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Tax Flash News



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Profit from services rendered by Indian permanent establishment to overseas HO not includible in PE income under India-USA tax treaty

Executive summary

In *JP Morgan Chase Bank*,[1] the Mumbai Bench of the Income-tax Appellate Tribunal ('the Tribunal') examined whether the excess of service revenue over related costs earned by the Indian permanent establishment ('PE') from its Head Office ('HO') and overseas offices was taxable in India as per the India-USA tax treaty ('the Treaty').

The Tribunal held that such excess arising from the inter-office services was not liable to be included in the profits attributable to the Indian PE as per the provisions of Article 7(3) of the Treaty.

The Tribunal observed that the arm's length attribution principle under Article 7(2) is expressly subject to Article 7(3) which prevents recognition of profits arising from internal charges within the same enterprise. The services covered by Article 7(3) are not restricted to general administrative services or incidental or ancillary services.

[1] *JP Morgan Chase Bank* v. *ADIT* (ITA No. 3839/Mum/2006) – involves cross-appeals

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Facts of the case[2]

The taxpayer, a US-tax resident, was a banking company.

It carried on its banking business in India through its branch office, which constituted its PE in India under the Treaty.

During the relevant financial year (i.e. FY 2001-02), the Indian branch rendered correspondent banking and investor services to its HO and other overseas branches.

In its books of account, the Indian branch recorded the revenue and the corresponding expenditure relating to these services.

While computing its taxable income in India, the taxpayer excluded the excess of the revenue over the expenditure on the premise that the Indian branch and its overseas offices constituted different establishments of the same juridical banking enterprise and, therefore, the profit element arising from such intra-enterprise dealings could not be treated in the same manner as income earned from an independent third party.

The Revenue, however, rejected the taxpayer's interpretation of the Treaty and held that the excess constituted business profits arising from the services performed by the Indian branch and therefore formed part of the taxable profits attributable to the Indian PE.

[2] The other grounds of appeal, including transfer pricing issues, allowability of certain expenses, and loss arising from diminution in the value of investments have not been covered in this note.

Relevant provisions

Article 7(1) of the Treaty recognises the right of the Contracting State in which the PE is situated to tax so much of the business profits of the foreign enterprise as is attributable to that PE.

Article 7(2) of the Treaty provides that, *subject to the provisions of paragraph 3*, the profits attributable to the PE will be those which such PE 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 PE ('the arm's length attribution principle').

Article 7(3) of the Treaty consists of three limbs.

The first limb provides for deduction of certain expenditure while determining the profits of a PE.

The second and third limbs deal with the exclusion of payment, and the amount charged, by the PE to its HO or any of its other offices for specified items while determining the PE profit. The specified items include royalties, commission, charges for specific services or management etc. Thus, while computing the PE profit:

- No deduction shall be allowed in respect of payments

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made by the PE to its HO or any of its other offices for such specified items ('the second limb').

- *Likewise*, no account shall be taken for the amounts charged by the PE to the HO or any of its other offices for such specified items ('the third limb' or 'the reciprocal provision').

However, the reimbursement of actual expenses is excluded from this provision.

Revenue's contentions

The profits attributable to the functions performed through the PE were required to be determined on the assumption that it was a separate and independent enterprise operating under similar conditions and dealing at arm's length (Article 7(2)).

Relied upon the OECD Commentary on Article 7, which distinguished between general administrative functions and services constituting a commercial activity capable of being rendered to outside customers. The former required allocation or reimbursement of actual expenses, and the latter required arm's length remuneration.

The services performed by the Indian branch constituted identifiable and substantive business activities which provided real, economic and commercial benefits to the overseas offices. Accordingly, the profit element arising from such activities was required to be recognised under Article 7(2) of the Treaty.

Referring to the expression *"Likewise"* appearing in the third limb of Article 7(3), the Revenue argued that the third limb dealing with the exclusion of amounts charged by the PE to its HO could operate only where the second limb concerning payments by the PE had first been attracted. Since the taxpayer's case did not involve any disallowance under the second limb, the third limb of Article 7(3) to exclude the profit element could not operate independently.



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Tribunal's decision

The Tribunal ruled in favour of the taxpayer and held that the excess of service revenue over costs arising from the specified inter-office service charges was not liable to be included in the profits attributable to the Indian PE under the Treaty.

Key observations of the Tribunal included:

Interplay between Article 7(2) and Article 7(3)

The Revenue's contention that the Indian branch had performed substantive functions giving rise to attributable profits undoubtedly merited consideration under the arm's length attribution principle, i.e. Article 7(2), but that proposition cannot be applied in isolation from the express qualification making paragraph 2 subject to paragraph 3 of Article 7.

Second and third limbs of Article 7(3)

The second limb deals with the debit side of computation, while the third limb deals with the credit side. Both the limbs ensure consistent treatment of such inter-office charges and prevent recognition of profits arising from internal charges within the same enterprise.

The expression *"Likewise"* signifies correspondence or similarity in treatment. It does not make the operation of the succeeding provision conditional upon an actual event occurring under the preceding provision. The reciprocity does not necessarily imply that both transactions must arise in the same financial year.

The Revenue's interpretation would produce an anomalous result, because identical charges for specified services could receive different treatment merely depending upon whether or not the PE had, during the same year, made any corresponding payment falling within the second limb.

The OECD and UN Commentaries could not override the specific qualification or restriction in the Treaty.

The taxpayer had not sought exclusion of the expenditure incurred in performing the specified services; its claim was confined to the profit element arising from the inter-office charges. Therefore, the computation had to ensure that the underlying expenditure was neither deducted twice, nor the same amount was excluded more than once.

Nature of services

The third limb does not employ the expression "general administrative services" or is not confined to incidental or ancillary services. On the contrary, the provision specifically refers to commission or management charges etc. and separately provides an exception for reimbursement of actual expenses and interest payments by banking companies. The third limb remains applicable even if the services performed by the Indian branch have commercial value.

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Judicial precedent

Distinguished the ruling in *Bank of Nova Scotia*,[3] noting that the disputed amount in the instant case did not represent an additional markup independently computed by the transfer pricing officer, rather it represented the profit already recorded in the Indian branch's books of account and excluded by the taxpayer from its taxable income by specifically invoking the provision of Article 7(3). The Tribunal acknowledged that while transfer-pricing provisions applied to dealings between a PE and its overseas offices, the taxability of such profit still had to be examined under Article 7(3) of the Treaty.



Our comments

The ruling provides important guidance on the interaction between Articles 7(2) and 7(3) of the Treaty and confirms that the express treatment of specified inter-office charges under Article 7(3) prevails over the general arm's length attribution principle.

This ruling is particularly relevant for computing PE profits, as it clarifies that the profit element in specified inter-office charges may be excluded.

[3] *The Bank of Nova Scotia* v. *ADIT* (ITA No. 3530/Mum/2009) Mumbai Tribunal

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