Ref No. 16/05/19-20 **Date:** 17th May 2019

<u>Kind Attn:</u>

Foreign Tax and Tax Research Division-I,
Central Board of Direct Taxes.

By email to: usfttr-1@gov.in

Subject: Comments & Suggestions to ‘Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment’.

Ref: ‘Report on Profit Attribution to Permanent Establishments’ published on www.incometaxindia.gov.in on 18th April 2019.

Dear Sir,

We are grateful for the opportunity to comment and provide suggestions on the ‘Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment’.

The “Report on Profit Attribution to Permanent Establishments (‘PE’)” (‘Report’) is indeed well-researched and thought provoking in many aspects. However, on account of short duration of time period afforded to provide suggestions after publication of the Report, we are constrained to offer few comments due to inability to conduct detailed analysis.

We offer our comments below on the Report:

1. Implication of revision to Article 7[1] of OECD MTC on Profit Attribution to PE:

1.1. Article 7 of OECD MTC along with its Commentary underwent fundamental revision in the year 2010 with the 2010 update to OECD Model and Commentary. Apart from deletion of Paragraph 4 of Article 7 itself, the Commentary on Paragraph 2 also underwent changes with this updation. Paragraph 4 of Article 7 (pre-2010 provision) gave Contracting States the option to adopt customary apportionment method to determine profits to be attributed to PE whereas commentary to Article 7(2) (pre-2010 provision) prescribed adoption of the books of accounts of the permanent establishment as a starting point for the exercise of profit attribution. With the adoption of 2010 OECD Report on Attribution of Profits to PE introducing the concept of Authorized OECD Approach (‘AOA’), both possibilities were given a pass.

1.2. However, it may be noted here that Article 7(2) (pre-2010 provision) indeed embodied the arm’s length principle corresponding to the economic concept of ‘Transfer Pricing’. The separate entity approach advocated under Article 7(2) (pre-2010 provision) indeed led to the

[1] Made by 2010 Update of the OECD Model Tax Convention and Commentary

application of the concept of Transfer Pricing. This is evident from various references to Commentary on Article 7[2] of Draft OECD MTC of 1963 as well as Commentary on Article 7[3] of UN MTC of 2001. Thus, non-existence of Transfer Pricing principle under the Separate Entity approach in Article 7(2) (pre-2010 OECD MTC era) as mentioned in the Report[4] is ambiguous.

1.3. Having stated as above, determination of profits attributable to the PE in accordance with customary method of apportionment under Article 7(4) (pre-2010 provision[5]) has always been permissible to the Assessing Officer in case separate accounts of PE have not been maintained or cannot be relied upon. This has also been brought out in the Report[6]. Accordingly, critical evaluation of AOA and reference to India's position on AOA[7] is not necessary if attribution of profits is to be determined under Article 7(4) (pre-2010 provision).

1.4. It may therefore be suggested that Rule 10 may expressly state as under:

- ***Application of transfer pricing principle is permitted when direct accounting method is adopted for computing profits attributable to PE;***
- ***Whereas fractional apportionment method may be adopted in case separate accounts of PE have not been maintained or cannot be relied upon.***

2. Determining 'Profits derived from India' & 'Revenue derived from India':

2.1. *'Profits attributable to PE in India'* are to be determined by apportioning the 'Profits derived from India' by individual weighted factors of sales, employees (manpower & wages) and assets. Further, 'Profits derived from India' are arrived at by multiplying 'Revenue derived from India' with 'Global Operational Profit Margin' by keeping a floor of 2% of 'Revenue derived from India'.

2.2. 'Profits derived from India'

2.2.1. When computing 'Profits derived from India' as per the formula, the Report suggests introduction of a floor equivalent to 2% of 'Revenue derived from India' so that the revenue interests of India are protected under circumstances when Indian operations may be profitable whereas global operations may result in a loss. Application of such floor is inappropriate on the following grounds:

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[2] Paragraph 11 and 12 both make references to the concept of mispricing and consequent substitution for open market prices in order to rectify PE accounts and arrive at the amount of properly attributable profits.
[3] Paragraph 15 explicitly states that the separate entity principle corresponds to the "arm's length" principle referred in the Commentary on Article 9.
[4] See Paragraph 36 and 44 of the Report.
[5] Comparable provision can be found at Article 7(4) of UN MTC 2001 & 2017.
[6] See Paragraph 139, 140 and 162 of the Report.
[7] See Paragraph 99 of the Report.

- Existence of a floor rate would imply that PEs in India may never be allowed to make a loss. This implication may be far from real life circumstances whereunder a PE in India of a foreign enterprise may incur losses on account of variety of bona-fide reasons[8];
- Fractional apportionment method eventually is an estimation method to determine profit attribution. Thereunder, even if the Global Operating Profit Margin of the Foreign Enterprise would indeed be greater than the real Operating Profit Margin of the PE, nevertheless PE is made to bear a higher tax burden on that count. Likewise, on the contrary, if the Global Operating Profit Margin of the Foreign Enterprise is indeed lower than the real Operating Profit Margin of the PE or is even negative, then the PE should not be made to bear a mandatory tax burden.
- Fractional apportionment method does not per se violate non-discrimination principle embodied in double tax conventions[9]. However, deeming 2% of 'Revenue derived from India' as 'Profit derived from India' may produce an outcome upon application of profit apportionment factors that may result into a more burdensome taxation on such PE when compared to a comparable Indian enterprise carrying on the same activities. This could amount to discrimination of such PE in India compared to a comparable Indian enterprise carrying on the same activities and may not be permitted under the respective double tax convention.

2.2.2. It may therefore be suggested that a floor rate may not be introduced while defining 'Profits derived from India'. If at all a floor rate may be legislated to deal with circumstances where global operations may result in a loss, then such floor rate should be derived from research on empirical data.

2.3. 'Revenues derived from India'

2.3.1. The phrase 'Revenue derived from India' has been used differently at various paragraphs of the Report denoting different interpretations. At Paragraph 159 of the Report, the phrase has been used to mean 'Revenue generated from customers within India'. Whereas, its definition provided at Footnote 83 to Paragraph 159 of the Report intends to supplement an artificial meaning to it[10]. Further, the final apportionment formula[11] indicates that the phrase intends to include total sales revenue derived by Indian operations from sales in India and outside India.

[8] As opposed to unsubstantiated economic theory referred to in Paragraph 160 of the Report which holds that an enterprise is likely to continue its operations in India only if it finds such operations profitable.
[9] See Para 34 of Commentary to Article 24 of OECD MTC 2010 / 2017.
[10] 'Revenue derived from India' has been explained to include all receipts arising or accruing or is deemed to accrue or arise from India which are chargeable under the head Profits and gains of business or profession. It may be noted that 'revenue' unlike 'income' does not accrue nor could it be deemed to accrue or arise.
[11] See Paragraph 199 to the Report.

2.3.2. It may therefore be suggested to correct such incongruence by:

- ***Aligning the definition of 'Revenue' to the definition given under Income Computation and Disclosure Standard – IV (Revenue Recognition)[12].***
- ***Clarifying that 'Revenues derived from India' would include total sales revenue derived by PE from sales within India and outside India.***

We sincerely hope that the above comments may be useful to the CBDT for making necessary amendments to Rule 10 of Income Tax Rules, 1962.

Yours sincerely,

Pankaj Bhuta [B.Com (Hons.), F.C.A.]
Harshal Bhuta [M.Com., F.C.A., A.D.I.T., LL.M. (Hons.) in International Tax Law (Wirtschaftsuniversität Wien)]

Address : 2-I, Jeevan Sahakar, 2nd Floor,
Sir P. M. Road, Fort,
Mumbai – 400001, India.
Telephone : +91 22 22660010 / 3427 ; 43471727
E-mail : info@bhutaco.com
Website : www.bhutaco.com

[12] "Revenue" is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person's resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.