IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH `B' NEW DELHI

BEFORE SHRI G.D. AGRAWAL, VICE PRESIDENT
AND
SHRI CHANDRA MOHAN GARG, JUDICIAL MEMBER

I.T.A.No.1597/Del/2009
Assessment Year : 2003-04

I.T.A.No.1598/Del/2009
Assessment Year : 2004-05

M/s Consulting Engineering Corporation India Branch Office, D-6, Pamposh Enclave, New Delhi-110048	vs	JDIT(OSD) Circle-1(1), International Taxation, 204, Drum Shape Building, New Delhi.

I.T.A.No.1275/Del/2009
Assessment Year : 2003-04

I.T.A.No.1172/Del/2009
Assessment Year : 2004-05

ADIT Circle-1 (1), New Delhi. (Appellant)	vs	Consulting Engineers Corporation, D-6, Pamposh Enclave, New Delhi. (Respondent)

Appellant by: Shri M.P. Rastogi, Adv. & Smt. Lalita Krishnamoorty CA
Respondent by :S/ Shri Sanjeev Sharma, CIT DR & Vivek Kumar Sr.DR

O R D E R

PER CHANDRA MOHAN GARG, JUDICIAL MEMBER

The above captioned appeals of the assessee as well as of the revenue have been preferred against the order of CIT(A)-XXIX, New Delhi dated 10.12.2008 for AY 2003-04 and 2004-05.

Revised ground in ITA 1597/Del/2009 for AY 2003-04 of the assessee

"1. The assumption of jurisdiction under section 148 of the Income Tax Act, 1961 is without authority of law and is void.

2. That the Id. Assessing Officer has no valid material to assume jurisdiction under section 147 of the Income Tax Act, 1961 and consequentially reasons so framed is null, void and bad in law. In the absence of valid material available on record for formation of reason to believe that there has been an escapement of income by the Id. Assessing Officer the reopening is bad in law.

3. That there was no reason to believe as contemplated under section 147 of the Income Tax Act, 1961 that income chargeable to tax had escaped assessment and hence the assessment as framed by the Id. Assessing Officer is not valid in law and deserves to be quashed.

4. That the reasons alleged to have been recorded are not based on facts but on suspicion which cannot be the foundation for formation of reason to believe as contemplated under the provisions of section 147 of the Income Tax Act, 1961 and hence the reopening is bad in law and reassessment as framed deserves to be quashed.

5. The Id CIT (Appeals) had erred in holding that the Assessing Officer had validly invoked and had rightly assumed the jurisdiction under section 147 of the Income Tax Act, 1961.

6. That in the absence of any PE in India in terms of DTAA (Double Taxation Avoidance Agreement), no profits alleged to have accrued to the appellant are there and consequently the levy of tax as made by the AO is arbitrary, unjust and bad in law.

7. That the appellant functions as a Branch of the US Non-resident involving only in preparatory and auxiliary activities for US Non-resident the cost whereof is reimbursed by US hence there could be no income accrued to the appellant and consequently the assumption of income at Rs.19,62,250j - as business income is arbitrary, unjust and bad in law. Even in US where the firm has HO and is based, even they are not making even a part of this profit %. How can a branch who is simply

doing a small portion of the job such as drafting and engineering can be deemed as making so high % of profit, when the most of the crucial job of the project lies with the HO, including the liabilities of the design if the building fails at any given time.

8. That in the absence of any income embedded in the amount reimbursed by US Nonresident to its Branch (appellant), acting as a pure a cost centre the assessment at a figure of Rs.19 ,62,250 / - as business income is bad in law.

9. That there is no international transaction with an Associated Enterprise (AE) as contemplated under Section 92C of the Income Tax Act, 1961 hence no income ought to have been deemed under Section 92C of the Income Tax Act, 1961.

10. That the provisions of Section 92C in terms are not applicable and consequently the assessment made at Rs.19,62,250/- as business income as made by the AO is arbitrary, unjust and at any rate very excessive.

11. Without prejudice to grounds above the AO ought not to have taken into consideration the figure of profits from the US Return for the calendar year 2003 but should have taken the figures for the calendar year 2002 for the determination of attributable profits and subjected it to a further downward adjustment for functions performed, assets employed, working capital available and risk assumed and consequently the adoption of global profit rate of 8.50 % is very high.

12. That the CIT (Appeals) had erred in directing the AO to calculate attributable profit at 50% of the figure arrived at by the AO after applying the profit rate of 8.5% representing the global profit ratio of the assessee.

13. That the authorities ought to have adopted the status of the appellant as individual instead of Foreign Company. CEC is a firm and not a company even in us. It is 100% owned by the single individual hence does not fall in the category of a Company."

Revised grounds in ITA No. 1598/Del/2009 for AY 2004-05

"1. That in the absence of any PE in India in terms of DTAA (Double Taxation Avoidance Agreement), no profits alleged to have accrued to the appellant are there and consequently the levy of tax as made by the AO is arbitrary, unjust and bad in law.

2. That the appellant functions as a Branch of the US Nonresident involving only in preparatory and auxiliary activities for US Nonresident the cost whereof is reimbursed by US hence there could be no income accrued to the appellant and consequently the assumption of income at Rs.23,89,345/ - is arbitrary, unjust and bad in law.

3. That in the absence of any income embedded in the amount reimbursed by US Nonresident to its Branch (appellant), acting as a pure a cost centre the assessment at a Rs.23,89 ,345 / - is bad in law.

4. That there is no international transaction with an Associated Enterprise (AE) contemplated under Section 92C of the Income Tax Act, 1961 hence no income ought to have been deemed under Section 92C of the Income Tax Act, 1961.

5. That the provisions of Section 92C in terms are not applicable and consequently the assessment made at Rs.23,89,345/ - as made by the AO is arbitrary, unjust and at any rate very excessive.

6. Without prejudice to grounds above the AO ought to have adopted the correct figure of the profit from US Return for the calendar year 2003 for the determination of attributable profits and subjected it to a further downward adjustment for functions performed, assets employed, working capital available and risk assumed and consequently the adoption of global profit rate of 10 % is very high.

7. That the CIT (Appeals) had erred in directing the AO to calculate attributable profit at 50% of the figure arrived at by the AO after applying the profit rate of 10.6% representing the global profit ratio of the assessee.

8. That the authorities ought to have adopted the status of the appellant as individual instead of Foreign Company. CEC

is a firm and not a company even in US. It is 100% owned by the single individual hence does not fall in the category of a Company. "

2. The grounds of the revenue in ITA No. 1275/Del/2009 for AY 2003-04 and in ITA No. 1172/Del/2009 for AY 2004-05 are similar which read as under:-

"1. In the facts and in the circumstances of the case the CIT(A) has erred in directing the AO to calculate attributable profit at 50% of the figure arrived at after applying the profit rate of 8.5% which represents the global profit ratio of the appellant ignoring the fact that the PE also assumes risks in respect of work done by it and the HO earns its own profit in respect of part of expenses not attributable to PE and so the taxable profit should be income as determined by the AO.

2. On the facts and in the circumstances of the case the Ld. CIT(A) -XXIX, New Delhi has not disclosed any reason or basis to reduce the attribution of profit by 50%.

3. On the facts and in the circumstances of the case, the Ld. CIT(A) has erred in substituting his own estimate of income without pointing out defects in the basis adopted by the AO for estimation of attribution of the profit. Such substitution of the estimate is contrary to the principle laid down by Hon'ble apex court in cases of CST vs H M Esufali H M Abdulali (1973) 90 ITR 271 and Kachwala Gems vs JCIT (2007) 288 ITR 10.

4. The order of the CIT (A) be set-aside and that of AO be restored. "

3. Briefly stated the facts giving rise to these appeals are that the assessee's case was reopened u/s 147/148 of the Income Tax Act, 1961 for AY 2003-04 by issuing notice dated 06.03.2007. The assessee replied that the earlier return may be considered to be return filed in response to notice u/s 148 of the Act. The AO rejected the objection of the assessee towards reopening of assessment

u/s 147 and 148 of the Act and made an addition of Rs.15,39,789 towards Arms' Length Price (ALP) reimbursement of Indian branch. The aggrieved assessee preferred an appeal before the CIT(A) mainly on two grounds, first, challenging the reopening of assessment u/s 147 and 148 of the Act and, secondly, challenging the addition made by the AO on account of cost +8.5% reimbursement of total expenditure of Indian Branch.

4. Ld. CIT(A) decided the appeal of the assessee for AY 2003-04 by passing the impugned order dated 10.12.2008 and held that the AO has rightly assumed jurisdiction u/s 147 and 148 of the Act on legal grounds and contention of the assessee towards reopening of assessment was rejected.

5. From the record of ITA 1597/Del/2009 for AY 2003-04 and ITA 1598/Del/2009 for AY 2004-05 of the assessee, we observe that the AO made similar kind of addition in both the years by holding that the total expenditure incurred as per audited expenditure and income account requires to be computed by adding mark up of 8.5% in AY 2003-04 and the mark up of 10% for AY 2004-05. Therefore, the assessee has raised similar grounds on this count in both the appeals. The assessee also challenged conclusion of the AO that the assessee appellant has a fixed place of business in India as PE in the form of branch office through which the business of the assessee is partly carried out, therefore, in terms of para 2(c) of Article 5 of Indo US DTAA, this represents a fixed place of business through which business of the enterprises is

carried out and, accordingly, this constitutes Permanent Establishment (PE) of the assessee and the income attributable to the operation carried out by the PE shall be taxable in terms of Article 7 of the Indo US DTAA.

6. In both the assessment years under consideration, the CIT(A) upheld the findings of the AO that the assessee has PE in India in the form of branch office. The CIT(A) partly allowed ground of the assessee on the issue of attribution of profit to the branch office, PE of the assessee in India and directed the AO to calculate attributable profit at 50% of the figure arrived at after applying the profit rate of 8.5% for AY 2003-04 and 10.6% for AY 2004-05 which represents the global profit ratio of the assessee company in the relevant financial years.

7. Now, being aggrieved by the impugned appellate orders of the CIT(A), the assessee as well as the revenue is before this Tribunal on the grounds as reproduced hereinabove.

Ground no. 1 to 5 in AY 2003-04 of the assessee

8. At the outset, we find it appropriate to take up legal grounds of the assessee against the reopening of assessment u/s 147/148 of the Act. We have heard arguments of both the sides and carefully perused the relevant material placed on record. Ld. Counsel of the assessee submitted that the AO has no valid material to assume jurisdiction u/s 147 of the Act and consequently

reasons so framed by the AO and action thereunder is null, void and bad in law as in absence of valid material available on record for formation of reason to believe that there has been an escapement of income, the reopening of assessment is bad in law. Ld. Counsel vehemently contended that there was no reason to believe before the AO as contemplated u/s 147 of the Act that the income chargeable to tax had escaped assessment, hence, reassessment framed by the AO is not valid in law and deserves to be quashed. Ld. Counsel of the assessee also contended that the impugned reasons alleged to have been recorded are not based on fact but on suspicion which cannot be the foundation for formation of reason to believe as contemplated under the provisions of section 147 of the Income Tax Act, 1961 and hence the reopening is bad in law and reassessment as framed deserves to be quashed. Ld. Counsel pointed out that the ld. CIT (Appeals) grossly erred in holding that the Assessing Officer had validly invoked and had rightly assumed the jurisdiction under section 147 of the Act for issuance of notice u/s 148 of the Act. Ld. Counsel reiterated its argument before the authorities below and submitted that the reopening of assessment may be quashed under the facts and circumstances of the case.

9. Replying to the above, ld. DR submitted that at the time of initiating proceedings u/s 147 and 148 of the Act, the AO is not expected to reach a final conclusion regarding the taxability of such income under the Act, only a prima facie belief regarding escapement of income would be sufficient for invoking

the provisions of section 147 of the Act. A reference can be made to the decision of **Hon'ble Supreme Court in the case of Raymond Woollen Mills (1999) 236 ITR 34 (SC) and ITO vs Selected Co. Ltd. (1996) 217 IGTR 597 (SC)** where it has been held that formation of belief is within the realm of subjective satisfaction of ITO. Ld. DR also pointed out that during the assessment proceedings for AY 2004-05, it was found by the AO that the assessee was liable to tax in India but a higher mark up depending upon the activities performed by the assessee branch office in India as the 1.83% mark up did not represent the Arms's length remuneration, therefore, the case of the assessee was well within the ambit of deemed escapement as provided in sub-section clause (a) of Explanation 2 to section 147 of the Act.

10. On careful consideration of above submissions and on careful perusal of the relevant operative part of the impugned order, we observe that the CIT(A) rejected the legal objection and contention of the assessee against the reopening of assessment u/s 147/148 of the Act with following observations and conclusion:-

> *"5.2 A careful examination of the submissions made by the appellant in this regard, indicated that the arguments advanced by the appellant are not valid. It is undisputed fact that the appellant has filed return of income showing a markup of 1.83% for the said assessment years. However, the AO has recorded his finding that during the assessment proceedings for the assessment year 2004-05, it was found that the income of the Appellant was liable to tax in India but a higher markup depending upon the activities performed by the appellant's*

branch office in India, and that 1.83% markup did not represent the arm's length remuneration. Therefore, the tax liability which was not determined gave rise to the reason to belief that the Appellant has such income which has escaped assessment and thus is not complying with the provision of 139 of the Act. Therefore, the case of the Appellant falls within the ambit of deemed escapement as provided in sub clause (a) of the explanation 2 to section 147 and that is why the AO issued notices under section 148 of the Act for invoking the provisions of section 147 of the Act. Further, there are judicial precedents to the effect that at the time of initiating the proceedings the AO is not expected to reach a final conclusion regarding the taxability of such income under the Act, only a prima facie belief regarding escapement of income would be sufficient for invoking the provisions of section 147 of the Act. A reference can be made to the following two decisions of Supreme Court which make it clear that merely a prima facie belief with respect to escapement of income has to be found –

(i) It has been laid down by SC in case of Raymond Woollen Mills (1999) 236 ITR 34 that where there is a prima facie material, the sufficiency and correctness of the belief cannot be questioned at this stage. At this stage, the final outcome of proceedings is not relevant. In other words, at the initiation stage, what is required is reason to believe, and not the established fact or computation of income. Whether the material would conclusively prove the escapement is not the concern at this stage. It may be seen that AO has referred to the findings of the A.Y. 2002-03 in the reasons. This clearly indicates the facts and application of laws which has gone into forming his reason to belief. It has nowhere been denied that the appellant was not carrying out the activities during the years under consideration (i.e. the years of which notice u/s 147 has been issued). Similar views have been expressed in the case of ITO vs. Selected Co. Ltd. (1996) 2 J 7 IGTR 597 (SC) where it has been held that formation of belief is wherein the realm of subjective satisfaction of ITO.

(ii) Similar view has been expressed in the case of Hindustan Aluminum Corporation vs. ITO (2002) 254 ITR 370 (Cal.)

(iii) It is enough, if the AO has reason to belief that Income has escaped assessment. It is not necessary to have all the details of computation of escaped assessment at the time of

issue of notice. It was so held in the case of G. Sukh vs. DCIT 252 ITR 320.

Thus, the action of the AO is strictly in conformity with the provisions of the law as laid down in the act as well as jurisprudence evolved as a result of court decisions. The ground of appeal raised by the Appellant on the validity of invoking the provisions of section 147 by the AO is, accordingly, dismissed for the assessment years 2003-04.

The above legal position clearly indicates that the AO has rightly jurisdiction u/s 147 and accordingly the ground of appeal no. 1 to 4 are rejected."

11. In view of above, from page no. 5 of the impugned order, we observe that for reopening of assessment u/s 147 and 148 of the Act, the AO recorded following reasons:-

"Indian entity provides engineering design and consultancy services to the Head Office. For these services Indian branch is reimbursed at cost plus 1.83% only. This does not appear to be an arm's length remuneration. Indian branch is hence not disclosing income which would be receivable if it were to be paid the arm's length remuneration for the services provided. The case has not been assessed u/s 143(3) and estimated income escaping assessment is more than Rs. 1 lac."

12. In the above facts and circumstances of the case, we observe that the action of the AO was not prompted by any whim, surmise or conjecture but the assessment for AY 2003-04 was processed u/s 143(1) of the Act and during the course of assessment proceedings for 2004-05, the AO noticed that Indian entity provides engineering design and consultancy services to the Head Office. For these services, Indian branch is reimbursed at cost plus 1.83% only. This does not appear to be an arm's length remuneration. Therefore, the AO invoked jurisdiction u/s 147 and 148 of the Act for reassessment and reopening of

assessment. At this juncture, we respectfully take cognizance of the decision of Hon'ble Apex Court in the case of Raymond Woollen (supra) wherein it was held that where there is a prima facie material, the sufficiency and correctness of the belief cannot be questioned at this primary stage. The final outcome of the proceedings are also not relevant at this stage. Their lordships further clarified that at the time of initiation stage what is required is reason to believe and not the established fact or computation of income which escaped assessment. In the case of ITO vs Selected Co. Ltd. (supra), their lordships also held that formation of belief is within the realm of subjective satisfaction of the AO. Under these circumstances, we are inclined to hold that the action of the AO was proper and in conformity with the provisions of the Act as well as ratios evolved as a result of court and Tribunal decisions on this issue. Accordingly, legal contention and ground of the assessee in ground no. 1 to 5 being devoid of merit deserve to be dismissed and we dismiss the same.

Ground no. 6 to 10 in ITA No. 1597/Del/2009 and ground no. 1 to 5 in ITA No. 1598/Del/2009

13. The assessee has also raised additional grounds before the CIT(A) by alleging that there is no PE in India in terms of DTAA (Double Taxation Avoidance Agreement), with the US, and no business profit can be said to have accrued in India and, accordingly, the assessee is not liable to be taxed in India. The ld. Counsel for the assessee submitted that the ld. CIT (Appeals) has erred in holding that the assessee branch office in India constitutes its PE. Ld.

Counsel of the assessee further pointed out that the assessee denies its liability to be assessed to tax in India as all sums received by it are on account of reimbursement of expenses only and do not bear the character of income.

14. Ld. DR replied that on the facts of the case and physical presence of the assessee in India in the form of immoveable property, offices, development centers, fixed assets at various places and number of employees, their qualification and nature of work done by them clearly indicate that the core business of preparing drawing and design is being done in India. Ld. DR has submitted following written submissions on the issue:-

> *"Based on the facts of the case and physical presence of the assessee in India in the form of immovable properties, offices, development centers, fixed assets at various places and number of employees, their qualification and the nature of work done by them which indicate that the core business of preparing drawing and designs is being done in India, the claim of the assessee that its activities are covered by Article 5(3)(e) of the tax treaty i.e. activities are of preparatory and auxiliary in nature has no factual basis. The assessee is carrying out the business of preparation of drawings and designs and also doing structural calculations and this work is being done exclusively by the Indian branch and this is the core business of the assessee and by no stretch of imagination such a work can be considered as claimed by the assessee to be covered by the exclusionary clauses. The revenue submits that the reliance on the decision of the Hon'ble Supreme Court is out of context as in that case the Indian subsidiary was being paid at arm's length. The Indian subsidiary was being paid for the back office operations. In the present case the main business is being carried out in India and it has not been compensated at all other than funding of meeting the expenses. Other case laws cited by the assessee in the written submission on the issue of auxiliary and preparatory activities are distinguishable on facts and the ratio does not apply to the*

facts of the case. In view of the facts of the case, the assessee has PE in India under the provisions of paragraph 1 and 2 of Article 5 of the treaty."

15. Replying to the above, ld. Counsel of the assessee has drawn our attention towards written synopsis and submitted additional argument as rejoinder to the issue. From para 10 at page 3, we observe that the main contention of the assessee on the issue of PE reads as under:-

"10. Before the Commissioner of Income Tax (Appeals), the assessee raised the grounds that for the purposes of taxation of business profits of a foreign entity in India, there must be a PE and the existence thereof is a pre-condition for taxation purposes. The PE has to be considered in accordance with the Double Taxation Avoidance Agreement (DTAA) with US. The PE has been defined in Article 5 of the DTAA and it includes a branch, but paragraph 3 of Article 5, which is an exclusionary provision, states in clause (e) that the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxillary character for the enterprises shall not be deemed to be the permanent establishment as contemplated under Article 5 of the DTAA and because the Indian branch is only engaged in the supporting services to the US Head Office which are in the nature of preparatory and auxillary services; hence no income can be assessed in terms of Article 7 of the US DTAA because as per Article 7, only such income which is attributable to the PE can be assessed in the source country."

16. To support the above contention, ld. Counsel of the assessee has placed reliance on the decision of **Hon'ble Supreme Court in the case of DIT (International Taxation) vs Morgan Stanley and Co. Inc. (2007) 292 ITR 416 (SC)** and contended mainly threefold propositions and arguments:-

"(i) In the instant case also, the Indian branches are only engaged in back office support services which are in the nature of preparatory and auxillary services. The Indian branches are not doing any independent business and have no authority to conclude any contract in India. They are doing only the job of preparation of load data and preliminary calculations of firm for possible size of structural elements on the instructions and directions of US Head office in relation to the contracts obtained and executed only in US.

(ii) The Indian branch offices are only doing job of preparation of load data and preliminary calculations for possible size of structural elements in respect of the contracts obtained and executed in US. In other words, the activities carried on by the Indian branches are in aid or support of the main activities carried out in US. Every aspect of the main transaction, i.e. the 'contract, was concluded in US and the receipts in relation to the services rendered in contract have also been earned in US. Accordingly, the Indian branch in view of Article 5(3) of the US DTAA cannot be considered as a permanent establishment in India and in the absence of the permanent establishment in India, no income can be said to have accrued in India in terms of Article 7 of the DTAA. Therefore, no income in respect of the activities carried out by the Indian branches is liable to be taxed in India.

(iii) The income as offered by the assessee in the income-tax return filed was under some misconception of law. However, it is a settled proposition of law that even if any income has been shown and declared in the income-tax return, the assessee may resile from the position because the income has to be assessed in accordance with the provisions of law and not on the basis of admission of an assessee."

17. On careful consideration of above submissions on the issue of PE and careful perusal of the relevant operative part of the impugned order, we observe that the assessee is agitating the issue with the contention that the PE has been defined in Article 5 of the DTAA between India and US which includes branch but para 3 of Article 5 which is exclusionary provision states in clause (e) that

the maintenance of stock of goods, fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise shall not be deemed to be the PE as contemplated under Article 5 of DTAA because the Indian Branch is only engaged in the supporting service to the US Head office. It is also contended that the services and activities of the assessee entity are in the nature of preparatory and auxiliary services, hence, no income can be assessed in India in terms of Article 7 of Indo US DTAA because as per Article 7, only such income which is attributable to the PE can be assessed in the source country.

18. In this context, ld. DR has drawn our attention towards page no. 304 and 305 of the Paper Book of the assessee and submitted that as per assessee entity during the year under consideration, there were 95 employees of high qualification in the field of civil engineering, draftsmanship coupled with high skill of management working in Indian Branch office of the Indian entity. Ld. DR also pointed out that the physical presence of the assessee in India at various places in the form of immoveable property etc., number of employees, their qualification and the nature of work done by them clearly indicates that the core business of preparing drawing and design was being done in India. Ld. DR vehemently contended that the claim of the assessee is not sustainable that its

activities are covered by Article 5(3) (e) of the Tax Treaty and the activities are auxiliary and preparatory in nature.

19. On careful consideration of relevant material placed before us and rival submissions and contentions on the issue of PE, we observe that as per list submitted by the assessee before the authorities below for the period 2003-04, there were 95 employees of high qualification working for the associated enterprises of US. In terms of Article 5(2) (b) of Indo US DTAA, the assessee entity represents a fixed place of business of the enterprise through which substantial work was carried out by the assessee which constitutes PE of the assessee in terms of Article 5(2)(b) and (c) of Indo-DTAA. On careful consideration of provisions of DTAA between India and US, specially Article 5(3) r/w Article 7, we clearly gather a consolidated meaning that the income attributable to the operation carried out by the PE shall be taxable in India. In this context, we may refer letter of the assessee dated 29.4.2008 wherein the assessee submitted before the CIT(A) the details of role and distribution of work profile between US office and the Indian office. This letter clarifies that the India Branch office role was mainly towards engineering calculation and drafting as per direction, instruction and guidelines provided by the US team.

20. We also note that it was also confirmed by the assessee before the CIT(A) in this letter dated 29.04.2008 that the India Branch office during the relevant point of time was primarily engaged in back end jobs and working under total

control, superintendence and direction of the Head office in USA. It was further confirmed that in absence of any jobs to the Indian branch office, its workers and supervisory staff on the bench doing R&D was not resulting in any productive work. In view of above factual matrix about the working and activity of the Indian branch office, and its role towards US Head office, clearly show that Indian branch office during the relevant period carried out engineering, calculations as well as drawing of various architectural designs for the US office.

21. Admittedly, the assessee entity branch office was also doing R&D work for the US Head office and the same was being done exclusively by the Indian branch which was the core business of the assessee and we decline to accept the contention of the assessee that such a work was of preparatory or auxiliary character within the ambit of Article 5(3)(e) of the Indo US treaty. In the case of Morgan Stanely and Co. Inc. (supra) the Hon'ble Apex Court in the peculiar facts and circumstances of the case observed that as per agreement between Morgan Stanely and Co. USA and Indian company the Indian entity was engaged in supporting the front office and in para 8 of this order, their lordships held that when Indian entity is performing in India, only back office operations, then to the extent of the back office functions, the second part of Article 5(1) is not attracted. The ld. DR pointed out para 15 of this order and submitted that even deputationist employees

constitute PE, then in the present case, 95 employees of high technical and managerial sill would definitely constitute PE.

22. On vigilant reading of this decision, we note that the benefit of the ratio of first part of decision is not available for the assessee as on careful examination of activities and modus operandi of the assessee, we have already reached to a conclusion hereinabove in this order that the important work assigned to Indian branch office was preparation of drawing, designs and doing structural calculations which require high technical and managerial skill, therefore, this important facet of the Indian Brach cannot be said to be a preparatory and auxiliary work of a back office but at the same time, we note that the US office minimise their cost of services and other expenses by assigning and appointing highly technical and materially skilled professional to discharge main function of US Head office in India at low cost. The Hon'ble Apex Court in the case of Morgan Stanley (supra) in para 15 held that even employees which are highly experienced in their specialised fields lends their expertise to Indian entity in that that sense there is a service PE under Article 5(2)(1) of Indo-US DTAA. The operative para 15 (at page 428) reads thus:-

> *" 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.

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."

23. Thus, we respectfully hold that the case laws cited and relied by the assessee are clearly distinguishable from the facts and circumstances of the present case. In view of our conclusion that the assessee is a PE in India as per provisions of Article 5(2)(b) and (c) of Indo-US DTAA, the contentions of the assessee are dismissed and hence ground no. 6 and 10 in AY 2003-04 and 1 to 5 in AY 2004-05 are dismissed.

Ground No. 11 & 12 in ITA No.1597/Del/2009, Ground No. 6 & 7 in ITA 1598/Del/2009, Ground no. 1,2 & 4 of the Revenue in ITA No.1275/Del/2009 for AY 2003-04 and ITA No.1172/Del/2009

24. Apropos these similar grounds in the both the years, ld. Counsel for the assessee submitted that without prejudice to the earlier grounds of the assessee, it is further contended that the AO ought not to have taken into consideration the figure of profits from the US return for the calendar year 2003 but should have taken the figures for the calendar year 2002 for 2003-04 and figures for the calendar year 2003 for AY 2004-05 for the determination of attributable profits and subjected it to a further downward adjustment for functions performed, assets employed, working capital available and risk assumed and consequently the adoption of global profit rate of 8.5% and 10.6% for respective assessment years is very high. Ld. Counsel further contended that the CIT(A) had erred in directing the AO to calculate attributable profit at 50% of the figure arrived at by the AO after applying 8.5% and 10.6% respectively for the assessment year under consideration representing the global profit ratio of US head office of the assessee.

25. Replying to the above, ld. DR supported the impugned order and submitted that the AO as well as the CIT(A) was right in holding that the attributable profit to the Indian PE on the basis of risk assumed, assets used and activities performed by the PE in the given set up of activities allocation between the HO and PE, the Indian branch in the status of PE does entire

designing and drawing work which includes the risk of design and drawing. The DR further contended that in the light of the fact that Indian branch also takes same risk as the important designing and drawing calculations are carried out by the Indian company, therefore, allocation of the profit determined by the AO after applying Rule 10 of Income Tax Rules 1962 was rightly held to be attributable to the operations carried out by the PE in India. The ld. DR strongly supported the assessment order and submitted that the AO calculated attributable profit at 100% of the figure arrived at after applying the profit rate of 8.5% for AY 2003-04 and 10.6% for AY 2004-05 according to the global profit ratio of the assessee. The ld. DR also submitted that the calendar year 2002 for AY 2003-04 and calendar year 2003 for AY 2004-05 cannot be said to be a suitable bench mark for adopting global profit rate because financial year for AY 2003-04 goes up to 31.3.2003 and financial year for AY 2004-05 goes up to 31.3.2004.

26. On careful consideration of above contentions, at the outset, from bare reading of the impugned order, we observe that this issue has been decided against the assessee by the CIT(A) with following observations in AY 2003-04:-

> *"From the above it can be seen that rule 10 has to be applied in accordance with para 2 of the article 7 accounting thereby that only the profits which are attributable to the PE can be taxed in India. Application of global profit rate to the Indian turn over results in the profit of the enterprise relatable*

to Indian operations. However this has to be attributed to the PE on the basis of risks assumed, assets used and activities performed by the PE. Given the set up activities allocation between the head office and the PE, it is seen that even though marketing, sale promotion and quality checks are being carried out by the Head Office, the Indian branch does the entire drawing and design work which also includes assuming the risks of drawing and design. It is thus true that the Indian branch also takes some risk as the important drawing, designing and calculations are carried out by the Indian company. Looking to the totality of situation it is seen that 50% of the profits determined by the AO after applying rule 10 are attributable to the operations carried out by the PE in India. Accordingly the AO is directed to calculate attributable profit at 50% of the figure arrived at after applying the profit rate of 8.5% which represents the global profit ratio of the appellant. This covers the grounds of appeal no. and 10 of the appellant.

Ground of appeal no. 7 relates to adoption of status of foreign company as against correct status of appellant as being an individual. The appellant has filed a copy of the return filed before US Tax Authority for calendar year 2002 wherein the effective date for election as that the Corporation has been shown to be from 1.1.1989. The appellant has accordingly placed reliance on the provisions of Income-tax Act as contained in clause 17 of section 2 which means that any body corporate incorporated by or under the laws of a country outside India will be considered to be a company for the purpose of Income-tax Act but at the same time the appellant has also placed reliance of provisions of the Companies Act as contained in clause 7 to section 2 wherein it is mentioned that the body corporate does not include a corporation sole. However, it is to be kept in mind while applying or determining the status of the appellant the provision of Income-tax Act have to be applied. As per provisions of Income- tax Act any body corporate incorporated by or under the laws of any country outside India has to be treated as a company. Moreover, in terms of paragraph 2 of article 3 any term not defined in the statute has to be determined in accordance with the provisions of laws of that State concerning the taxes to which the Convention applies. Applying this principle from this clarification given in

> *the treaty, it is clear that an election to be treated as sole corporate will not affect the application of the provisions of Indian Income-tax Act and, therefore, the appellant has to be treated as a company for the purpose of status. The AO has accordingly correctly applied and determined the status of the appellant as a foreign company, therefore, ground of appeal no. 7 is dismissed."*

27. On careful consideration of above submissions, we note that from earlier part of this order, we have upheld the findings of the authorities below that the assessee has PE in India as per provisions of Article 5 (2)(b)(c) of Indo US DTAA. Coming to the issue of attribution of profits to PE in India, from page no. 191 to 209 of the Paper Book, which contains transfer pricing analysis report, the assessee itself has adopted the mark up to the cost at 1.83% and at the same time, the AO found that the net profit earned by the Head Office of the assessee in US tax return was 8.5% which was based on sales. The revenue authorities have observed that the assessee has not submitted record of uncontrolled transactions and the record of analysis, how the uncontrolled transactions are comparable to the case of the assessee as per requirement of Rule 10B(2) of the Income Tax Rules, 1962. In this situation, the AO was right in adopting the profit of 8.5% for AY 2003-04 and 10.6% for AY 2004-05 to calculate attributable profit. However, the ld. Counsel of the assessee has raised this objection that the AO adopted the wrong calendar year for adoption of global profit rate but we are unable to accept this contention as financial year for respective assessment years is spread over upto 31st March and in the light of this fact that the percentage of global profit was higher in calendar year 2003,

the adjustment would be neutral and academic, therefore, this contention of the ld. Counsel of the assessee is not found to be acceptable.

28. Turning to the ground of the revenue in cross appeals, ld. DR submitted that the CIT(A) has erred in directing the AO to calculate attributable profit at 50% of the figures arrived after applying profit rate of 8.5% for AY 2003-04 and 10.6% for AY 2004-05 which actually reduce the global profit ratio of the assessee by ignoring the fact that the PE also assumes risk in respect of work done by it and the Head office at USA earns its own profit in respect of part of expenses not attributable to PE so that the taxable profit should be the income of the PE in India as rightly determined by the AO. Ld. DR vehemently contended that the CIT(A) has not disclosed any reason or basis to reduce the attribution of profit by 50% and in substituting his own estimate of income without pointing out any figure in the basis adopted by the AO for attribution of the profit to the PE in India. Ld. DR further contended that such kind of estimation by the CIT(A) is contrary to the principles laid down by the Hon'ble Supreme Court of India in the cases of CST vs H M Esufali H M Abdulali (supra) and Kachwala Gems vs JCIT (supra). Ld. DR finally prayed that the impugned order may be set aside by restoring that of the AO on this issue.

29. Ld. Counsel for the assessee replied that the CIT(A) was wrong in assuming that the entire work of the US Head office has been assigned to Indian Branch and then allocated 50% of the total profits to Indian Branches. Ld.

Counsel further contended that while splitting up profit between US office and Indian Branch, the revenue authorities had to consider vertical balance sheet for the calendar year 2002-03 for the respective assessment year against which the CIT(A) has to take into account this very fact that the actual income returned was before the US revenue department. Ld. Counsel pointed out that for the AY 2003-04, the CIT(A) had taken into consideration the vertical balance sheet whereas for AY 2004-05, the CIT(A) had taken into account the income tax return filed by the assessee in India. Ld. Counsel also submitted that as per section 92 of the Act, the ALP in relation to an international transaction shall be determined by one of the most appropriate method prescribed therein having regard to the nature of transaction or function performed. Ld. Counsel further contended that Rule 10B has further explained the procedure for determination of ALP under various methods prescribed u/s 92C of the Act. Ld. Counsel further submitted that the CIT(A) applied the profit split method as explained in Part B of Sub-rule (1) of Rule 10B of the Income Tax Rules 1962. Ld. Counsel has drawn our attention that first of all, the combined net profit of the AE arising from the international transaction in which they are engaged will be determined and then the relative contribution made by each of the AE towards the earning of such combined net profit should be evaluated on the basis of function performed, assets employed and risk assumed by each enterprise and then combined net profit is split amongst the enterprise in

proportion to their relative contribution as evaluated under sub clause (ii) of Rule 10B.

30. Ld. Counsel has also drawn our attention towards page 20 to 22 of the Paper Book and submitted that the relative contribution to the whole transaction which was carried out by the US Head office and branch office in India has been furnished before the CIT(A) on his direction during the first appellate proceedings. It was further contended on behalf of the assessee that from perusal of the contribution of work in a particular contract, it is clear that right from the stage of discussion and obtaining the contract and till its finalisation, all risks including capital risk, professional risk, investment risk, bad debts, legal suits, matters relating to patent, trade mark and intellect property rights, insurance and damages are entirely borne by the US Head office and the branch office in India have done only engineering calculations as per instruction and directions of the US Head office without bearing any risk.

31. Replying to the above, ld. DR submitted a rejoinder supporting the ground of the revenue in cross appeals and submitted that as per income standard of CEC US Head office for the period ended on 31.12.2003 available on Paper Book page 300, the earning before tax were USD 246589 on the revenue of USD 2324705 and total expenses incurred were of USD 1877959 consisting of direct cost of USD 809945 and operating cost of USD 1068014 which also includes Indian expenses. Ld. DR further submitted that as per TP

study of 22 foreign companies operating in US, the profit margin before tax was 2.34% and US Head office of assessee earned profit of about 8.5% and 10.6% respectively for the assessment year under consideration, therefore, the profit percentage of 2.34 on the revenue of USD 23247705 comes to USD 54398, therefore, the US Head office earned super profit of USD 192191 due to Indian operations for which the US Head office incurred very low cost and expenses.

32. Ld. DR also pointed out that the AO simply attributed the profits earned by the assessee based on cost incurred in India and USA and the AO has applied mark up on cost and has approved the cost plus method as a most appropriate method, attribution of profit to Indian PE based on expenses incurred in India amounts to use of profit split method taking the cost incurred in two tax jurisdiction as a key split in the profit. The ld. DR also contended that the CIT(A) ignored liberal approach of the AO wherein the AO has considered the actual figures of cost incurred and did not take into account the cost of these services if rendered in US and on this account, the AO had not made any adjustment due to locational savings and the AO has attributed profits to the Indian entity on a very lower side, therefore, the CIT(A) has no justification for further reducing the profits of Indian PE by 50%. The ld. DR further submitted that once profits are attributed to Indian operations based on Rule 10 of Income Tax Rules 1962 as done by the AO, then there is no scope of attributing a part of this profit to US Head office. The ld. DR also pointed out that the CIT(A) has failed to appreciate

that the profits earned by the assessee have already been allocated to the Head office and Indian PE based on mark up to cost incurred by them and there cannot be further attribution as all the development activities have taken place in India and only the marketing and quality control activities have taken place in USA.

33. On careful consideration of above rival submissions, from the relevant part of the impugned order, we observe that the AO has not brought out any fact or material into existence that the risk of marketing and quality control activity have taken place and all developmental activities have taken place in India. In this situation, it cannot be said that risk is involved exclusively either on the Head office or on the PE branch office in India. Obviously, from stage of discussion and obtaining the contract till its final marketing to the respective client have been undertaken by the US Head office but at the same time this fact cannot be ignored that the PE branch office in India contributed towards all development activities at the cheaper cost of service and human resources in comparison to USA, therefore, we are of the view that for earning higher profit in comparison to USA, comparable companies as adopted in transfer pricing study, the US Head office earned higher profit due to low cost of services and human input by Indian PE. At the same time, although we note that the risk factor was also borne by the Indian PE branch, we also note this fact that certain risk in regard to capital investment, bad debts and other legal obligations were

borne by the US Head office, therefore, the AO rightly adopted the global profit of the US Head office for benchmarking the percentage of profit and the AO attributed 100% profit to the Indian PE. At this juncture, from the impugned order, we also observe that the CIT(A) has taken into account this very fact that the Indian branch takes some risk as the important drawing and designing calculations are carried out by the Indian company and impliedly other risks as stated above were taken by the US Head office and, therefore, in the totality of these facts and circumstances, the CIT(A) was justified in holding that 50% of the profits determined by the AO after applying rule 10 were to be attributable to the operations carried out by the PE in India.

34. On the basis of foregoing discussion, we are in agreement with the action of the CIT(A) that he directed the AO to calculate attributable profit @50% of the figure arrived after applying profit rate of 8.5% for AY 2003-04 and 10.6% for AY 2004-05. Finally, we reach to a conclusion that the contentions of the assessee for wrong adoption of global profit of the US Head office are not sustainable. At the same time, we also observe that the CIT(A) was reasonable and justified in directing the AO to calculate the attributable profit at 50% of the figure arrived by the AO after applying global profit rate of US Head office for the respective assessment years under consideration in these appeals. Accordingly, ground no. 11 & 12 for AY 2003-04 and ground no. 6 & 7 for AY

2004-05 of the assessee as well as ground no. 1 to 4 of the revenue in both the appeals for AY 2003-04 and 2004-05 are dismissed.

Ground no. 13 of the assessee for AY 2003-04 and gorund no. 8 of the assessee for AY 2004-05

35. Ld. Counsel for the assessee submitted that the revenue authorities ought to have adopted the status of the assessee as individual independent foreign company because the CEC is a firm and not a company even in the US as it is 100% owned by a single individual and, hence, does not fall in the category of a company. Ld. Counsel for the assessee further contended that the authorities below ought to have adopted the status of the appellant as individual instead of foreign company because the assessee is a firm and not a company even in US as it is 100% owned by a single individual, hence, does not fall in the category of a company.

36. Ld. DR replied and pointed out that that as per details of employees with designation and salary available on page 304 and 305, Mr. A.K. Jalla is the Vice President of Indian PE and in the ground itself, the assessee is accepting that the CEC is a firm and not a company even in US, then in terms of Indo US Treaty Part 2 of Article 3, wherein any term has not been defined in the treaty, then the provisions of the laws of that contracting state will be applied. The DR further pointed out para 6 of the impugned order and submitted that the assessee was rightly treated as a company for the purpose of status as per the provisions of the Act and in consonance with the provisions of the Indian US Treaty.

37. On careful consideration of above submissions, we find it appropriate to reproduce the relevant operative part of the impugned order in para 6 which reads as under:-

> *"6. Ground of appeal no. 1 relates to adoption of status of foreign company as against correct status of appellant as being an individual. The appellant has filed a copy of the return filed before US Tax Authority for calendar year 2002 wherein the effective date for election as that the Corporation has been shown to be from 1.1.1989. The appellant has accordingly placed reliance on the provisions of Income-tax Act as contained in clause 17 of section 2 which means that any body corporate incorporated by or under the laws of a country outside India will be considered to be a company for the purpose of Income-tax Act but at the same time the appellant has also placed reliance of provisions of the Companies Act as contained in clause 7 to section 2 wherein it is mentioned that the body corporate does not include a corporation sole. However, it is to be kept in mind while applying or determining the status of the appellant the provision of Income-tax Act have to be applied. As per provisions of Income- Tax Act any body corporate incorporated by or under the laws of any country outside India has to be treated as a company. Moreover, in terms of paragraph 2 of article 3 any term not defined in the statute has to be determined in accordance with the provisions of laws of that State concerning the taxes to which the Convention applies. Applying this principle from this clarification given in the treaty, it is clear that an election to be treated as sole corporate will not affect the application of the provisions of Indian Income-tax Act and, therefore, the appellant has to be treated as a company for the purpose of status. The AO has accordingly correctly applied and determined the status of the appellant as a foreign company, therefore, ground of appeal no. 1 is dismissed. "*

38. In view of above conclusion of the CIT(A), we observe that in the ground itself, the assessee has mentioned that US Head office is a firm and not a company even in the US tax status, therefore, the assessee should be given the

status of individual instead of foreign company. We further observe that the CIT(A) has rightly concluded that while applying or determining the status of the appellant, the provisions of Income-tax Act have to be applied. As per provisions of Income- Tax Act, anybody corporate incorporated by or under the laws of any country outside India has to be treated as a company. Therefore, we hold that the assessee was rightly treated as a foreign company for the purpose of tax status and the AO correctly applied and determined the status of the assessee as a foreign company for the purpose of tax payer status of the assessee. Accordingly, ground no. 13 of the assessee for AY 2003-04 and ground no. 8 of the assessee for AY 2004-05 being devoid of merits are dismissed.

39. In the result, the appeal of the assessee in ITA No. 1597/Del/2009 for AY 2003-04 and ITA 1598/Del/2009 for AY 2004-05 as well as appeals of the Revenue in ITA No. 1275/D/2009 and 1172/Del/2009 are hereby dismissed.

Order pronounced in the open court on 31.10.2014.

Sd/-	Sd/-
(G.D. AGRAWAL)	(CHANDRAMOHAN GARG)
VICE PRESIDENT	JUDICIAL MEMBER

DT. 31st OCTOBER, 2014
'GS'

Copy forwarded to:-

1. Appellant
2. Respondent
3. C.I.T.(A)
4. C.I.T.
5. DR

By Order

Asstt.Registrar