



BMR Legal

A D V O C A T E S

**Attribution of Profits – Approaches &
Conflicts**

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Mukesh Butani

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I. Permanent Establishment

PE – Article 5 of OECD/UN MC



India's Treaty Position on PE

- India's old treaties follow 1962 draft OECD Model (Egypt and Greece).
- Recent trend to expand the ambit of PE → closer to the prevalent UN model.

Fixed Place PE

All tax treaties have a similar clause as OECD Model except with Bulgaria.

Insurance PE

Treaties with Zambia, Finland and Malaysia contain Insurance PE.

Asset Test

Inclusion of other items such as:

- 'warehouse in relation to a person providing storage facility for others',
- 'farm, plantation or other place where agriculture, forestry, plantation are carried on', or
- 'premises used as a sales outlet or for receiving or soliciting orders.'

Service PE

Treaties with:

- USA, UK, Singapore, Luxembourg, Canada contain Service PE clause with varied time-period in the range of 3-9 months.
- Canada, China, Singapore, Switzerland, UK and USA do not contain the expression 'same or connected projects' in Art. 5(3)(b).

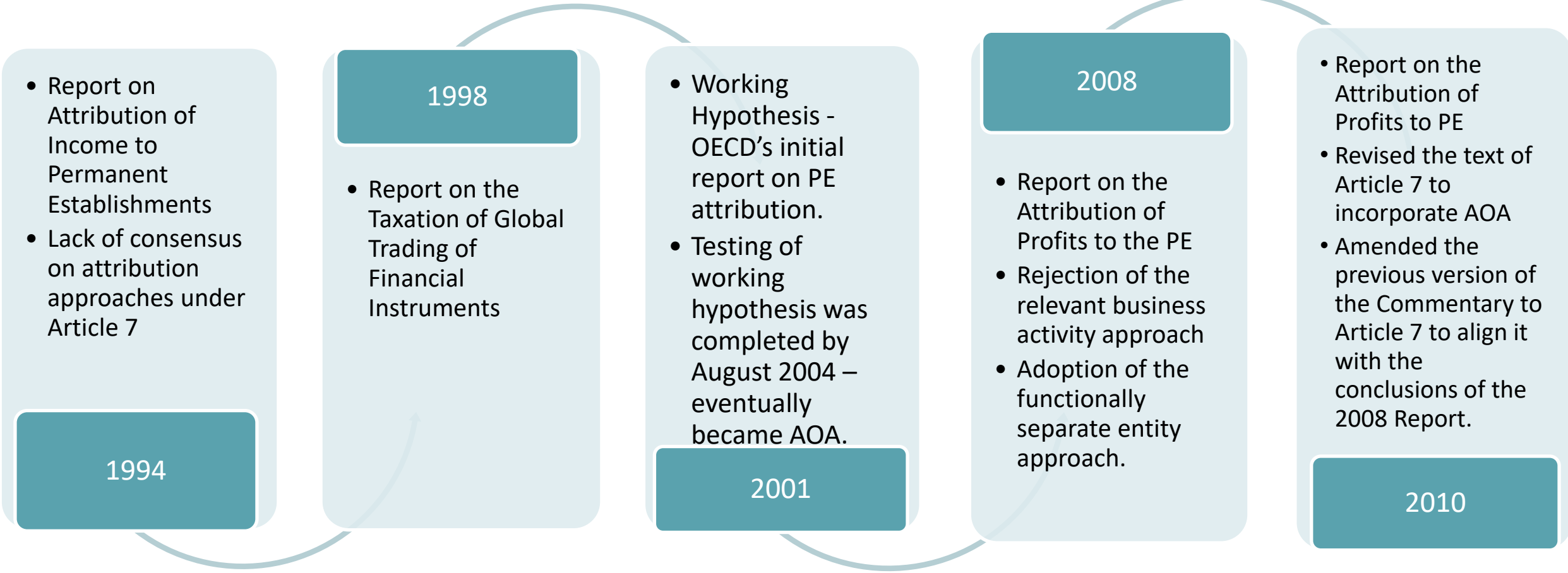
BEPS Action Plan 7

Preventing Artificial Avoidance of PE Status	MLI	OECD MC, 2017	India's Position
Commissionaire arrangements & similar strategies	Article 12	Article 5(5), 5(6)	Reservation on the word 'routinely' under Article 5(5) despite fully adopting this MLI provision
Restricting the scope of exceptions to PE	Article 13	Article 5(4)	Opted for Option A that introduced a qualification to avail specific activity exemption to establish a fixed place PE.
Splitting-up of contracts	Article 14	Article 5(3)	Provision to apply to all its CTA (unless reservation is made by other CTA partner)
Definition of a person closely related to an enterprise.	Article 15	Article 5(8)	Provision to apply to all its CTA (unless reservation is made by other CTA partner)

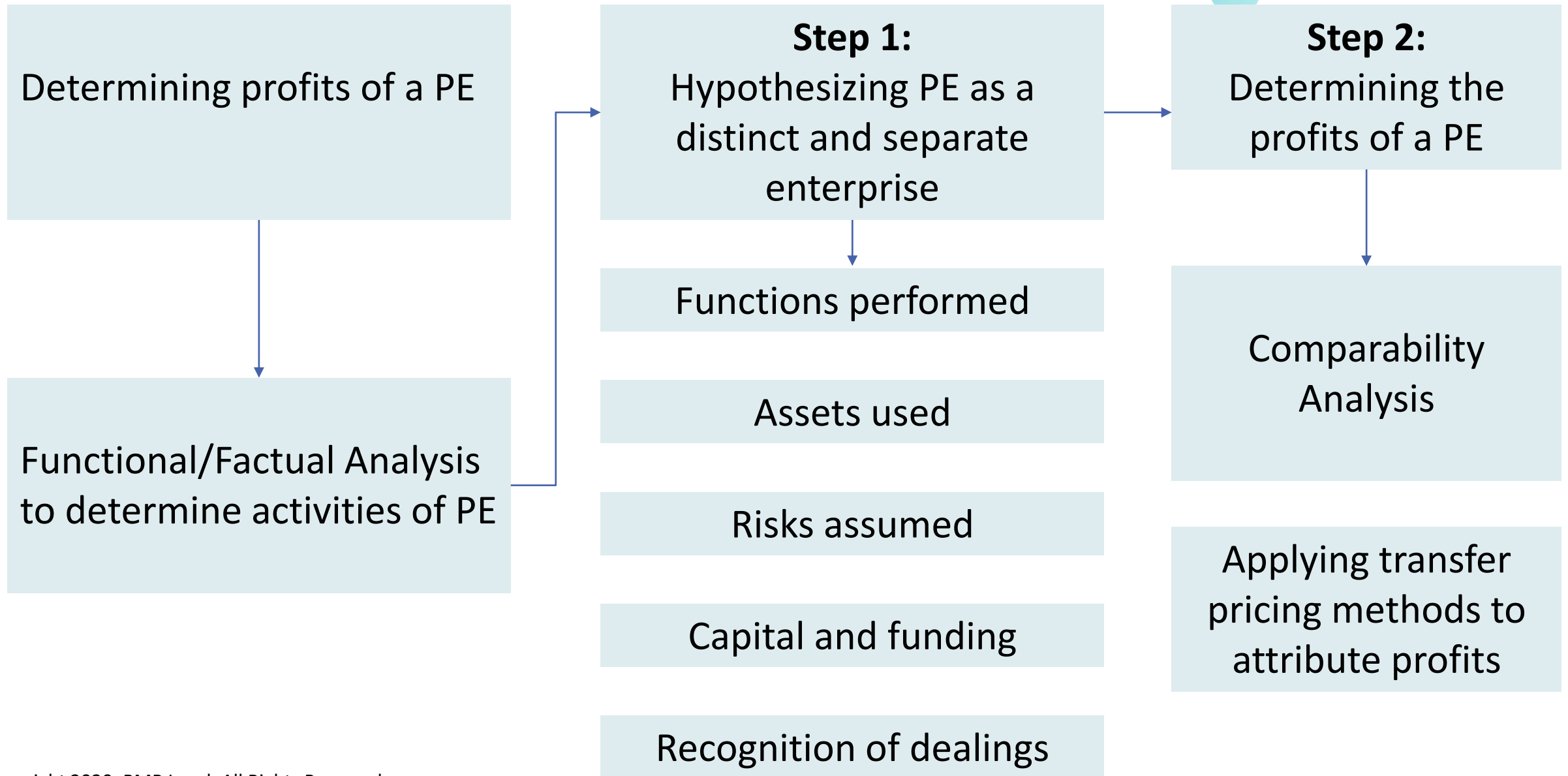
II. Attribution Principles

1. International Customary Law

Evolution of Authorized OECD Approach – Article 7



Authorized OECD Approach



Friction between OECD and UN Approach

Limited Force of
Attraction
Article 7(1) of UN

“profits of the enterprise may be taxed in the other State but only so much of them as is attributable to...(b) sales in that other State of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind...”

Restricted
deduction of
expenses
Article 7(3) of UN
(Retained)

“no such deduction shall be allowed in respect of amounts by the PE to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management...”

Accepts domestic
apportionment
methods
Article 7(4) of UN
(Retained)

“...it has been customary in a Contracting State to determine the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”

2. India's Treaty Position

India's Treaty Position on Attribution

- India's tilt towards **Article 7 of UN Model**:

Profits are to be attributed to a PE as if it were a 'distinct and separate entity':

- (a) Direct accounting method based on the separate accounts of the PE; or
 - (b) Indirect apportionment method under the domestic laws in India [Rule 10 of the IT Rules], where detailed and accurate accounts are not available
- Treaties with Singapore, Canada, Mauritius, Poland provide an additional clause that in case correct quantum of profits attributable to PE is not determinable then the profits attributable to PE may be estimated on a reasonable basis.

Reservation on inclusion of Authorized OECD Approach (AOA) under Art. 7(2) of the OECD MC.

- a) Approach favours capital exporting countries.
- b) Approach does not address the issue of digital business models
 - a) Business profits are dependent on sale revenue and costs; sale revenue, in turn, depends on both demand and supply → hence it is not appropriate to attribute profits exclusively on the basis of FAR alone.

3. Domestic Law Policy

Current Domestic Law Policy

Step 1: Taxable profits to be attributed in accordance with books of account as separately maintained

Separate and distinct entity approach

In accordance with arm's length principle and FAR analysis

If the AO is of the opinion that the actual income *"cannot be definitely ascertained"**

**The AO must demonstrate that the income of the non-resident arising from any business connection cannot be ascertained from accounts or from material available on record.*

Step 2: Rule 10
Books of account not maintained separately or rejected by tax officer

- A) Percentage Turnover as considered reasonable;
- B) Global Proportional Approach;
- C) Any other manner as AO may deem fit.

CBDT Committee Proposal for Public Consultation

- CBDT committee examined the existing scheme of profit attribution under Article 7 of the DTAA and recommend changes to Rule 10 of the ITR.
- Released proposal on April 18, 2019
- Addressed concerns relating to excessive taxation due to its uncertainty and *ad hoc* basis for determining profits attributable to a PE

Concluded

- Both demand and supply of goods were integral contributors to business profits; and
- A mixed approach that accounts for both these factors should be used to attribute profits.

Rejected

Formulary apportionment as it would require country wise information of the MNEs to arrive at their global profit for apportionment.

Suggested

Fractional apportionment as it considers only those profits that have been derived from India

CBDT proposal : Critique

May increase cases of MAP due to double taxation

Restricted scope as recommends changes to Rule 10 which applies only in specific situations

Disregards established arm's length transfer pricing principles

Tax is based on revenue and non-profitability criteria

No objective criteria has been given to weigh the four allocation factors.

Business Connection: SEP Test

Explanation 2A*

- Transaction with respect to goods or services in India exceeding a prescribed amount of aggregate revenue.
- Continuous soliciting of business or interacting with users through digital means in India

Explanation 3A**

- Advertisement targeting an IR or a customer who accesses advertisement through IP address located in India;
- Sale of data collected from an IR or who uses IP address located in India; and
- Sale of goods and services using data collected from IR or who uses IP address located in India

Comments -Explanation 2A

- Alignment with BEPS AP 1.
- Adopts both revenue-based test and user-based test as alternatives – wider in scope than that recommended under BEPS AP 1.

* Finance Act 2018 w.e.f. 1.4.2019

Comments - Explanation 3A

- The amendment to SEP provision converges with Equalization Levy 2020.
- Will Equalisation levy 2020 be redundant?

* Finance Act 2020 w.e.f. 2021

Migration from FAR to FARM Analysis

Concept of Source Based Taxation

India for the purpose of attributing appropriate profits to digital business models exploring (for specified business) 'Market Analysis' along with FAR

For the purpose of taxing digitalized businesses FARM analysis could possibly yield better results versus traditional FAR analysis

This analysis factors market access related benefits derived on account of digitalized economy

4. Jurisprudence

Formulary Apportionment

Ad-hoc attribution

FAR Analysis

- | | | |
|--|--|--|
| <ul style="list-style-type: none">• Convergys Customer Management Group Inc v. ADIT
[2012] 28 taxmann.com 128 | <ul style="list-style-type: none">• Motorola Inc v DCIT
(2005) 95 ITD 269 (Delhi) | <ul style="list-style-type: none">• DIT International Taxation, Mumbai v. Morgan Stanley
292 ITR 416 (SC) |
| <ul style="list-style-type: none">• E-Funds Corporation v. ADIT
[2017] 86 taxmann.com 240 (SC) | <ul style="list-style-type: none">• Nortel Networks India International Inc [TS-355-ITAT-2014 (Delhi) | <ul style="list-style-type: none">• CIT v Hyundai Heavy Industries Co Ltd
(2007) 291 ITR 482 (SC) |

Jurisprudence on Digital PE

Right Florists ITA No. 1336/Kol/2011

- **Issue** - Taxability of payments made by an Indian resident to Google and Yahoo for advertisement services.
- **Held** - Such payments were not considered to be FTS in the absence of human intervention, and hence were not taxable in India.
- Relied on Yahoo (ITAT-Mum)
- **PE** - A virtual PE cannot arise by virtue of website itself.

Mastercard (2018) AAR No. 1573/2014 New Delhi

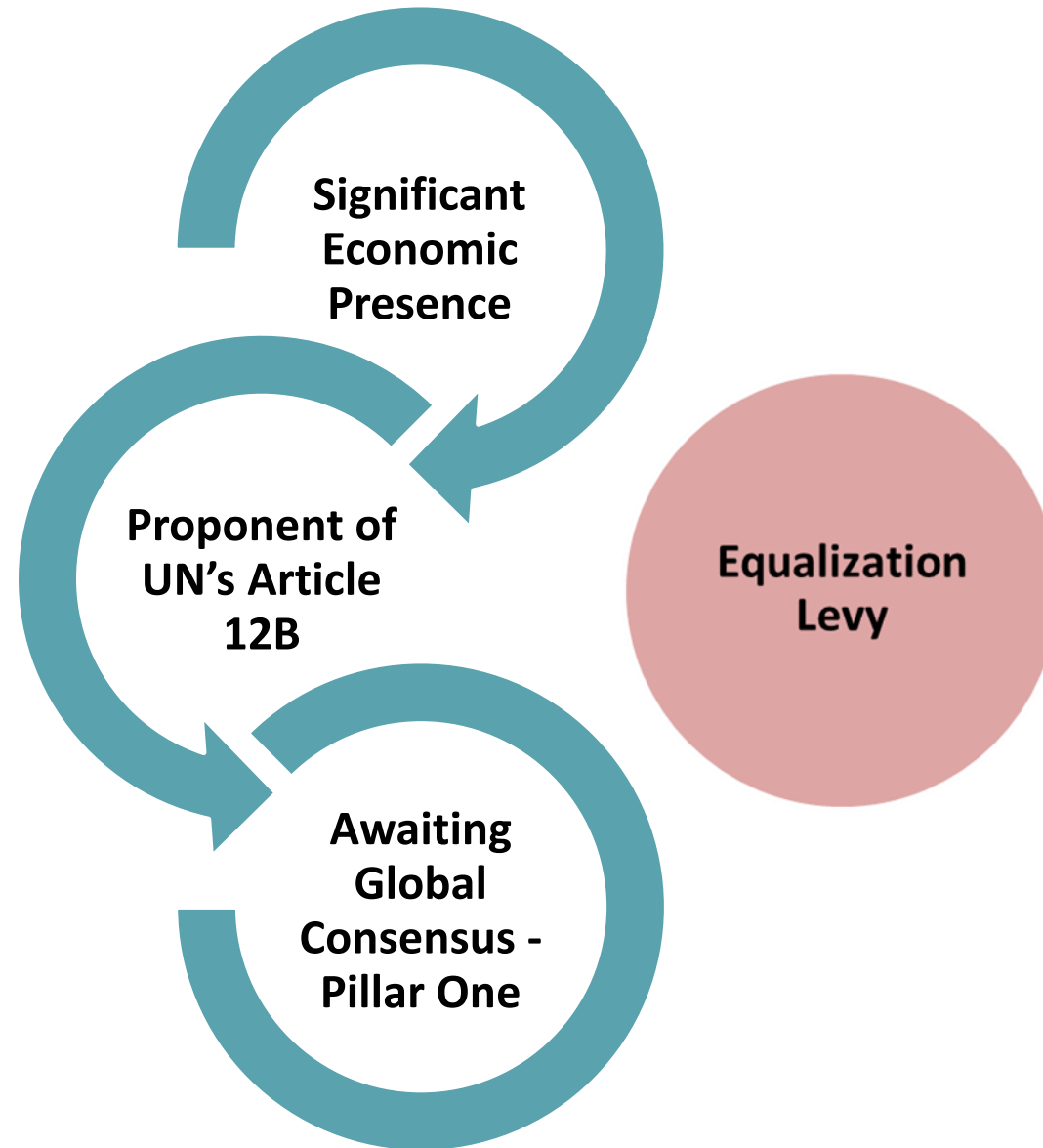
- **Issue** – Presence of PE in India
- **Held** – Constituted a fixed PE and dependent agent PE in India under the India-Singapore DTAA.
- **PE** – Automated equipment such as a server can also create a PE. Rejected ratio of Morgan Stanley on attribution

Yahoo (2011) taxmann.com 431 (ITAT-Mum)

- **Issue** - Services rendered for uploading and display of the banner advertisement of the Dept of Tourism of India on Yahoo portal.
- **Held** - Payment made to Yahoo on its portal was not in the nature of royalty but in the nature of business profit and in the absence of any PE in India, it was not chargeable to tax in India.

Conundrum

India's fight for a fair share of taxes



Conundrum

Arm's Length Principle

- Promotes tax neutrality by putting associated and independent enterprises on equal footing.

- Complex to apply to changing (digital) business models.
- Defies economic reality.

Global Formulary Approach

- Simpler and uniform approach.
- Reduce compliance costs for taxpayers and tax administration.
- More certainty for taxpayers.

- Difficulty in reaching a consensus on factors and weightage.
- Some countries will benefit from this approach while others may not.

Takeaways

- A pragmatic solution to the challenge of rebalancing taxing rights is needed.
- ALP should be re-examined or applied in tandem with other approaches to arrive at an outcome.
- Indian policy makers need deeper reflection to revisit the OECD AOA approach and the ALP to align with the global approach.

Mukesh Butani

mukesh.butani@bmrlegal.in

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Glossary of Terms

- **AO:** Assessing Officer
- **AP:** Action Plan
- **CBDT:** Central Board of Direct Taxes
- **CTA:** Covered Tax Agreement
- **BEPS:** Base Erosion Profit Shifting
- **FAR:** Functional, Asset and Risk Analysis
- **FARM:** Functional, Asset, Risk, and Market Analysis
- **FTS:** Fees for Technical Services
- **IR:** Indian Resident
- **ITA:** The Income Tax Act, 1961
- **ITR:** The Income Tax Rules, 1962
- **MAP:** Mutual Agreement Procedure
- **MC:** Model Convention
- **MLI:** Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS
- **OECD :** Organization for Economic Co-Operation Development
- **SEP:** Significant Economic Presence
- **UN MC:** United Nations Model Double Taxation Convention between Developed and Developing Countries 2017