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ATTRIBUTION OF PROFITS TO A PE TO BE BASED ON INDEPENDENT ENTITY APPROACH, IRRESPECTIVE OF LOSSES INCURRED AT ENTITY LEVEL - FULL BENCH OF THE DELHI HIGH COURT

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In *Hyatt International Southwest Asia Ltd Vs Additional Director of Income Tax (2024 SCC OnLine Del 6546)*, a Full Bench of the Delhi High Court held that a Permanent Establishment (PE) is to be treated as an independent taxable entity under Article 7 of the India-UAE Double Taxation Avoidance Agreement (Tax Treaty) and that attribution of profits to a PE based on the entity's global income is unmerited and misconceived.

Background - Reference to the Full Bench

- In the instant case, Hyatt International Southwest Asia Ltd (Taxpayer), relied upon the decision of the Delhi High Court in *Nokia Solutions and Networks OY, (2022 SCC OnLine Del 5088)* (Nokia Solutions), and claimed that since the Taxpayer incurred a global loss, no profit or income could be attributed to its alleged PE in India. In Nokia Solutions, the Delhi High Court affirmed the order of the Income Tax Appellate Tribunal (2005 SCC OnLine ITAT 1) and upheld the attribution of profits to a PE of an enterprise on the basis of the foreign entity's global profitability.
- A second Division Bench of the Delhi High Court disagreed with the view expressed in Nokia Solutions and took a view that the profits of a PE should be assessed and chargeable to tax in India irrespective of losses incurred at overall entity level. In light of the divergent views expressed on the issue by two Division Benches of Delhi High Court, a reference was made to a Full Bench of the Delhi High Court to adjudicate on the issue whether profit / income could be attributed to a PE of an enterprise in India if the enterprise incurs losses (*Hyatt International Southwest Asia Ltd v Additional Director of Income Tax, 2023 SCC OnLine Del 8474*).

Proceedings before the Full Bench: Contentions of the Taxpayer and the Revenue

- The Taxpayer contended that under Article 7 of the India-UAE Tax Treaty, profits of a UAE-based enterprise are taxable only in the UAE (and not India). The Taxpayer contended that a foreign enterprise can only be taxed in India if the following three conditions are cumulatively met:
 - ✓ the enterprise is making a profit,
 - ✓ it has a PE in India and
 - ✓ part of that profit is attributable to the PE.

- The Revenue argued that Article 7 of the Tax Treaty treats a PE as a separate and distinct enterprise, thus requiring profit attribution based solely on independent activities of the PE, irrespective of the global profits or losses of the enterprise.

Ruling of the Full Bench

A Full Bench of the Delhi High Court ruled in favour of the Revenue held that a PE was to be treated as a separate and independent entity qua the global entity for attribution of profits regardless of profits or losses incurred by the entity at global level. Key factors and observations noted by the Full Bench of the Delhi High Court are as set out below:

- Article 7 of the Tax Treaty stipulates that the profits of an enterprise should only be taxed in the state of its residence. However, if the enterprise operates in the other state through a PE, the profits attributable to that PE can also be taxed in that other state. Article 7(2) treats the PE as a distinct and separate entity for the purposes of determining its profits.
- Profits of a PE are treated as independently taxable in the state where it is located, even though the PE is part of a global enterprise.
- The Court rejected the argument that taxation should be based on the overall profitability or income of the enterprise as a whole. It ruled that only the profits arising from the activities of the PE within the state where it operates should be taxed (independent of the global financials).

Comments

The Full Bench noted the construct of Article 7(1) and 7(2) of the India-UAE Tax Treaty and held that a PE is to be treated as an independent taxable entity and hence, global income or profit of the enterprise is not relevant or determinative in the allocation of profits to a PE. Thus, effectively, a PE of a foreign entity would have to pay taxes on the income attributable to its operations in India, irrespective of the global profit or loss incurred by the foreign entity.

Taxpayers who relied upon Nokia Solution's ruling to claim that no profits should be attributed to the Indian PE in the absence of global profits / income should assess the impact of this judgment and can expect a fresh round of notices from tax authorities.

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