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CBDT releases draft report on attribution of income to the PE

Public consultation paper on proposal for attribution of profits to permanent establishment

Historically, there has been lack of certainty and clarity regarding the methodology followed by Indian tax authorities for attribution of profits to a Permanent Establishment ("PE") of a non-resident in India. Recognizing this, the Central Board of Direct Taxes ("CBDT") formed a Committee with the following mandate:

a. Examine existing scheme of profit attribution to PE under Article 7 of Double Taxation Avoidance Agreements ("DTAAs");

b. Examine contribution of demand side and supply side factors in profit attribution; and

c. Recommend 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.

The Committee has submitted a comprehensive report titled '*Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment*', which the CBDT has made available for stakeholder comments on 18 April 2019. The observations and recommendations of the Committee are summarized below:

a. Existing scheme of profit attribution to PE under Article 7 of DTAAs

Business income of a non-resident is taxable in India if it satisfies the 'business connection' threshold under the Income-tax Act, 1961 ("IT Act") as well as PE threshold under the applicable DTAA, if any. The taxable income of the PE in India is restricted to the profits attributable to it. The attribution rules under the IT Act and under India's DTAAs are detailed below:

Income attribution to a PE under the IT Act

Where a non-resident has a 'business connection' in India (and the whole of its business is not exclusively carried out in India), the taxable income is restricted to the profits attributable to the business activities carried out in India. Such profits are computed based on 'books of account' and 'financial statements' maintained in India.

However, if no books of accounts are maintained or if the income tax authority is of the opinion that it is not possible to determine actual income from the books of account maintained by the non-resident, the Assessing Officer ("AO") can, currently, compute this income based on the following options prescribed in Rule 10 of the IT Rules:

(a) at such percentage of turnover accruing or arising as the income tax authority may consider reasonable;

(b) proportionate profits of the business of non-resident in the same ratio of receipts (accruing or arising) in India to total receipts of the non-resident's business; or

(c) in such manner as the income tax authority may deem suitable.

The current method of income attribution under Rule 10, therefore, allows a broad discretion to the income tax authority without any clear or specific guidance.

Profit attribution under the DTAAs

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Relevant provisions in DTAAs dealing with business profits are based on Article 7 of the Model Tax Conventions. Article 7 allocates the right to taxation of the PE between the Contracting jurisdictions. It states that business profits of an enterprise of a Contracting State shall be taxed in the other Contracting State only to the extent such profits are attributable to the PE in that State.

The Committee's Report observes that at present, the following three standard versions of Article 7 exist in DTAAs and model tax conventions prepared by Organisation of Economic Co-operation and Development ("OECD")[1] and United Nations ("UN"):

(i) Article 7 recommended by OECD Model Convention prior to 2010;

(ii) Revised Article 7 introduced by OECD in its Model Convention in 2010; and

(iii) Article 7 of the UN Model Convention.

(i) In the Commentary on Article 7 in 2008 version of the OECD Model Tax Convention (prior to 2010), the OECD recognized and acknowledged apportionment of profits based on one of the following criteria, i.e. receipts (or sales revenue), expenses, or working capital. Further, the OECD also provided guidance on where one basis could be considered preferable to another. The Article also provided for apportionment method for attribution of profits.

(ii) However, in 2010, Article 7 of the OECD Model Tax Convention was modified and a new commentary was introduced. Under the revised Article 7, the OECD mandated the Authorized OECD Approach ("AOA") as the preferred approach for attribution of profits to a PE. The AOA requires attribution of profits to the PE on the basis of functions performed, assets used and risks assumed ("FAR") analysis per prescribed OECD's Transfer Pricing guidelines.

(iii) Article 7 of the UN Model Tax Convention is broadly similar to the pre-2010 version of Article 7 of the OECD Model Tax Convention. An additional option of attributing profits to a PE by way of apportionment is available in paragraph 4 of Article 7 of UN model tax convention as well as the pre-2010 OECD model tax convention, and most of the Indian tax treaties based on them.

The provision in Indian DTAAs are similar to Article 7 of the UN Model Tax Convention (with slight variations). The Committee has observed that in accordance with these provisions, profits are to be attributed to a PE as if it were a 'distinct and separate entity':

(a) Direct accounting method based on the separate accounts of the PE; or

(b) Indirect apportionment method under the domestic laws in India [Rule 10 of the IT Rules], where detailed and accurate accounts are not available.

Regarding significant amendments were made in 2010 update of the OECD Model Tax Convention, the Committee has observed that:

- It has introduced FAR analysis as the basis of profit attribution to a PE;
- This reiterates taxation of profits solely on the basis of contributions made by supply side factors while completely ignoring the sales, and thereby contributions made by maintenance of markets and demand side factors to the profitability of the non-resident enterprise; and
- The revision has omitted the option to determine attributable profits by way of 'apportionment', which is permissible under the pre-2010 OECD and UN model conventions.

The Committee has observed that for post 2010 OECD model convention, one of the primary implications of this is that in cases where business profits cannot be readily determined on the basis of accounts, the income will now have to be determined by undertaking FAR analysis, thereby

[1] India is not a member of OECD Model Convention and commentary is not binding on it.

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completely ignoring the demand side factors, eg: sale receipts, derived from that tax jurisdiction. The Committee has also noted that India has consistently objected to this FAR based AOA approach and Indian treaties are not modelled on the post 2010 revised OECD model convention.

Position of India on inadequacies of revised Article 7, AOA & FAR based profit attribution

India has documented its disagreement with revised Article 7 by not only reserving its right to not include it in its DTAAs, but also by documenting the rejection of the approach inherent in it. Further, India has also conveyed its view that the process of attribution of profits by using FAR analysis, negates role of 'demand side factors' in the profitability of an enterprise.

Lastly, since revised Article 7 recommended by OECD (since 2010 onwards) has not been incorporated in any of the Indian DTAAs, the question of applying AOA for profit attribution also does not arise.

b. Contribution of demand side and supply side factors in profit attribution

The Committee has then proposed 'demand and supply side factors' based rules for profit attribution to the PE (instead of FAR analysis). The tax base is 'business profits', which is a factor of both demand and supply of goods. Both production and sales are essential for generation of profits and neither should be ignored for determining profits that would be taxable in a jurisdiction. It is justified for both production and market jurisdictions to tax part of the profits to which their economies have contributed; for this purpose, allocation of profits among the states should be in a manner that avoids double taxation.

The Committee further observed that there are three possible approaches for profit attribution:

a. Purely supply side approach;
b. Purely demand side approach; and
c. A mixed approach.

The Committee concludes from its analysis of international practices that the mixed approach is most commonly followed; though there are a few instances of a purely demand approach while a purely supply side approach (as above) does not appear to be followed in any jurisdiction.

Recognising the wide scope of discretion accorded to the AO under Rule 10 of the IT Rules in terms of the apportionment method for attribution of profits, the Committee has observed that this creates uncertainties for taxpayers and results in protracted tax disputes. Clear, simple and universally applicable rules for apportionment based profit attribution to a PE are needed in the domestic law.

The Committee observes that a number of rulings on profit attribution in the Indian context have been made by Courts/ Tribunal by adopting different methods for apportionment based attribution of profits, owing to a lack of guidance under the current Rule 10.

Need for clarity in India's approach on PE attribution: Various options for a more specific rules

In order to formulate a simple, uniform and consistent method of profit attribution under Rule 10, the Committee considered options based on the mixed or balanced approach, which allocates profits between the demand and supply jurisdictions.

The Committee considered that 'formulary apportionment method' which apportions the consolidated global profits of the non-resident enterprise (across all the jurisdiction it operates in) as theoretically the best option. However, in view of the practical constraints in obtaining

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information related to jurisdictions outside India, it concludes that this is currently not a feasible method. Consequently, a 'fractional apportionment approach' based on apportionment of profits derived from India has been considered as the best option by the Committee. Such an approach is, according to the Committee, permissible under Article 7(4) of Indian DTAAs as well as Rule 10 of the domestic law. Out of various possible options of apportioning profits, a three factor method based on one-third weight each accorded to sales (representing demand), manpower and assets (representing supply) has been proposed. The method can be applied in the following steps:

(i) By determining the profits derived from Indian operations of the enterprise. 'Profits derived from India' has been defined as 'revenue derived from India' * Global operating profit margin[2].

[**Where the enterprises is incurring global losses, or its global operational profit margin is less than 2%, the profits derived from India will be taken at 2% of the revenue/ turnover derived from India**.]

(ii) By apportioning the profits from Indian operations of the enterprise to the PE on the basis of the three factors of sales (33% weight) and manpower and assets (together 67% weight).

(iii) By deducting from such profits of the enterprise, any profits that may have already been taxed in India[3]

Profit Attribution in Significant Economic Presence (SEP) Nexus in case of new business models

The Committee has observed that given that the newly introduced SEP provisions[4] trigger tax implications as and when the prescribed threshold is breached, it is important that the principles of profit attribution to SEP are clarified in the case of digitalised business. For such emerging business models in which users contribute significantly to profits of the enterprise, the Committee proposes the inclusion of 'users' as the **fourth** factor for apportionment, in addition to the other three factors of sales, manpower and assets.

Applying a weight to the 'users', a lower weight of 10% is proposed in case the 'users' in the business model involves 'low or medium user intensity' and a higher weight of 20% in business models involving 'high user intensity'.

c. Final recommendations of the Committee

In light of the observations detailed above, the Committee has made the following recommendation for apportionment based computation under Rule 10:

a) Rule 10 to be amended in case of income attributable to a PE's operations as under:

Profits attributable to operations in India = 'Profits derived from India' x [SI/3xST + (NI/6xNT) + (WI/6xWT) + (AI/3xAT)][5]

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[2] EBITDA margin
[3] DIT vs Morgan Stanley (SC)
[4] Introduced vide Finance Act 2018
[5] Where, the terms are defined to mean:
'Profits derived from India' = Revenue derived from India x Global operational profit margin
SI = sales revenue derived by Indian operations from sales in India
ST = Global sales revenue
NI = number of employees employed located in India in respect of Indian operations
NT = total number of employees in respect of Indian operations inside or outside India
WI = wages paid to employees employed in respect to Indian operations
WT = total wages paid to employees in respect to Indian operations inside or outside India

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b) The amended rules should provide that 'profits derived from Indian operations' will be higher of the following amounts:

- The amount arrived at by multiplying the revenue derived from India with Global operational profit margin, or
- 2% of the revenue derived from India

c) In case a 'business connection' is primarily constituted through the existence of SEP, income attributable to the operations carried out in India should be:

- *In case of digital models with low and medium user intensity*: With users assigned a weight of 10% and other three factors assigned weight of 30%, the formula shall be as following:

  'Profits derived from India' x [(0.3 x SI/ST) + (0.15 x NI/NT) + (0.15 x WI/WT) + (0.3 x AI/3 x AT)] + 0.1][6]
- *In case of digital models with high user intensity*: The users should be assigned a weight of 20%, while the share of assets and employees be reduced to 25% each after keeping the weight of sales as 30%. The formula works as under:

  '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][7]

d) No further profits will be attributable to the Indian operations where business connection of an enterprise in India is represented by the activities of an associated enterprise ("AE"), resident in India; and

- the enterprise does not receive any payments on accounts of sales/ services from such resident [or such payments do not exceed an amount of INR 1 mn]; and
- the activities of that associated enterprise have been fully remunerated by the enterprise by an arm's length price (ALP)

e) Where however the payments received by that enterprise on account of sales/ services from persons resident in India exceeds the amount of INR 1 mn, then profits attributable to the operation of that enterprise in India will be derived based on general rules mentioned above, from which the profits already taxed in the hands of the AE will be deducted.

The Committee recommends the amendment of Rule 10 accordingly. Alternatively, an amendment in the domestic tax law itself to incorporate a provision for profit attribution to PE may be considered.

Our observations

(i) In order to attribute profits to a PE under India's domestic tax law, the current provisions of the Act (ie Rule 10) follow generalised apportionment principle. The Report makes a welcome attempt to make Rule 10 more specific.

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

[6] Seems to be a typo; the formula should instead read as: 'Profits derived from India' x [(0.3 x SI/ST) + (0.15 x NI/NT) + (0.15 x WI/WT) + (0.3 x AI /AT)] + 0.1]

[7] Seems to be a typo; the formula should instead read as: Profits derived from India' x [(0.3 x SI/ST) + (0.125 x NI/NT) + (0.125 x WI/WT) + (0.25 x AI/AT)] + 0.2]

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(ii) The Report recommends incorporation of 'fractional apportionment' method in Rule 10. The Report reiterates India's rejection of the AOA (which is based on the FAR analysis) for the attribution of profits to a PE. While applying the fractional apportionment method, the Report recommends the demand factor (ie sales in India) to be included.

(iii) When applied to a non-DTAA situation, the proposed Rule 10 would be able to quantify tax outcome for a PE /business connection in respect of Indian operations. In cases where a taxpayer has access to a DTAA with India, most of such treaties mandate the attribution of income to a PE on the basis that the PE is a 'single, distinct and separate' enterprise [Article 7(2)]. However, the treaty further states that nothing in paragraph 7(2) will preclude attribution to a PE based on a country's customary approach [Article 7(4)] and the result of such apportionment is in conformity with principle of Article 7. In India, whether this customary approach is the apportionment based Rule 10 or after the introduction of Transfer Pricing provisions in the Act in 2001 (along with the CBDT Circular of 2001 and 2004)[8], it is the 'arm's length principle' is a matter of debate which requires a careful consideration.

(iv) Another important corollary is whether the proposed method would apply only to cases where profit attribution is not possible based on accounts prepared on a 'separate entity' approach. This is likely to add to the debate on the concept of income attribution to a PE, going forward if the tax authorities reject the books of accounts of a PE and proceed to invoke Rule 10.

(v) It is worthwhile to mention that this proposed inclusion of market factor to the concept of income attribution to a PE is a matter of international discussion and would require changes to the DTAAs. Such a proposal may result in double taxation, as treaty partners may not accept the aforesaid approach leading to potential double taxation for taxpayers requiring resolution under bilateral procedures.

(vi) Regarding implementation of Rule 10, despite the added clarity, there are several areas where computational challenges will likely remain. For instance, the proposed amendment to income attribution rules is essentially a domestic law measure by India. It will not necessarily align with the understanding of its tax treaties with OECD members bound by OECD's FAR based authorised approach (AOA) to income attribution. The revised formula under Rule 10 may invariably create a mismatch in such cases as to taxable profits of a PE (and consequent foreign tax credit) in India and residence country, respectively.

(vii) Another concern would be levy of tax on minimum attribution of 2 percent of revenues derived from India particularly in cases where the non-resident enterprise has global losses. Such a deemed 'minimum attribution' could lead to final tax cost and may not even be justified if Indian operations are also incurring losses. Controversies emanating from such mismatches would need to be resolved either in a judicial forum and/or through Mutual Agreement Procedure mechanism.

(viii) Lastly, computational challenge for taxpayers, and for the Revenue alike, would remain for collating reliable data in respect of global and India sales, manpower and assets; data points particularly in respect of manpower costs could be highly confidential too and may not be readily available.

[8] Circular no. 14/2001 and circular no. 5/2004

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