taxsutra All rights reserved

taxsutra

# CBDT Draft Report on PE Profit Attribution - A Different Angle

Date: May 10,2019

**Radhakishan Rawal (Partner, Deloitte Haskins and Sells LLP)**

CBDT recently released a Report on Attribution of Profits to Permanent Establishment for public consultation. This report has generated significant debate within the Indian tax fraternity and this is likely to spill over globally as well. The author would like to thank Taxsutra for facilitating deliberation on the proposal through number of articles. A lot has already been said and written on the Report and as a late comer the author feels it appropriate to comment only on specific issues and bring out new viewpoints. It is now well accepted by all that the current tax laws (or at least some of them) are obsolete as a result of fast changing technology and new business models, even the transfer pricing provisions and the supremacy of the ALP principle appear to be getting challenged and the struggle for setting new rules is yet to see light at the end of the tunnel. The solution could be a new law or even reading the existing law in a different manner. The author according thinks it appropriate not to get constrained by his previous work[2] on the issue of attribution, interpretations taken or not considered by him about fifteen years back in his publications.

**1. CBDT initiative - A welcome move to end the guess work!**

We did not have a proper answer to the issue of arbitration[3] for almost 100 years now (or we never had) and the issue appeared to be getting addressed in an arbitrary manner in various forums. The following observations of the judicial authorities need to be noted:

The Bombay high court in the case of Blue Star Engineering Co. (Bombay) (P.) Ltd. v. CIT [1969] 73 ITR 283 (BOM.) observed as follows:

*We are not impressed by the said submission of Mr. Mehta. 2.5 per cent, no doubt, is some guess-work done by the Income-tax Officer, but substituting it by 10 per cent, again would be nothing more than indulging in further guesswork.*

The Supreme Court in the case of Hukam Chand Mills Ltd. v. CIT [1976] 103 ITR 548 (SC) observed:

*In the absence of some statutory or other fixed formula, any finding on the question of proportion involves some element of guess work. The endeavour can only be to be approximate and there cannot in the very nature of things be great precision and exactness in the matter. As long as the proportion fixed by the Tribunal is based upon the relevant material, it should not be disturbed.*

The review of certain recent judicial precedents may also suggest that the outcomes are still based on some high level presumptions or subjective judgments.

Once a scientific formula is adopted in the law, the arbitrariness or absolute discretion or subjective calls on these aspects would not be required. No doubt the formula itself may turn out to be arbitrary as one size cannot fit all, yet it could eliminate years of litigation and uncertainty. Plus one can hope that the formula will get fine-tuned and improved over a period of time and will also adopt industry specific features.

**2. Does proposed Rule 10 violate FAR or TP?**

The Report runs into 84 pages, contains various analysis, observations, justifications or rationales from pages 1 to 81 and contains recommendations on amendment to Rule 10 in pages 81 to 84. Reading of recommendations contained in para 190 could give an impression that the books of accounts maintained by the tax payer would be ignored and taxable income would be determined only on the basis of the amended Rule 10.

However, para 162 of the Report provides that the modified rule will be used only in those situations where there are no India centric financial statements or where the books of account have been rejected under the appropriate provisions of the Act or where for some specific reason that is recorded by the AO, the accounts do not adequately reflect the profits that can be attributable to the PE as an independent and separate entity.

taxsutra All rights reserved

The above para suggests that the amended Rule 10 will be invoked in a limited situations where the assessee does not maintain India centric accounts or do not maintain appropriate accounts[4]. In all other cases Rule 10 will not be applied and FAR / TP will continue to prevail. Thus the proposed Rule 10 does not appear to be contradicting TP principles. Situations where Rule 10 may be invoked may be treated as non-compliance by the tax payer (i.e. non-maintenance of accounts or proper accounts) which makes application of TP principles difficult.

Thus while most part of the discussion in the Report suggests that TP principles are to be ignored for the purpose of attribution of profits to PE, in view of para 162, that does not seem to be the final recommendation of the Committee.

**3. Does proposed Rule 10 override the provisions of tax treaty?**

Article 7(2) of the Indian tax treaties (i.e. based on OECD Model 2005 or 2008) contains arm's length principle. However, when Rule 10 is to be applied in exceptional situations[5], it may be possible to argue that the provisions of tax treaties are not overridden. This is for the reason that treaty also contemplates that the tax payer would maintain appropriate books of accounts, documentation etc. When the tax payer does not comply with these domestic law requirements, it may be difficult to take a view that the proposed Rule 10 overrides tax treaty provisions.

**4. Customary method under Article 7(4)[6]**

The Report appears to be taking a view that existing Rule 10 is the “customary method” referred in para 4 of Article 7 and appears to be proceeding on the basis that Rule 10 even after amendment cannot be seen as violation of treaty obligations.

The word “customary” means according to custom or usage, ordinary or common, usual, accustomed, regular, habitual, routine, ordinary, popular etc. The concept of customary can easily be explained on the basis of an example. To travel from Lower Parel to Santacruz, a Mumbaikar may use train or bus or car (private or taxi). Once in two three years when every thinks come to a standstill due to heavy rains and flood, the Mumbaikar may have to walk from Lower Parel office to Santacruz home. Would it be possible to make a statement that it is customary for a Mumbaikar to walk from his office in Lower Parel to Santacruz? Absolutely not.

Rule 10 is a last resort and is to be applied when everything else fails. It cannot be said to be a method applied regularly or routinely. After analysing more than fifteen judicial precedents, the Committee observes[7] that the courts have repeatedly endorsed the right of the right of the Assessing Officer to attribute profits under rule 10, even in cases where treaties are applicable. However, a quick reading of the grounds addressed by the judicial authorities in these cases does not suggest that the issue before the court was whether Rule 10 is a customary method for the purpose of Article 7(4).

The OECD Commentary on Article 7(4)[8] observes “…… should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

The methods commonly followed under the Indian law to determine taxable income is “computation method” (i.e. section 28 to 43D) or “presumptive method” (section 44B, section 44BB etc.) and these methods do not apportion the profits to various parts of the enterprise. Chapter X contains transfer pricing provisions and its scope is restricted to determine income (or allowance for expenditure) arising from international transactions. A non-resident may establish a branch in India and conduct business through such branch. The branch may earn income from transactions with independent parties / customers in India and may also have some transactions with head office. The profits of the branch would be predominantly determined on the basis of provisions of section 28 to 43D and some adjustments may be made in terms of Chapter X. However, on that basis it would be too aggressive to state that profits attributable to the PE are determined on the basis of Chapter X. Such profits at best can be said to be getting influenced to some extent by Chapter X.

**5. Scope of Article 7(1)**

Article 7(1)[9] is worded as follows:

*“1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise*

taxsutra All rights reserved

*carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."*

The issue to be addressed is, how to determine the profits attributable to the PE referred in the second sentence of Article 7(1). The right to tax such profits is given to the source country (i.e. the country in which the PE is situated) and such profits must be determined in terms of the provisions of the domestic law of the source country. Hence, if the PE exists in India, the profits attributable to the PE needs to be determined in terms of the provisions of the Income Tax Act, 1961 (the Act). Such determination could be as per the normal provisions of the Act. Para 12 of the OECD Commentary[10] on Article 5 suggests that when the accounts are maintained by the PE, such accounts would generally be the starting point. In cases where accounts are not maintained under the domestic law, attributable profits may be determined as per amended Rule 10.

So far so good. The real debate could be on the extent to which the profits so determined as per the domestic law (say Rule 10) need to be adjusted in terms of Article 7(2). This is analysed in the subsequent para.

**6. Extent to which Article 7(2) restricts attribution under Article 7(1)**

Article 7(2), as it prevails in most of the Indian tax treaties, is reproduced hereunder:

*"2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

The real issue is the scope of PE as a distinct entity contemplated in Article 7(2). The following interpretations can be considered:

- One interpretation (say Interpretation A) could be that the separate entity hypothesis is to be restricted to the transactions between the PE and the head office[11] and the amount of profits arrived for the purpose of Article 7(1) (on the basis of the domestic law) need to be adjusted only to the extent the transaction between the HO and PE is not at arm's length. This interpretation could be on the basis of the words *"...and dealing wholly independently with the enterprise of which it is a permanent establishment"* at the end of Article 7(2).
- Other interpretation (say Interpretation B) could be that separate entity hypothesis is not restricted only to the transactions between HO - PE but for the purpose of all the activities of the PE. In this case the profits derived for the purpose of Article 7(1) on the basis of the domestic law could substantially get influenced.
- Yet another interpretation (say Interpretation C) could be that even when Interpretation B is adopted, the adjustments which can be made to the profits determined for the purpose of Article 7(1) on the basis of the domestic law, would be only to the extent the transactions between the HO and PE are not at arm's length. This is for the reason that attribution of profits to the operations carried out in India has to be done in accordance with the domestic law. Chapter X will influence mainly when the transactions are international transactions and not when the transactions are with independent parties. The transfer pricing provisions do not talk anything about how much profits should or could be earned from transactions with independent parties or how much profits should be attributed to the operations / functions pertaining to the transactions with independent parties. However, if how much profit arises from the operations pertaining to the transactions with independent parties is specifically is legislated under the domestic law (i.e. Rule 10), can this be diluted on the basis of transfer pricing provisions, which is meant only for the purpose of related party transactions?

Interpretation A and C are difficult as they do not appear to have been much talked about, neither is the CBDT Report relying on this line of thinking[12] nor is the OECD Commentary giving this impression. However, OECD Commentary or Article 7(2) also do not seem to be specifically going against this line of thinking. Consider the following:

- Article 7(2) simply says *"there shall in each Contracting State be attributed to that PE"*. Nowhere it says that attribution as per Article 7(2) represents a cap or profits more than that cannot be attributed.
- Article 7(2) (as it prevailed prior to the 2010 update and as it exists in most of the Indian tax treaties) does not categorically override provisions of Article 7(1). In the 2010 update of the OECD Model, Article 7(1) is made subject to the provisions of Article 7(2)[13].
- OECD Commentary on Article 7(2) categorically states that para 2 contains the central directive for

taxsutra All rights reserved

taxsutra

- allocation of profits. It also says ideally one has to start with the accounts prepared as per the domestic law and make further adjustments to it from arm's length principle perspective. Substitute for the profits as per the accounts under the domestic law could be Rule 10.
- Most part of Article 7(2) Commentary focuses only on the transactions between head office and PE.

If Interpretation A or C are possible, which undoubted are difficult, then Rule 10 and Article 7(2) can co-exist.

**7. General**

This article is not intended to be comprehensive and contains analysis of only certain issues arising from the proposed Rule 10.

---

[1] Partner Haskins and Sells LLP. The views expressed in this article are personal views of the author.

[2] Attribution et al Taxation of Permanent Establishment (2004), Snow White publications, The Taxation of Permanent Establishments an international perspective (2006), Spiramus publication (UK)

[3] How to attribute profits of an enterprise to different functions?

[4] It can be hoped that complete rejection of the tax payer's accounts by the tax authorities would not become routine.

[5] Para 162 of the Report

[6] Chapter 8 of 2004 publication contains detailed analysis of Article 7(4)

[7] Para 133, page no. 61

[8] Para 25 of the OECD Commentary 2005 on Article 7. Reference is made to the 2005 Commentary as the 2008 Commentary appears to have been influenced by the OECDs Attribution project.

[9] OECD Model 2005. This provision got amended in the 2010 update of the OECD Model.

[10] OECD Commentary 2005

[11] Or other PE of the same entity

[12] Report attempts to take shelter under Article 7(4) to sustain application of the proposed Rule 10

[13] Even after the 2010 update whether Interpretation A and C is possible could be a subject matter of separate examination.