up charged by MSAS for provision of service to MSCo based on arm's length principle.

(iii) Attribution of further profits in the hands of PE of MSCo where the transaction is at arm's length.

(iv) Appropriateness of remuneration based on margin on total operating cost of PE for determining profit attributable to service PE.

21. As stated above, one of the main points which arises for determination in the present case is : whether the AAR was right in ruling that as long as MSAS was remunerated for its services at arm's length, there should be no additional profits attributable to the applicant or to MSAS in India.

22. To answer the above question one has to examine the provisions of the I.T. Act as well as the provisions of DTAA between India and U.S.A.

23. Sections 92 to 92E of the I.T. Act contains transfer pricing provisions in the I.T. Act with effect from the financial year commencing from 1.4.2001. With the enactment of the said sections the rules for the interpretation and implementation of the said provisions were also amended so as to include Rules 10A to 10E in the Income Tax Rules. Sections 92A and 92B provide meanings of the expressions "Associated Enterprise" and "International Transaction" respectively with reference to which the income is to be computed under Section 92 of I.T. Act.

24. We quote hereinbelow Sections 92A and 92B of the I.T. Act:

"Meaning of associated enterprise. Section 92A. (1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise □

(a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or

(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

(2) For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,

(a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent. of the voting power in the other enterprise; or

(b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent. of the voting power in each of such enterprises; or

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent. of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than ten per cent. of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent one the use of 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 ha exclusive rights; or

(h) ninety per cent. or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family, or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent. interest in such firm, association of persons or body of individuals; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Meaning of international transaction. Section 92B. (1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature or purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise; or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise."

(emphasis supplied)

25. Section 92B defines "International Transaction" to mean a transaction between two or more associated enterprises which are, either or both of whom are non residents. The said transaction covers purchase, sale or lease of tangible or intangible property or provision of services or lending or borrowing money or any other transaction having an impact on the profits, income, losses or assets of such enterprises and shall include a mutual arrangement between two or more associated enterprises for the allocation or apportionment of any cost or expense incurred in connection with the benefit, service or facility provided to anyone or more of associated enterprises.

26. Determination of arm's length price in relation to international transaction is provided for in Section 92C to the I.T. Act read with Rule 10B. We quote herein below Section 92C of the I.T. Act read with Rules 10B and 10C of the Income Tax Rules which reads as under:

"Computation of arm's length price. Section 92C. (1) The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:-

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub- section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent. of such arithmetical mean.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, one the basis of material or information or document in his possession, of the opinion that-

(a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or

(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D, the Assessing Officer

may proceed to determine the arm's length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

Provided that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length should not be so determined on the basis of material or information or document in the possession of the Assessing officer.

(4) Where an arm's length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined:

Provided that no deduction under section 10A or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section.

Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible under the provisions of Chapter XVIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

Determination of arm's length price under section 92C.

Rule 10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely: -

(a) comparable uncontrolled price method, by which, -

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

(ii) such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;

(iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

(b) resale price method, by which, -

(i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;

(ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;

(iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;

(iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;

(v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;

(c) cost plus method, by which, -

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;

(ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;

(iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark- up in the open market;

(iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-

clause (iii);

(v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provisions of services by the enterprise;

(d) profit split method, which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which -

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprise performing comparable functions in similar circumstances;

(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);

(iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction :

Provided that the combined net profit referred to in sub-clause (i) may, I the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises I proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction;

(e) transactional net margin method, by which, -

(i) the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realized by the enterprise and referred to in sub-

clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

(2) For the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:-

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to be transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction if -

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

Most appropriate method.

Rule 10C. (1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to be facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:-

(a) the nature and class of the international transaction;

(b) the class of classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises:

(c) the availability, coverage and reliability of data necessary for application of the method;

(d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(f) the nature, extent and reliability of assumptions required to be made in application of a method."

(emphasis supplied)

27. The methods, quoted above, namely, CUPM, RPM, CPM, PSM, TNMM etc. are mentioned in Section 92C read with Rule 10B. The most appropriate method has to be applied for computation of the arm's length price. It will depend on the facts and circumstances of each particular international transaction (see: Rule 10C). Section 92C inter alia provides that if the Assessing Officer, during the course of any proceedings for the assessment on income, is of the opinion on the basis of material or information or document that the price charged or paid in an international transaction has not been determined on arm's length basis or if he finds that the assessee has not maintained proper documents relating to the international transaction in accordance with the provisions of the I.T. Act or if he finds that the data used in the computation of arm's length price is not reliable, the Assessing Officer may proceed to determine the arm's length price in relation to the said transaction. Rules 10B, 10C and 10D explains the determination of ALP under each of the above methods.

28. At this stage, it may be noted that on the question of appropriateness of the said TNMM, the AAR did not give its ruling as the transfer pricing as proceedings had commenced before the tax officer before MSCo could seek the ruling. However, after the impugned ruling, Transfer Pricing Officer and the Assessing Officer have found the said method (TNMM) to be appropriate. In our view, apart from the orders passed by the Assessing Officer and the Transfer Pricing Officer, the said method (TNMM) is the appropriate method in the case of Service PE as TNMM apportions the total operating profit arising from the transaction on the basis of sales, costs, assets, etc.

29. As regards determination of profits attributable to a PE in India (MSAS) is concerned on the basis of arm's length principle we have quoted Article 7(2) of the DTAA. According to the AAR where there is an international transaction under which a non-resident compensates a PE at arm's length price, no further profits would be attributable in India. In this connection, the AAR has relied upon Circular No.23 of 1969 issued by CBDT as well as Circular No.5 of 2004 also issued by CBDT. This is the key question which arises for determination in these civil appeals.

30. To answer the above question we quote Article 7 of the U.N. Model Convention which reads as under: "ARTICLE 7 : ATTRIBUTION OF BUSINESS PROFITS Article 7 of the UN Model Convention states as under: business profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where en 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 he same or similar conditions and dealing wholly or independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for he use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year-by-year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

Note: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations."

31. Article 7 of the U.N. Model Convention inter alia provides that only that portion of business profits is taxable in the source country which is attributable to the PE. It specifies how such business profits should be ascertained. Under the said Article, a PE is treated as if it is an independent enterprise (profit centre) dehors the head office and which deals with the head office at arm's length. Therefore, its profits are determined on the basis as if it is an independent enterprise. The profits of the PE are determined on the basis of what an independent enterprise under similar circumstances might be expected to derive on its own. Article 7(2) of the U.N. Model Convention advocates the arm's length approach for attribution of profits to a PE.

32. The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) not all profits of MSCo would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The quantum of taxable income is to be determined in accordance with the provisions of I.T. Act. All provisions of I.T. Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry- forward and set-off losses etc. However, deviations are made by DTAA in cases of royalty, interest etc. Such deviations are

also made under the I.T. Act (for example: Sections 44BB, 44BBA etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a PE. The impugned ruling is correct in principle insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE).

Conclusion:

33. To conclude, we hold that the AAR was right in ruling that MSAS would be a Service PE in India under Article 5(2)(l), though only on account of the services to be performed by the deputationists deployed by MSCo and not on account of stewardship activities. As regards income attributable to the PE (MSAS) we hold that the Transactional Net Margin Method was the appropriate method for determination of the arm's length price in respect of transaction between MSCo and MSAS. We accept as correct the computation of the remuneration based on cost plus mark-up worked out at 29% on the operating costs of MSAS. This position is also accepted by the Assessing Officer in his order dated 29.12.06 (after the impugned ruling) and also by the transfer pricing officer vide order dated 22.9.06. As regards attribution of further profits to the PE of MSCo where the transaction between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an associated enterprise (that also constitutes a PE) is remunerated on arm's length basis taking into account all the risk-taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be need to attribute profits to the PE for those functions/risks that have not been considered. The entire exercise ultimately is to ascertain whether the service charges payable or paid to the service provider (MSAS in this case) fully represents the value of the profit attributable to his service. In this connection, the Department has also to examine whether the PE has obtained services from the multinational enterprise at lower than the arm's length cost? Therefore, the Department has to determine income, expense or cost allocations having regard to arm's length prices to decide the applicability of the transfer pricing regulations.

34. Economic nexus is an important aspect of the principle of Attribution of Profits.

35. In the light of what is stated above, the impugned ruling by AAR stands modified to the extent indicated hereinabove. Accordingly, both the civil appeals filed by the applicant (MSCo) and by the Department are partly allowed with no order as to costs.