# Delhi ITAT's ruling on Attribution of Profits to DAPE - Lending an Economic Perspective

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**Rahul K Mitra**
Chartered Accountant

In a recent ruling, the Delhi Tribunal, by following its earlier rulings delivered in the taxpayer's own case, upheld the oft cited theory that where an agent of a foreign enterprise, being ideally a local group company of the foreign enterprise, has been found to have been rewarded at arm's length for such services of agency performed for the foreign enterprise, in the tax assessment carried out in the hands of the agent, then no further profits may ever be attributed in the hands of the dependent agent permanent establishment (DAPE) of the foreign enterprise, which might have been triggered by the said agent, being the local group company. While so holding, the Tribunal had relied upon the ruling of the Hon'ble Supreme Court in the case of Morgan Stanley.

I am attempting to lend a different perspective to the relevant issue in the current article, by referring to the fundamentals of transfer pricing (TP) and economics. DAPE is a concept enshrined in international tax treaties in order to enable a host jurisdiction to levy taxes in the hands of a non-resident entity, on profits attributable to distribution functions, if any, performed in substance by an agent of the non-resident, where the legal form of agency, i.e. lack of ownership of debtors and inventory by the agent, could have otherwise impeded upon the attribution of such profits relating to distribution functions in the hands of the local entity, i.e. the agent, through the standalone application of TP, if one were to ignore the concept of allocation of profits for assumption of risks and economic ownership of assets by an entity, which does not legally own the same, being more of a recent introduction under Actions 8 to 10 of BEPS 1.0.

Thus, the concept of DAPE has since long been introduced in international tax treaties with a view to enable the host jurisdiction to levy taxes, in the hands of a non-resident entity, on the delta or difference between the profits relating to distribution functions, if any, performed in substance by the agent; and the remuneration for agency functions actually received by the agent from the non-resident principal, by hypothesising or equating the DAPE as/ with the foreign entity itself, performing distribution functions, in order to assign ownership of debtors and inventory to the DAPE, i.e. the foreign entity, being always the legal owner thereof in an arrangement of agency.

It is respectfully submitted that the motherhood statement that if the agent is remunerated at arm's length by the foreign principal then no further profits can ever be attributed in the hands of the DAPE of the foreign principal constituted in the host jurisdiction, is not sacrosanct; and cannot be said to have universal application. The above motherhood statement attempts to always limit the amount of attribution of profits to a DAPE to the arm's length remuneration received by the agent for its agency functions of securing orders or concluding contracts on behalf of the principal, which defeats the whole purpose of incorporating the concept of DAPE in international tax treaties.

One needs to appreciate that functions of the agent, which trigger the existence of a DAPE under Article 5 of tax treaties, are different from those, which lead to attribution of profits to the DAPE under Article 7 of tax treaties. Functions of securing of orders or conclusion of contracts performed by a dependent agent for a foreign enterprise, being its principal, trigger existence of a DAPE of the foreign enterprise in the host jurisdiction under Article 5 of tax treaties. However, such limited functions, by themselves, do not automatically result in attribution of profits to the DAPE of the foreign enterprise under Article 7 of

tax treaties. Performance of significant peoples' functions (SPF) by the dependent agent for assumption of risks and economic ownership of assets, being debtors and inventory, on behalf of the foreign enterprise, which incidentally are different from the mere securing of orders or conclusion of contracts, trigger attribution of profits to the DAPE of the foreign enterprise under Article 7 of tax treaties.

There is no doubt that if an agent merely performs functions of securing orders or concluding contracts on behalf of its foreign principal; and nothing beyond the same, then though the said functions would otherwise result in constitution of a DAPE of the foreign entity in the host jurisdiction, yet the quantity of profits to be attributed to the DAPE would be restricted to the arm's length remuneration actually received by the agent for such agency functions.

However, if the agent, in addition to performing the functions of securing of orders or concluding contracts on behalf of the principal, also carries out SPF for assumption of risks and economic ownership of assets in the form of debtors and inventory, which are legally owned by the foreign principal, in a manner, which a buy-sell distributor; and not an agent simpliciter, would perform, then the functional, asset and risk (FAR) profile of the DAPE would be that of a normal risk taking distributor, meriting allocation of profits commensurate to such enhanced FAR profile. There is no doubt that such profits commensurate to the FAR profile of a normal risk taking distributor would not be limited to the profits to be earned by an agent for the basic functions of securing of orders or concluding contracts on behalf of the foreign principal.

Thus, the correct approach in the matter of attribution of profits to DAPE would be to first quantify the amount of profit that needs to be attributed to the DAPE of the foreign principal in the capacity of a distributor, having regard to the entire spectrum of functions performed by the agent, including assumption of risks, if any, by the agent with reference to debtors and inventory, which are obviously legally owned by the foreign principal, as discussed above; and thereafter evaluate whether such quantum of profit has already been earned and taxed in the hands of the agent, in which case no further profits may be attributed in the hands of the DAPE of the foreign enterprise; or in case the agent had earned lesser profits than such quantum, then only the shortfall would need to be attributed as profits in the hands of the DAPE.

Let us assume that the all-encompassing FAR profile of such hypothesised distributor, being the DAPE, i.e. the foreign entity itself, would lead to the quantification of profits worth 10 as per a robust TP analysis. Thereafter, one would need to see as to how much profits has the agent actually received as part of commission from the foreign principal. Assuming that such profits earned by the agent amount to 7, then an additional amount of 3 would need to be attributed as profits to the DAPE. On the other hand, if the agent has already earned profits worth 10, then clearly no further profits would need to be attributed to the DAPE.

It is submitted that the ruling of the Hon'ble Supreme Court in the case of Morgan Stanley, which is generally relied upon by taxpayers and the judiciary for supporting the motherhood statement that if the agent is remunerated at arm's length by the foreign principal then no further attribution of profits can ever be made to the DAPE of the foreign principal constituted in the host jurisdiction, does not come in aid of taxpayers in the matter of quantification of profits to a DAPE.

The said ruling of the Hon'ble Supreme Court in the case of Morgan Stanley was delivered in the context of its unique facts, where the cost base of a service permanent establishment (PE) of a non-resident entity (F Co), constituted through the presence of its own expatriates in India, was booked in the hands of a group company located in India (I Co), being a contract service provider to F Co, due to a cross-charge thereof by F Co upon I Co; and since I Co had already earned arm's length profits on such cost base through a mark-up thereon, as part of the remuneration received from F Co, the Hon'ble Supreme Court was pleased to deliver a legendarily pragmatic ruling to the effect that since the profits, which should have otherwise been attributed to the service PE of F Co in the form of mark-up on the cost base thereof, were already reflected in the books of I Co, then no purpose would have been served by re-allocating the same in the hands of the service PE of F Co, as the host country, namely India, was not deprived of the taxes relating to the profits of the service PE, the quantification of which was never in doubt, being in the form of a mark-up on the relevant cost base.

It is not difficult to fathom that the said ruling of the Hon'ble Supreme Court does not throw any light on

how the profits attributable to a DAPE of a foreign company may be computed under TP, as the Hon'ble Supreme Court never had the occasion to consider and adjudicate upon such issue. Therefore, it may not be correct to rely upon the said ruling of the Hon'ble Supreme Court to argue and adjudicate that the profits attributable to a DAPE of a foreign entity would always need to be limited to the arm's length remuneration received by the agent, which had triggered constitution of such PE, without first analysing the all important point as to whether the agent had earned arm's length profits commensurate to agency functions simpliciter or even to distribution functions, as discussed above, in case the agent would have performed such distribution functions in substance while defraying the functions under the legal arrangement of agency.

If the agent is found to have earned arm's length profits commensurate to even distribution functions, if any, performed in substance by itself, as discussed above, implying that the task of quantification of profits to DAPE has been over, albeit in the hands of the agent, then of course the principles of the ruling of the Hon'ble Supreme Court in the case of Morgan Stanley may be applied to the effect that there would not be any need to unnecessarily re-allocate any part of such profits to the DAPE, as it would lead to double taxation of the same profits, namely once in the hands of the agent; and again in the hands of the DAPE of the foreign entity.

In case taxpayers and the judiciary would only be satisfied to establish a theorem in the context of attribution of profits to a DAPE, which respectfully submitted, is not required in the context of economics based subjects like TP and PE, the same may be rephrased as follows – "where the total quantum of profits required to be attributed to the DAPE of a foreign enterprise, as arrived at on the basis of the application of principles of TP, are found to have been already taxed in the hands of the dependent agent of the foreign enterprise as part of the remuneration received from the foreign enterprise, then no further profits would need to be attributed to the DAPE of the foreign enterprise."

One craves for the day when taxpayers and Revenue Authorities would collaboratively engage with each other in matters relating to attribution of profits to DAPE; or for that matter any other form of PE, by applying the principles of arm's length price under TP; and discarding legal arguments. One can say from personal experience that whenever proper and adequate arm's length profits commensurate to distribution functions have been attributed, whether – (a) initially to the agent, which constituted the DAPE; or (b) to the DAPE, namely after excluding the profits earned by the agent on remuneration received from the foreign principal, the Indian Revenue has always been open to pragmatically accept such manner of attribution of profits to the DAPE, particularly in advance pricing agreements and mutual agreement procedures.