1 May 2019

Global Tax Alert

News from Transfer Pricing

Indian Tax Administration invites public comments on proposal to amend rules on profit attribution to permanent establishment

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Executive summary

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.

Detailed discussion

Background

The taxation of a nonresident in India is governed by the provisions of the Indian ITL and the provisions of the relevant tax treaty. Business income of a nonresident can be taxed in India if it satisfies the requisite thresholds provided under the Indian ITL as well as in the applicable tax treaty. The thresholds are measured by applying the concept of business connection (BC) under the Indian ITL and PE under the tax treaty. In either case, the profits that may be taxed in India are limited to income which is reasonably attributable to operations in India if a BC exists under Indian ITL or, as the case may be, profits attributable to the PE.

The profit attribution principles, which are typically contained in Article 7 of tax treaties, require profits to be attributed to the PE as if it were a distinct and separate entity. Under the Indian ITL, the rules for attribution of profits to a BC are contained in Rule 10 of the Income Tax Rules, 1962 (the Rules) which generally grant the tax authorities wide powers to determine profit attribution, including use of formulary apportionment methods. While not explicitly provided in the Indian ITL, the tax authorities generally take the view that the provisions of Rule 10 can also be applied for determining profits attributable to a PE under a tax treaty in certain circumstances.

Recognizing the significance of issues relating to profit attribution to a PE as well as the need to bring greater clarity and predictability, a Committee was formed by the CBDT to examine the existing scheme of profit attribution to a PE and to recommend changes to Rule 10.

On 18 April 2019, the CBDT released the Committee's report for public consultation, specifically requesting comments on the conclusions and recommendations, considering the objectives and policy rationale underlying the recommendations. Public comments 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.

Scenario	Determining profit attribution
A nonresident person with a BC in India that derives sales revenue from India	**Step 1**: Determine profit derived from India, i.e., the higher of the following amounts: a) The revenue derived from India x 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 x [S_I/3xS_T + (N_I/6xN_T) + (W_I/6xW_T) + (A_I/3xA_T) Where, 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 and outside India N_I = Number of employees employed with respect to Indian operations and located in India N_T = Total number of employees employed with respect to Indian operations and located in India and outside India W_I = Wages paid to employees employed with respect to Indian operations and located in India W_T= Total wages paid to employees employed with respect to Indian operations and located in India and outside India A_I = Assets deployed for Indian operations and located in India A_T = 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.

<table>
<tr><th>Scenario</th><th>Determining profit attribution</th></tr>
<tr><td>A nonresident person with a BC in India primarily constituted by the existence of users beyond the prescribed threshold in India</td><td>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><tr><th>User intensity</th><th>Weights</th></tr><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></table>
Formula for low and medium intensity –

Profits derived from India x [0.3 x S_I/S_T + (0.15 x N_I/N_T) +(0.15 x W_I/W_T) + (0.3 x $A_I/3xA_T$)] + 0.1]

Formula for high intensity –

Profits derived from India x [0.3 x S_I/S_T + (0.125 x N_I/N_T) +(0.125 x W_I/W_T) + (0.25 $A_I/3xA_T$)] + 0.2]</td></tr>
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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.

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