Attribution of profits to Permanent Establishment

The Chamber of Tax Consultants - 5 October 2019
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Contents

- Background of PE
- How should profits be attributed to a PE?
- Important case laws on profit attribution
- CBDT proposal for amendment of PE attribution rules
- Questions??

What is Permanent Establishment (“PE”)?

Permanent establishment – Act vs DTAA

Taxation of Non Residents in India

Under the Act

Under the treaties

Business Connection

- Inclusive definition, covers dependent agents concluding contracts in India for non-resident principals
- Interpreted widely by Courts
- Expanded further by the recent introduction of the concept of Significant Economic Presence ("SEP") –
  - any transaction in respect of goods, services, or property carried out by a non-resident in India, including provision of download of data or software in India, if the aggregate of payments arising from such transactions during the previous year exceeds the prescribed threshold; or
  - systematic and continuous soliciting of business activities or engaging in interaction with the prescribed number of users in India through digital means

PE - narrower and better defined

- Some sort of physical presence required under the current law for constitution of PE
- Challenges posed by evolving business models (especially digital business) not requiring physical presence – presently under consideration by various countries as well as the OECD
- SEP provisions under current law not to impact taxpayers from treaty countries until treaties amended to include similar provision
  - *India's observation on the OECD Commentary: India reserves the right to include a provision in Article 5 of tax treaties to the effect that an enterprise having an SEP in India will be deemed to have a PE in India*

Consequences of constitution of PE in India

1

Higher tax rate of 40% (plus applicable surcharge and cess) on profits attributable to PE of foreign companies in India (on a net income basis)

2

Computation of profits attributable to the PE subject to the Indian domestic tax law provisions

- Restrictions relating to disallowance of expenditure for withholding tax default, allowance of certain expenses on payment basis, deduction of head office expenditure, etc to apply

3

Various Indian income-tax compliances to be undertaken (such as obtaining Permanent Account Number, filing income-tax returns, withholding tax compliances, maintenance of books of accounts and auditing of the same)

4

Transfer pricing compliances to be undertaken for transactions between PE and head office or other related entities in the group

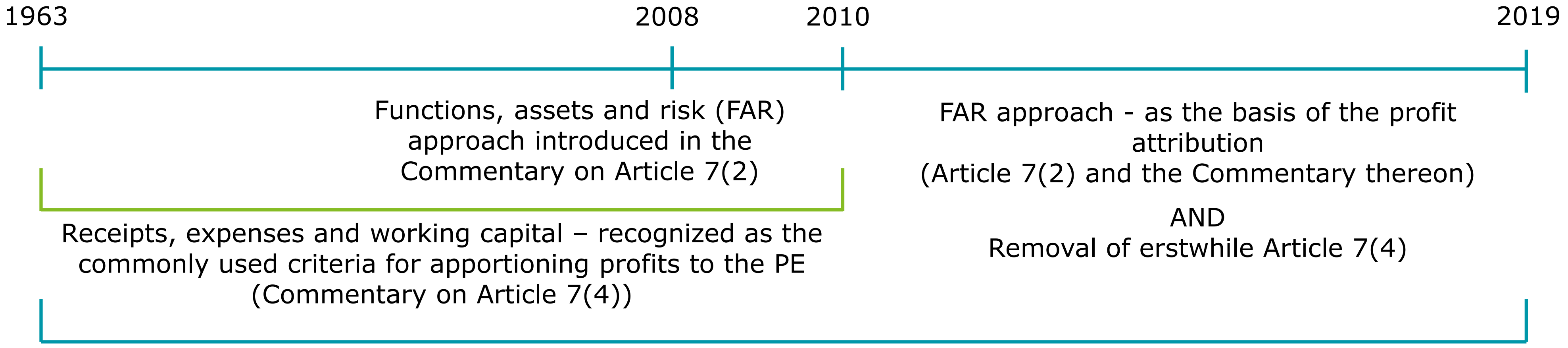
- Section 92F of the Act defines an 'enterprise' to mean a person including a PE of such a person

Right of source country to tax profits of foreign enterprise operating in its jurisdiction – when Permanent Establishment ("PE") exists i.e. Source Based Taxation

How should profits be attributed to a PE?

Article 7 of Model tax conventions - Journey so far (1/2)

OECD model



1963

2008

2010

2019

Functions, assets and risk (FAR) approach introduced in the Commentary on Article 7(2)

FAR approach - as the basis of the profit attribution
(Article 7(2) and the Commentary thereon)

AND
Removal of erstwhile Article 7(4)

Receipts, expenses and working capital – recognized as the commonly used criteria for apportioning profits to the PE (Commentary on Article 7(4))

'distinct and separate' enterprise approach considered as corresponding to the 'arm's length principle'

1980

UN model

2019

- Similar to Pre-2010 OECD model convention.
- However, provides greater taxation rights to the source country in the form of FOA rules and restrictions on deduction of certain expenses
- Sales taken into account, both in the direct accounting method as well as in the indirect apportionment method
- 'Distinct and separate' enterprise approach considered as corresponding to the 'arm's length principle'

1969

Indian tax treaties

2019

- Most treaties similar to UN model convention and Pre-2010 OECD model convention

Article 7 of Model tax conventions - Journey so far

1963 Draft Convention

- First OECD draft double taxation convention
- States that if separate accounts are maintained then they must be taken into account when attributing profits to a PE
- Clarified that there may be situations where the accounts need to be rectified and as an example, discusses the case of goods transferred from the head office in one state to a PE in another state at a price that is not at arm's length price.

1977 and 1992 Model Tax Conventions

Contained certain clarifications, however the essence of Article 7 as envisaged in the model tax convention 1963 was retained.

2008 Model Tax Convention

- OECD recognized and acknowledged apportionment of profits based on one of the following criteria, i.e. receipts (or sales revenue), expenses, or working capital.
- Provided for apportionment method for attribution of profits.
- This might have been possible, if PE to be taxed on profits that it would be expected to make if it was a distinct and separate entity. This would normally be achieved by determining profits in accordance with the applicable principles of accounting, where separate accounts are maintained for the PE, provided the PE functions as a separate entity in a manner that would maximize its own profits as a supposedly separate entity

OECD Approach v/s UN Approach – A comparison

OECD approach

Pre-2010 version

- Accepted apportionment method for attribution of profits based on domestic laws
- Allows deduction of sunk costs incurred outside source country from profits derived by PE

Post-2010 version (AOA)

- Follows FAR Analysis for profit attribution and alignment with transfer pricing guidelines
- Omitted apportionment method for attribution of profits based on domestic tax laws

UN approach

- Primarily derived from OECD pre-2010 version
- Grants taxing rights to source countries
- Accepted apportionment based on receipts, expenses and working capital
- Accepted apportionment method for attribution of profits based on domestic laws
- Accepted limited force of attraction rule
- Ensures actual profits of entity derived by the PE from source country subjected to tax without any notional adjustments for sunk costs (royalties, fees, commission or interest) borne outside source country

OECD Model Tax convention post 2010

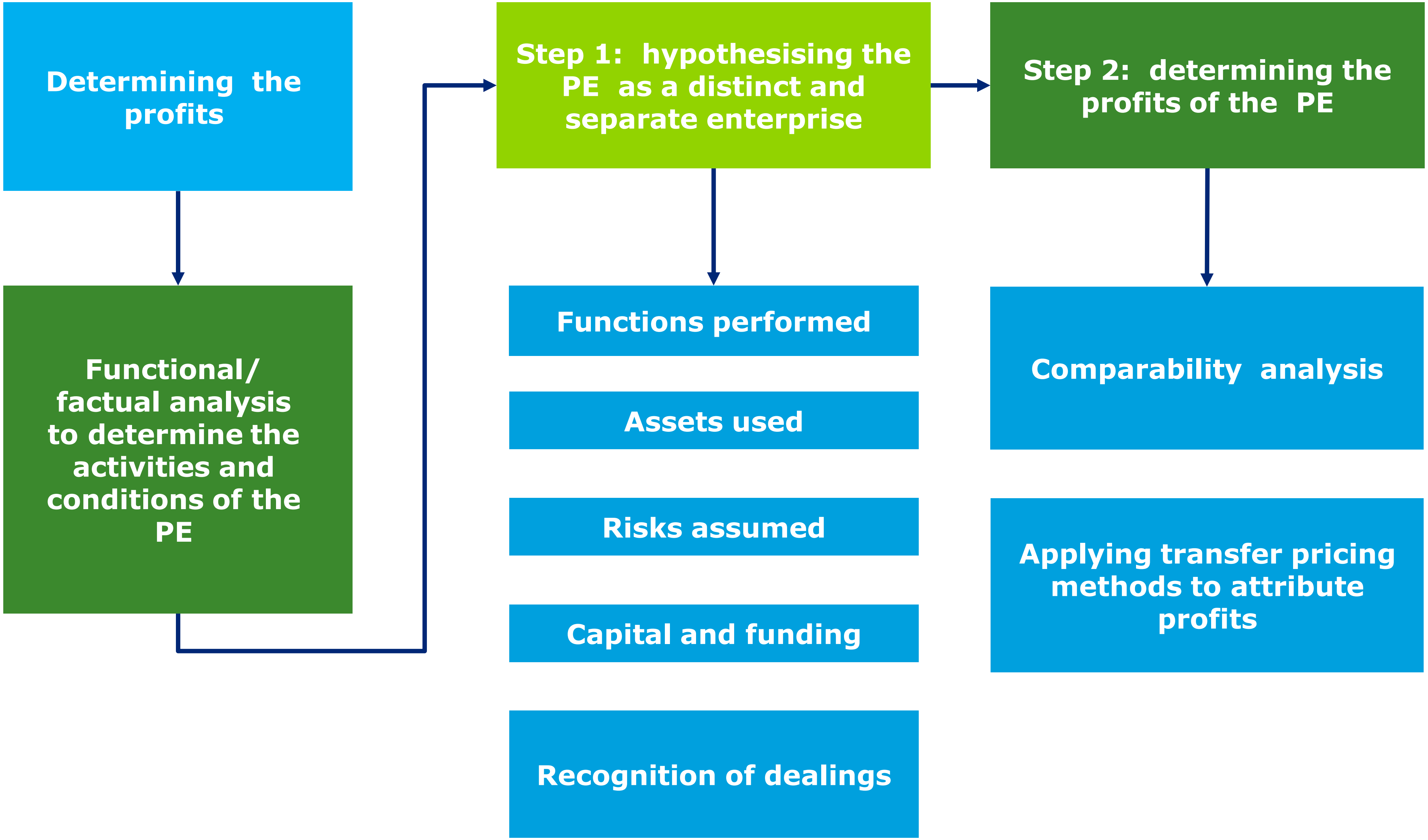
Authorized OECD Approach

- In 2010, the OECD adopted the Authorized OECD Approach (AOA), which has been incorporated into the Commentary on Article 7 of the Model Tax Convention (‘MTC’)
  - AOA relies on the concept of **significant people functions (SPFs)** to determine the activity attributable to the PE
  - OECD Transfer Pricing Guidelines are applied by analogy to dealings between the PE and the other parts of the enterprise, taking into account the functions performed, assets used, and risks assumed by the PE
- All OECD countries treat the **PE as a separate enterprise**, but the attribution of profits analysis can differ from country to country, as determined under either local principles or the specific treaty under which the analysis is being performed
- India does not accept or agree with the AOA to attribute profits to PE based on FAR analysis

“FAR Analysis” – *Thy* Key

Authorized OECD Approach

Steps involved



Determining the profits

Functional/ factual analysis to determine the activities and conditions of the PE

Step 1: hypothesising the PE as a distinct and separate enterprise

Functions performed

Assets used

Risks assumed

Capital and funding

Recognition of dealings

Step 2: determining the profits of the PE

Comparability analysis

Applying transfer pricing methods to attribute profits

Additional Guidance on the Attribution of Profits to PE

2016 to 2018 - Post BEPS Action 7 era

2016 Discussion Draft

Presented two types of fact patterns regarding attribution of profits to PE

- Dependent agent PEs (DAPEs), including those created through commissionaire and similar arrangements
- Warehouses as fixed place of business PEs

Demonstrated a series of numerical examples and potential differences that may result from attributing profits to these new PEs under AOA

2017 Discussion Draft

This draft affirmed the following points:

- There should be no double taxation as a result of attributing profit to a PE
- Through the accurate delineation of the transaction, the net amount of profits attributable to PE might be positive, zero or even negative.
- Source countries may adopt convenient ways of recognizing the existence of a PE and collecting the appropriate amount of tax

Additional Guidance on the Attribution of Profits to PE

2016 to 2018 - Post BEPS Action 7 era

Key changes in 2018 final report

- Sets out general principles for the attribution of profits to PEs in light of the changes to Article 5 of the OECD Model Tax Convention

- Includes examples dealing with the attribution of profits to a PE relating to warehousing activities, commissionaire arrangements, an online advertising sales structure, and procurement activities (discussed in the subsequent slides)

- Key principle across the examples is that the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise

- This principle applies regardless of whether a tax administration adopts the AOA or any other approach used to attribute profits.

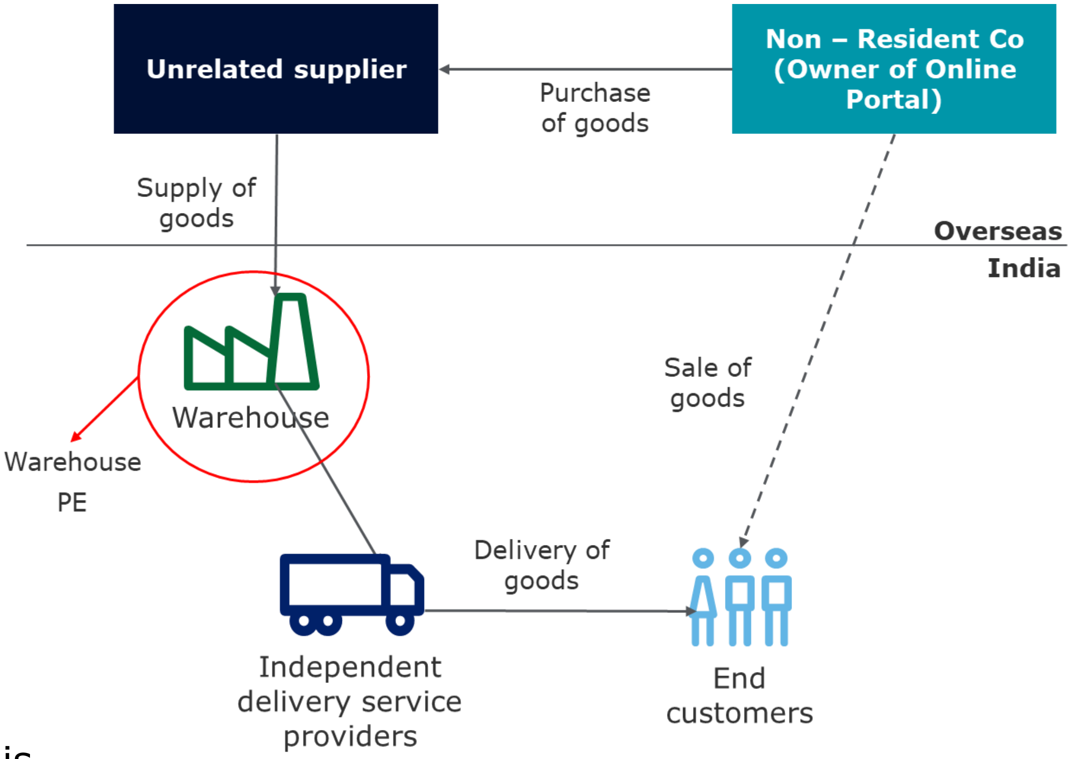
- Discusses the interaction of Article 9 and Article 7 to avoid double taxation in the source country

- Clarifies that while some functions may be considered as both 'significant people functions' under AOA and 'risk control functions' under Article 9, any conclusion cannot be drawn regarding alignment of two principles

- No duplicate attribution should be made based upon a single function considering the same as significant people function and risk control function at the same time

- Does not intended to extend the application of the AOA to countries that have not adopted that approach in their treaties or domestic legislation

Case study 1 – E-Commerce companies



Facts of the case

- Customers purchase goods from an online portal
- Goods are purchased from unrelated supplier parties and stock of goods are stored at a large warehouse engaging significant personnel for storage and delivery of goods
- Goods are delivered to customers by third party service providers, pursuant to online sale of goods

Attribution analysis

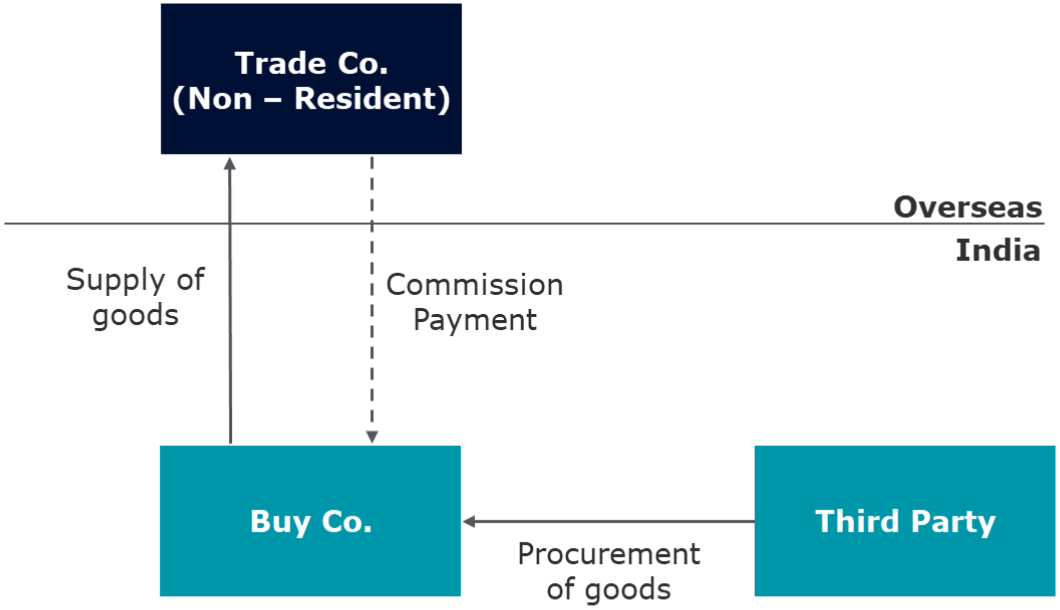
<u>Step 1</u>:

- Conduct a detailed functional and factual analysis
- Functional and factual analysis shows that the Head Office is performing functions of purchasing the goods from unrelated suppliers and sale of goods to third party customers
- The functional and factual analysis shows that the PE is performing functions of management of warehouse and hiring of third party service providers for delivery of goods

<u>Step 2</u>:

- The attribution is done by applying the arm's length principle to the transactions between the PE and the Head Office. The Head Office would pay the price that it would have had to pay if it had obtained the storage and delivery services from an independent enterprise (considering the nature of functions and assumption of risks)

Case study 2 – Procurement support services



Facts of the case

- TradeCo has a core business of procurement and sale of goods in country S (Overseas)
- BuyCo, a related company in India, performs procurement activity on behalf of TradeCo from unrelated suppliers in India. It does not own the goods at any point of time nor has any entitlement to the amount charged by TradeCo from its customers
- TradeCo pays a commission as a percentage of cost of purchases made by BuyCo on its behalf
- TradeCo has a PE in India as BuyCo habitually concludes the contracts on behalf of TradeCo for procurement of goods

Attribution analysis

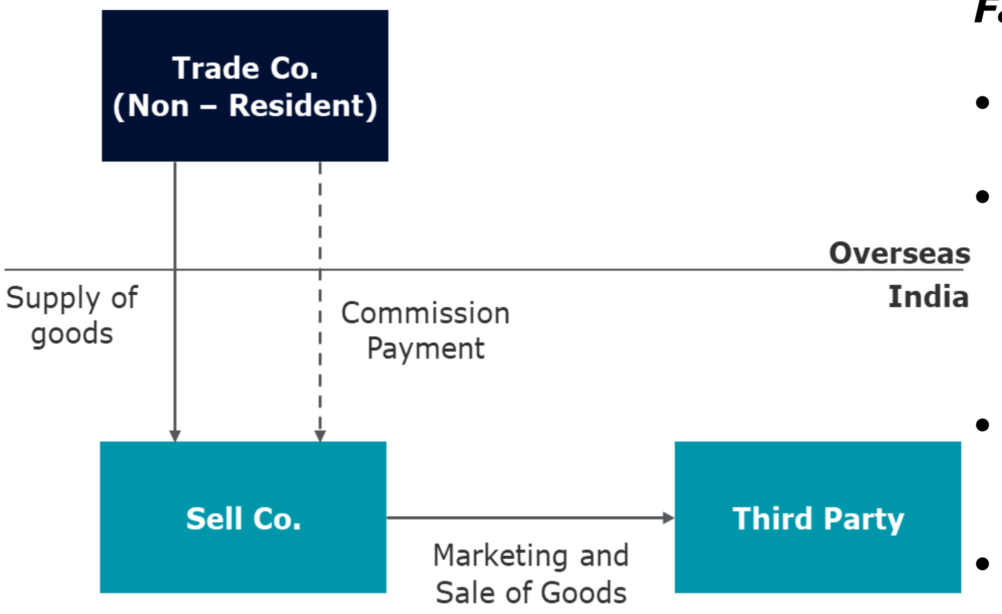
<u>Step 1</u>:

- The functional and factual analysis shows that TradeCo is performing functions of sale of goods to third party customers in Country S (overseas).
- The functional and factual analysis shows that the PE is performing functions of <u>purchase of goods from unrelated suppliers in India</u>. <u>Further, it is also performing significant functions relating to the inventory in India</u>.

<u>Step 2</u>:

- As step two, the attribution is done by applying the arm's length principle to the transactions between the PE and the Head Office. The appropriate attribution would be at the price that TradeCo would have had to pay if it had purchased the goods from an unrelated supplier performing the same functions in India that BuyCo performs on behalf of TradeCo ie using comparables

Case study 3 – Commissionaire



Facts of the case

- TradeCo, a company in Country S, has a core business of buy and sale of goods
- SellCo, a related company, performs marketing and sale activities on behalf of TradeCo in Country Y as a commissionaire. It does not own the goods at any point of time nor has any entitlement to the amount paid by the buyers for the goods
- Personnel of SellCo are responsible for warehousing the inventory and determining and monitoring the appropriate inventory levels
- TradeCo pays a commission as a percentage of sale revenue received
- TradeCo has a PE in country Y as SellCo habitually concludes the contracts and holds inventory on behalf of TradeCo for the sale of goods

Attribution analysis

<u>Step 1</u>:

- The functional and factual analysis shows that the TradeCo performs the function of purchasing the goods from unrelated suppliers
- The functional and factual analysis shows that the PE is performing <u>functions of sale of goods to the final customers</u>. Further, it is also <u>performing significant functions relating to the assumption of inventory risk in country Y</u>

<u>Step 2</u>:

- The attribution is done by applying the arm's length principle to the transactions between the PE and the Head Office. The appropriate attribution would be at the price that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities as done by SellCo

Global Developments

USA - In the USA, less than 1/3rd sates are employing 3 factor formula wherein equal weightage is given to sales, payroll and assets each and more than 1/3rd states are adopting sales as the only factor while considering distribution of profit.

UK - Profit is attributable based on equal weightage to revenue and payroll factor. It has also industry specific formula for insurance, railway, airline and shipping industries.

Switzerland - Three methods.
Direct method: profits distributed based on separate accounting;
Indirect method: profits are apportioned based on factors such as turnover, payroll or sales.
Mixed method: profits are distributed based on firstly direct method and then by apportioning based on Indirect method

China - Deemed profit method under which 3 variants are prevailing:

1. Total revenue Method;
2. Cost Plus Method;
3. Expenditure Plus Method.

European proposal for Common Consolidated Corporate Tax Base - Profits derived within Europe attributed to different tax jurisdictions within EU on the basis of a simple formula:

- 1/3rd profits are attributed on the basis of sales;
- 1/3rd on the basis of manpower and wages (one sixth on the basis of wages and one sixth on the basis of number of personnel); and
- 1/3rd on the basis of assets.

Attribution of profits under Indian law

Attribution of Profits to PE

Where PE books of accounts are maintained in India

- Attribution of the profits can be done based on actual profits made by the PE based on the books of accounts **(Direct Accounting Method)**
- They can also be tested using the arms length test based on the FAR analysis principles laid down under TP

Where PE books of accounts are not maintained in India

- AO given wide powers under **Rule 10** –'Determination of Income in the case of Non-Residents' of the IT Rules
- Rule 10 provides that the amount of such income for the purposes of assessment to income-tax may be calculated by:
  - **Presumptive Method**: Ad-hoc profits as a percentage of revenue estimated as attributable to the PE *[Rule 10(i)]*
  - **Proportionate Method**: Proportionate profits based on world income attributed to the PE *[Rule 10(ii)]*
  - **Other Method**: In such other manner as the tax authority may deem suitable *[Rule 10(iii)]*

Important case laws on profit attribution

Attribution in case PE books of accounts are not maintained in India

Tax officers have been using rule 10 to attribute profits on an ad-hoc basis

Sr. No.	Case Law	Forum	Date	Result
1.	Morgan Stanley & Co. Inc [(2007)292 ITR 416 (SC)]	Supreme Court	09-07-2007	Nil - if remunerated at arm's length
2.	Rolls Royce PLC [2011] 13 taxmann.com 233 (Delhi)	High Court - Delhi	30-08-2011	35% of Global Profits
3.	Galileo International Inc [(2011) 336 ITR 264 (DELHI)]	High Court - Delhi	25-02-2009	15% of revenue earned in respect of booking made in India
4.	Motorola Inc. [2005] 95 ITD 269 (Delhi)(SB)	(SB) ITAT - Delhi	22-06-2005	20% of Global Profits
5.	Linklaters & Paines [2012] 28 taxmann.com 250 (Mumbai - Trib.)/[2013] 56 SOT 116 (Mumbai - Trib.)	ITAT - Mumbai	19-12-2012	100% of Global Profits (force of attraction principle)
6.	BBC Worldwide Ltd [2010] 3 taxmann.com 761 (Delhi - Trib.)	ITAT - Delhi	23-07-2010	Nil - if remunerated at arm's length
7.	Amadeus Global Travel Distribution SA [2010] 3 taxmann.com 777 (Delhi - Trib.)	ITAT - Delhi	29-10-2010	15% of Revenue of the Assessee
8.	Ericsson Telephone Corporation India AB (India Branch) [2018] 96 taxmann.com 258 (Delhi - Trib.)	ITAT - Delhi	04-07-2018	20% of Global Profits
9.	GE Energy Parts Inc. Vs ADIT	ITAT - Delhi	27-01-2017	For Sales - 10% of sales For Marketing activities – 26%
10.	Arrow Electronics India Ltd. Liaison Office [(2018) 94-taxmann-299]	ITAT - Bangalore	31-03-2017	40% of Global Profits
11.	Daikin Industries Ltd. [2018] 65 ITR(T) 693	ITAT - Delhi	28-05-2018	10% of Sales in India

Profits attribution to PE is a vexed issue wherein there are varying judgements passed by the Appellate Authorities

Summary of Judicial Precedents

100% **Scale of Profit Attribution to PEs in certain cases** 0%

Ansaldo SPA 75%	Linmark 50%	Arrow* 40%	ZTE Corp 35%	Rolls Royce 35%	Galileo 15%	Outotec 10%	BBC/ SET Satellite 0%

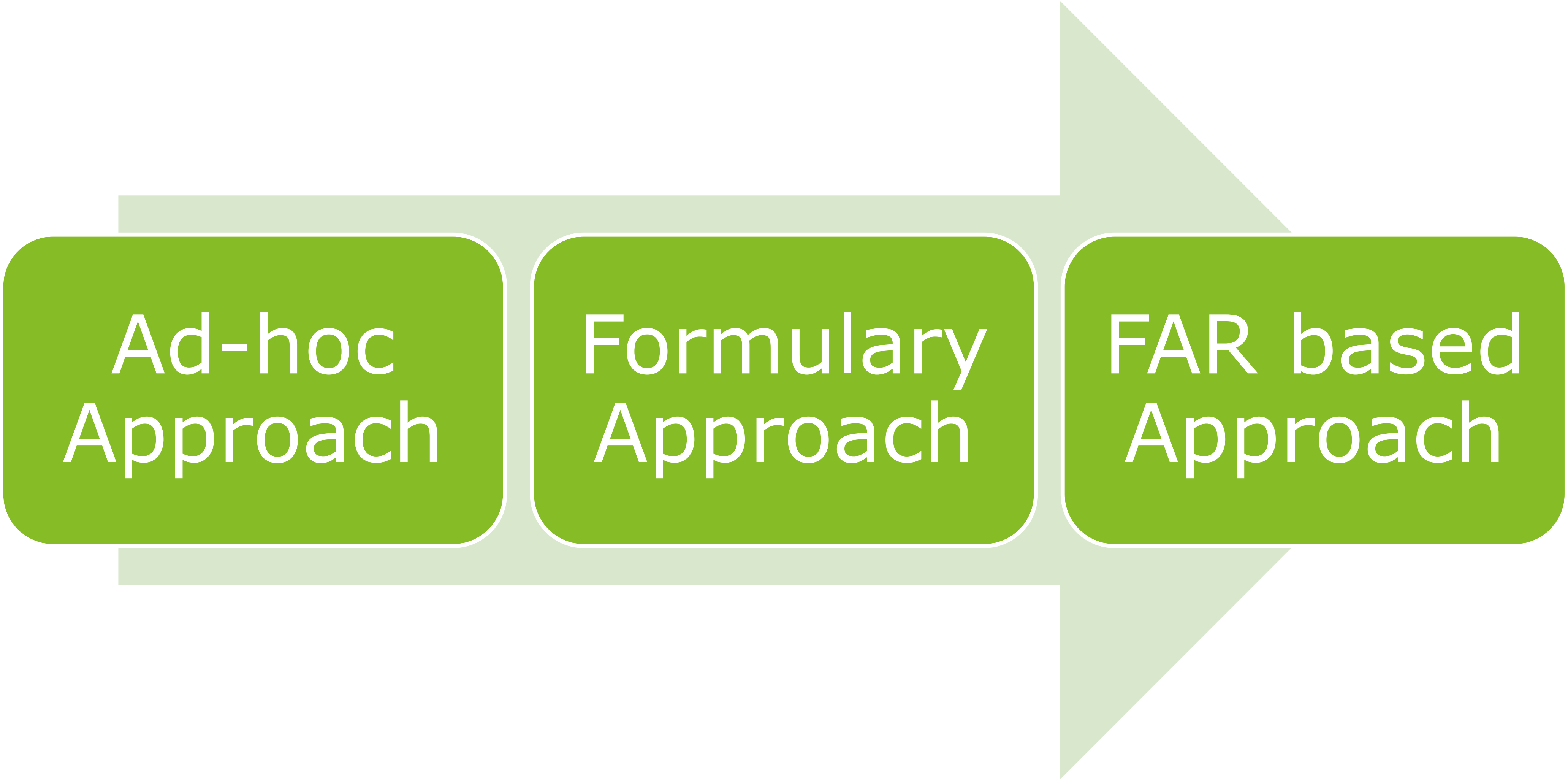
**Application of TP based method of profit attribution*

Key Factors that affect profit attribution of PE in India

- Demarcation of roles and responsibilities
- Nature and extent of risk borne
- Arms length remuneration
- Documentation

Small changes in key factors results in major changes in attribution rate

Journey of profit attribution of PE



Ad-hoc Approach

Formulary Approach

FAR based Approach

CBDT proposal for amendment of PE attribution rules

Committee – Mandate and observations

CBDT committee - mandate

Background

- Lack of clear guidance/computation mechanism leading to disputes and protracted litigations
- It was considered essential to undertake necessary measures to bring **clarity, consistency and predictability in the domestic attribution rules, that are permissible under the treaties**

Mandate of the committee

Considering the above, the CBDT constituted a committee with following Mandate:

- *Examine existing scheme of profit attribution to PE under Article 7 of Double Taxation Avoidance Agreements ("tax treaties")*
- *Examine contribution of demand side and supply side factors in profit attribution*
- *Recommend the changes needed in Rule 10 of the Income-tax Rules, 1962 ("IT Rules") to provide specific rules on how profits are to be attributed to a non-resident person having PE in India*

OECD Approach v/s UN Approach – Key observations

India's reservations

- India has expressed its reservations on the post 2010 OECD model which emphasizes attribution of profits based on FAR analysis

Demand side factors ignored

- Developing countries like India are mostly net importer of capital and technology
- Adopting the OECD approach would result in substantial loss of tax revenue

Deduction

- Deduction for sunk costs (i.e. royalty, interest, etc.) between PE and Head Office resulting in erosion of taxable base in India

Deviation from Accounting Standards (AS)

- Major deviation from generally accepted AS where sales component cannot be ignored

Views of Academicians & Experts

Prof. Klaus Vogel – on relevance of sales

- *"It cannot convincingly be denied that providing a market contributes to the sales income at least to same extent as providing the goods does. There is no valid objection, therefore, against a claim of the sale state to tax part of the sales income."*
- *"…., the recipient State is justified in requiring to be allowed to participate in the taxation of the proceeds of the sales of the goods – in the same way as it participates where interest and royalties are involved…."*

Reuven S. Avi-Yonah, USA – on inadequacy of FAR approach

- Residual profit (in the form of cost savings) resulting from the relationship among the group members of a multinational enterprise – cannot be allocated under FAR based methods
- Functional analysis can only be applied to those functions that can be assigned to the group members
- US case of Bausch and Lomb supports this argument

Prof Dr. Ulrich Schreiber – on Sales-Based Apportionment of Profits

- While MNCs can freely decide where to locate production, the decision where to serve their customers is far less flexible
- Hence profit attribution to sales location considerably reduces incentives to shift profits and investments to low tax locations
- Decoupling of profits from investment locations and linking profits to points of sale will be a solution to the problem of tax competition and promote global tax neutrality

Views of certain other Academicians and Experts also cited to support the mixed approach

Mixed approach – Alternative methods

Formulary apportionment

- Apportionment based on 3 factor formula
  - Sales
  - Manpower / wages / payroll
  - Assets or property
- Apportionment based on consolidation of profit derived from different countries

Committee's view

Not practically feasible –

- CbCR applicable only beyond prescribed threshold
- Lack of clarity as to whether information in CbCR can be used for profit attribution

✗

Fractional apportionment

- Permissible under Article 7 of DTAA and Rule 10 of ITA
- Attribution of profits derived by foreign entity from India only – apportionment on the basis of certain factors
- Consolidation of profits from different countries not required

Committee's view

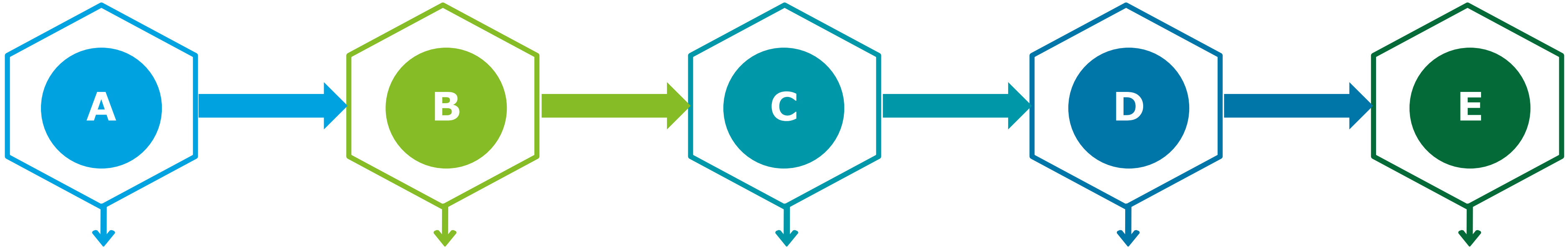
- Apportionment based largely on India related information – Practically feasible
- Considerable merit in following three factor approach (sales, manpower and assets) with equal weight assigned to each of them

✓

Committee – Proposals

Proposal on attribution of profits to permanent establishment

CBDT Committee - Key proposals



De-minimus profits to be attributable

‘Profits derived from India’ to be higher of:

a) amount arrived at by multiplying the ***revenue derived from India*** with Global operational profit margin (Earning before interest, depreciation and tax “EBIDTA”) or

b) 2% of revenue derived from India

3-factor based fractional approach

Equal weights (i.e., one-third) to be accorded to sales, employees (manpower and wages) and assets.

4-factor based approach for digital businesses (SEP)

- Low and medium user intensity:
  - Weight of 10% to be assigned to users, and
  - 30% each to above-mentioned three factors (sales, employees and assets)
- High user intensity:
  - Weight of 20% to be assigned to users,
  - 30% to sales; and
  - 25% each to employees and assets

Reduction of profits taxed in the hands of AE

attributable profits, profits earned by an AE in India and charged to tax (in its hands) shall be reduced.

No attribution in specified cases

No attribution in cases where business connection is constituted by activities of AE resident in India, and

- Quantum of sales
- /services does not exceed INR 1 mn or no payment is received; and
- activities of the AE are remunerated on an arm’s length basis

Proposed Rule 10 to be applied in limited situations where accounts are not available

Proposal on attribution of profits to permanent establishment

Recommendation of the committee - Formula based attribution

Profits attributable to PE proposed to be determined based on the following formula#

$$= Profits\ derived\ from\ India\ \times \left\{\left(\frac{SI}{3\times ST}\right)+\left(\frac{NI}{6\times NT}\right)+\left(\frac{WI}{6\times WT}\right)+\left(\frac{AI}{3\times AT}\right)\right\}$$

where,

'Profits derived from India' = Revenue derived from India x Global operating profit margin

SI = sales revenue derived by Indian operations from sales in India

ST = total sales revenue derived by Indian operations from sales in India and outside India

NI =number of employees employed with respect to Indian operations and located in India

NT = total number of employees employed with respect to Indian operations and located in India and outside India

WI= wages paid to employees employed with respect to Indian operations and located in India

WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India

AI = assets deployed for Indian operations and located in India

AT = total assets deployed for Indian operations and located in India and outside India

For digital businesses, a variant formula (with weightage to users) has been prescribed (refer previous slide)

Proposal on attribution of profits to permanent establishment

Recommendation of the committee - Formula based attribution

Digital Businesses

Profits derived from India to be apportioned based on low, medium and high intensity users as mentioned below:

Factors	Low & Medium intensity users	High intensity users
Sales	30%	30%
Employees	15%	12.5%
Wages	15%	12.5%
Assets	30%	25%
Users	10%	20%

Profits attributable to operations in India in cases of low and medium user intensity business models =

‘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]

Profits attributable to operations in India in cases of high user intensity business models =

‘Profits derived from India’ x [0.3 x SI/ST + (0.125 x NI/NT) +(0.125 x WI/WT) + (0.25 AI/3xAT)] + 0.2]

Proposal on attribution of profits to permanent establishment

Merits of FAR based approach

FAR facilitates taxation based on value creation

Demand as a value driver

- Reference to PE being " *a distinct and separate enterprise engaged in* ***the same or similar activities***" under the Tax Treaties and "*only so much of income as is attributable to the* ***operations carried out in India***" under the Act.
- Return for market when it is not owned or controlled by any enterprise : in nature of "rent" or "market access fee"?

Merit of a FAR based analysis

- FAR analysis compensates for activities resulting in capturing more market/higher sales (by giving a sales based return) : Encourages value based taxation-"inherent objective of BEPS proposals"
- TP principles also permit two sided method (Profit Split), which can sufficiently remunerate any significant marketing function or IP
- Attributing group synergy– Covered in two sided analysis

Notional Taxation

- Economic analysis based on local comparables adequately factor in the local market characteristics/return (e.g. location savings)
- Additional return for market - leads to artificial taxation?

Proposal on attribution of profits to permanent establishment

Key discussion Aspects

- Whether Rule 10 or the application of TP provisions is customary in the Indian Context?
- Relevance of India’s reservations to the revised Article 7 in 2010 OECD MC?
- Whether Article 7(4) is subject to Article 7(2) and can be used only in cases where profits cannot be attributed under a separate entity hypothesis?
- Whether the proposal to use the apportionment based method even in treaty cases will lead to treaty override? For SEP, would the formula have relevance in treaty cases?

Committee – Proposals

Proposal on attribution of profits to permanent establishment

Fundamental issues

FAR facilitates taxation based on value creation

Demand as a value driver

- Reference to PE being "*a distinct and separate enterprise engaged in* ***the same or similar activities***" under the Tax Treaties and "*only so much of income as is attributable to the* ***operations carried out in India***" under the Act.
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Notional Taxation

- Economic analysis based on local comparables adequately factor in the local market characteristics/return (e.g. location savings)
- Additional return for market - leads to artificial taxation?

CBDT Committee Draft Report

Fundamental issues

Whether FAR analysis is a newly introduced concept?

- Para 44 (Page 25) of the CBDT Draft Report states the FAR analysis for the profit attribution has been introduced for the first time Post-2010 OECD model
- FAR approach had already been introduced in 2008 (Revised) OECD commentary
- "arm's length principle" already recognised in Pre-2008 OECD Commentary

Can Rule 10 directly be applied even if treaty is applicable?

- Para 133 (Page 61) of the CBDT Draft Report states that the Courts have endorsed the right of AO to attribute profits under Rule 10 even in cases where tax treaties were applicable
- However, Courts in various cases have only decided on the percentage of profits to be attributable to India

Is Rule 10 a customary method in India for profit attribution?

- As per Article 7(4) of the most Indian tax treaties – Apportionment method can be used only if it is customary in a Contracting State to do so and the same is in line with the principles contained in this Article
- The Committee has concluded that attribution of profits by way of apportionment is well within the mandate under most of the tax treaties entered into by India – Requirement of the apportionment to be customary ignored
- Which method can be said to be customary in India - Rule 10 or TP provisions?

Rule 10 to be applied – as a last resort or in all cases?

- The Committee has recognized (Para 180, Page 77) that Rule 10 is to be applied only when business profits of a non-resident derived from India cannot be accurately derived from its accounts of the Indian business
- However, the final recommendations on amendment of Rule 10 are silent on the above

Attribution of income to permanent establishment in India

Comparison of proposed formula with existing Rule 10

New Formula

Profits attributable to operations in India =

‘Profits derived from India’ x [SI/3xST + (NI/6xNT)
+(WI/6xWT) + (AI/3xAT)]

In case of Digital Business, profits derived from India to be apportioned based on low, medium and high intensity users as mentioned below:

Factors	**Low & Medium intensity users**	**High intensity users**
Sales	30%	30%
Employees	15%	12.5%
Wages	15%	12.5%
Assets	30%	25%
Users	10%	20%

Old formula (Rule 10)

i. at such percentage of the *turnover* so accruing or arising as the [Assessing Officer] may consider to be reasonable, or

ii. on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or

iii. in such other manner as the [Assessing Officer] may deem suitable.

Is the weightage of sales effectively reduced in the new formula?

Proposal on attribution of profits to permanent establishment

Computational aspects (1/2)

Revenue derived from India

- Defined to include all receipts arising or accruing or is deemed to accrue or arise from India, chargeable under the head profits and gains of business or profession
- May be understood to include all sales whether effected through a PE or not (expanding nexus?): Clarification required that only the sales effected through a particular PE will be considered for formula

Users

- Separate weightage for users: is not the user base reflected in revenue?
- Differentiating Active vs Passive users

Global Profits

- The term "Global operational profit margin' needs to be explained to clarify:
  - Profit of the enterprise vs profit of the group (attribution of return for IPs owned by principals?)
  - Profit of business group/segment vs profit of all segments in the group
- 2% minimum profits proposed: Contrary to economic realities

Proposal on attribution of profits to permanent establishment

Computational aspects (2/2)

Use of EBIDTA

- Use of EBIDTA margin proposed on the assumption that the PE does not own any capital or hold any assets: proposition debatable especially in the case of highly leveraged or asset intensive industries
  - Can an Industry specific formula be looked upon?
- In addition, there may be instances where PE owns any asset or deploys borrowed funds for Indian operations or relies substantially on fixed assets located in head office ("HO") jurisdiction
- Inconsistency with treaties (providing for apportionment of "total profits" vis-a-vis "notional profits") - Profit before Taxes a better reflective ?

Employees and Assets

- Clarification required for determination of employees and assets "with respect to Indian operations" located in and outside India : Likely challenge in cases of common employees and assets
- Legal vs economic assets: many IPs may not be recorded in books
- A single formula for all industries may not capture the industry specific niceties
- In certain cases, the employees and assets of the associated enterprise will be deemed to be employed or deployed in the Indian operations and located in India – would increase supply side weightage in India

Proposal on attribution of profits to permanent establishment

Issues

Other issues

- Secondment of employees – How will the formula work?
- Rejection of FAR – Any implications for transfer pricing approach?
- Use of apportionment based method even in treaty cases – A potential treaty override?
- Potential double taxation and / or FTC credit mismatch
- Outcome of ongoing assessments
- No approval mechanism
- Whether formula proposed for attribution should be followed for lower/nil tax withholding certificates u/s 197 / 195?

Authorized OECD Approach v/s Fractional apportionment proposed by CBDT

Authorized OECD Approach

Two step analysis

- PE – distinct, separate and independent enterprise capable of
  - Undertaking functions, owning assets and assuming risks
  - Entering into transactions with other related and unrelated enterprises
  - Entering into dealings with the enterprise of which it is a part (intragroup dealings)

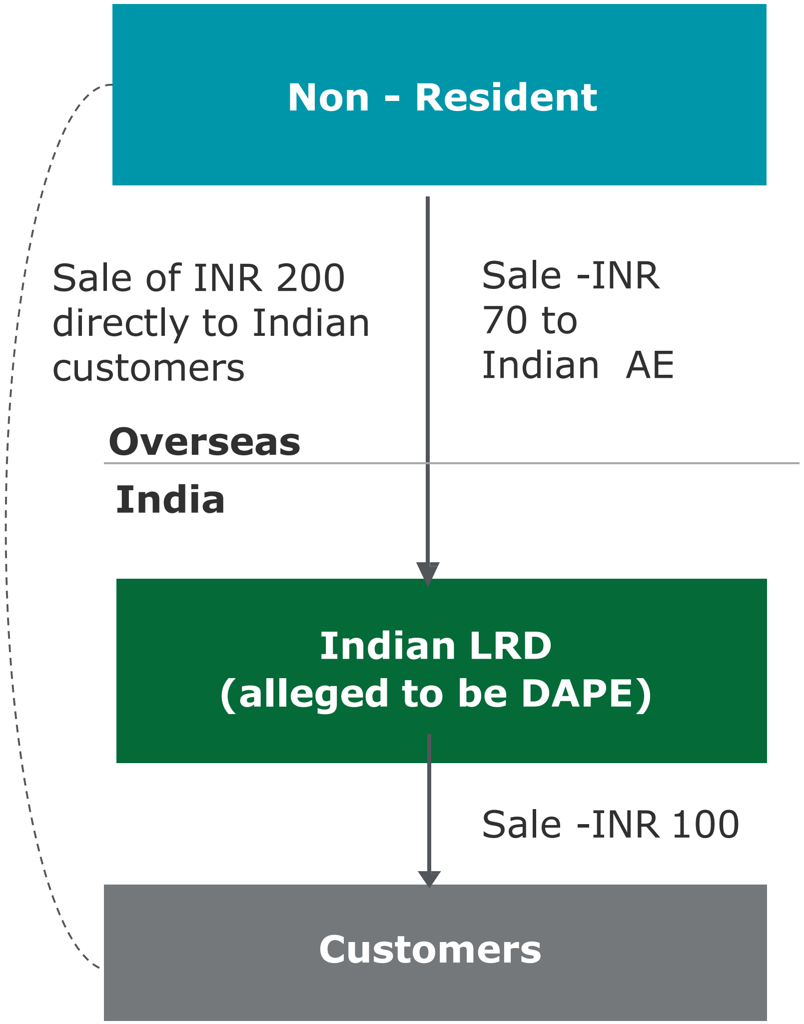
- Apply arms’ length principle to the above intragroup dealings

Fractional Apportionment by CBDT

Proposed amendments to Rule 10

- Emphasis on significance of both supply and demand factors
- Rejects FAR approach / Authorized OECD Approach by underlining India’s position to OECD Model tax Convention (“MC”)
- Outlines the “fractional apportionment” method

Case Study 4 – Fractional Apportionment Method



Facts of the case

Particulars	Details pertaining to India operations
Employees	• Sales Function - in India - 15 • Sales Function - located outside India - 5 • R&D & manufacturing Function - located outside India - 50
Employee cost	• Sales Function – in India - INR 1500 • Sales Function – located outside India - INR 1000 • R&D & manufacturing function – located outside India - INR 5000
Assets	• Sales related assets – in India - INR 500, • Sales related assets – located outside India - INR 500 • R&D and manufacturing related assets – located outside India-INR 2000
Profitability /EBITDA	• India-2%, • Non-Resident – 5%, • Overall Group-10%

Case Study 4 – Fractional Apportionment Method

1. Issue – Revenue derived from India

A. What will be the revenue derived from India –

   a) 100

   b) 270

   c) 300

Points for discussion

Ambiguity around the phrase 'revenue derived from India' –

- It is revenue generated from customers within India*

or

- it includes all receipts arising or accruing or deemed to accrue or arise from India which are chargeable to tax under the head profits and gains of business or profession**

* Para 159, pg. 70 of the CBDT report
** Footnote 83, pg. 70 of the CBDT report

Case Study 4 – Fractional Apportionment Method

2. Issue – Employees

- What if there is a common employee or employee is party working for India operations as well as overseas AE?

3. Issue – Assets

- Should the “Assets deployed in India” include intangible assets as well? What if such intangible is not deployed for sales function?

Case Study 4 – Fractional Apportionment Method

4. Issue – Global Operational Profit Margin

A. For the purpose of Global Operational Profit Margin, what would be considered
   a) Non-Resident’s profit margin – 5 %
   b) Group’s profit margin – 10%

B. What would be considered as Global Operational Profit Margin, if the below segment level profits margins are available

Segment	Non-Resident (in %)	Group (in %)
Trading	2	3
Manufacturing	2	6
R&D	1	1

Points for discussion

In case of deemed minimum attribution of 2% –

- Notional income vs. real income (which is loss or less than 2%)
- Availability of Tax Credit in overseas country
- Not in line with Article 7(4) of Indian tax treaties which provides for apportionment of “total profits”

Case Study 4 – Fractional Apportionment Method

5. Issue – Equally – weighted three factors approach (sales, employee and assets)

Points for discussion

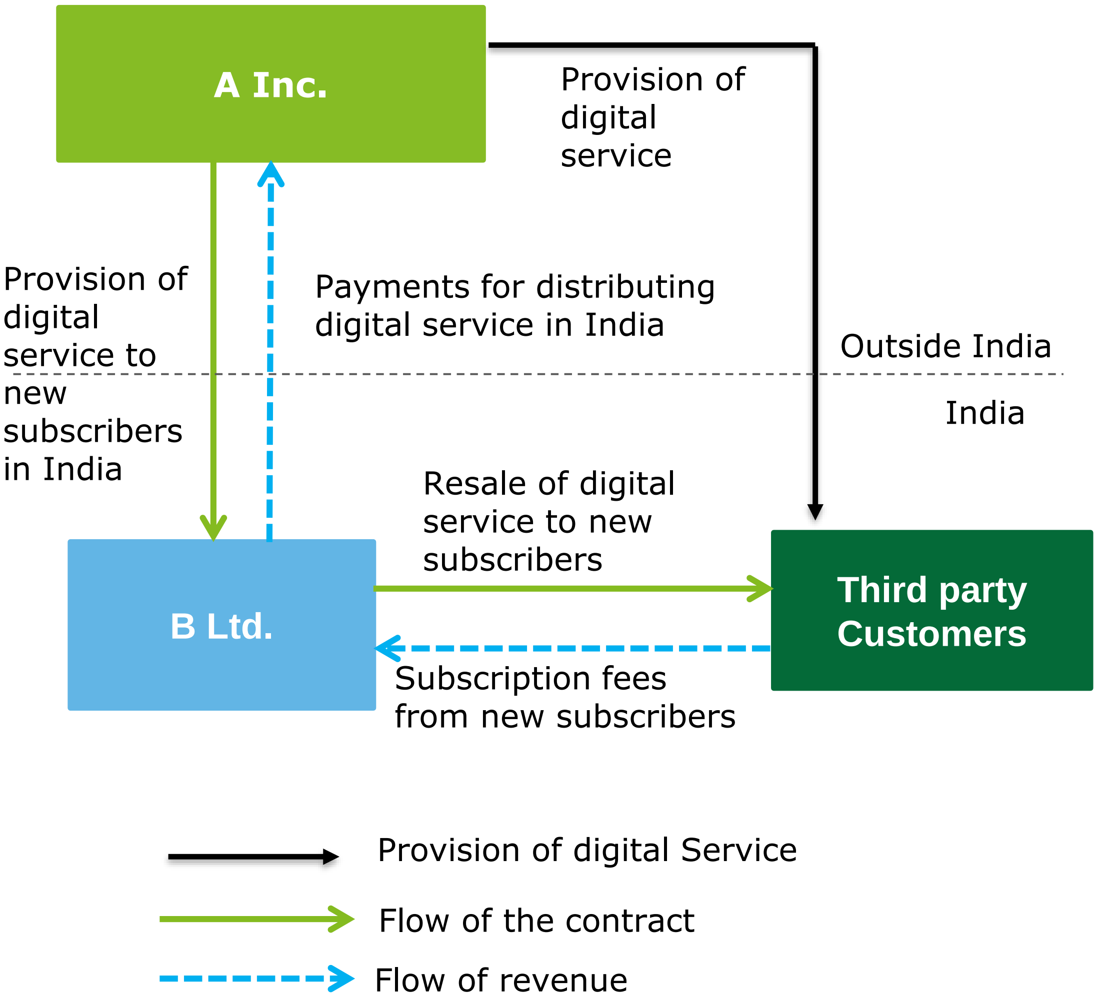
“Does one size fits all”

- For a company in the business of software development, is it reasonable to provide equal weightage to an employee sitting in different jurisdiction providing back-end support services?
- In case of mining sector, is it not reasonable to assign weightage to the extraction factor?

Other Points for Discussion

- Challenge in collating the details required for Fractional apportionment
- Can Revenue authorities use data from CbCR for the purpose of Fractional Apportionment Method?
- If Arm’s Length Price is a supply side approach as per the CBDT, can it be used for entities other than PE? Will it stand the test of discrimination between resident entity & non-resident entity?

Case Study 5 – Revised profit allocation and Nexus Rules*



Facts of the case:

- The digital service is delivered by A Inc.
- B Ltd. will act as a reseller of the digital service in India and retain ROS 3 percent as an arm's length remuneration
- B Ltd. is the contracting party with subscribers
- B Ltd. :
  - Resale of digital services to new subscribers
  - Renders marketing support services
  - Renders business development support services

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5A – User Participation* (1/4)

Relevant data for A Inc. & B Ltd. is tabulated as below:

Particulars	A Inc. (in INR in crores)	B Ltd. (in INR in crores)
Revenue	400	1,000
Receipt of distribution fees	634	-
Expenses	500	300
Payments for distributing service	-	634
Profit	534	67
Number of employees employed with respect to Indian operations	80	50
Wages paid to employees employed with respect to Indian operations	300	150
Assets deployed for Indian operations	120	60

Global operational profit margin (in percent)	10.00

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5A – User Participation* (2/4)

Analysis of the case

- To determine the residual or non-routine profits, the consolidated profit and loss account of A Inc. and B Ltd. is drawn. The return on sales of 3 percent is attributed as “routine” return to each entity and balance is determined as residual or non-routine profits.

Particulars	Consolidated (A Inc. + B Ltd.) (INR in crores)
Total Revenue	1,400
Total Expenses	800
Consolidated PBT to be attributed between A Inc. and B Ltd	**600**
Routine return attributed based on ROS	
A Inc.	42
B Ltd.	42
Balance to be allocated as non-routine return between A Inc. and B Ltd	**516**

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5A – User Participation* (3/4)

Analysis of the case

- To attribute a proportion of residual or non-routine profits to the value created by activities of users, number of subscribers of A Ltd and B Ltd have been identified.

Particulars	%	Subscriber numbers in millions
User Base in India	5	10
User Base outside India	95	200
Total	**100**	**210**

- Based on the percentage of user base in India vis-à-vis outside India, residual or non-routine profits have been attributed to A Ltd and B Ltd.

Particulars	Consolidated (A Inc. + B (INR in crores)
Balance to be allocated as non-routine return between A Inc. and B Ltd	516
A Inc.	492 (516*95%)
B Ltd.	25 (516*95%)

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5A – User Participation* (4/4)

Other points for discussion

- Allocating profits based on “user” may lead to misalignments between where profits are taxed and where value is created.
- Manner of characterizing/ quantifying user intensity? Differentiation between active / passive users?
- Do you think only User-based factors would suffice to attribute profits in case of digital PEs?

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5B – Marketing intangibles* (1/2)

Analysis of the case

- To determine the residual or non-routine profits, the consolidated profit and loss account of A Ltd. and B Ltd. is drawn. The return on sales of 3 percent is attributed as routine return to each entity and balance is determined as residual or non-routine profits.

Particulars	Consolidated (A Inc. + B Ltd.) (INR in crores)
Balance to be allocated as non-routine return between A Ltd and B Ltd	516

- To attribute a proportion of residual or non-routine profits to the value created by marketing intangibles, marketing expenses incurred by A Ltd and B Ltd have been considered.

Particulars	%	Amount In INR' crores
Marketing spend - B Ltd.	20	50
Marketing spend – A Inc.	80	200
Total	**100**	**250**

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5B – Marketing intangibles* (2/2)

Analysis of the case

- Based on the percentage of marketing expenses incurred in India vis-à-vis outside India, residual or non-routine profits have been attributed to A Ltd and B Ltd.

Particulars	Consolidated (A Inc. + B (INR in crores)
Balance to be allocated as non-routine return between A Inc. and B Ltd	516
A Inc.	413 (516*80%)
B Ltd.	103 (516*20%)

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5B – Marketing intangibles* (2/2)

Other points for discussion

- How is the Government planning to establish that Marketing Intangible is created basis the FAR / activities of PE and attribute profits accordingly?
- Is it a correct approach to change market jurisdiction’s taxing rights based on the “value” created in the market?

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Case Study 5C – Significant Economic Presence (1/2)

Analysis of the case

- Using Fractional apportionment formula *(relying on the public consultation paper on the proposal for amendment of Rules for Profit attribution to PE, released by CBDT)* :

<u>In case of digital business</u> *(digital models with high user intensity)*

$$(SI \times GLNPM) \times \left\{ \left(0.3 \times \frac{SI}{ST}\right) + \left(0.125 \times \frac{NI}{NT}\right) + \left(0.125 \times \frac{WI}{WT}\right) + \left(0.25 \times \frac{AI}{AT}\right) + 0.2 \right\} = \mathbf{67.99}$$

Particulars		Data
Sales revenue derived by Indian operations from sales in India	SI	1,000
Total sales revenue derived by Indian operations from sales in India and outside India	ST	1,010
Number of employees employed with respect to Indian operations and located in India	NI	50
Total number of employees employed with respect to Indian operations and located in India and outside India	NT	80
Wages paid to employees employed with respect to Indian operations and located in India	WI	150
Total wages paid to employees employed with respect to Indian operations and located in India and outside India	WT	150
Assets deployed for Indian operations and located in India	AI	50
Total assets deployed for Indian operations and located in India and outside India	AT	80
Global operational profit margin (in percent)	GLNPM	10
India Users weightage (Low and medium user intensity)	UI	0.10
India Users weightage (High user intensity)	IT	0.20

Case Study 5C – Significant Economic Presence (2/2)

Other points for discussion

- Will OECD follow India’s approach towards Fractional apportionment

*OECD - public consultation document addressing the tax challenges of the digitalization of the economy

Questions????????

Thank You ☺