# *29 May 2019*

To

Shri Deepak Kapoor

Under Secretary [FT&TR-I (1)]

Foreign Tax & Tax Research Division

Central Board of Direct Taxes,

Department of Revenue, Ministry of Finance

Government of India

**Subject**: Industry Response to the report on Amendment of rules for profit attribution to Permanent Establishment

Dear Sir,

On behalf of the Asia Internet Coalition **(“AIC”)** and its members, I am writing to express our sincere gratitude to the Central Board of Direct Tax **(“CBDT”)**, for the opportunity to submit comments on the proposal for **Amendment of Rules for Profit Attribution to Permanent Establishment**. Headquartered in Singapore, AIC is an industry association comprised of leading internet and technology companies in the Asia Pacific region with a mission to promote the understanding and resolution of Internet and ICT policy issues in the region. Our current members are Airbnb, Amazon, Apple, Expedia Group, Facebook, Google, LinkedIn, LINE, Rakuten, Twitter and Yahoo (Oath).

The objective of this submission is to provide comments and recommendations to the report of the Committee constituted by the CBDT[[1]](#footnote-1) on ‘Amendment of rules for profit attribution to Permanent Establishment’ (‘Report’)[[2]](#footnote-2).

We commend CBDT on proposing the changes in the methodology for taxing multinational companies, including digital firms, having permanent establishment (PE) in India by giving weightage to factors like domestic sales, employee strength, assets and user base. We also recognize the significance of issues relating to attribution of profits to a permanent establishment as well as the need to bring greater clarity and predictability in the applicable tax regime.

As responsible stakeholders in this process, we appreciate the ability to participate in the public consultation process. As such, please find appended to this letter detailed comments and recommendations, which we would like to respectfully request CBDT to consider.

Should you have any questions please do not hesitate to contact our Secretariat Mr. Sarthak Luthra at [Secretariat@aicasia.org](mailto:Secretariat@aicasia.org) or at +65 8739 1490. Importantly, we look forward to providing our inputs and recommendations and contribute to the industry dialogue.

Sincerely,



**Jeff Paine**

**Managing Director**

**Asia Internet Coalition (AIC)**

***Enclosure***

**Detailed Comments and Recommendations**

# Introduction

## Taxation of profits attributable to a Permanent Establishment (‘PE’) is a topic of interest to both tax administrators as well as taxpayers. Lack of definitive rules under the Income-tax Act, 1961 (‘IT Act’) and inconsistent allocation by the courts in different case laws have led to a lot of uncertainty in taxation for non-residents.[[3]](#footnote-3)

## The Organization for Economic Co-operation and Development (‘OECD’) is developing consensus-based measures that aims to build stability and bring certainty to the global tax system. Under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (‘BEPS’), over 125 countries and jurisdictions are collaborating to implement the BEPS measures and tackle BEPS. India is an active participant in this initiative and must stand by its commitment to honour the consensus-based measures being developed by the OECD. Since this effort has the backing of most developed and developing economies of the world, it will regard the interests of all parties, through a consensus-based approach.

## The BEPS action 7 report suggested changes to the article of PE and concluded that such changes did not require any substantive changes to the existing guidance on attribution of profits to PEs under Article 7 of the OECD Model Tax Convention (‘MTC’).[[4]](#footnote-4)

## The international community has also made important progress towards addressing the tax challenges arising from digitalization of the economy and has agreed to continue working multilaterally towards achievement of a new consensus-based long-term solution in 2020. Countries and jurisdictions participating in the OECD/G20 Inclusive Framework on BEPS have stepped up efforts towards reaching a global solution to the growing debate over how to allocate taxation rights in relation to multinational enterprises in a rapidly digitalizing economy. Two central pillars have been identified in the policy note[[5]](#footnote-5) released by the OECD.[[6]](#footnote-6)

## The OECD has also recently issued a public consultation document to address the challenges of digitalization of the economy. These options were broadly, (a) Measures to address base-eroding payments (restrictions in tax deductibility / treaty benefits, where other countries levy low rates of tax on income or gains) with (b) New rights to tax profits based on either (or a combination of) specific proposals focused on attributing value to marketing intangibles, user participation and Significant Economic Presence (‘SEP’). The document signals an expectation of changes in both the allocation of taxing rights between countries across the whole economy, and the ability of businesses to benefit from low effective tax rates in some jurisdictions.

## As a step towards bringing certainty for attribution of profits to a PE, the CBDT through its Report seeks to amend Rule 10 of the Income-tax Rules, 1962 (‘IT Rules’) for profit attribution to PE. Through a public consultation notification dated April 18, 2019, feedback from stakeholders has also been sought within a period of 30 days.

## Needless to say, that taxing rights for a digitalized economy is a matter of great significance to a lot of countries and a consensus-based long-term solution to the issues posed by a rapidly digitalizing economy will be reached in 2020. Therefore, the coming months are of great importance for the international community and India should not look at such an emerging issue in an isolated manner and propose unilateral amendment to rules for PE attribution under the domestic tax law. In case the domestic rules for profit attribution are not aligned with the final OECD guidance on profit attribution, such unilateral measures taken by the CBDT would lead to inequity, double taxation, increased litigation and increased administrative dialogue and inconvenience. This would reduce India’s attractiveness as an investment destination, negatively impacting India’s overall rating on ease of doing business and bringing down the impetus for economic activity. Thus, India should draft rules in accordance with international consensus so as to bring stability and certainty for the taxpayer from global tax system perspective. Also, the rules should be aligned with the final OECD guidance addressing the challenges of digitalization of the economy, which would be published in 2020.

# Key Principles to consider any changes in the rule for attribution of profit by India

In considering any potential changes in the rule for attribution of profit by India, the following key principles should underpin any long-term solution:

* Tax be **levied on real profits, not revenue**.
* **Apply in an economically principled way to both loss making and profit-making** companies/businesses.
* Be **proportionate, neutral, equitable,** and **enforceable** so that, on an overall basis, it is **applicable to all types of businesses** such that the new tax rules **do not ring-fence the digital economy, do not result in different tax rates for foreign and domestic taxpayers,** and do not create market distortions.
* Achieve consensus and maximize **consistency** in its application globally. It is critical that international consensus is achieved with sufficient detail to foster consistent application and **avoid multi-layer taxation** – inconsistent variations of the achieved consensus must not be adopted by countries unilaterally.
* Include **mechanisms for effective dispute resolution**.The changes in the rule for attribution of profits **must not undermine the existing tax treaty network** and should provide pathways for effective dispute resolution.
* Be **easy to comply with and reduce administrative burden**.The changes in the rule for attribution of profits in India shouldnot increase disputes or result in multi-layer taxation.

# Executive Summary of key recommendations

## ***A. Amendment to rules be aligned with internationally accepted principles as per Article 7 of the Indian tax treaties and OECD guidelines***

## Any acceptable framework must avoid double taxation (or multi-layered taxation) and thus, should be aligned with the internationally accepted principles as per Article 7 of the Indian tax treaties and OECD guidelines. Further, any solution on profit attribution should place a high emphasis on simplicity and certainty.  The OECD has been diligently working on a consensus-based approach to achieve stability and tax certainty for enterprises and tax administrations.  Unilateral measures by countries, not in accordance with international consensus, will undermine this global effort.  Therefore, the proposed amendments must be deferred and aligned with the outcome of the OECD efforts. Without prejudice to this, it must be clarified that these profit attribution rules have no bearing on the existing tax treaty positions for profit attribution, unless the relevant tax treaties are amended. (Refer detailed comments in Para 5.1 below)

## As the proposals relate to Rule 10 of the IT Rules, the existing arm’s length standard and its application under transfer pricing (‘TP’) provisions of the IT Act and tax treaties must remain unchanged as the changes cannot be extended to taxpayers in treaty countries without appropriate amendments to the existing tax treaties.  This recommendation is consistent with the adoption of the SEP provisions. This should be explicitly clarified. (Refer detailed comments in Para 5.2 below)

## Any exercise of profit attribution must provide principled, consistent results, *de hors* of the entity form or PE.  The proposed approach postulates on identical facts, a different outcome between profit attribution to a PE and profit determined for a subsidiary under the arm’s length principle.  Since the arm’s length approach under TP does not create such differences, the proposed approach must be aligned with the outcome of the OECD efforts to remove this inconsistency. (Refer detailed comments in Para 5.3 below)

## Consistency amongst countries is critical in profit attribution since mismatch in taxable profits of a PE leads to double taxation or multilayered taxation discouraging business investments and a significant increase in tax disputes and settlement requests (Mutual Agreement Procedure or Alternate Dispute Resolution). Therefore, the proposed amendments must be in accordance with international consensus and aligned with tax treaty provisions.

## Any amendments must be guided by the tenets noted above in Para 3. (Refer detailed comments in Para 5.4 below)

***B. Recommendations on fractional apportionment approach***

Without prejudice to the above recommendations, the following must be considered:

## Digitalization is widely becoming the economy itself and hence user participation or SEP proposal as a measure to ring fence one economic sector for special and different taxation, against the recommendation of the OECD in the Action 1 – 2015 Final Report[[7]](#footnote-7), is inappropriate.  Thus, the proposed amendments must remove the user intensity based factor, and treat digitalized businesses like any other business. (Refer detailed comments in Para 5.5 below)

## A minimum profit requirement of 2% is arbitrary and inconsistent with basic economic and taxation tenets.  Indian courts have consistently upheld the real income theory and a minimum profit requirement is contrary to this theory.  Thus, the minimum profit requirement of 2% must be deleted. (Refer detailed comments in Para 5.6 below)

**While a fractional apportionment approach must not be followed for reasons outlined above, the suggested fractional apportionment approach is erroneous on account of the following and must not be pursued:**

## Application of the Benefit principle of taxation (i.e. increase in demand on account of allocation of profit to the market state) on the basis of an inflexible fractional apportionment does not create the so called ‘virtuous cycle’ in the market state. (Refer detailed comments in Para 5.7 below)

## *Ad hoc* weights assigned to demand and supply side factors are rigid and not based on any economic principle or study that ascertains what factors have contributed to the generation of revenues and resulting profits or losses and their relative proportions. The approach proposed therefore is arbitrary and without being sensitive to any factual and economic basis. (Refer detailed comments in Para 5.8 below)

## Computation of ‘global operational profit margin’ without deduction of interest, amortization (including amortization of research and development intangibles) and depreciation is unfair, discriminatory, illogical and inconsistent with basic economic and taxation tenets. (Refer detailed comments in Para 5.9 below)

## The proposed formulae where user intensity is to be factored appear to be inaccurately conditioned for 3 times of total assets deployed for Indian operations and located in India and outside India. (Refer detailed comments in Para 5.10 below)

## As the Report does not objectively describe several elements (such as meaning of the terms ‘wages’, ‘employees’ and ‘assets’) of the apportionment formulae, it is bound to lead to more uncertainty for taxpayers and further increase taxpayer litigation. (Refer detailed comments in Para 5.11 below)

## The recommendation in the Report implies that all of employees and assets of the Associated Enterprise (‘AE’) will be deemed to be employed or deployed in the Indian operations and located in India, thus leading to ambiguity in the application of this recommendation as well as flawed outcome based on economic principles. (Refer detailed comments in Para 5.12 below)

# Detailed recommendations

## ***A. Amendment to rules be aligned with internationally accepted principles as per Article 7 of the Indian tax treaties and OECD guidelines***

## Proposed amendment to the rules is not in accordance with internationally accepted principles as per Article 7 of the Indian tax treaties and OECD guidelines

## **Recommendation:** Any acceptable framework must avoid double taxation (or multi-layered taxation) and thus, should be aligned with internationally accepted principles as per Article 7 of the Indian tax treaties and OECD guidelines. Further, any solution on profit attribution should place a high emphasis on simplicity and certainty.  The OECD has been diligently working on a consensus-based approach to achieve stability and tax certainty for enterprises and tax administrations.  Unilateral measures by countries, not in accordance with international consensus, will undermine this global effort. Therefore, the proposed amendments must be deferred and aligned with the outcome of the OECD efforts.  Without prejudice to this, it must be clarified that these profit attribution rules have no bearing on the existing tax treaty positions for profit attribution, unless the relevant tax treaties are amended.

## This is on the basis of the following:

## Proposed rules are inconsistent with most Indian tax treaties:

## Article 7 of most[[8]](#footnote-8) Indian tax treaties provides that profits for the purposes of attributing to the PE will be the amount that the PE is 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 PE.[[9]](#footnote-9) The determination of such profits is nothing but adherence to the arm’s length principles under the TP guidelines based on Functions, Assets and Risks (‘FAR’) analysis and on the tenets of comparability.

## The Report suggests a fractional apportionment on the basis that it is permissible under Article 7(4) of Indian tax treaties as well as Rule 10 of the IT Rules. The Report states that the Article 7 (Business profits) of the Indian tax treaties is similar to Article 7 of the (‘United Nations’) UN MTC and the pre-2010 OECD MTC.[[10]](#footnote-10) The Report acknowledges that Article 7 of the OECD MTC was revised in 2010. The revision was to adopt the conclusions in the report on attribution of profits to PE dated July 22, 2010 issued by OECD in order to provide maximum certainty on how profits should be attributed to PE.[[11]](#footnote-11) The Authorised OECD Approach (‘AOA’) is suggested for attribution of profits to the PE under the revised OECD MTC. However, India[[12]](#footnote-12) has reserved its right to use the pre-2010 version of Article 7 (as is also observed in the Report) [[13]](#footnote-13). Further, it is observed in the Report that Article 7 of the OECD MTC / AOA recommended by OECD is based on a purely supply side approach towards profit attribution, which attempts to completely neglect the role of demand in contributing to profits.[[14]](#footnote-14)

## The 2010 update to OECD MTC only provided greater certainty on attribution of profits to PE to rely on the arm's length principle by resorting to FAR analysis. The FAR analysis is incidentally in itself the very lifeline of arm's length principles under the TP provisions. This approach was neither constrained by the original intent of the Article nor historical practice and interpretation of Article 7 of OECD MTC, as rightly indicated in the OECD commentary.[[15]](#footnote-15) This is notwithstanding the fact that IT Act also prescribes the application of arm’s length price under TP regulations to a PE in India.[[16]](#footnote-16)

## Further, fractional apportionment method will not produce an allocation of profits that would be the same as that under separate accounting (i.e. separate and distinct entity approach) and arm’s length pricing. By disregarding the FAR analysis, such method tends to disregard market conditions as well as particular circumstances of the individual enterprise and ignores the management’s own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to economic facts. Inherently, it runs the risk of allocating profits to an entity that is actually making losses based on what third parties would realistically do in similar circumstances. Further, considering that the global operating profit margin of an enterprise may not always be commensurate with the functions and risks attributable to the PE, it would therefore lead to an imbalanced attribution of profits, which is at its core not arm’s length.

## Fallacious proposition that demand side not factored in the AOA:

## The averment in the Report that TP principles based on FAR analysis fails to capture the demand side is not correct. The Report makes an interesting comment that marketing efforts are not what justifies market state taxation.  Marketing functions ‘only modify preferences without contributing in any way to the disposable income or the ability of consumers to pay for goods.’ The Report bases its policy foundation on the existence of consumers willing to pay, and not to any marketing activity of the enterprise.  In fact, the Report is clear in its view that the incorporation of marketing activity in the AOA's assessment of functions, assets and risks is simply a manifestation of the AOA basing profit attribution solely on supply side factors, and does not reflect the "demand side factors" that contribute to the profits of an enterprise undertaking business in a state.

## In our view, a FAR analysis adequately captures marketing functions, strategy, brand marketing and development, etc. The ‘market’ is not owned or controlled by any entity and the return for this is not attributable to any particular entity. Further, the use of local comparables (in appropriate cases) based on a robust functional analysis adequately reflects the arm’s length return which takes into account any return from market earned by an independent enterprise. TP principles permit the use of profit split method in cases *inter alia*, where the PE creates valuable marketing intangibles which would also take into account the return for such marketing intangibles. To note that the adoption of the profit split method has been advocated in more instances consequent to the final report on the revised OECD guidance on the application of the transactional profit split method (2018), as borne out by the examples contained therein.

## Proposed rules must not alter the existing TP methodologies under Indian TP regulations

* + **Recommendation:** As the proposals relate to Rule 10 of the IT Rules, the existing arm’s length standard and its application under TP provisions of the IT Act and tax treaties must remain unchanged as the changes cannot be extended to taxpayers in treaty countries without appropriate amendments to the existing tax treaties.  This recommendation is consistent with the adoption of the SEP provisions.  This should be explicitly clarified.

This is on the basis of the following:

* + Since the proposed rules relate to amendment of Rule 10 of the IT Rules, these must not have bearing on the existing TP filings and compliances made by multi-national companies under Chapter X of the IT Act. This aspect must be affirmed by the CBDT to quell any uncertainty that may emanate from the introduction of the rules. It is also important to note that these changes cannot be read into treaties unless the treaties are amended through mutual renegotiation. This aspect was also confirmed for the implementation of the SEP rules.

## Proposed rules lead to misaligned results in case of subsidiary and PE

* + **Recommendation:** Any exercise of profit attribution must provide principled, consistent results, *de hors* of the entity form or PE.  The proposed approach postulates on identical facts, a differing outcome between profit attribution to a PE and profit determined for a subsidiary under the arm’s length principle.  Since the arm’s length approach under TP does not create such differences, the proposed approach must be aligned with the outcome of the OECD efforts to remove this inconsistency.

This is on the basis of the following:

## In cases of subsidiary(s) of a foreign enterprise, the taxable income would still be calculated using arm’s length principle whereas in the case of an alleged PE (performing same function as the subsidiary), the taxable income would be calculated using the proposed fractional apportionment method. The taxable income under the above two scenarios may vary significantly under the proposed methodology. Therefore, recommendations provided in the Report would result in two different set of tax rules for AEs and other PEs.

* It is also relevant to note that the Supreme Court also supports the view that that no further profit should be attributed to a PE in India if it has been compensated at arm’s length price. However, the fractional apportionment approach suggested in the Report does not fully appreciate this position and suggests to attribute profits over and above the arm’s length price.

## ALP is foundational to the attribution of profits and determination of transfer prices – the existence of a PE or AE relationship is only a form of legal entity that should not colour the determination of how profits are to be attributed or transfer prices are to be determined. The same arm’s length principle should govern these two aspects and double standards should not be adopted as it would result in discrimination between the types of entities and distorts the tenets of international taxation of business profits and associated enterprises.

## Proposed rules are *ad hoc* and are not supported by economic principles or studies and international consensus, leading to double taxation and thus requiring significantly increased number of cases for resolution through bilateral procedures

* + **Recommendation:** Consistency amongst countries is critical in profit attribution since mismatch in taxable profits of a PE leads to double taxation or multi-layered taxation discouraging business investments and a significant increase in tax disputes and settlement requests (Mutual Agreement Procedure or Alternate Dispute Resolution). Therefore, the proposed amendments must be in accordance with international consensus and aligned with tax treaty provisions. Any amendments must be guided by the tenets noted above in Para 3.

This is on the basis of the following:

## Any proposed framework must function keeping in mind mechanisms to relieve double taxation, as in every case these proposals will allocate taxable income away from a state which otherwise would have the right to tax that income under existing rules. Therefore, bringing unilateral amendments in the Indian domestic law in the form of rejection of TP / AOA and to apply the proposed modified rule in cases where there exists a tax treaty, would result in double taxation but more importantly cannot be done without amending the tax treaties. This would invariably create a mismatch in taxable profits of a PE (and consequent foreign tax credit) in India and residence country respectively and thus requiring significantly increased number of cases for resolution through bilateral procedures (Mutual Agreement Procedure or Alternate Dispute Resolution) under the tax treaty. Further, bilateral resolutions will be difficult to achieve (in absence of international acceptance of the proposed rules) and thereby defeating the purposes of bilateral procedures.

## The Report discussed views of academicians that support the formulary apportionment framework. However, several authors[[17]](#footnote-17) have consistently criticised the formulary apportionment framework. The allocation of profits according to the arm’s length standard is a cornerstone of the international tax system. If such an important and running system is to be abandoned, there should be clear evidence of the superiority of the proposed new system, which must not be *ad hoc* but must consider economic situations, functions and other case specific imperatives and provide case specific scientific results. This prerequisite is not fulfilled with regard to formulary apportionment.

***B. Recommendations on fractional apportionment approach***

Without prejudice to the above recommendations the following must be considered:

## No specific requirement of user-based profit attribution formula for digitalized businesses as these are similar to other business models

* + **Recommendation:** Digitalization is widely becoming the economy itself and hence user participation or SEP proposal as a measure to ring fence one economic sector for special and different taxation, against the recommendation of the OECD in the Action 1 – 2015 Final Report[[18]](#footnote-18), is inappropriate.  Thus, the proposed amendments must remove the user intensity based factor and treat digitalized businesses like any other business.

## This is on the basis of the following:

## The Report outlines that user data and user participation contributes to value and profits for the business, which needs to be taken into account for attributing profits, once the minimum nexus threshold of taxable presence by SEP or otherwise, as required by the IT Act[[19]](#footnote-19) and the relevant tax treaty is satisfied.[[20]](#footnote-20)

## Further, the Report observes that the users carry out the work of employees and are also assets to the enterprise.[[21]](#footnote-21) In our view, this reasoning is flawed as it is clear that raw data of the users, in itself is not useful and the value is created (if at all) by using analytics which is where the functions, assets and risks reside. The users cannot be equated to employees / assets as unlike in case of employees, there is no contractual relationship between the foreign enterprise and the users, there is no payment being made by the foreign enterprise to the users (for which the users are liable to tax) etc. It should be appreciated that large development and capital costs are required to scale a digitalized business designed to compete globally, to develop competitive services, and investment in infrastructure is needed to deliver them. As enterprises’ user base grow, enterprises incur proportionately larger capital and operating costs to increase capacity and invest significantly in research and development in order to continue to provide both existing as well as additional products and services. Enterprises also are subject to significant risks in these investments and in several cases these investments do not result in generating any additional revenue or profits and may actually result in losing money due to the investments made in developing these products and services. Employees are generally under the direction and control of enterprises and users are neither under the control nor the direction of enterprises when they use their services. Therefore, it is an absurd notion that users carry out the work of employees. Similarly, assets are also at the disposal of the enterprise to direct, use and dispose off as they see fit. A user cannot be an asset as an enterprise cannot use the user as they choose to as the users have a choice to use the products or services of any particular enterprise. Therefore, users are not a substitute for assets and / or employees in a digitalized business or any business. In fact, arguably users maybe a proxy for sales, rather than a proxy for employees and hence constitute a demand-side variable rather than a supply side one. Demand-side variables are already considered taking into account the 30% to 33% factor, hence including the user constant depending on intensity is erroneous and not warranted. Thus, allocating profit on account of users would lead to duplication and double counting of profits attributable to a PE in India.

## Without prejudice to the above, user data and user participation do not create value for a digitalized business in any way different than any other business, namely through substantial investments in personnel and risk capital. The business model operates through employees and assets located at identifiable places, performing observable functions. The concept of ‘scale without mass’ is misleading when used to suggest that highly digitalized enterprises somehow are able to create profits without making substantial risk bearing investments in their businesses. Suggestions that highly digitalized businesses are able to create marginal revenue without commensurate investment also are inaccurate, as all such business must make continuous investments in technology, infrastructure, customer support, trust and safety, privacy, emerging regulatory compliance and numerous other areas and keep taking on continuous risks in order to grow their business.

## Management structures controlling functional divisions of highly digitalized businesses are organized along the same principles as any other business. Companies with highly digitalized business models must continuously invest billions of dollars in research and development to maintain market position and keep developing new products and services, just as many pharmaceutical companies, consumer brands, or other businesses must invest to maintain their market positions.

## Further, highly digitalized business models are dependent on technology to succeed, and companies with such business models compete with each other globally in order to design the products, features, platforms, and analytical tools that drive their businesses and not the users. Therefore, attribution of profits for digitalized business must not include ‘user’ as the fourth factor, that too as a constant, irrespective of number of contracts or density of user base. Also, this would add variances in case of a business using a physical and digitalized mode to sell goods / services.

## No requirement to attribute minimum profits derived from Indian operations

* + **Recommendation:** A minimum profit requirement of 2% is arbitrary and inconsistent with basic economic and taxation tenets.  Indian courts have consistently upheld the real income theory and a minimum profit requirement is contrary to this theory.  Thus, the minimum profit requirement of 2% must be deleted.

## This is on the basis of the following:

## The Report provides that the minimum amount of profit derived from Indian operations will be 2% of revenues derived from India.[[22]](#footnote-22) This is on the basis that an enterprise is likely to continue its operations in India only if it finds such operations profitable.[[23]](#footnote-23)

## The approach suggested in the Report is not in line with the theory of taxation on real income basis and this proposition suggests to tax ‘notional income’ where the enterprise is running into losses at the global level. This is likely to impact multinational enterprises engaged in projects with a long gestation period, say the infrastructure sector, for instance. Further, this is likely to create controversies which may need resolution either in a judicial forum and / or through Mutual Agreement Procedure mechanism. It also runs counter to the arm’s length principle if the results so demonstrate a loss.

While a fractional apportionment approach must not be followed for reasons outlined above, the suggested fractional apportionment approach is erroneous on account of the following and must not be pursued:

## A biased application of the ‘Benefit principle’

* + Under the ‘Benefit Principle’ of taxation, tax on business profits can be considered a necessity since it enables shifting of resources from enterprises to the State to enable maintenance and development of public goods that are essential for efficient functioning of markets and for facilitating economic growth. The resultant economic growth financed by tax revenue increases disposable income of people and thereby spurs demand within the economy, leading to greater profits for the enterprises, thereby putting in place a virtuous cycle that leads to a win-win situation for all stakeholders.
  + Therefore, the Committee has asserted that allocating more tax revenues of foreign enterprise to the market state creates a ‘virtuous cycle’, indicating that this tax revenue eventually creates more demand in the local market, thereby benefiting the foreign enterprises. The Committee further asserted that allocating such tax revenue to the countries of supply creates a ‘vicious cycle’, as the lack of tax resources expended in the market state depresses demand, ultimately harming the foreign enterprises in the long run. Ultimately, these taxes may be passed on to the consumers in the form of higher prices resulting in actually a depression of demand, reduction of customer choice and access to products and services resulting in overall reduction of consumption and thereby less economic activity.
  + However, the above rationale would not be justified by imposing an inflexible fractional apportionment approach (as suggested by the Committee) just to create the so called ‘virtuous cycle’ in the market state which is not supported by economic data.

## *Ad hoc* allocation of weights to four factors ie sales, assets, employees and users

* + *Ad hoc* weights assigned to demand and supply side factors are rigid and not based on any economic principle or study that ascertains what factors have contributed to the generation of revenues and resulting profits or losses and their relative proportions.   The approach proposed therefore is arbitrary and without being sensitive to any factual and economic basis.

## Equal weightage (ie ~33% each) has been given to sales, assets and employees under the suggested three factor-based profit attribution formula.

## Allocation of weights appears to be inappropriate since sales is given high weightage without there being any justified and empirical rationale for this, purely for the reason of there being a market. The functions and risks involved are also ignored while assigning these weights. Thus, the allocation of weights is mechanical in nature and not defined based on economic value addition, suggesting a ‘one size fits all’ approach.

## Further, the Report outlines a weightage of 10% / 20% to users in user-based profit attribution formula. The Report observes that since the users carry out the work of employees and are also assets to the enterprise, the relative weightage of employees and assets to be adjusted downwards (to 60% / 50%), keeping the weightage of sales fixed at 30%.[[24]](#footnote-24)

## The above reasoning seems flawed as users are not a substitute for assets and / or employees as discussed in detail in para 5.5 above.

## Computation of ‘Global operational profit margin’

## Computation of ‘global operational profit margin’ without deduction of interest, amortization (amortization of research and development intangibles) and depreciation is unfair, discriminatory, illogical and inconsistent with basic economic and taxation tenets.

## As per the Report, ‘profits derived from Indian operations’ will be higher of the following amounts:[[25]](#footnote-25)

* Revenue derived from India \* Global operational profit margin; or
* 2% of the revenue derived from India.

## ‘Global operational profit margin’ has been defined to mean Earnings before Interest, Taxes, Depreciation and Amortization (‘EBITDA’).[[26]](#footnote-26) Such profits do not take into account deduction for interest, taxes, depreciation, and amortization.

## This rule is stated several times in the Report, so this seems to be an intentional choice.  The Report does provide a justification of sorts, to the effect that ‘sunk costs’ should not be allowed as a deduction against income for purposes of PE profit attribution. The explanation is that in ‘the case of a PE which is not owning R&D or assets ideally no rent should be attributed to R&D or to assets in the form of depreciation. Thus, the operating margin valuation should exclude depreciation, interest and R&D costs. However, for simplification the Committee was of the view that the global profit margin should be taken as EBITDA margin as this figure is a known number and easy to calculate. EBITDA excludes depreciation and interest costs.’[[27]](#footnote-27)  The Report seems to draw for conceptual support on Article 7(3) of the UN MTC (on which most of Indian tax treaties are based), which restricts deductibility of royalty, interest and some other expenses paid to the head office for purposes of PE profit attribution determinations***.***

## The exclusion of depreciation and interest seems to be without any basis since they form essential costs in the operations of a business and must therefore be deducted in arriving at the global operational profit margin. The proposed methodology is therefore prejudicial for companies which are engaged in a business undertaking heavy capital investment.

## Additionally, the proposition to exclude amortization (including amortization of research and development intangibles) is also flawed. Highly digitalized businesses rely more heavily on their investments in technology and know-how than traditional businesses. Such businesses have to make continuous investments in technology, infrastructure, customer support, trust and safety, privacy, emerging regulatory compliance and numerous other areas in order to grow their business. Thus, the proposed methodology is prejudicial for such companies as well.

## It is also useful to note that the use of the operating profit margin as a profit level indicator in the application of the transactional net margin method refers to profit before interest and tax (reference may be made to Rule 10TA for definition of operating profit margin.[[28]](#footnote-28)

## Further, globally multinational enterprises operate different business under separate entities which ultimately fold into the ultimate parent company (which may or may not be listed).

## Error in formula where user intensity is to be considered

## The proposed formulae where user intensity is to be factored appear to be inaccurately conditioned for 3 times of total assets deployed for Indian operations and located in India and outside India.

## In both formulae where user intensity is to be factored, there appears to be an error. The denominator in the asset base weightage is erroneously conditioned for 3 times of total assets deployed for Indian operations and located in India and outside India.

## No definitive guidance for ‘wages’, ‘employees’ and ‘assets’

* + As the Report does not objectively describe several elements (such as meaning of terms ‘wages’, ‘employees’ and ‘assets’) of the apportionment formulae, it is bound to lead to more uncertainty for taxpayers and further increase taxpayer litigation.  The suggested fractional apportionment approach does not define or clarify several aspects leaving significant uncertainty in determination of profit attribution, such as on:
* Wages paid to employees include employee stock options, commission on sales, etc;
* Employees with respect to Indian operations include employees undertaking administrative activities (such as finance, policy supervision, etc), contract work force;
* Wages paid to employees that perform functions for the entities across the globe - specifically in the context of arrangements of stewardships, short-term/ long term secondments;
* Employees working across the globe and performing functions for global operations (including India);
* Assets employed for Indian operations include non-operating assets such as cash, marketable securities, leased assets, etc, treatment of intangible assets, other assets not appearing the balance sheet;
* Assets made available to overseas customers for overseas operations;
* No methodology prescribed for valuing assets, especially intangible assets on and off the balance sheet.

## Proposed formula is flawed since it incorrectly factors the employees and assets of AE which are not performing the functions of the foreign enterprise

## The Report provides that in case the business connection of an enterprise in India is represented by the activities of an AE and payments from sales / services exceeds INR 1 million, the employees and assets of the AE are to be deemed to be employed or deployed in the Indian operations and located in India for the purpose of determining profit attribution.[[29]](#footnote-29)

## In our view, the proposed deeming of AE employees and assets as employed for Indian operations for profit attribution is erroneous since ordinarily the AE would be compensated under Indian TP principles. Without prejudice to this, it is relevant to note that in certain cases where business connection / PE is constituted, only a part of the employees and assets of the AE are utilized for the purpose of Indian operations. However, the recommendation in the Report implies that all of employees and assets of the AE will be deemed to be employed or deployed in the Indian operations and located in India, thus leading to ambiguity in the application of this recommendation as well as a flawed outcome based on economic principles.

# C. Other recommendations

## Non-application of user-based profit attribution formula under Article 7 of tax treaty

## **Recommendation:** Without prejudice to the earlier suggestion, the CBDT must provide a clarification that user-based profit attribution formula will not be applicable in tax treaty cases.

## This is on the basis of the following:

## The Report suggests that in case a ‘business connection’ is primarily constituted through the existence of users beyond prescribed threshold in India i.e. SEP, income attributable to the operations carried out in India should be calculated on four factor basis i.e. users, sales, employees and assets depending on the level of user intensity.[[30]](#footnote-30)

## Herein, it is contextual that the concept of SEP is provided under the IT Act and is currently not present in the Indian tax treaties. Therefore, in case an enterprise constitutes a business connection on account of SEP in India as per the IT Act and also forms a PE as per the applicable DTAA (say on account of dependent agent PE or fixed place PE), it is not clear as to whether the profits should be attributed on the three factor based profit attribution formula or user based profit attribution formula.

## Clarification regarding customary approach to be followed under the tax treaties as the proposed method cannot be applied unless treaties are amended.

## **Recommendation:** The CBDT must look to align the approach for attribution of profits to a PE on the basis of consensus as it emerges post OECD’s recommendations in the final reports on attribution of profits.

This is on the basis of the following:

## Most of India tax treaties mandate the attribution of income to a PE on the basis that the PE is a ‘single, distinct and separate’ enterprise [Article 7(2)]. However, the treaties further provide that nothing in paragraph 7(2) will preclude attribution to a PE based on a country’s customary approach [Article 7(4)] and the result of such apportionment is in conformity with principle of Article 7.

## In India, whether this customary approach is the apportionment-based Rule 10 or after the introduction of TP provisions in the Act in 2001, (read along with the CBDT Circular of 2001 and 2004)[[31]](#footnote-31), it is the 'arm's length principle' is a matter of debate which requires careful consideration. Circular 14 of 2001 under the IT Act issued in connection with the Finance Act 2001 that introduced transfer pricing regulation in India provides[[32]](#footnote-32) that the definition of ‘enterprise’ as provided in Section 92F(iii) of the IT Act includes a PE of an enterprise even though a PE is not a separate legal entity. It further explains that transaction between a foreign enterprise and its PE, for example between a head office and a branch in India, are also subject to TP regulations.

## Further, Circular 5 of 2004 provides that in determining the profits attributable to an IT-enabled BPO unit constituting a PE, it will be necessary to determine the price of the services rendered by the PE to the Head office or by the Head office to the PE on the basis of ‘arm’s length principle’. For this purpose, arm’s length price is defined to have the same meaning as in Section 92F(ii)[[33]](#footnote-33)of the Act.

## In addition, the Supreme Court of India[[34]](#footnote-34) in deciding on attribution of profits to PE has held that such attribution should be made in adherence with the applicable arm’s length principle.

## Considering the above, the approach recommended in the Report is contrary to prevailing judicial position and administrative application. Considering this, the CBDT should not accept the proposed recommendation and abstain from adopting a unilateral approach on this important international tax topic.

## Rule 10 is only a residuary mechanism

## **Recommendation:** While including any amendments, the CBDT must clarify that Rule 10 should be applied only in situations where India specific financial statements are not available. A clarification must be provided on the prospective applicability of the modified rule along with the transitional provisions to bring certainty to the taxpayers.

This is on the basis of the following:

## The Report discusses the application of Rule 10 where India specific financial statements are not available or where books of accounts have been rejected under the IT Act.[[35]](#footnote-35) Accordingly, Rule 10 is a residuary provision. However, in the recommendation section of the Report, this aspect has not been specified which gives the impression that in all situations, Rule 10 must be applied.

1. It is the apex administrative body for income taxes under the Ministry of Finance, Government of India. [↑](#footnote-ref-1)
2. Public consultation on the proposal for amendment of rules for profit attribution to PE dated April 18, 2019, available at - <https://incometaxindia.gov.in/news/public_consultation_notice_18_4_19.pdf> [↑](#footnote-ref-2)
3. The provisions of IT Act apply to a non-resident only to the extent they are more beneficial than an applicable tax treaty. While the IT Act does not provide for the concept of PE itself (provided through the tax treaty framework), there is reference in it to a relatively broader concept of ‘business connection’. This concept of business connection artificially extends the scope of income that is chargeable to income tax for a non-resident. The term has been defined inclusively in the IT Act and includes amongst others, dependent agents and the recently introduced provision of SEP. Rule 10 of the Rules provides a residuary mechanism (where income chargeable is not capable of being definitely ascertained by the tax officer) for calculating the income attributable to *inter alia* a business connection. The rule allows the tax officer discretion in choosing any method besides providing two methods – (i) as a percentage of turnover, or (ii) as a ratio of global profits to global receipts, applied to receipts from India. In cases of tax litigation over attribution of profits to a PE, Courts have upheld different methodologies including more widely a methodology based on formulary apportionment of profits to a PE by applying global profit percentage to turnover from India sales further conditioned to proportion of activities carried out in India usually on an *ad hoc* basis [↑](#footnote-ref-3)
4. The BEPS action 7 report however did mandate the development of additional guidance on how the existing rules of Article 7 would apply to PEs resulting from the changes in the report, taking into account the revised guidance contained in the BEPS actions 8-10 report (Aligning Transfer Pricing Outcomes with Value Creation). In this backdrop, the OECD released two public discussion drafts on the attribution of profits to PE in July 2016 and June 2017. After considering the comments received, the OCED thereafter issued the report providing additional guidance on attribution of profits to PE in March 2018, which sets out high-level general principles for the attribution of profits to PE in the circumstances addressed by the BEPS action 7 report. The additional guidance covers specific examples dealing with warehousing, delivery, merchandising and information collection activities, commissionaire structure (related intermediary) etc. The key principle across the examples is that the profits attributable to a PE are those that the PE would have derived if it were a ‘separate and independent enterprise’. This principle as per the additional guidance is applicable regardless of whether a country adopts the Authorised OECD Approach or any other approach used to attribute profits. [↑](#footnote-ref-4)
5. Addressing the Tax Challenges of the Digitalization of the Economy – Policy Note (As approved by the Inclusive Framework on BEPS on January 23, 2019 - <https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalization.pdf> [↑](#footnote-ref-5)
6. The first pillar focusses on how the existing rules that divide up the right to tax the income of multinational enterprises among jurisdictions, including traditional transfer-pricing rules and the arm’s length principle, could be modified to take into account the changes that digitalization has brought to the world economy. This will require a re-examination of the so-called ‘nexus’ rules – namely how to determine the connection a business has with a given jurisdiction – and the rules that govern how much profit should be allocated to the business conducted there. The second pillar aims to resolve remaining BEPS issues and will explore two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation. [↑](#footnote-ref-6)
7. Addressing the Tax Challenges of the Digital Economy [↑](#footnote-ref-7)
8. Several tax treaties entered into by India (e.g. DTAA’s with Germany, Netherlands, France etc.) allow fractional apportionment only in exceptional cases and prescribe that the results under fractional apportionment should not deviate principally from the results obtained under a separate entity principle i.e. arm’s length principles under TP guidelines. [↑](#footnote-ref-8)
9. This principle applies regardless of whether a tax administration adopts the AOA contained in Article 7 in the 2010 version of the OECD MTC as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments, or any other approach used to attribute profits under a previous version of Article 7 of the MTC. [↑](#footnote-ref-9)
10. There are slight differences in the UN MTC and the pre-2010 OECD MTC, primarily on account of ‘force of attraction’ rule and ‘limitation of deductible expenses’. [↑](#footnote-ref-10)
11. This new version of 2010 report is an updated version of the report on attribution of profits to PE adopted in 2008 (by OECD) which takes account of the new wording of the Article 7 without any substantive changes to the conclusions of the 2008 report. [↑](#footnote-ref-11)
12. Refer para 1.1 of ‘Positions on Article 7’ of ‘Non-OECD Economies positions on the OECD Model Tax Convention’ of the commentary on OECD MTC [↑](#footnote-ref-12)
13. Refer paragraph 110 at page 54 of the Report [↑](#footnote-ref-13)
14. Paragraph 62 at page 32 of the Report [↑](#footnote-ref-14)
15. Refer paragraph 3, 5 and 6 of the commentary of Article 7 of OECD MTC [↑](#footnote-ref-15)
16. Section 92F(iii) read with section 92F(iiia) of the IT Act [↑](#footnote-ref-16)
17. Professor Dr Dr H.C. Wolfgang Schön and Erik Röder, Max Planck Institute for Tax Law and Public Finance [↑](#footnote-ref-17)
18. Addressing the Tax Challenges of the Digital Economy [↑](#footnote-ref-18)
19. As per section 9(1)(i) of the IT Act [↑](#footnote-ref-19)
20. Paragraph 174 at page 74 of the Report [↑](#footnote-ref-20)
21. Paragraph 178 at page 76 of the Report [↑](#footnote-ref-21)
22. Paragraph 199(ii) at page 82 of the Report [↑](#footnote-ref-22)
23. Paragraph 160 at page 70 of the Report [↑](#footnote-ref-23)
24. Paragraph 178 at page 76 of the Report [↑](#footnote-ref-24)
25. Paragraph 199(ii) at page 82 of the Report [↑](#footnote-ref-25)
26. Paragraph 159 (in footnote 84) at page 70 of the Report [↑](#footnote-ref-26)
27. Footnote 82 at page 70 of the Report [↑](#footnote-ref-27)
28. *"Operating profit margin" in relation to operating expense means the ratio of operating profit, being the operating revenue in excess of operating expense, to the operating expense expressed in terms of percentage; (*j*)  "operating expense" means the costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations including costs relating to Employee Stock Option Plan or similar stock-based compensation provided for by the associated enterprises of the assessee to the employees of the assessee, reimbursement to associated enterprises of expenses incurred by the associated enterprises on behalf of the assessee, amounts recovered from associated enterprises on account of expenses incurred by the assessee on behalf of those associated enterprises and which relate to normal operations of the assessee* ***and] depreciation and amortisation expenses relating to the assets used by the assessee****, but not including the following, namely:—*

    1. *interest expense;*
    2. *provision for unascertained liabilities;*
    3. *pre-operating expenses;*
    4. *loss arising on account of foreign currency fluctuations;*
    5. *extraordinary expenses;*
    6. *loss on transfer of assets or investments;*
    7. *expense on account of income-tax; and*
    8. *other expenses not relating to normal operations of the assessee; )*

    [↑](#footnote-ref-28)
29. Paragraph 199(v) at page 83 of the Report [↑](#footnote-ref-29)
30. Paragraph 199(iii) at page 82 of the Report [↑](#footnote-ref-30)
31. Circular no. 14/2001 and circular no. 5/2004 [↑](#footnote-ref-31)
32. Para 55.16 of the Circular 14/2001 [↑](#footnote-ref-32)
33. It appears that in the Circular 5/2004, this Section was erroneously referred as 92F(iii). [↑](#footnote-ref-33)
34. DIT vs Morgan Stanley & Co (2007) 292 ITR 416 (SC); CIT vs Hyundai Heavy Industries Co Ltd (2007) 291 ITR 482 (SC) [↑](#footnote-ref-34)
35. Paragraph 162 at page 71 of the Report [↑](#footnote-ref-35)