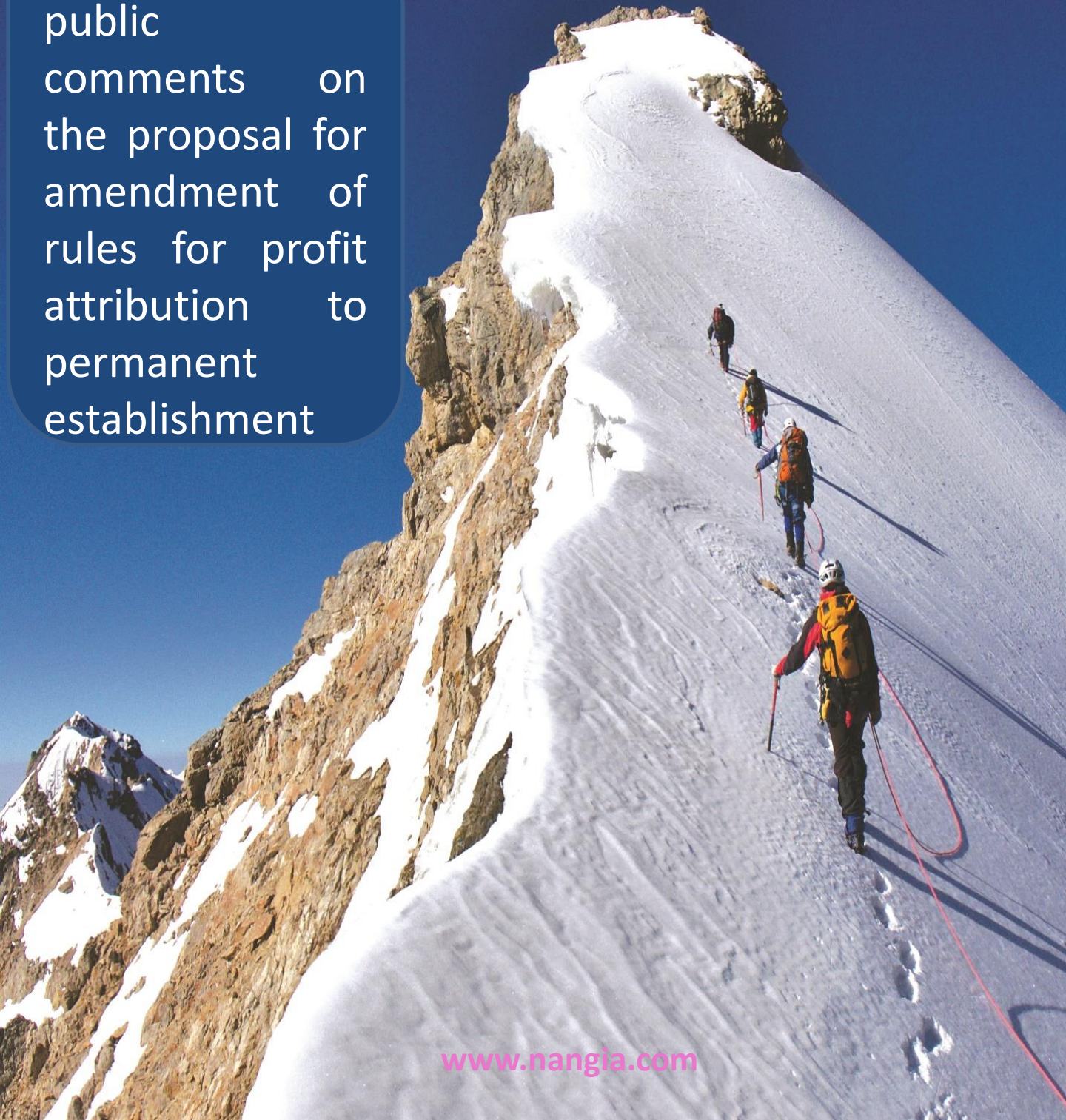


NEWSFLASH

April, 2019 – Volume 115

CBDT invites public comments on the proposal for amendment of rules for profit attribution to permanent establishment



CBDT invites public comments on the proposal for amendment of rules for profit attribution to permanent establishment

Background

Attribution of profit for taxing the income of a foreign enterprise as attributable to its permanent establishment (PE) has always been complex in absence of specific rules or formula. Income of a non-resident is taxed upon satisfaction of the threshold under the Income-tax Act, 1961 (Act) and relevant Double Taxation Avoidance Agreement (DTAA). The Act governs the concept of business connection and PE is determined under DTAA for ascertaining the chargeability of tax in India. In the cases where business connection or PE is established, profits of the entity are taxable in India to the extent the same are attributable to the operations carried out in India.

The Act provides that the amount of attributable profits can be determined using the methods prescribed under Rule 10. However, the methodology specified in the Rule 10 is wide and incorporates methods which involves a lot of discretion. Thus, there arises lack of uniformity in the approach of the tax officers, which leads to the wide diversity in the methods finalized by the appellate authorities in different cases.

Considering the significance of the issue in respect of profit attribution, a committee was formed to examine the existing scheme of profit attribution to PE under Article 7 of the DTAA and recommend changes in Rule 10 to achieve greater clarity and predictability.

On 18 April 2019, the committee submitted its report seeking public comments on the recommendations made by it.

Committee has discussed in detail the concepts impacting determination of profits attributable to a PE

❑ Key factors deriving the profit attribution

Key factors in attribution of profits are demand and supply of the product/ services as no business can derive profits without completing both. Both, the production of goods/ procurement of service and their sale contributes to the business profits of an entity. Thus, if the said components are scattered over different jurisdictions, each jurisdiction gets a valid justification for taxing the profits contributed by their respective economies.

❑ Different approaches to profit attribution

- a) **Supply Side Approach** - It allocates business profits exclusively to the jurisdiction where factors of production are deployed and supply side activities are undertaken
- b) **Demand Side Approach** - This approach allocates all business profits exclusively to the jurisdiction where customer is located.
- c) **Mixed Approach** - This approach allocates profits where consumers are located and the jurisdiction where factors of production are located & supply side activities are undertaken

Mostly, international tax treaties have adopted mixed approach or demand approach in formulating the rules for profit attribution. Also, many academicians and experts advocate demand side approach.

❑ Structure of Article 7 and India's position

Article 7 has been structured under various tax treaties on the basis of three different versions of model conventions which includes the following:

- a) Article 7 recommended by the OECD model convention prior to 2010;
- b) Revised article 7 introduced in 2010;
- c) Article 7 of UN model Convention

Indian tax treaties incorporate Article 7 of UN model convention which has similarities with pre-2010 OECD model Convention. Accordingly, it requires profits to be attributed to the PE as if it were a distinct and separate entity on the basis of accounts of PE. In case where the detailed and accurate accounts are not available to enable determination of profits attributable to the PE, it can be determined by indirect apportionment under domestic tax law.

Though, Article 7 of UN model convention has been derived from pre-2010 version of Article 7 of OECD, it has significant difference as it includes the concept of force of attraction and limitation of deductible expense. In certain tax treaties, article 7 of UN model convention applies with certain modification.

Whereas, the revised article 7 introduced in 2010 seeks to take functions, assets and risk or FAR analysis as the basis of the profit attribution. This version has completely overlooked the contribution of market jurisdiction. Another downside of this version was that where accounts were not available or inaccurate, the determination of attributable profit was done by taking FAR into account without taking sales into account. As part of revision, it issued guidance through Authorized OECD approach (AOA) which explains how it intends the article 7 on the profit attribution to be applied. This approach restricts the taxing right of the jurisdiction that contributes to business profits by facilitating demand and thereby, has potential to break the virtuous cycle of taxation that benefits all the stakeholder in the global economy.

Instead, it can set a vicious cycle in place that is destined to lead to losses for all the stakeholders.

Indian tax treaties have largely adopted Article 7 of UN model convention since for the sustenance of its economy and global trade, it is essential that taxing rights are fairly attributed on the basis of both demand and supply and not restricted to the supply side alone as is advocated in AOA. In order to achieve equity, India has chosen business profits, which takes both sales and supply into account, as its tax base and not value addition. India had made strong reservations against the revised article 7 and the concept of AOA and has not adopted the same in any of its tax treaties.

Committee Deliberation on possible options for attribution of profits

Formulary apportionment method and the fractional apportionment method have been broadly considered by the committee as options to attribute profits to a PE.

Formulary apportionment uses three factor formula which includes sales, accounts manpower or wages or payroll denominating human activities as the second factor and assets or property as the third factor. However, this formula is not easy to apply as it requires complete country wise information which may be difficult to extract. Thus, making it impractical approach to determine the attributable profits. However, the Committee considers the option of fractional apportionment method to be in line with India tax treaties and Rule 10. This method would require data relevant only to India, thereby making it more feasible to apply. The Committee has prescribed a three-factor method based on equal weight accorded to sales (representing demand), and man-power and assets (representing supply including marketing activities).

As in the case of digital economy, a new nexus rule in the form of significant economic presence has been introduced which takes into account "user" as its base for ascertaining the value creation.

In consideration of role of user, the committee has arrived at a unanimous view that user contribution should be included as the fourth factor for apportionment in addition to the other three factors i.e. sales, manpower and assets. However, it decided to assign different weights to different categories of digital business depending upon the user intensity

Committee Recommendations

The committee has recommended three factor formula in general and four factor formula in case where business connection gets constituted primarily through 'user' beyond the prescribed threshold. The summarized recommendations are as below:

Case A (Constitution of business connection in general)*

In the given scenario, apportionment of the profits derived from India shall be made on the basis of three equally weighted factors of sales, employees (manpower & wages) and assets.

Formula in this case is as under:

Profits attributable to operations in India = Profits derived from India x $[S_i/3xS_T + (N_i/6xN_T) + (W_i/6xW_T) + (A_i/3xA_T)]$

Where,
'Profit derived from India' shall be higher of the following amounts:

- The revenue derived from India x Global operational profit margin;
- 2 percent of the revenue derived from India

Here,

S_i = Sales revenue derived by Indian operations from sales in India
 S_T = Total sales revenue derived by Indian operations from sales in India & outside India

N_i = Number of employees employed with respect to Indian operations & located in India

N_T = Total number of employees employed with respect to Indian operations & located in India & outside India
 W_i = Wages paid to employees employed with respect to Indian operations & located in India

W_T = Total wages paid to employees employed with respect to Indian operations & located in India & outside India

A_i = Assets deployed for Indian operations & located in India

A_T = Total assets deployed for Indian operations & located in India & outside India

Case B (Constitution of business connection primarily by existence of users beyond the prescribed threshold in India)*

This approach would undertake four factors consisting of sales, employees (manpower and wages), assets and users and weights would be assigned on the basis of user intensity. In case of Low and medium user intensity, 10% weight to users and 30% each to other three factors would be assigned. While in case of high user intensity, 20% weight to user, 25% each to assets and employees and 30% to sales would be assigned. Formulae in the given scenarios would as follows:

a) Low and medium user intensity

Profits derived from India x $[0.3 \times S_i/S_T + (0.15 \times N_i/N_T) + (0.15 \times W_i/W_T) + (0.3 \times A_i/3xA_T)] + 0.1]$

b) High user intensity:

Profits derived from India x $[0.3 \times S_i/S_T + (0.125 \times N_i/N_T) + (0.125 \times W_i/W_T) + (0.25 \times A_i/3xA_T)] + 0.2]$

*Note

- No attribution shall be done in case where business connection is constituted through the activities of resident associated enterprise which gets remunerated at arm's length price for consideration received below Rs. 10,00,000 on account of sale or services.
- However, attribution shall be done using three factors or four factor formula by reducing the profits that have already been subjected to tax in the hands of the AE in case consideration is more than INR 1,000,000

NANGIA'S TAKE

CBDT's initiative to have defined rules and formula for attribution of profits is a welcome step as it would help in reducing litigations around the issue and provide certainty to the taxpayers as well as the tax authorities. Pertinently, the Committee's recommendations have given due consideration to the fact that India is a capital-importing country and hence, it would be suitable to develop a new source principle to tax profits derived from the 'market jurisdiction'.

The recommendations made by the CBDT giving due weightage to various elements in the economy would be advantageous for developing economy as it would seek to incorporate all the value generating components. However, the discussion on user in the report could create an anomaly with the impending Significant Economic Presence (SEP) rules, which would considerably impact companies operating in the digital space. Also, the suggestion of the Committee to bring an amendment in the Income tax Act itself to incorporate a provision for PE profit attribution needs to be well-thought-out conjointly with the upcoming Direct Taxes Code.

The final rules need to be aligned with the international tax principles emerging from the Organization for Economic Co-operation and Development (OECD) guidance on PE attribution as well as the OECD Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations (OECD TPG). It is also important to consider the potential risk of double taxation if the final rules are not consistent with the tax treaties under consideration.

An active participation from the industry in this reason-governed deliberation process would ensure that the final rules on PE profit attribution are fair in all ways!

ABOUT US

Nangia Advisors LLP is a premier professional services organization offering a diverse range of Taxation, Transaction Advisory and Business Consulting services. Nangia Advisors LLP has presence currently in Noida, Delhi, Gurugram, Mumbai, Dehradun, Bengaluru and Pune. Nangia Advisors LLP has been in existence for more than 38 years and has been consistently rated as one of the best advisory firms in India for entry strategy, taxation, accounting & compliances over the past many years. Nangia Advisors LLP had announced a strategic collaboration agreement with Andersen Global last year in May. Andersen Global is an international association of legally separate, independent member firms comprised of tax and legal professionals around the world. Established in 2013 by US member firm Andersen Tax LLC, Andersen Global now has over 4,000 professionals worldwide and a presence in over 129 locations through its member and collaborating firms.

Quality of our people is the cornerstone of our ability to serve our clients. For this reason, we invest tremendous resources in identifying exceptional people, developing their skills, and creating an environment that fosters their growth as leaders. From our newest staff members through senior partners, exceptional client service represents a dedication to going above and beyond expectations in every working relationship.

We strive to develop a detailed understanding of our clients' business and industry sector to offer insights on market developments and assist our clients develop effective strategies and business models. We have the resources and experience necessary to anticipate and competently serve our clients on issues pertaining to all facets of Tax and Transaction Advisory. We take pride in our ability to provide definite advice to our clients with the shortest turnaround time. The business and tax landscapes have changed dramatically, and the pace and complexity of change continues to increase. We can assist you navigate this shifting landscape.

OUR OFFICES

NOIDA

A-109, Sector-136,
Noida (Delhi- NCR)
201304,
INDIA

DELHI

B-27, Soami Nagar,
New Delhi – 110017,
INDIA

GURUGRAM

812-814, Tower B,
Emaar Digital Greens
Sector 61,
Gurugram,
Haryana- 122102

MUMBAI

11th Floor, B Wing, Peninsula
Business Park, Ganpatrao
Kadam Marg, Lower Parel,
Mumbai – 400 013. INDIA

DEHRADUN

First Floor, "IDA"
46 E. C. Road,
Dehradun – 248001,
Uttarakhand.
INDIA

BENGALURU

150/1 Infantry Road,
Bengaluru – 560001
Karnataka
INDIA

PUNE

Office number 3, 1st
floor, Aditya,
Centeegra, Fergusson
College
Road, Next to Mantri
House,
Pune - 411004

GET IN TOUCH WITH US: contact@nangia.com, 0120-2598000, www.nangia.com

Copyright © 2019, Nangia Advisors LLP All rights reserved. The information provided in this document is provided for information purpose only, and should not be construed as legal advice on any subject matter. No recipients of content from this document, client or otherwise, should act or refrain from acting on the basis of any content included in the document without seeking the appropriate legal or professional advice on the particular facts and circumstances at issue. The Firm expressly disclaims all liability in respect to actions taken or not taken based on any or all the contents of this document.