Recognizing the significance of issues relating to profit attribution to a permanent establishment (PE) as well as the need to bring greater clarity and predictability, a Committee was formed by the Indian Tax Administration, i.e., Central Board of Direct Taxes (CBDT), to examine the existing scheme of profit attribution to PEs and to recommend changes to the existing rule contained in the Indian Income Tax Law (ITL). The Committee’s report was released for public consultation on 18 April 2019.

After considering various options, the Committee has recommended a mixed or balanced approach that allocates profits between the jurisdiction where sales take place and the jurisdiction where supply is undertaken, with necessary safeguards to prevent excessive attribution on one hand and to protect the interests of Indian revenue on the other. The report therefore concludes that the option of “fractional apportionment” based on apportionment of profits derived from India would be acceptable under tax treaties as well as the Indian ITL.

The Committee found considerable merit in the three-factor method based on equal weight accorded to sales (representing demand) and manpower and assets (representing supply including marketing activities). Further, in the case of attribution of profits to a “significant economic presence,” the Committee
has recommended that user contribution can be a substitute for either assets or employees and considered the option of following the approach of the European Union (EU) regarding the Common Consolidated Corporate Tax Base (CCCTB).

Overall, the Committee’s recommendations seem to consider the needs of India as a capital-importing country and seek to develop a new configuration of the source principle to tax profits derived from the “market jurisdiction.” However, certain refinements and modifications need to be considered to the recommendations to better align the outcome with international tax principles emerging from the Organisation 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).

The CBDT should also consider the potential risk of double taxation if the residence country of the taxpayer does not consider the approach to be consistent with the tax treaty as well as the compliance burdens on taxpayers. Multinational enterprises (MNEs) with business operations in India should review the implications of the recommendations on their business models as well consider any risk of double taxation.

Public comments on the report can be sent electronically by 18 May 2019 to the CBDT at the email address usfttr-1@gov.in.

Key observations of the Committee on the approach to profit attribution

Use of functions, assets and risks (FAR) analysis
The Committee observes that at present three standard versions of Article 7 exist in tax treaties and the OECD Model Tax Convention (OECD MTC), viz. the two versions that existed in the OECD MTC pre- and post-2010 and the one that continues to be a part of the United Nations (UN) Model Tax Convention (UN MTC). One of the primary implications of the revisions introduced in Article 7 of the OECD MTC and the adoption of the Authorized OECD Approach (AOA) by the OECD, of necessitating reliance upon the FAR analysis for profit attribution and excluding the option of apportionment, was that in cases where business profits could not be readily determined based on accounts, the same were required to be determined by considering the function, assets and risk. However, this approach completely ignores the sales receipts derived from source tax jurisdiction.

Implications of demand and supply factors in the economy
The Committee observes that the business profits are contributed by both demand and supply of the goods. Accordingly, a jurisdiction contributes towards demand (A) by facilitating the economy and the ability of their resident to pay, or (B) by maintenance of markets that enable the sales.
Further, the jurisdiction that contributes to the production or supply of goods also contributes towards the business profits of an enterprise. This gives rise to a valid justification of taxation by them of the profits to which their economies have contributed. Where the economies of both Contracting States to 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.

Objectives and policy rationale regarding India’s position on the AOA

The Committee believes the AOA 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 stakeholders in the global economy. Instead, it can set a vicious cycle in place that is destined to lead to losses for all stakeholders. Thus, while the AOA may be favorable to the interests of certain countries that are net exporters of capital and technology, it is likely to have a very significant adverse impact on all other stakeholders, especially the developing economies like India, which are primarily importers of capital and technology.

Further, India has consistently communicated and shared its view that since business profits are dependent on the sales revenue and costs, and since the sale revenue depends on both demand and supply, it is not appropriate to attribute profits exclusively based on FAR alone. The revised Article 7 of the OECD MTC has also not been incorporated in any of India’s tax treaties and, therefore, the additional guidance issued by the OECD with reference to AOA cannot apply to India’s tax treaties. Accordingly, the recommendations proposed by the Committee are based on the rationale that both demand and supply factors of economy affect and contribute to the business profits.

Possible options for PE profit attribution by apportionment

The Committee states that profit attribution by apportionment under Rule 10 should be in accordance with India’s position and views. Accordingly, the Committee broadly considered the formulary apportionment method and the fractional apportionment method as options to attribute profits to a PE.

With respect to the formulary apportionment method, the Committee did not consider it to be feasible and practical as it requires an apportionment of consolidated profits of the enterprise derived from different jurisdictions and it may not be feasible to obtain details related to operations in other jurisdictions. However, the Committee considers the option of fractional apportionment to be in line with India’s tax treaties and Rule 10. It also considers the option to be more feasible and practical since it would largely be based on information related to Indian operations. For this purpose, the Committee prescribes a three-factor method based on equal weight accorded to sales, representing demand, and manpower and assets, which represent supply including marketing activities.

Profit attribution to significant economic presence

On profit attribution in the case of a digital economy business, the Committee arrived at a unanimous view that the user contribution can be a substitute for either assets or employees, and supplement their role in contributing to the profits of the enterprise. The Committee considered the option of following the approach of the EU CCCTB and assigning users the same weight as the other three factors. However, the Committee noted that different weights are to be assigned to different categories of digital businesses depending upon the level of user intensity.

Need to avoid double taxation of profits derived from Indian operations

Recognizing the need to avoid double taxation of profits from Indian operations in the hands of a PE, which may primarily be brought into existence either by the presence of an Indian subsidiary carrying on parts of an integrated business, whose profits are separately taxed in its hands in India, the Committee found it justifiable that the profits derived from Indian operations that have already been subject to tax in India in the hands of a subsidiary should be deducted from the apportioned profits. The Committee observed that in a case where no sales take place in India, and the profits that can be apportioned to the supply activities are already taxed in the hands of an Indian subsidiary, there may be no further taxes payable by the enterprise.

The Committee recommendations on the profit attribution approach

Considering the various considerations, the Committee finalized its recommendations, which are summarized in the below table.
<table>
<thead>
<tr>
<th>Scenario</th>
<th>Determining profit attribution</th>
</tr>
</thead>
</table>
| A nonresident person with a BC in India that derives sales revenue from | **Step 1:** Determine profit derived from India, i.e., the higher of the following amounts:  
  a) The revenue derived from India $\times$ Global operational profit margin  
  b) 2% of the revenue derived from India  

**Step 2:** Apportionment of the profits derived from India based on three equally weighted factors of sales, employees (manpower & wages) and assets.  
  a) Profits attributable to operations in India = Profits derived from India $\times$ $\left[\frac{SI}{3xST} + \frac{NI}{6xNT} + \frac{WI}{6xWT} + \frac{AI}{3xAT}\right]$  
     
     *Where,*  
     - $SI$ = 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  

**Step 3:** If the BC is due to the activities of a resident associated enterprise (AE) and the AE receives any payments (as below) on accounts of sales or services from any resident person and the activities of that AE have been fully remunerated by the nonresident enterprise by an arm's-length price.  
  a) Payments less than or equal to INR1,000,000 (approx. US$14,000) - No further profits will be attributable to the operation in India.  
  b) Payments more than INR1,000,000 - Profit attributable to the Indian operation will be derived by apportionment and deducted from the same the profits that have already been subjected to tax in the hands of the AE. |
**Scenario**

A nonresident person with a BC in India primarily constituted by the existence of users beyond the prescribed threshold in India

**Determining profit attribution**

The approach is as above; however, Step 2 will be replaced by the following four-factor approach consisting of sales, employees (manpower and wages), assets and users wherein the following weights are assigned:

<table>
<thead>
<tr>
<th>User intensity</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low and medium</td>
<td>10% weight to users and 30% each to other three factors</td>
</tr>
<tr>
<td>High</td>
<td>20% weight to user, 25% each to assets and employees and 30% to sales</td>
</tr>
</tbody>
</table>

*Formula for low and medium intensity -*

\[
\text{Profits derived from India} \times [0.3 \times \frac{S_i}{S_T} + (0.15 \times \frac{N_i}{N_T}) + (0.15 \times \frac{W_i}{W_T}) + (0.3 \times \frac{A_i}{3 \times A_T})] + 0.1
\]

*Formula for high intensity -*

\[
\text{Profits derived from India} \times [0.3 \times \frac{S_i}{S_T} + (0.125 \times \frac{N_i}{N_T}) + (0.125 \times \frac{W_i}{W_T}) + (0.25 \times \frac{A_i}{3 \times A_T})] + 0.2
\]

**Implications**

Profit attribution to a PE is one of the most complex subjects in international tax. The complexity is further exacerbated by the diversity in the business models, lack of consensus among the countries on the most appropriate way of profit attribution as well as the uncertainty due to limited judicial and administrative guidance on the topic. The OECD guidance on profit attribution also recognizes that the AOA should not be understood as representing the only appropriate approach for attributing profits to a PE. Many tax treaties contain a version of Article 7 that does not require use of the AOA. In cases governed by those tax treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might be a function of the interrelation between the tax treaty and the domestic law of the jurisdiction where the PE is located. Thus, a case-by-case analysis is required. Further, in the Indian context a number of disputes have arisen on the appropriate approach to the attribution of profits to a PE. Therefore, the CBDT’s intention to provide guidance on the subject is a positive development and can be expected to provide certainty.

Overall, the recommendations on profit attribution to a PE seem to consider the needs of India as a capital-importing country and seek to develop a new configuration of the source principle to tax profits derived from the “market jurisdiction.” However, certain refinements and modifications need to be considered to the recommendations to better align the outcome with international tax principles emerging from the OECD guidance on PE attribution as well as the OECD TPG.

The CBDT should consider the potential risk of double taxation and compliance burden on taxpayers before finalizing the rules. MNEs with business operations in India should review the implications of the recommendations on their business models as well consider any risk of double taxation. It is important for companies to continue to monitor the developments in this area and to consider actively engaging with policymakers.
For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (India), National International Tax Services Leader, Hyderabad
• Jayesh Sanghvi  jayesh.sanghvi@in.ey.com

Ernst & Young LLP (India), National Transfer Pricing Leader, New Delhi
• Vijay Iyer  vijay.iyer@in.ey.com

Ernst & Young LLP (United States), Indian Tax Desk, Chicago
• Roshan Samuel  roshan.samuel1@ey.com

Ernst & Young LLP (United States), Indian Tax Desk, San Jose
• Archit Shah  archit.shah@ey.com

Ernst & Young Solutions LLP, Indian Tax Desk, Singapore
• Gagan Malik  gagan.malik@sg.ey.com

Ernst & Young LLP (United Kingdom), Indian Tax Desk, London
• Amit B Jain  amit.b.jain1@uk.ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Transfer Pricing Group

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 001978-19Gbl
1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com