Attribution of Profits – Approaches & Conflicts

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I. Permanent Establishment
## PE – Article 5 of OECD/UN MC

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[Image of logos for OECD and UN]
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.

**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’.

**Insurance PE**

Treaties with Zambia, Finland and Malaysia contain Insurance PE.

**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

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<td>Restricting the scope of exceptions to PE</td>
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II. Attribution Principles

1. International Customary Law
• Report on Attribution of Income to Permanent Establishments
• Lack of consensus on attribution approaches under Article 7

1994

1998
• Report on the Taxation of Global Trading of Financial Instruments

2001
• Working Hypothesis - OECD's initial report on PE attribution.
• Testing of working hypothesis was completed by August 2004 – eventually became AOA.

2008
• Report on the Attribution of Profits to the PE
• Rejection of the relevant business activity approach
• Adoption of the functionally separate entity approach.

2010
• Report on the Attribution of Profits to PE
• Revised the text of Article 7 to incorporate AOA
• Amended the previous version of the Commentary to Article 7 to align it with the conclusions of the 2008 Report.
Determining profits of a PE

Functional/Factual Analysis to determine activities of PE

Step 1: Hypothesizing PE as a distinct and separate enterprise
- Functions performed
- Assets used
- Risks assumed
- Capital and funding
- Recognition of dealings

Step 2: Determining the profits of a PE
- Comparability Analysis
- Applying transfer pricing methods to attribute profits
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 DTAAs 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
# Inconsistent Jurisprudence

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<th>Ad-hoc attribution</th>
<th>FAR Analysis</th>
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<td>• E-Funds Corporation v. ADIT [2017] 86 taxmann.com 240 (SC)</td>
<td>• Nortel Networks India International Inc [TS-355-ITAT-2014 (Delhi)</td>
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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.
India’s fight for a fair share of taxes

- Significant Economic Presence
- Proponent of UN’s Article 12B
- Awaiting Global Consensus - Pillar One
- Equalization Levy

Pillar One
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.
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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