

Attribution of profits – Recent Developments



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Option B : 5.30pm to 7.30pm

Attribution of Profits - Proposed Rule 10

Proposal on attribution of profits to business connection

Attribution of profits to PEs : Domestic law framework



Position under Domestic law

- Section 9 of the domestic law provides that in case a non-resident has a 'business connection' in India, only that income of the non-resident will be taxed in India which is attributable to Indian operations
- Finance Act, 2018 has also introduced the concept of 'Significant Economic Presence' ("SEP") as a factor which would lead to a business connection, if prescribed threshold of users/ revenue is exceeded. The threshold is yet to be prescribed. The SEP provision will apply only to in non-treaty situations
- For profit attribution under the domestic law, Rule 10 provides that in case,
 - profits attributable to a business connection cannot be definitely ascertained,
 - the tax authorities may resort to any of three methods viz. percentage of turnover (presumptive), proportionate or discretionary method
- Finance Act, 2001 introduced TP provisions in the domestic law. TP provisions incorporate the definition of PE as an 'associated enterprise' of the non-resident. Transactions between a PE and its non-resident HO are therefore subject to TP provisions
- Whilst several judicial rulings uphold FAR based TP analysis for attribution of profits, other rulings have upheld the apportionment method by application of rule 10, citing lack of relevant financials and TP analysis

Proposal on attribution of profits to permanent establishment

Attribution of profits - Concern and approaches



Concern and approaches

The main problem – absence of statutory guidance

- Profits attributable to operations in India are taxable in India
- In a situation where few (say two) functions of a business are performed in India and few (say three) functions are performed outside India, how to attribute profits to the functions?
- If total profit is 100 should the allocation be 50:50, 40:60, 30:70 or any other ratio?

Approaches under the domestic law to tax cross border businesses

- Taxation based on profits determined as per India centric books of accounts
- Presumptive taxation : Section 44B, section 44BB, section 44BBA etc.
- Taxation on gross basis : Section 115A
- Rule 10 methods (significant discretion to tax authorities)

Approach of judicial authorities

- Issues resolved on the basis of high level subjective presumptions (**Annexure A**)
- At higher level reluctance to indulge in “further guess work”

Proposed Rule 10 addresses the core attribution problem

Proposal on attribution of profits to permanent establishment

CBDT Committee-Key Proposals

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*

Approach of the Committee and Proposals

- Emphasized that business profits are contributed by both demand and supply side, hence, profits should be allocated to market jurisdiction as well.
- Discusses different approaches to profit attribution – (1) 'supply based approach'; (2) 'demand based approach'; and (3) 'mixed or balanced approach' (based on both demand / supply);
- Rejects functional, asset and risk ("FAR") approach by underlining India's reservation on OECD Model Convention as amended in 2010, and commentary.
- Prescribes Fractional apportionment method (rejects formulary) (*refer next slide for recommendations*)
- Considers that the fractional apportionment method can be applied in treaty cases since Indian Tax Treaties do not follow FAR based approach and permit use of an apportionment based approach

Proposal on attribution of profits to permanent establishment

CBDT Committee-Key Proposals

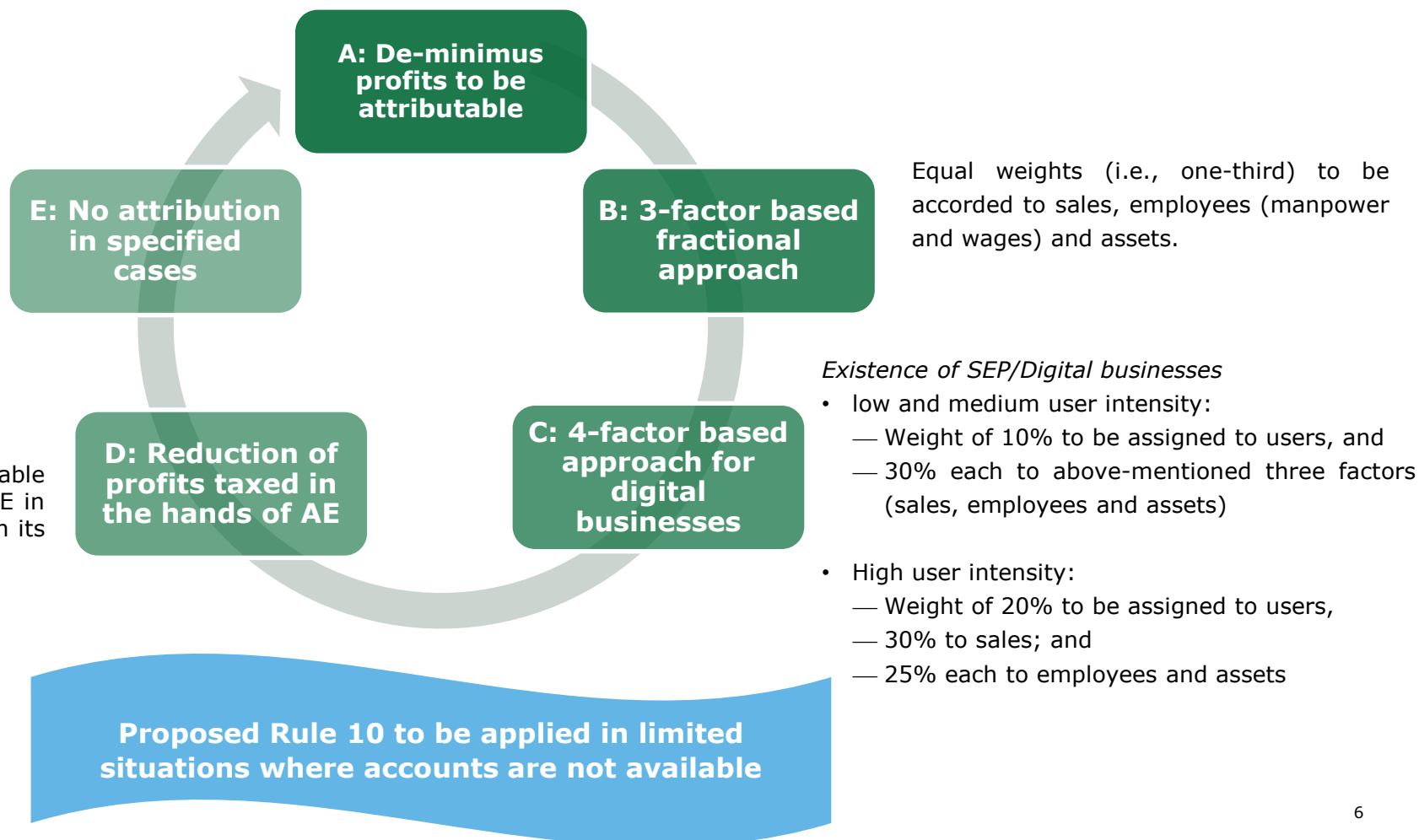
'Profits derived from India' to be higher of:

- amount arrived at by multiplying the *revenue derived from India* with Global operational profit margin (Earning before interest, depreciation and tax "EBIDTA") or
- 2% of revenue derived from India

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

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

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



Profit attribution to Permanent Establishment

Recommendation of the committee : Formula based attribution

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

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

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)

Profit attribution to Permanent Establishment Illustrations



Illustrative example 1

Particulars	Number
Employees	Sales -India-15, Outside India-5 (not India specific) R&D and manufacturing -Outside India-50
Employee cost	Sales -India-INR 1500, Outside India-INR 1000 (not India specific) R&D & manufacturing -INR 5000
Assets	Sales assets - India INR 500, Outside India INR 500 (not India specific) R&D and manufacturing assets -Outside India-INR 2000
Profitability/EBITDA	India-2%, Global-10%

- Revenue derived from India- 70 or 100 or 270?
- “employees located overseas with respect to Indian operations”-5, a proportion of 5 or proportion of 55
- Assets deployed for Indian operations located outside India”?
- Consideration of economic value of intangible assets?
- **Result 1-** $100 \times 10\% \times (1/3 + (1/6 \times 15/20) + (1/6 \times 1500/2500) + (1/3 \times 500/1000)) = 7.25$, i.e. 7.25% of sales [**only sales people without proportion**]
- **Result 1-** $100 \times 10\% \times (1/3 + (1/6 \times 15/70) + (1/6 \times 1500/7500) + (1/3 \times 500/3000)) = 4.58$, i.e. 4.58% of sales [**manufacturing and sales people without proportion**]

***Several combinations can arise in the application of formula**

Overseas

Non-Resident

Sale -INR 70 to Indian AE / 200 to other Indian customers

India

Indian LRD (alleged to be DAPE)

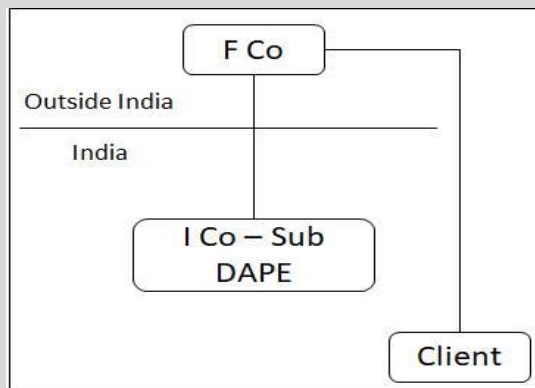
Sale -INR 100

Customers

Profit attribution to Permanent Establishment Illustrations



Illustrative example 4



Particulars	INR Mn
Revenue from Indian clients	100
Attributable profits (Rule 10)	25
Arm's length payment to subsidiary	10
Profits taxable in the hands of F Co.	15

No attribution, when the Indian AE is compensated at ALP and where revenue from Indian clients does not exceed Rs. 1 mn

Interaction with the domestic TP rules and treaty provisions....

- Applicability of rule related to “business connection” to “permanent establishment”
- Existing Rule 10 as a customary method in terms of Article 7(4)
 - Article 7(4)-“ **Insofar as it has been customary** in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, **nothing in paragraph 2 shall** preclude that Contracting State from determining the profits to be taxed by **such an apportionment as may be customary**; the **method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles** contained in this Article”
- Transfer pricing provisions as a customary method in terms of Article 7(4)
- Interplay between proposed Rule 10 and transfer pricing principles [Para 199, 162 of the report]

.....Interaction with the domestic TP rules and treaty provisions

- Proposed Rule 10 and Article 7
 - Article 7(1) – The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise 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.
 - Article 7(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*
- Application of proposed Rule 10 when there is a “significant economic presence”

**Attribution of Profits – OECD Secretariat
proposal : Unified Approach Pillar One
[Oct 2019]**

New nexus and profit allocation rules

- The unified approach proposal draws on the commonalities identified in the May programme of work

Reallocating taxing rights in favour of the **user/market country**

Envisaging a **new nexus rule not dependent on physical presence** in the user/market country

Going **beyond the arm's length principle** and **departing from the separate entity principle**

Searching for **simplicity, stabilisation** of the tax system, and **increased tax certainty** in implementation

The proposal does not, at this stage, have consensus political support from the G20/OECD inclusive framework on BEPS.

New nexus and profit allocation rules

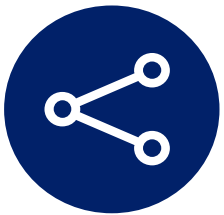
Key features of OECD secretariat's proposed unified approach



- **Scope of new taxing right**
 - Large consumer-facing businesses



- **New nexus rules**
 - Not dependent on physical presence



- **New profit allocation rules**
 - Calculated using a three-tier mechanism



- **Robust dispute prevention and resolution**
 - Including binding arbitration

New nexus and profit allocation rules

Scope

Approach covers highly digital business models but goes **wider...**

...broadly focussing on **consumer-facing businesses**

“Businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element.”

**Possible
revenue
threshold?**

€750 million revenue

**Possible
exclusions**

Extractives commodities
financial services

Three tier mechanism

Profit allocation – beyond the arm's length principle

New taxing right

Amount

A

- **New taxing right**
 - Allocates a **portion of deemed residual profit** to market jurisdictions using a **formulaic** approach

Modification of existing allocation

Amount

B

- **Fixed “baseline” return** for marketing and distribution functions

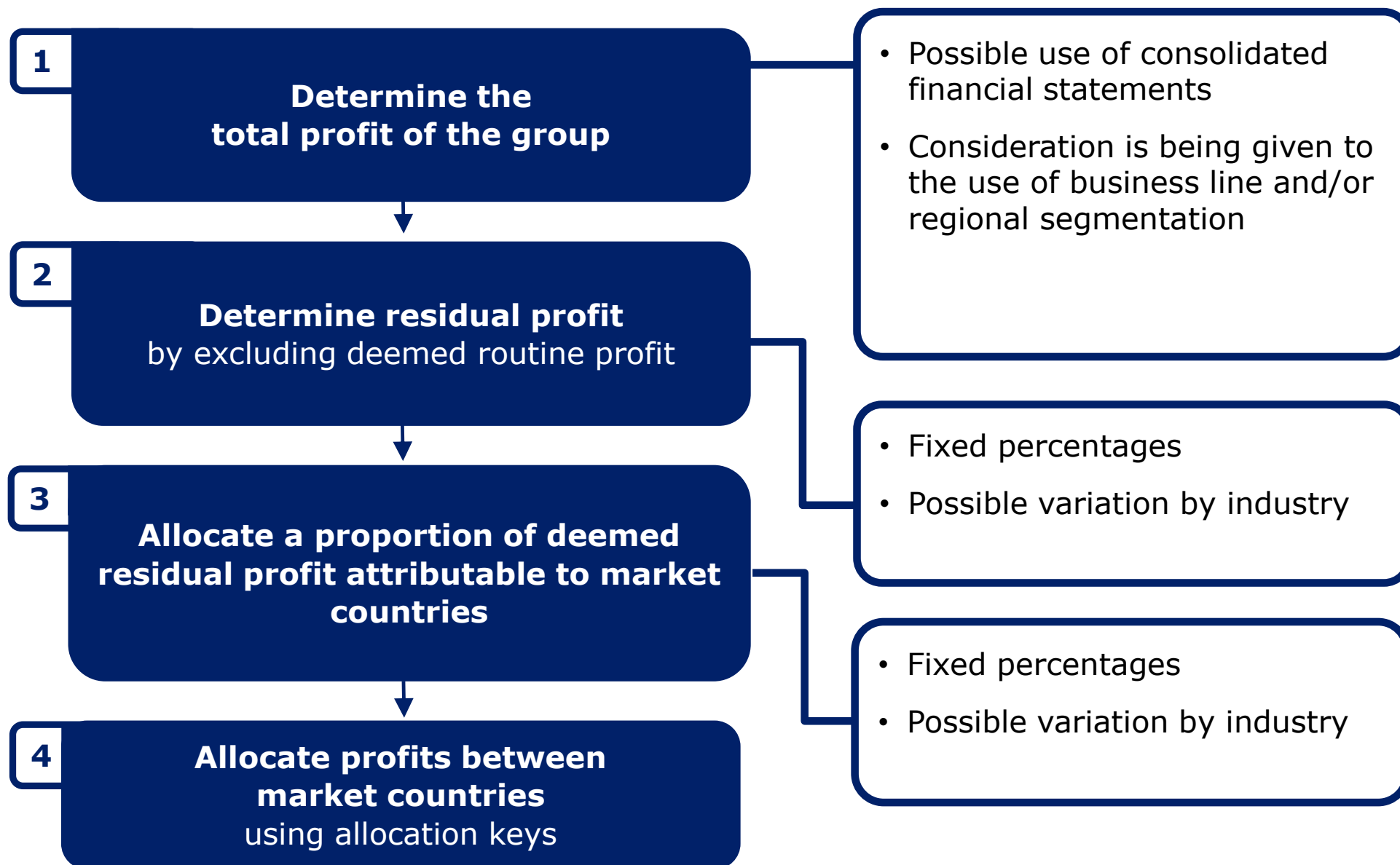
Amount

C

- **Additional return** based on transfer pricing analysis and subject to binding arbitration

Three tier mechanism – Amount A

New taxing right



Three tier mechanism – Amount B

Fixed return for baseline marketing and distribution functions

Establish a fixed return for “baseline” or routine marketing and distribution activities

- Intention of OECD secretariat to

Reduce disputes

Increase certainty

Three tier mechanism – Amount C

Additional return based on arm's length transfer pricing

Provides businesses and tax authorities with the ability to **recognise profit in excess** of the return calculated under Amount B

where

the marketing and distribution activities taking place in the market country go **beyond the baseline level of functionality**

or

the group or company perform **other business activities** in the country unrelated to marketing and distribution

Any additional profit must be supported by the arm's length principle

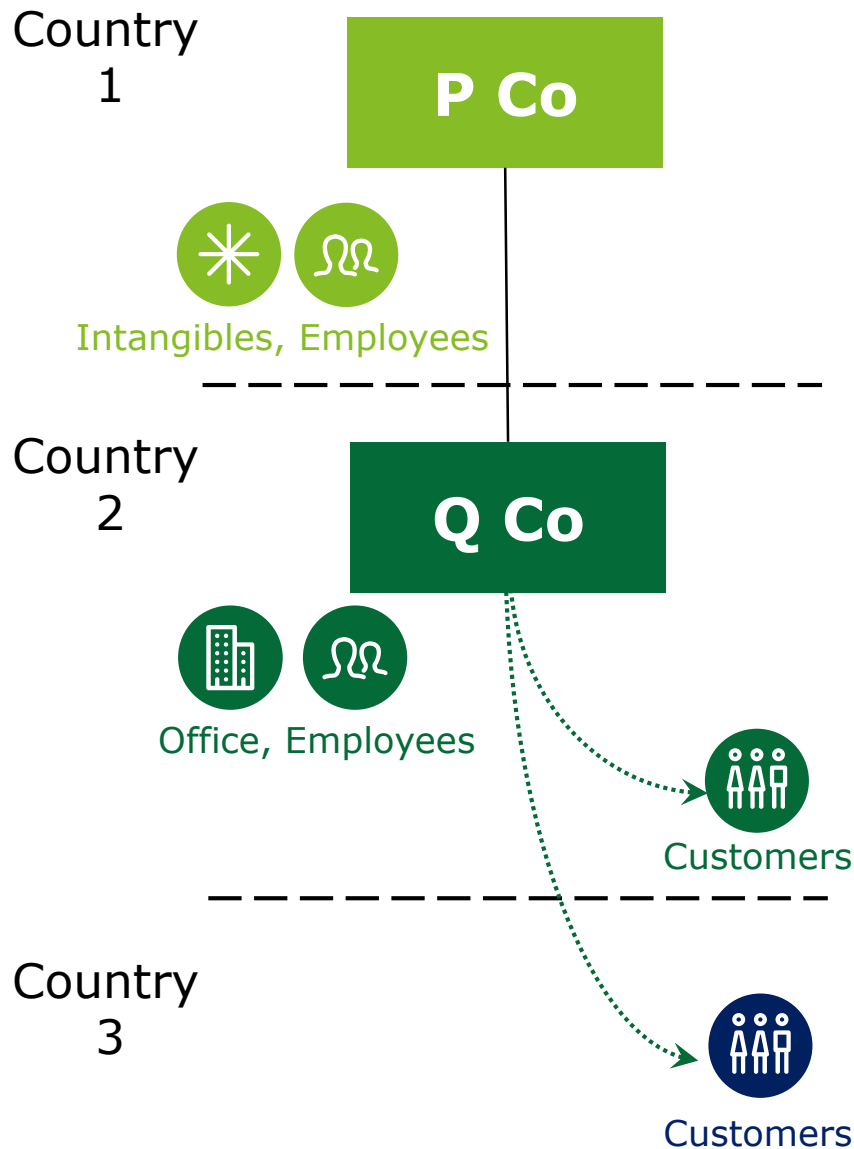
Ensure profits are not duplicated in market country

Prevent double taxation

Robust measures to resolve disputes, including binding arbitration

OECD example

Group provides a streaming service



- **P Co**

- Owns all intangibles
- Currently entitled to all non-routine profit

- **Q Co**

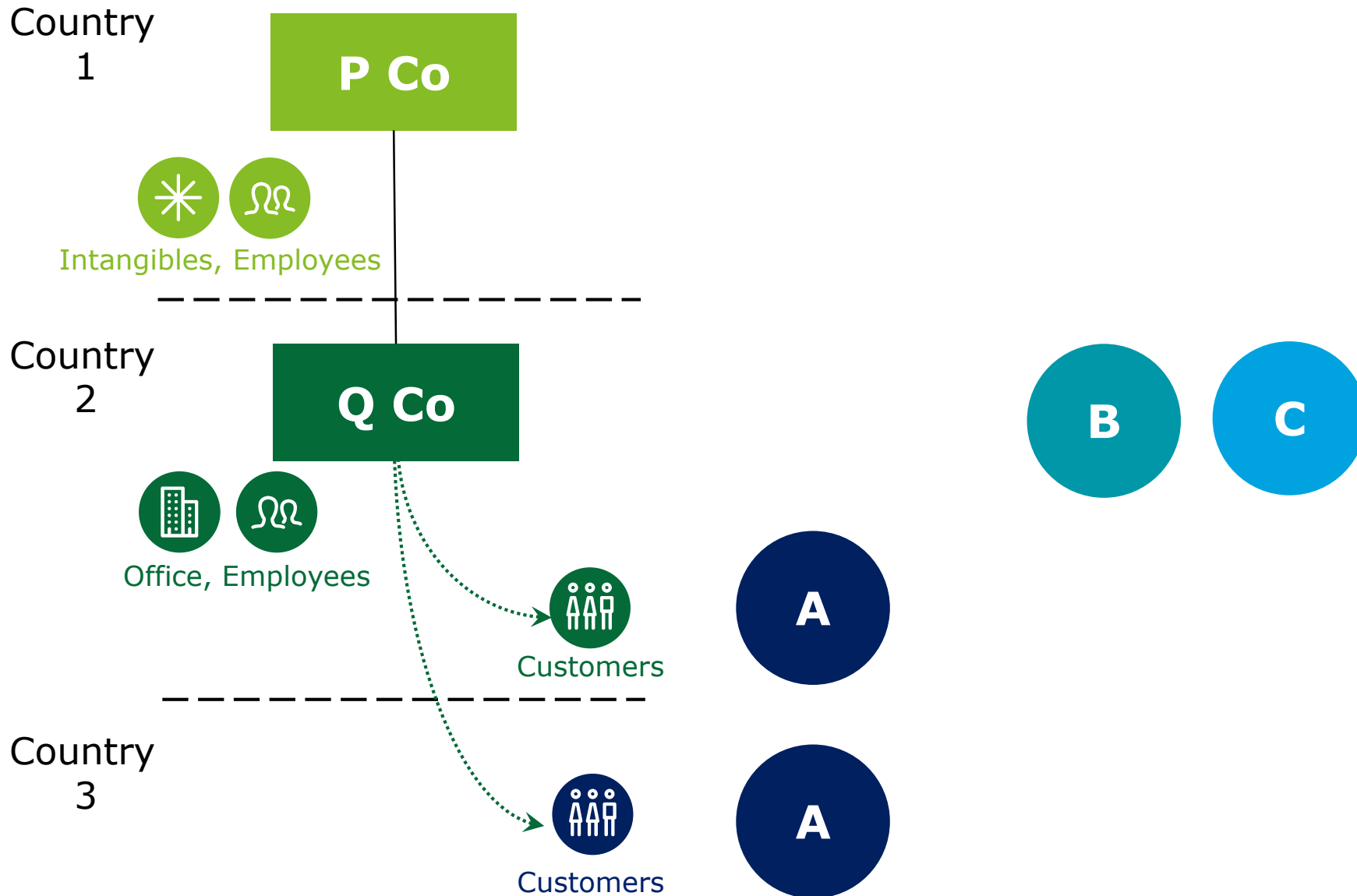
- Performs marketing and distribution activities
- Sells streaming services to country 2 customers

- **Q Co**

- Also sells streaming services to country 3 customers
- No physical presence in country 3

OECD example

Group provides a streaming service (Cont'd)



Source: OECD Public Consultation Document

Annexures

Annexure A

Operations in India	Profits determined by the tax authorities	Profits approved by the courts
Negotiation of the deal, procurements of orders, arrangements for opening letter of credit by agent in India ¹	10%	10%
Use of word 'Intercontinental' in India ²	20%	5%
Conclusion of contract of purchasing agent in India ³	75%	10%
Conclusion of loan agreement in India ⁴	100%	0%
Procurements of raw materials from India ⁵	10%	10%
Performance of Guarantee in after sale of goods outside India ⁶	20%	0%
Supervision of execution of Purchase contracts from India ⁷	25%	25%
Canvassing orders and securing import/export licence in India ⁸	7.5%	0% ⁹
Provides equipment to the customers relating to oil and gas, energy, transportation and aviation business ¹⁰	10%	10%
marketing, sales, warehousing, after sales service and technical services to the customers through branch office ¹¹	40%	30%

^[1] 4 ITD 654; ^[2] 4 ITD 334; ^[3] 41 ITR 781; ^[4] 62 ITR 686; ^[5] 23 ITR 101; ^[6] 109 ITR 158, 19 ITD 125, 5 ITD 91

^[7] 73 ITR 283; ^[8] 108 ITR 874;

^[9] The court held that such activities were not carried on behalf of the non-resident

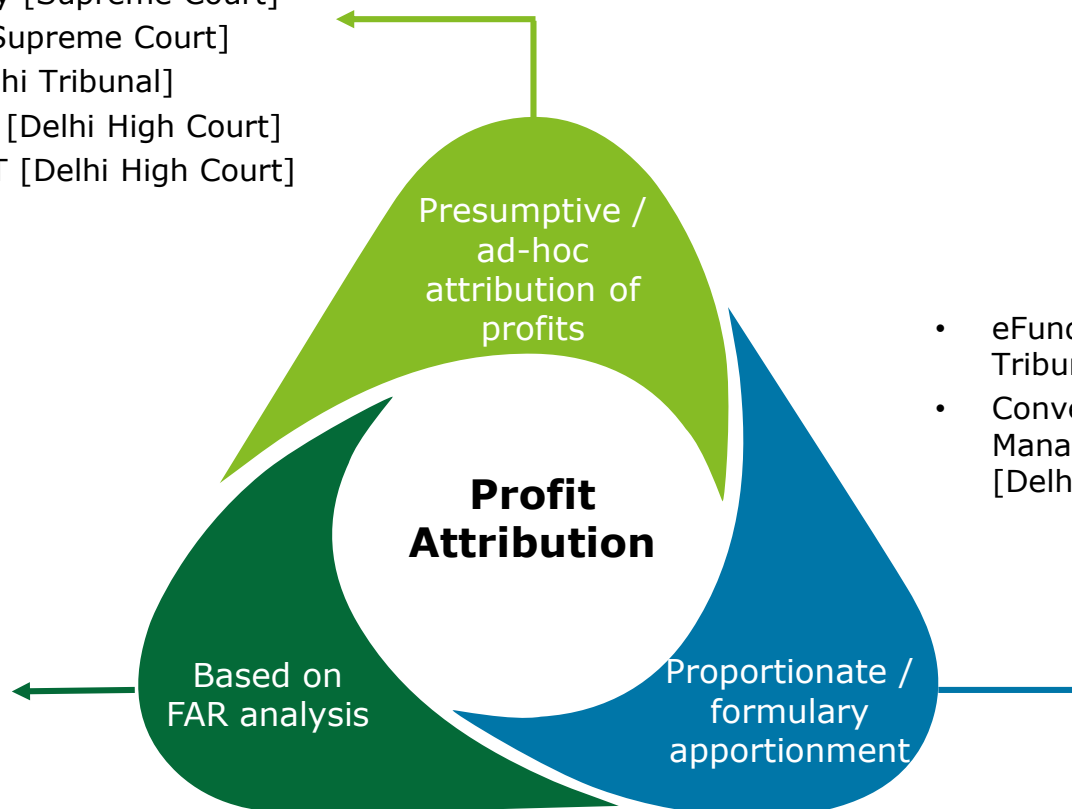
^[10] [2019] 101 taxmann.com 142 (Delhi); ^[11] [2017] 79 taxmann.com 154 (Delhi - Trib.)

Profit attribution to Permanent Establishment

Indian jurisprudence on attribution of profits

- Anglo French Textile Company [Supreme Court]
- Hukum Chand Mills Limited [Supreme Court]
- Galileo International Inc. [Delhi Tribunal]
- Rolls Royce Singapore P. Ltd. [Delhi High Court]
- GE Energy Parts Inc. Vs. ADIT [Delhi High Court]

- Morgan Stanley and Co. Inc. [Supreme court]
- Hyundai Rotem Company [Delhi Tribunal]
- Arrow Electronics India Ltd. [Bangalore Tribunal]



- eFunds Corporation [Delhi Tribunal]
- Convergys Customer Management Group Inc. [Delhi Tribunal]

Rule 10 upheld primarily in cases where the taxpayer did not produce any analysis / TP study did not reflect all functions performed by the PE