<u>Summary of Proposal for Amendment of Rule for Profit Attribution to Permanent Establishment</u>

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The Central Board of Direct Taxes (for brevity 'CBDT') has released a paper for public consultation on the proposals pertaining to the amendment of rules which deal with profit attribution to Permeant Establishment (for brevity 'PE'). The current rule does not lay down a universal approach for determination of profits attributable to PE, leaving to the discretion of Assessing Officer a wide power for such attribution. This has led to multiple rounds of litigations both by tax payer and revenue. The Courts also held in different matters, different profit attributions making this more complicated. Further, the tax payer is also burdened in absence of a concrete mechanism, which leads to tax uncertainty. Hence, the CBDT thought in the best interests of tax payers and to achieve a universality in attributions of profits to PE, brought out a paper for public consultation dealing with the amendments to such rules. The paper was published on 18th April 2019 and CBDT has provided a window of 30 days for providing the comments on the proposed amendments. Such comments can be mailed to usfttr-1@gov.in. In this write up, we have tried to concisely capture the key contents in the paper, so that reader can go through this write up and make his suggestions to the proposed amendments.

<u>Background:</u>

Before going to the proposed amendments, let us capture the context in which the amendments are being tried to brought in. Section 4 of Income Tax Act, 1961 (for brevity 'Act') is the charging section which provides income tax on the total income. Section 5 of Act deals with the scope of total income. Vide sub-section (2), the total income of a non-resident includes all income from whatever source derived which is received or is deemed to be received in India by or on behalf of such person or accrues or arises or is deemed to accrue or arise to non-resident in India. Section 9 of the Act deals with instances where income deemed to accrue or arise in India to any person. Vide Section 9(1), income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. Vide Explanations to such sub-section, the scope of expression 'business connection' is laid down.

<u>Position under Domestic Act:</u>

Hence, if a non-resident has a business connection as explained in Section 9(1), the income of such non-resident is deemed to accrue or arise in India. However, Explanation 1 to Section 9(1) states that in case of business of which all the operations are not carried out in India, the income of business deemed to accrue or arise in India ***<u>shall be only such part of the income as is reasonably attributable to the operations carried out in India.</u>***

<u>Attribution under Domestic Act:</u>

It appears to be simple to arrive at income as is reasonably attributable to the operations in India, but there are number of practical challenges to such determination. One being, the exercise as to whether a non-resident has a business connection in India or not, is completely a factual exercise and a highly subjective matter. Hence, this happens in majority of the instances at a period of time substantially different from the time of happening of the transactions. Two, it is rare that a non-resident maintains a separate set of books of accounts pertaining to Indian operations to facilitate the determination of such income which is attributable to Indian operations. Even assuming such books of accounts are maintained that determination of profits is not an easy task.

Hence, in this connection, Rule 10 of Income Tax Rules, 1962 (for brevity 'Rules') has been prescribed to determine the income of non-residents in case the income of non-resident cannot be definitely ascertained. Vide such rule, the Assessing Officer (for brevity 'AO') has been given three options to determine the income of non-resident which is subjected to tax in India to the extent of operations carried out in India. The income may be ascertained by AO – (i) at such percentage of the turnover so accruing or arising as AO may consider it reasonable (presumptive method) or (ii) on any amounts which bears the same proportion to the total profits and gains of the business (computed in accordance with the provisions of the Act) of such person as the receipts so accruing or arising bear to the total receipts of the business (proportionate method) or (iii) in such other manner as AO may deem suitable (discretionary method). Hence, it is evident that AO has given wide discretion for attribution of profits pertaining to the non-resident.

Apart from the above, the story gets more complicated in light of the Double Taxation Avoidance Agreements (for brevity 'DTAA'). Section 90 of the Act empowers the Central Government to enter arrangements with other countries to avoid double taxation of the income. Vide such section, India has entered multiple DTAA with multiple countries. Section 90(2) of Act states that the provisions of the Act will apply to the extent they are more beneficial to him. In other words, if the position as per DTAA is more beneficial than the position under the Act, the non-resident can choose the position under DTAA since the same is more beneficial to him. Hence, it assumes importance to understand the position under DTAA in terms of business connection to better understand the proposed amendments.

Position under DTAA:

There are two widely used model conventions namely OECD and UN Model Conventions. Both of them differ in various aspects, but these two are widely used model convention which all the countries use to enter respective DTAA. India has tax treaties based on UN model conventions with certain changes. OECD model conventions generally provides greater taxing rights to the residence country rather than source country. However, UN model conventions provide greater taxing rights to the source country rather than residence country.

Article 7 of such model conventions deals with 'business profits'. Vide such Article, any person carrying business in other contracting state may be taxed in such other contracting state only if there exists a permanent establishment in such other contracting state. Article 5 of model conventions deal with 'Permanent Establishment'. The concept of 'business connection' under the Act is akin to the concept of 'Permanent Establishment' under the DTAA.

Once there exists a PE in the other contracting state as per Article 5, then the profits of business will be subjected to tax in the other contracting state. In other words, the business profits cannot be brought into tax in other contracting state in absence of PE despite of the fact that there exists a business connection in terms of Section 9 by virtue of Section 90(2). The scope of PE as per the UN model convention is wider than the scope of PE in OECD model convention. Further, Article 7 states that once a PE is in existence in other contracting state, the profits of such PE shall be subjected to tax only to the extent of profits that are attributable to PE.

Attribution under DTAA:

As per Article 7(2) of UN model conventions, wherever separate accounts of PE are available and can be relied upon, such PE shall be treated as distinct and separate entity and income shall be computed under the head 'profits and gains of business or profession'. Certain payments or notional payments made by PE to the head office that may not be deductible under the provisions of Article 7(3) of model

conventions as well as Section 44C of the Act will not be allowed as deductions. Once the profits can be calculated in the above manner, then invoking provisions of Article 7(4) is unwarranted. In other words, the provisions of Article 7(4) will apply only in a situation where separate accounts are not maintained or cannot be relied upon to apply provisions of Article 7(2).

Article 7(4) states that where it is customary that the contracting state attributes profits to PE by way of an apportionment, then it is permissible to apportion profits to such PE as per the customary method of contracting state, which refers back to Rule 10 of Rules as discussed above.

The Problem:

As stated earlier and as evident from the above, the problem is that the separate accounts of PE will not be generally available and even if available, the AO states the same cannot be relied. Taking this position AO, by resorting to provisions of Article 7(4) uses the Rule 10 mechanism to arrive at such profits which are attributable to the PE to the extent of Indian operations. AO uses the discretionary method which will result in huge attributions, where the tax payer have to undergo multiple rounds of litigations to get to a lower attribution. Further, the discretionary method of AO also leads to tax uncertainty.

Based on the above, the Committee has called for information from major centres, including Mumbai, Chennai, Hyderabad, Bangalore, Kolkata, Ahmadabad and Delhi to understand the current methodology adopted by AOs. After a review of such information, the Committee has understood that there is little uniformity among the AOs in the manner of attribution to PE and application of Rule 10. Hence, the Committee has decided to arrive a simple, uniform and consistent method of profit attribution under Rule 10 bringing in great clarity, predictability and objectivity in the process of attribution of profits and reducing tax disputes and litigation.

The Search:

The Committee has begun the search for identification of a simple, uniform and consistent method of profit attribution. The challenge that exists to come up with a simple, uniform and consistent method are many. The main is zeroing on the method in which profits to be apportioned. Whether the profits belong to the place where the factors of production reside or where the consumers reside? This is important because, if it is said that profits arise only because of factors of production (supply side factors), then the country in which manufacturing is taken place should be entitled for the entire profits. Alternatively, if it is said, the profits arise only because of market/consumers (market side factors), then the profits belong to the such country where markets/consumers reside, leaving the state in which the factors of production reside.

Any of the above method would lead to other country losing revenue and also does not reflect the economic position of the transaction. It is beyond any doubt that profits will not exist just because of availability of factors of production or markets. Profits will be available only if both factors of production and markets are in existence. The fight is what is the weightage that should be allotted to factors of production and markets, so that each country would be eligible to tax such proportions.

In this connection, the Committee has examined the revised position under Article 7 of OECD model convention, international practices, the views of leading academicians on the current subject and also the economic basis of attributions of profits. We shall discuss them hereunder.

Revised Article 7 of OECD model convention:

Pre-2010 position:

Article 7 of OECD model convention, prior to 2010, has always suggested that profits to be attributed based on supply side factors and market side factors in absence of separate accounts of PE. The OECD Commentary on Article 7 (updated in 1977), where in it was stated that apportionment of profits should be based on one of the criteria i.e., receipts (or sales revenue), expenses and working capital, was a reasonable way of apportioning profits to PE. Thus, the position of OECD is clear till 2010 that profits has to be apportioned based on supply side factors and market side factors, further also provided guidance on when one of them as the basis for apportionment could be considered preferable to another depending upon the nature of tax payer.

Post-2010 position:

Post 2010, the OECD has introduced a concept for attribution of profits to PE namely 'Authorised OECD Approach' (for brevity 'AOA'). This concept is completely based on the 'separate entity approach', under which a PE is considered hypothetically as being a separate and independent entity from its Head Office, which performs the same or similar functions as that of an independent enterprise under same or similar conditions. The AOA uses the OECD Transfer Pricing guidelines and suggests that the profits to be attributed to the PE based on functions performed, assets employed, risks assumed. The AOA recommends two step approach to determine the profits attributable to PE, namely Step- 1: A functional and factual analysis of PE, aligned with FAR analysis and Step- 2: A comparability analysis to determine arm's length return (price) for PE's transactions.

Pre-2010 vs Post-2010:

The Committee observed that the changes are significant from two different perspectives. First, the post-2010, vide AOA, it approximated the process of profit attribution with that of transfer pricing, thereby leading to illusion that both of them are one and the same, and can be undertaken in an integrated manner by a common FAR analysis. Second, the AOA method has failed to consider the role of market side factors in contribution to the profits. The AOA has proceeded mainly attributing profits only on basis of FAR, represent market side factors and excluding sales from the equation, the contribution of market jurisdictions stands completely ignored.

The other significant change is that post-2010, OECD completely ignores the provisions of Article 7(4) by omitting it from 2010 model conventions. The impact of such an omission leads to a situation to adopt AOA, even in the situation where the separate accounts were not readily available or where they were not accurate, without taking sales into account.

The most important effect of these changes, with immense consequences for all market-based jurisdictions will stand to lose revenue, since sales is excluded from the equation in arriving at the profit attributions. The Committee also argues the attribution of profits on the basis of AOA will also effect the supply side jurisdictions in the longer run. If AOA is adopted, the market side jurisdictions will not yield any tax revenues, thereby the governments spend would take a dip, which leads to downfall of purchasing capacity, leading to lower consumption levels and thereby effecting the supply side jurisdictions to reduce the supply, which leads to reduction in profits. Hence, the Committee is of the view that AOA is not a right solution since it does not take the market side factors at all in the profit attribution exercise.

The above is the reason as to why Indian tax treaties do not contain the revised version of Article 7 which prescribes profit attribution based on FAR analysis. The Committee has observed that AOA

approach restricts the taxing rights of the jurisdiction that contributes to business profits by facilitating demand, and thereby has the potential to break the virtuous cycle of taxation that benefits all the stakeholders in global economy.

Economic Basis for Allocation of Taxing Rights in respect of Income from Business:

The Committee states that the business profits of an enterprise can be generally be understood as the surplus of its business receipts over its business expenses. The average profit, which actually forms the tax base in income tax and corporate tax regimes, is constituted by surplus of total revenues over the sum of all costs. Hence, Profits = (Price per unit * Quantity of Units sold) – (Sum of marginal costs for all units + assigned sunk cost).

Thus, business profits which constitute tax base is income tax and corporate tax depend largely on two variables, *sales revenue* and costs. Sales revenue in turn, depends upon two variables, price per unit and quantum of units sold.

The price of goods as well as the quantum of the units sold depends upon both demand and supply, all factors influencing them. Thus, for determination of profits of an enterprise, both demand and supply are essential, and absence or inadequacy of either of them can make the enterprise unprofitable. Hence, a jurisdiction which contributes towards demand by facilitating the economy and the ability of their resident to pay or by maintenance of markets that enables sales as well as jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. The Committee has observed that, where the economies of both contracting states in a tax treaty contribute to the business profits, there exists sufficient economic justification for profits to be allocated among them in a manner that avoids double taxation.

Options suggested by Committee:

Based on the above studies from various perspectives, the Committee has stated that India has clearly communicated the non-adoption of revised Article 7 of OECD, wherein AOA methodology is used for attribution of profits. Further, the non-adoption of revised Article 7 in India's treaties also communicates and signifies the same stand.

However, as stated earlier, a universal approach of attribution of profits is need of the hour to bring certain tax certainty and to address other connected issues. Hence, it is important to come up with a simple, uniform and consistent method of profit attribution under Rule 10, which should be in line with India's position on attribution of profits.

The Option of Formulary Apportionment:

The Committee states that this is one of the most talked about option. Vide this option, the profits are attributed basis an apportionment which consists of three factor formula. The first factor is sales, the second factor being manpower or wages, or payroll and third factor takes into account the assets or property. This approach is largely the same one which is adopted by US and is also proposed to be adopted by EU.

However, this option is not free from any challenges especially in absence of complete information. To make this option viable, the tax authorities should have jurisdiction wise sales revenue, pay roll information and assets or properties deployed. The said information is not easily available even after the roll out of CbCr (Country by Country Reporting), for the reasons that CbCr reporting requirement is applicable only to certain companies which meet the threshold and the data or information available

through CbCr can be used for attribution of profits is not clear as of now. Hence, the Committee has ruled out this option even this appears to be more scientific.

The Option of Fractional Apportionment by a Uniform Method:

The profits of various jurisdictions as needed in formulary apportionment are not required to arrive at profits attributable to PE in this method. The profits are determined only by taking those profits that have been derived by the PE and thereafter apportioning them on basis of certain factors. This approach garners support from Article 7(4) and existing Rule 10 and also blessed by Indian judiciary.

The Committee states that it is India's consistent position that profits are contributed independently by demand and supply, the apportionment would need to be based on factors representing demand as well as supply. The three-factor approach of sales, manpower and assets with equal weights assigned to each of them is proposed under this model.

The Committee argues that such model takes into account the contribution of demand and as well as supply to the profit of PE, and thereby reasonable allocates profits to the jurisdiction where the consumers and markets are located as well as where the factors of production and where activities on supply side are conducted. Further, by allocating $1/3^{rd}$ to sales and $2/3^{rd}$ supply side, it accommodates the role of marketing activities, which would be represented by manpower and assets, leading to equitable distribution of taxing rights among the supply and demand jurisdictions. Since it is based on the information available with PE, this method solves the challenge confronted by the earlier method.

An Option for Attribution on the basis of Demand & Supply:

The Committee also explored the option for attribution of profits on basis of supply side factors by resorting to FAR as advocated by OECD in AOA along with demand side factors represented by sales. This is nothing but a fusion of revised Article 7 for supply side factors and fractional apportionment which uses sales criterion for the demand side.

The Committee states that when an Indian subsidiary contributing to the business of foreign enterprise lead to creation of PE in India, the profits need to be attributed based only the demand side factors as the supply side factors have already been taken into account in the taxable income of the Indian Entity by virtue of transfer pricing regulations. Accordingly, where profits of Indian subsidiary are arrived at after the FAR and subjected to tax in India, they can be taken as the Indian profits contributed by the supply side factors. Following the consistent approach of allocating $1/3^{rd}$ profits on the basis of sales, the Committee states that weightage of attribution based on the sales can be kept @ 33%.

However, the above works out only when there is a subsidiary in India. In cases where there is no subsidiary in India and not part of profits derived from India are being subjected to tax in hands of any entity other than PE, the profits will then need to be attributed taking into account both the demand as well as supply side factors in ratio of 33:67. Since a significant portion of supply side factors reside outside India, the Committee observed that it is important to lay down a methodology for determination of supply side factors to avoid any ambiguity. For this Committee has proposed to adopt the methodology by taking a combination of $1/3^{rd}$ assets, $1/6^{th}$ wages and $1/6^{th}$ manpower. In absence of the above information, the AO should determine the supply side on pro-rata basis taking into account the factual matrix of case within the overall cap.

Hence, following this option, a minimum of 33% of profits derived from sales in India will invariably be attributable to the PE on basis of sales. In other words, in case of PE deriving profits from sales in India, where no part of these profits have been taxed in India in hands of any Indian Entity, the profits

attributable to such PE by AO should not be less than 33% of Indian profits, if no profit is to be attributed to India on account of factors other than sales.

Profits derived from India = Revenue derived from India * Global operational profit margin

However, if the global operations are leading to loss despite of the fact that Indian operations have profits, the Committee has decided that it would be better if a floor rate is available to tackle instances of loss and accordingly arrived that a minimum of 2% of gross revenue or turnover derived from Indian operations would be justified protecting revenue interest of India. In practice, this method can be applied in following steps:

i. Determine the profits derived from Indian operations of the enterprise. In case of global losses, or its global operational profit margin is less than 2%, the profits derived from India will be taken @ 2% of the revenue from India

ii. Apportion the profits from Indian operations of PE on basis of 3 factors of sales (33% weight) and manpower and assets (67% weight).

iii. Deduction of any profits from Indian operations of the enterprise, any profits that may have already been taxed in India (for instance, in hands of Indian subsidiary which gives rise to PE of enterprise in India).

Recommendations of the Committee:

The Committee has recommended amendments to Rule 10 by taking into consideration the three factors namely, sales, employees and assets. The formula under Rule 10 shall be as under:

$$\text{Profits derived from India} * [S_1/3 * S_T + (N_1/6 * N_T) + (W_1/6 * W_T) + A_1/3 * A_T)]$$

Where,

Profits derived from India shall be higher of amount arrived by multiplying revenue derived from India and global operational profit margin or 2% of revenue derived from India

S_1 = Sales Revenue derived by Indian Operations from sales in India

S_T = Total Sales Revenue derived by Indian Operations from sales in India and outside India

N_1 = Num of Employees employed with respect to Indian Operations and located in India

N_T = Num of Employees employed with respect to Indian Operations & located in & outside India

W_1= Wages paid to employees employed with respect to Indian Operations and located in India

W_T= Wages paid to employees employed with respect to Indian Operations and located in & out India

A_1= Assets deployed for Indian Operations and located in India

A_T= Assets deployed for Indian Operations and located in & out of India