

# CBDT's three pronged approach to profit attribution - Clarity or Confusion?

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### Introduction

1. The BEPS Action Plans ('BEPS APs') have been developed by the Organization for Economic Co-operation and Development ("OECD") and G20 countries with main aim of curbing tax-planning strategies that exploit gaps in tax rules to artificially shift profits to low or no tax jurisdictions. The BEPS AP 7 "Preventing the Artificial Avoidance of Permanent Establishment Status" seeks to curb tax strategies companies use to circumvent existing PE provisions in international tax treaties. Whilst the AP7 postulates a number of situations whereby a foreign company conducting business in India could be alleged to have a PE in India, the next step in any PE situation would be as how to determine the right/appropriate amount of tax that is attributable to the PE of the foreign company in India.

The main questions that arises in a PE situation are: (a) Which jurisdiction has the right to tax the business profits earned by the foreign company through its formal presence in a country? (b) If the country in which a foreign company has a formal presence has the right to tax the business profits earned by it by utilising the country's resources, how can the proportion of profits to be taxed be determined?

Various reports were published by the OECD, which provided guidelines on attribution of profits in the case of Permanent Establishments. The report Attribution of Profits to Permanent Establishments in 2010 (Attribution report 2010) focused on the interpretation and application of the revised and updated Article 7 of the Model Tax Convention ("MTC") and was an amended and revised version of the Attribution report in 2008. In the report the Authorized OECD Approach ("AOA") was based on the 'separate entity approach', under which a PE is recognised as hypothetically being a separate and independent entity from its Head Office (HO), which performs the same or similar functions as that of an independent enterprise under same or similar conditions. The AOA also provides that attribution of the profits of a PE should be ascertained on the basis of the functions performed by it, the assets it uses and the risks it assumes. Accordingly, the AOA determines the amount of attributable profit, based on OECDs Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines) by analogy (using the Arm's Length Principle).

Under Indian tax laws, if a non-resident has a business connection in India, profit attribution is only permissible on the part of its income that is 'reasonably attributable' to its operations in the country. The determination of profits 'Reasonably Attributable' is typically undertaken through one or more of the following mechanisms:

- (a) Rule 10 of the Income Tax Rules, 1962 ("the Rules")
- (b) Application of arm's length principle, having regard to Article 7 of BEPS Action Plan
- (c) Landmark judgments such as *Rolls Royce PLC v. DIT International Taxation* [\[2011\] 13 taxmann.com 233/202 Taxman 309/339 ITR 147 \(Delhi\)](#), *DIT v. Galileo International Inc.* [\[2009\] 180 Taxman 357/\[2011\] 336 ITR 264 \(Delhi\)](#) which have laid down the principle of attribution in specific facts and circumstances.

The choice of any particular approach was based on the facts and circumstances of each case, having regard to various factors such as nature of PE alleged by the revenue authorities,

existence of transfer pricing documentation, functional intensity of activities undertaken in India, etc.

In summary, until now significant ambiguity exists and lack of uniformity with respect to attribution of profits on account of absence of any formal guidance by CBDT. However, recently CBDT has issued a public consultation report<sup>1</sup> on attribution of profits to Permanent Establishments ("PEs") which, *inter alia*, discusses on various approaches for attribution of profits to PE.

The CBDT has constituted a committee to recommend a simple, uniform and consistent method of profit attribution under Rule 10, which will bring more clarity, predictability and objectivity to the process of attribution of profits and reducing tax disputes and litigation.

This article critically analyzes the approaches for attribution as suggested by the CBDT and implications thereof having regard to challenges with respect to treaty interplay and associated practical implementation.

## **2. Key considerations for rephrasing the current scheme of attribution under the Act**

- ◆ *Need for clarity in India's approach on PE attribution:* Lack of universal rule might lead to uncertainties for the taxpayers along with increased tax disputes. Hence, there needs to be a simple and universally applicable rule to bring in greater certainty and predictability amongst the stakeholders and prevent avoidable tax litigation in this respect.
- ◆ *Emphasis on Sales (representing demand) for determining attributable business profits:* The Committee observed that the primary intention for the revisions introduced in Article 7 of OECD MTC is that where business profits could not be readily determined on the basis of accounts, the same were required to be determined by taking into account function, assets and risk with complete ignorance to sales receipts derived from that tax jurisdiction; the exclusion of the latter being, in the opinion of the Committee, against the fundamental principles of generally applicable accounting standards.
- ◆ *Right to apportion profits continues notwithstanding OECD attribution principles based on FAR:* The Committee has observed that the Courts in India have repeatedly endorsed the right of Revenue Authorities to attribute profits under Rule 10 of the Rules, even in cases where tax treaties were applicable, thereby confirming that application of Rule 10 is permissible for attribution of profits in such cases. The Committee has further observed in multiple cases that Courts have upheld the right to attribute profits by apportionment, as permissible under the Indian Tax Treaties.

### **Critical analysis**

**3.** The CBDT committee is right in its approach that there needs to be a simple and universal approach for attribution of profits, and avoid litigation. However, the Committee has chosen to override the internationally accepted principles for attribution (read the AOA approach of the OCED 2010 guidelines), which embraces the need of a separate entity approach and provides a more logical and consistent approach to attribution.

### **Three factor approach for attribution of profits**

**4.** In a radical change to the traditional mode of attribution of profits to the PE, the CBDT has suggested a three factored approach. Accordingly, the Committee has suggested PE profit attribution based on a combination of: (i) profits derived from Indian operations, and (ii)

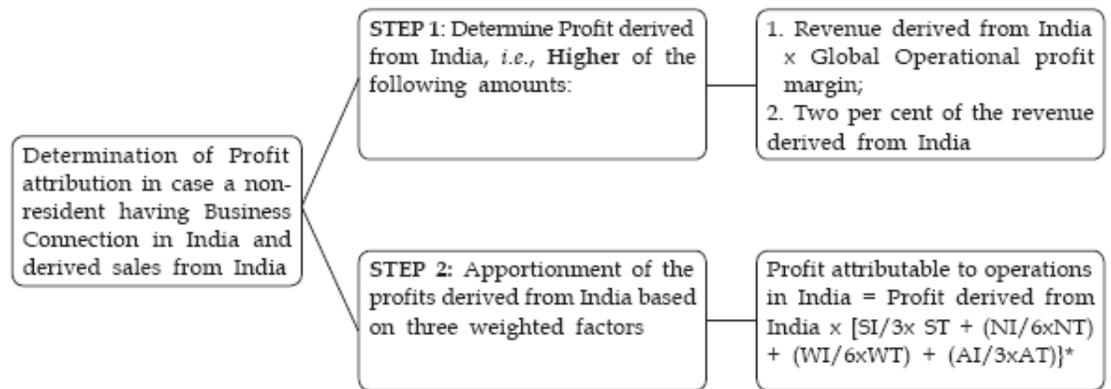
three factor method based on equal weight accorded to sales (representing demand), manpower and assets (representing supply, including marketing activities).

In other words, profits of the multinational enterprise will first be apportioned for Indian sales (amount arrived at by multiplying the revenue derived from India  $\times$  Global operational profit margin). As a second step, such profits will be attributed proportionately to :

- (a) sales within and outside India;
- (b) employees and wages within and outside India; and
- (c) assets deployed within and outside India for Indian operations, each with 33% weightage.

Further, to address a situation where the multinational enterprise suffers losses or has profit margin of less than 2%, a margin of 2% of revenue derived from Indian sale is proposed to be regarded as deemed profit for Indian operation, thereby recommending minimum base level taxation. With regard to digital economy, where nexus to taxation is attributed to the concept of significant economic presence, considering the role of users, a fourth factor (*i.e.*, user intensity) needs to be further built into the income attribution formulae:

- ◆ The Committee, therefore, recommended the "three factor approach" for profit attribution with equal weightage accorded to the: (i) sales representing demand, (ii) manpower, and (iii) assets which represent supply including marketing activities;
- ◆ Additionally, the business model in which the users contribute significantly to the profits of the enterprise, the same should also be taken into account for the purpose of attribution of profits, as the fourth factor for apportionment, in addition to the other three factors, *i.e.*, sales, manpower and assets.



\*Where,

SI = Sales revenue derived by Indian operations from sales in India

ST = Total sales revenue derived by Indian operations from sales in India & outside India

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

NT = Total number of employees employed with respect to Indian operations & located in India & outside India

WI = Wages paid to employees employed with respect to Indian operations & located in India

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

AI = Assets deployed for Indian operations & located in India

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

- ◆ The Committee assigns different weights to the different categories of digital business, depending upon the level of user intensity. The Committee further assigns lower weight of 10% to the users for those business models involving low or

medium user intensity and assigning a weightage of 20% to users in those business models involving high user intensity.

- ◆ The recommended guidance also provides an exception for enterprises in case of which the business connection is primarily constituted by the existence of users beyond the prescribed threshold, or in case of which users in excess of such prescribed threshold existing in India. In such a case user should be assigned a weight of 10% in cases of low and medium user intensity, while each of the other three factors should be assigned a weightage of 30%.
- ◆ In view of the principles laid down by the Hon'ble High Court in case of *DIT v. Morgan Stanley and Co. Inc.* IT Appeal No. 1576 (Mum.) of 2016 and 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 subjected 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.

## 5. Critical analysis

- (1) In the event of absence of any specific methodology designated by the CBDT, the computation of revenue derived from India in itself can be a very subjective computation depending upon the business models that may be followed by the taxpayers. The sales in Indian can be effectuated through various direct/indirect and ecommerce sales models, the measurement of which itself would require specific guidance/rules.
- (2) The concept of applying Global Operational Profit Margins is likely to produce illogical results, especially in cases of nascent operations in India. For instance, a US/Chinese company, which has recently commenced business operations in India, would be subject to disproportionate taxation in India, which otherwise might not have resulted, in case the attribution would be done following separate entity approach;
- (3) The weights allocated to sales, employees and assets has little or no reasonable basis. The weights to be allocated might differ on the basis of varied industries in which the taxpayers operate or depending upon the size of operations of the taxpayers, to name a few.
- (4) In addition to above, there would remain a computational challenge both for taxpayers and the revenue authorities alike for collating reliable data in respect of global and Indian sales, manpower and assets; data points, particularly in respect of manpower costs could be highly confidential too and may not be readily available.
- (5) For the purpose of determining profit attribution to PE, the aforesaid approach requires determination of amount of wages paid to employees in India, assets deployed for Indian operations, etc. This shall lead to additional compliance burden for those companies which do not maintain separate books of account in relation to their business operations in India. This may affect the Oil and Gas/EPC companies operating in India *via* multiple project offices.  
Thus, the aforesaid approach further exacerbates the complexity by keeping diverse business models under the same box, wherein the OECD approach would have produced a more logical result.
- (6) Another concern would be levy of tax on minimum attribution of 2 per cent of revenues derived from India particularly in cases where the non-resident enterprise has global losses. Such a deemed 'minimum attribution' could lead to final tax cost and may not even be justified if Indian operations are actually incurring losses. Controversies emanating from such mismatches would need to be

resolved either in a judicial forum and/or through Mutual Agreement Procedure mechanism.

- (7) Lastly, the proposed amendment to income attribution rules is essentially a domestic law measure by India. It will not necessarily align with the understanding of its tax treaties with OECD members bound by OECD's FAR based authorised approach (AOA) to income attribution. The revised formula under Rule 10 may invariably create a mismatch in such cases as to taxable profits of a PE (and consequent foreign tax credit) in India and residence country, respectively.

## Comments

6. Overall, the Committee's recommendations seem to consider the needs of India as a demand-centric/consumption economy and seek to develop a new configuration of the source principle to tax profits derived from the 'jurisdiction of consumption'. The suggested three factored approach aims to provide certainty and thereby reducing incessant litigation of the MNCs on the very contentious issue of attribution of profits. Further, having common principles in place shall also be helpful in eliminating ambiguity.

However, as is the case with most of CBDT circulars, some refinements and modifications need to be considered in order to suitably align the outcome of proposed India level recommendations with international tax principles emerging from the OECD and Indian Transfer Pricing Guidelines. Since in those genuine case(s) where the volume of operations in India is significant due to sales revenue being generated from India; in contrast to actual intensity of functions performed and risk undertaken by PE leading to insignificant attribution, the application of aforesaid CBDT approach may lead to absurdity in the form of higher tax outgo causing undue hardships to the taxpayers.

While the approach recommended by the CBDT may pave the path towards non-adversarial environment, the implementation needs to be observed and deliberated over in details, having regard to potential consequences on companies doing business with India. It is imperative that the CBDT should also evaluate the risk of potential double taxation if the "Jurisdiction of Supply" does not consider the approach to be consistent with the tax treaty as well as the Compliance burdens on taxpayers. Multi-National Enterprises (MNEs) with business operations in India should review the implications of the recommendations on their business models as well consider any risks of double taxation.

It would be interesting to watch the unfolding of ideas and the market sentiments, based on which the CBDT would finalise the attribution mechanism. However, one needs to watch out if such a approach helps the country to simplify the business needs or complicates the matter further. Practical implications of the same in real world situation will be a wait and watch situation.

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1. *The CBDT has invited comments from various stakeholders within thirty days of date of release of the report, post which the CBDT shall finalize the guidance on such issue, which are expected to be introduced through amend-ments to the provisions of the Act and Rules.*