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TAX FLASH NEWS

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# Report on proposed amendments of rules for profit attribution to permanent establishment in India open for public consultation

Recognising the significance of issues relating to attribution of profits to a Permanent Establishment (PE) as well as the need to bring greater clarity and predictability in the applicable tax regime, a Committee was formed by the Central Board of Direct Taxes (CBDT) to examine the existing scheme of profit attribution to PE and recommend changes in current domestic tax law (Rule 10 of the Income-tax Rules, 1962 (the Rules). The report submitted by the Committee was released by CBDT for public consultation on 18 April 2019[1].

## Key recommendations

Observing that business profits are contributed by both demand and supply of goods, the Committee recommends a mixed approach that allocated profits partly to the jurisdiction where the consumers are located and partly to the jurisdiction where supply activities are undertaken.  Based thereon, the Committee recommends a fractional apportionment approach that determines profit attribution based on a three-factor method, assigning equal weights to sales (representing demand) and manpower and assets (representing supply including marketing activities). Further, in cases of profit attribution for Significant Economic Presence (SEP), the Committee has recommended a four factor approach wherein ‘Users’ be considered as the fourth factor. Different weightages for the four factors are also recommended for businesses involving low and medium intensity versus those involving high user intensity. The Committee also recommends that the profits derived from Indian operations (on which the three-factor method would apply) can be arrived by multiplying the revenue derived from India with the global operational profit margin. To protect India’s revenue interest in situations where an enterprise is having global operating losses, the Committee recommends that profits derived from India be subject to a floor rate of 2 per cent.

The key recommendations as summarised above were provided by the Committee after detailed analysis of the existing rules, their legal history, the relevant economic and public policy principles, the international practices, view of academicians and experts, relevant case laws and methodology adopted by tax authorities dealing with these issues.

Key observations and recommendations of the Committee are summarised as follows:

## Key observations of the Committee

### *Need for clarity in India’s approach on PE attribution*

The business profits of a non-resident enterprise is subject to income tax in India if it satisfy the threshold condition of having a business connection in India as well as the threshold provided in the applicable tax treaties. For the cases satisfying the thresholds, the profits that are to be attributable to India are determined on the basis of the accounts of the PE. Where the detailed accounts are not

[1] Comments and suggestions may be sent electronically (in word format) at the email address usfttr-1@gov.in within 30 days of the publication of the report

available, the Rule 10 under India's domestic law can be applied which provides a wide discretion to the Assessing Officer including by way of formulary apportionment.

In this context, the Committee observes a concern that very diverse methodologies seem to have been adopted by Assessing officers under Rule 10 in different cases. This may be a result of the wide scope of discretion accorded under Rule 10 in terms of methodology for attribution of profits. Since lack of a universal rule can create uncertainties for taxpayers as well as result in more tax disputes, there appears to be a case for providing a simple and universally applicable rule to bring in greater certainty and predictability among the stakeholders and prevent avoidable tax litigation on this account.

The demand for clarity and objectivity has risen since the follow-up work in respect of profit attribution undertaken by OECD consequent to the Action 7 of BEPS project and the fact that Article 7 of the 2010 version of the OECD Model tax Convention (MTC) and the Authorised OECD Approach (AOA) prescribed therein have not been adopted by India in any of its tax treaties till date.

***Both demand and supply factors are relevant for PE attribution***

The Committee observes that business profits are contributed by both demand and supply of goods. Accordingly, a jurisdiction that contributes to the profits of an enterprise either by facilitating the demand for goods or facilitating their supply would be reasonably justified in taxing such profits. On the economic factors relating to the demand side, the Committee observes that a jurisdiction that contributes towards demand by facilitating the economy and the ability of their resident to pay or by maintenance of markets that enable sales also contributes towards the business profits of an enterprise. It is the market and the demand for consumption that dictates production and not vice versa. Based thereon, the Committee considers that a mixed or balanced approach that allocates profits between the jurisdiction considering both demand and supply factors is rather appropriate instead of purely supply approach or purely demand approach.

***Article 7 of the OECD MTC and the AOA ignores sales and the demand side factors***

The Committee observes that the revised Article 7 in the 2010 update of the OECD MTC and the approach for profit attribution to PE as per the AOA introduced reliance upon Function, Assets and Risk (FAR) analysis for profit attribution, which was not there earlier. Another significant change in revised Article 7 was to omit the option of determining attributable profits by way of apportionment, as may be possible under domestic tax laws. The significant impact of the revisions was to ensure taxation of profits solely on the basis of the contributions made by supply side factors, while completely ignoring sales and thereby the contributions made by the maintenance of markets and the demand side factors. This is also a major deviation from the generally applicable accounting standards for determining business profits, where business profits cannot be determined without taking sales into account.

The Committee also observes that the AOA approach may be favourable to the interests of certain countries that are net exporter of capital and technology, it is likely to have significant adverse impact on developing economies like India, which are primarily importers of capital and technology. It restricts the taxing rights of the jurisdiction that contributes to business profits by facilitating demand.

Overall, the Committee concludes that India cannot depend on OECD guidance and need to consider ways and means to bring greater clarity and objectivity in profit attribution under its tax treaties and its domestic laws, especially in consequence to the changes introduced as a result of BEPS Action 7.

***Option of formulary apportionment not considered feasible***

The Committee did not find the option of formulary apportionment method apportioning consolidated global profits feasible, in view of the practical constraints in obtaining information related to jurisdictions outside India. The application of formulary apportionment requires availability of complete information about the country-wise sales revenue as well as the deployment of manpower and assets, which is not easily available. While such information for large MNEs (whose turnover exceeds the threshold limit set for County-by-Country Reporting) may be available, it is not fully clear whether the information received under CbCR can be used for attribution of profits. Based on these challenges, the Committee considers that it may be preferable to adopt a method that focuses on Indian operations primarily and derives profits applying the global profitability, with necessary safeguards to prevent excessive attribution on one hand and protect the interests of Indian revenue on the other.

The Committee found the option of fractional apportionment based on apportionment of profits derived from India permissible under Indian tax treaties as well as Rule 10, and relatively feasible as it is based largely on information related to Indian operations.

***Profit attribution in Significant Economic Presence nexus***

After taking into account the developments in taxation of digital economy and the new Explanation 2A, inserted by the Finance Act, 2018, explicitly including SEP within the definition of business connection, the Committee considered it necessary to take into account the role and relevance of users in contributing to the business profits of multidimensional business enterprises. While the thresholds are yet to be prescribed, the Committee noted that it is important that the principles of profit attribution to SEP are clarified.

The Committee observed that the user data and activities contribute to the profits of the multidimensional enterprises, and there is a strong case of taking them into account, once the minimum nexus threshold of taxable presence by SEP or otherwise, as required by the Income Tax Act and the relevant tax treaties, is satisfied. The Committee found it reasonable that user contribution should be taken as the fourth factor for apportionment, in addition to the other three factors of sales, manpower and assets. However, different weightages are recommended for the user contribution factor depending on whether the business model involve low and medium user intensity or a high user intensity. The Committee also decided that since the users carry out the work of employees and are also asset to the company, the relative weightage of employees and assets will be adjusted downwards, keeping the weightage of sales fixed at 30 per cent in all such cases.

## Recommendations of the Committee

In view of the various considerations, the Committee made recommendations to make amendments to Rule 10 in the following manner.

A. ***Profit attribution based on equally weighted three factor -*** Profits attributable to India shall be determined by apportioning the 'Profits derived from India' by three equally weighted factors of sales, employees (manpower & wages) and assets as under:

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**Profits attributable to operations in India = '*Profits derived from India*' x [$S_I/3 \times S_T$ + ($N_I/6 \times N_T$) + ($W_I/6 \times W_T$) + ($A_I/3 \times A_T$)]**

- '*Profits derived from Indian operations*' is determined as higher of the following amounts:
  - a. '*Revenue derived from India*' x '*Global operational profit margin*'; or
  - b. Two percent of the revenue derived from India
- '*Revenue derived from India*' includes all receipts arising or accruing or is deemed to accrue or arise from India which are chargeable under the head Profits and gains of business or profession.
- '*Global operational profit margin*' shall be determined as the EBITDA margin (Earnings before interest, taxes, depreciation and amortization) of the enterprise.

</td></tr>
<tr><td>$S_I$</td><td>Sales revenue derived by Indian operations from sales in India</td></tr>
<tr><td>$S_T$</td><td>Total sales revenue derived by Indian operations from sales in India and outside India</td></tr>
<tr><td>$N_I$</td><td>Number of employees employed with respect to Indian operations and located in India</td></tr>
<tr><td>$N_T$</td><td>Total number of employees employed with respect to Indian operations and located in India and outside India</td></tr>
<tr><td>$W_I$</td><td>Wages paid to employees employed with respect to Indian operations and located in India</td></tr>
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|---|---|
| $W_T$ | Total wages paid to employees employed with respect to Indian operations and located in India and outside India |
| $A_I$ | Assets deployed for Indian operations and located in India |
| $A_T$ | Total assets deployed for Indian operations and located in India and outside India |

B. ***Profit attribution in case of SEP based on four factors*** - In the cases where the business connection is primarily constituted by the existence of users beyond the prescribed threshold in India, the profits attributable to India shall be determined by apportioning the 'Profits derived from India' on the basis of four factors of sales, employees (manpower & wages), assets and users as under:

- In cases of low and medium user intensity - 10 per cent weight to users and 30 per cent each to other three factors

**Profits attributable to operations in India = '*Profits derived from India*' x [0.3 x SI/ST + (0.15 x NI/NT) + (0.15 x WI/WT) + (0.3 x AI/3xAT)] + 0.1]**

- In cases of high user intensity - 20 per cent weight to users, 25 per cent each to asset and employees and 30 per cent to sales

**Profits attributable to operations in India = '*Profits derived from India*' x [0.3 x SI/ST + (0.125 x NI/NT) + (0.125 x WI/WT) + (0.25 x AI/3 x AT)] + 0.2]**

### *C. Relief from double taxation by providing deduction of profits derived from Indian operations*

The Committee observes that in view of the principles laid down by the Supreme Court of India in Morgan Stanley[2], as well as the need to avoid double taxation of such profits in the hands of a PE as well as an Indian Associated Enterprise (AE) resident in India (for instance, an Indian subsidiary) participating in an integrated business, profits that have already been subjected to tax in the hands of the AE should be deducted from the apportioned profits.

The recommendations of the Committee in this regard are –

- No further profits will be attributable to the operation of a enterprise in India, where the business connection in India is constituted by the activities of an associate enterprise that is resident in India and the enterprise does not receive any payments on accounts of sales or services from any person who is resident in India [or such payments do not exceed an amount of INR10,00,000] and the activities of associated enterprise have been fully remunerated by an arm's length price
- However, where the payments received by that enterprise on account of sales or services from persons resident in India exceeds the amount of INR10,00,000 then profits attributable to the operation of that enterprise in India will be derived by apportionment using the three factors or four factors and deducting from the same the profits that have already been subjected to tax in the hands of the associated enterprise. For this purpose, the employees and assets of the associated enterprise will deemed to be employed or deployed in the Indian operations and located in India.

[2] DIT v. Morgan Stanley [2007] 292 ITR 416 (SC)

## Our comments

Attribution of profits to permanent establishment is a complex and contiguous issue. From an India perspective, diverse methodologies have been adopted by Assessing officers under Rule 10 to determine the profit attributable to PE, leading to uncertainty for taxpayers. The Committee's report is a welcome step taken by CBDT towards providing a uniform approach for profit attribution. The public consultation approach is a welcome step and it shows a transparent approach on the part of the tax administration.

The 'Fractional Apportionment Approach' finally recommended by the Committee seems to keep India's positions and India's revenue interests strongly in consideration. The Committee's strong emphasis on demand-side factors seeks to place 'market jurisdiction' as a significant contributor to the profits of an enterprise from that jurisdiction. While the recommended approach may mitigate uncertainty that results from the current scope of discretion accorded to tax authorities under Rule 10, it is important to ensure that the final rules address the issues of potential double taxation as well as reconsiders some of the assumptions and mechanics of the recommended approach to better suit different cases of profit attributions.

The Committee report seems to take a very strong view that the application of arm's length principles on the basis of FAR analysis necessarily ignores the demand-side considerations. Based thereon, the rejection of the arm's length basis for PE attribution seems a significant divergence from internationally accepted principles for PE attribution.

The recommended 'Fractional Apportionment Approach' providing equal weightage to three factors (sales, manpower and assets) may seem as 'one size fits all' approach, may not be suitable for all cases alike. The floor of 2 percent for 'Profits derived from India' recommended by the Committee seems to pose a potential double taxation issue for taxpayers.

Overall, the various assumptions and computational aspect needs to be thoroughly reviewed to ensure there are no interpretation issues or implementation challenges. In this context, certain examples may be provided in the final rules so as to help avoid practical challenges/ ambiguities in the implementation of the rules. Also, MNEs having business activities in India need to review their business arrangements for implications arising from the report.

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