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Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
(Foreign Tax and Tax Research-I)

New Delhi, dated the 18th April, 2019

Subject: Public Consultation on the proposal for amendment of Rules for Profit attribution to Permanent Establishment-reg.

Taxation of non-residents in India is governed by the provisions of the Income-tax Act, 1961 ("the Act") and the provisions of the Double Taxation Avoidance Agreement(s) [DTAA(s)] concluded or adopted by the central government under the powers conferred under Section 90 or 90A of the Act, respectively. Under the Act, the income tax is charged for the assessment year in respect of the total income of the previous year of every person. In respect of a person who is a non-resident, the total income includes all income from whatever source derived which is received or deemed to be received or accrues or arises or deemed to accrue or arise in India. The incomes that shall be deemed to accrue or arise in India are specified in Section 9 of the Act which, inter alia, provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India shall be deemed to accrue or arise in India. However, in cases where a DTAA is also applicable, taxes on business income of a non-resident can be levied to the extent the same is permissible under such agreement. Thus, business income of a non-resident can be taxed in India if it satisfies the requisite thresholds provided under the Act as well as the threshold provided in the applicable tax treaty, by a concept of Permanent Establishment (PE), which is defined in Article 5 of Model Tax Conventions and tax treaties.

2. Under Article 7 in the Indian treaties, profits are to be attributed to the PE as if it were a distinct and separate entity on the basis of the accounts of the PE and where such

accounts are not available to enable determination of profits attributable to the PE, the profits attributable to the PE can be determined under the domestic laws. For the application of this method, the Assessing Officer in India can resort to Rule 10 of Income-tax Rules, 1962.

3. Recognizing 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, a Committee was formed to examine the existing scheme of profit attribution to PE under Article 7 of DTAA's and recommend changes in Rule 10 of the Income-tax Rules. The Committee has submitted its report (enclosed herewith) and it has been decided to seek stakeholder's comments on the Report of the committee.

4. **In this regard, suggestions/comments of the stakeholders and the general public are invited on the following question:**

- a. What are your views on the recommendations of the Committee as contained in Section 11 of the Report? In answering this question please consider the objectives and policy rationale behind the change which have been elaborated in detail in the Report.

5. **Comments and suggestions may be sent electronically (in word format) at the email address usfttr-1@gov.in within 30 days of the publication of this document on website of the Income Tax Department (www.incometaxindia.gov.in).**



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Central Board of Direct Taxes



PROPOSAL

FOR

AMENDMENT OF

RULES FOR PROFIT ATTRIBUTION TO

PERMANENT ESTABLISHMENT

(Report on Profit Attribution to Permanent Establishments)

*Submitted to the Central Board of Direct Taxes, Department of
Revenue, Ministry of Finance, Government of India*

Prepared by

**the Committee to Examine the issues related to Profit Attribution to Permanent
Establishment (PE) in India and Amendment of Rule 10 of
Income-tax Rules, 1962**

constituted by

**the Central Board of Direct Taxes,
Department of Revenue,
Ministry of Finance,
Government of India**

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Section 1

Constitution and Mandate of the Committee

1.1 Introduction

1. Taxation of non residents in India is governed by the provisions of the Income-tax Act, 1961 (hereinafter referred to “the Act”) and the provisions of the double taxation avoidance agreement(s) (hereinafter referred to as “agreement(s)” or “tax treat(ies)”), concluded or adopted by the Central government under the powers conferred under section 90 or 90A of the Act, respectively. Under the Act, the income tax is charged for the assessment year in respect of the total income of the previous year of every person. In respect of a person who is a non resident, the total income includes all income from whatever source derived which is received or deemed to be received or accrues or arises or deemed to accrue or arise in India. The incomes that shall be deemed to accrue or arise in India are specified in section 9 of the Act which, inter alia, provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India shall be deemed to accrue or arise in India. However, in cases where an agreement is also applicable, taxes on business income of a non resident can be levied to the extent the same is permissible under such agreement. Thus, business income of a non-resident can be taxed in India if it satisfies the requisite thresholds provided under the Act as well as the threshold provided in the applicable tax treaty, by a concept of Permanent Establishment or PE, which is defined in Article 5 of model tax conventions¹ and tax treaties.

2. Typically, all businesses consist of several activities, which can be broadly grouped into two categories. The first is the production or procurement of goods and provision of services and the second is their sale to the consumer and its use. No profits can possibly be derived by any business without completing both, thus making each of them absolutely essential for the generation of profits. Accordingly, if activities belonging to either of the categories are carried out in a tax jurisdiction, then there would be a case for taxation of profits contributed by those activities. Thus, profits arising from business that is only partly carried out in a jurisdiction need to be attributed to that jurisdiction for the purpose of taxation therein. The same principle is also laid down in section 9 of the Act, and further elaborated in rule 10 of the Income-tax Rules, 1962 ((hereafter referred to “the Rules”). Rules for profit attribution in tax treaties are usually based

¹ Most tax treaties around the world are derived from the two standard model tax conventions, prepared by the OECD and the UN Committee of Experts, but almost invariably, also include significant variations there from that are arrived by a process of negotiation by the Contracting States.

on one of the three standard versions² of Article 7 in model tax conventions prepared by OECD and UN Committee of Experts.

3. During the Base Erosion and Profit Shifting (BEPS) project undertaken by the G-20 countries, including India and the OECD along with other participants, there has been a number of changes in the definition of PE as a result of the Final Report on Action 7 of the BEPS Action Plan aimed at preventing the artificial avoidance of PE status, which has since been incorporated in Article 5 of the OECD as well as the UN model tax conventions. As part of the follow up work on Action 7 Report, work was also attempted to bring greater clarity on how these changes will impact issues related to profit attribution consequent to the expanded definition of permanent establishment. Accordingly, follow up work was undertaken by the Working Party-1 and Working Party-6 of OECD and some draft papers were prepared by the OECD, proposing guidance as to how profit would be attributable as per the Authorized OECD Approach (AOA)³. The AOA is a guidance developed by the OECD to explain how it intends the Article 7 on profit attribution to be applied. This guidance was developed by the OECD in 2010 after it introduced significant changes in the provisions of Article 7 thereby requiring profits to be attributed on the basis of functions, assets and risks (FAR), instead of the earlier rules for attribution based on direct accounting or indirect apportionment methods.

4. At present, there are at least 3 commonly adopted versions of Article 7 that feature in tax treaties around the world, the Article 7 recommended by the OECD model convention prior to 2010, the revised article 7 introduced in 2010 and the Article 7 of the UN model convention. Several countries, including India have made strong reservations (that are documented in the OECD Model Tax Convention) in the section on '*Position of Non OECD Economies*'. Accordingly, India does not accept or agree with the Authorized OECD Approach (AOA) to attribute profits to the PE on the basis of Functions, Assets and Risks (FAR).

5. The Article 7 in the Indian treaties corresponds to the UN Model Tax Convention which has certain similarities with the pre-2010 OECD Model Tax Convention. As per this provision, profits are to be attributed to the PE as if it were a distinct and separate entity on the basis of the accounts of the PE⁴ and where the detailed and accurate accounts are not available to enable determination of profits attributable to the PE, the profits attributable to the PE can be

² The three versions of Article 7 are elaborated in Section 3 of this report.

³ The final version of the 'Additional Guidance on Attribution of Profits to Permanent Establishments, BEPS Action 7' was published in March 2018 and is available at <http://www.oecd.org/ctp/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm>.

⁴ Paragraph 2 of Article 7 of UN Model Convention, Pre-2010 OECD Model Convention and almost all Indian tax treaties provides for Direct Accounting method for attributing profits of PE.

determined by an indirect apportionment under the domestic laws.⁵For the application of this method, the Assessing Officer in India can resort to domestic law through paragraph 4 of Article 7 of Indian DTAAAs (in most cases), which in the case of India is provided in rule 10 of Income-tax Rules, 1962.

6. There have been some concerns regarding the uncertainty and unpredictability resulting from the application of rule 10. These arise from the lack of specificity and the availability of very broad discretion to the AO without any clear and specific guidance, leading at times to claims of excessive taxation in India. The same concerns also appear to be reflected in the comments of OECD seeking details and specific guidelines on how profits are attributable in India. These concerns have led to the recognition of the issue as to whether there is a need to provide more specific rules or clear guidance on profit attribution under Indian domestic laws, especially rule 10 of the Rules, in order to bring greater certainty, consistency and predictability to the process of profit attribution under this rule.

7. Concerns have also been arising globally on how profits should be attributed in respect of profits generated from digital businesses. The Final Report on Action 1 of BEPS has pointed out that the rise and growth of digital economy has made the concept of physical presence redundant as the revolutionary developments in the telecommunication technology now allow a company located anywhere in the world to serve the customers globally without any physical presence. The existing tax rules can be difficult to apply for the taxation of digital enterprises which do not need a physical presence nexus anymore to actively participate in the economic life of a taxing jurisdiction resulting in a mismatch between where their profits are generated and where they are subjected to tax. Vide amendments in section 9, the significant economic presence threshold for taxation has now been explicitly recognized in the Act. This also opens the possibility for inclusion of a similar nexus rule in Indian tax treaties. It also highlights the need for clarifying rules related to profit attribution from such businesses.

8. The key features of digitalisation are scale without mass, importance of intangibles and role of user data and contribution have forced radical rethinking on rules governing its taxation. As the 2018 OECD Interim Report on Tax challenges⁶ arising from Digitalisation also acknowledges, the advent and expansion of digital economy has now further enhanced the need to bring clarity to the profit attribution rules. As the profit attribution rules in the Indian tax

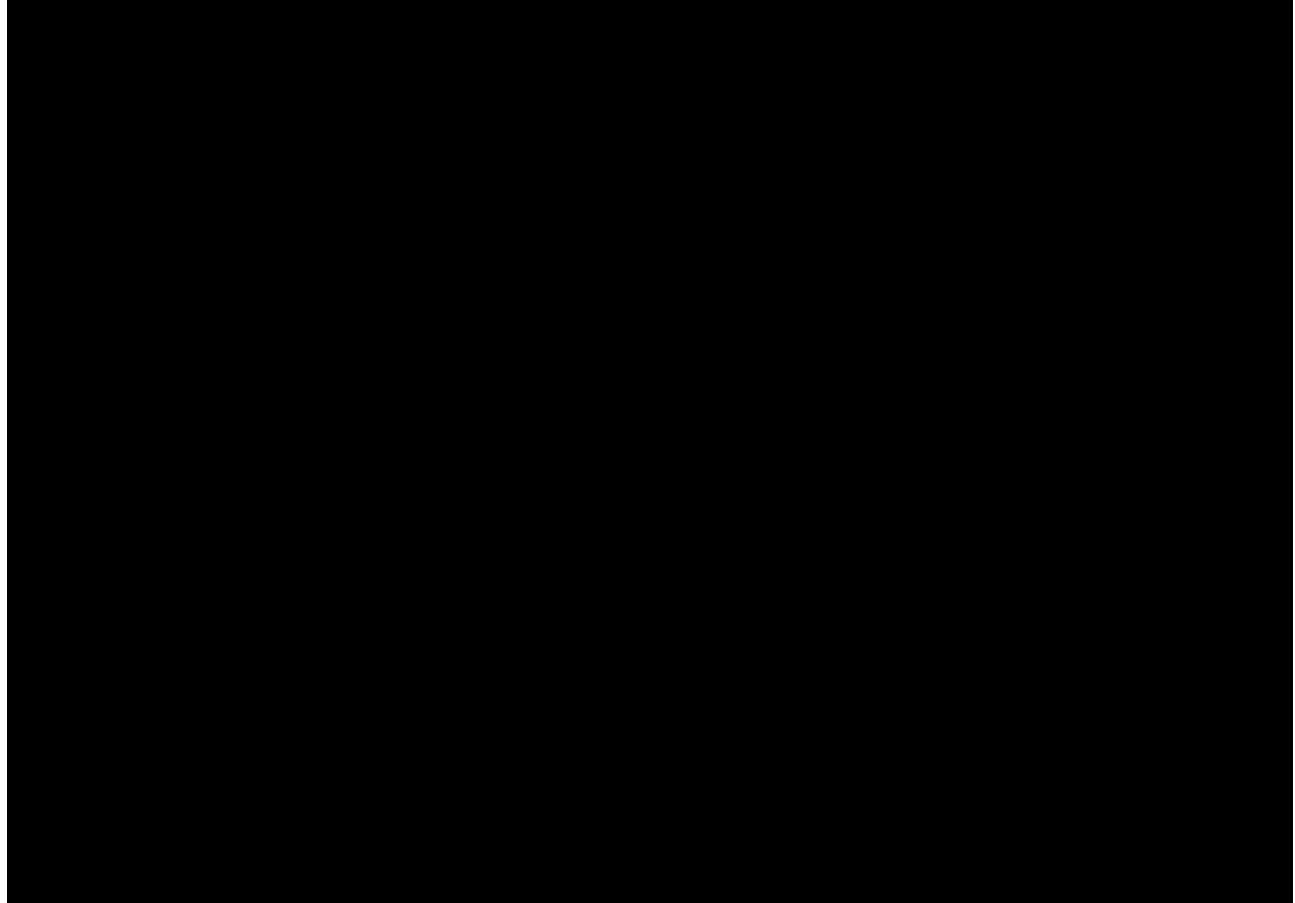
⁵ Paragraph 4 of Article 7 of UN Model Convention, Pre-2010 OECD Model Convention and almost all Indian tax treaties provides for fractional apportionment method for attributing profits to the PE, as available under domestic laws.

⁶ OECD Tax Challenges Arising from Digitalisation-Interim Report 2018 is available at <http://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm>

treaties and UN Model Tax Convention are different from the post-2010 OECD model tax convention, and since India does not agree with the AOA based on those rules, it becomes essential that necessary measures are considered and undertaken by India to bring greater clarity, consistency and predictability in its domestic rules that are permissible under its treaties.

1.2 Constitution of the Committee

9.



10. The Committee was accorded the following mandate:

- (i) Examine the existing scheme of profit attribution to PE under Article 7 of Double Taxation Avoidance Agreements.
- (ii) Examine the contribution of demand side and supply side factors in profit attribution.
- (iii) Recommend the changes needed in rule 10 of Income-tax Rules to provide specific rules on how profits are to be attributed to a non-resident person having PE in India.

1.3 Work of the Committee

11. In accordance with the mandate given to it, meetings of the Committee were held from time to time to finalize the report. The Committee took into account the history and evolution of different standards of profit attribution rules that currently prevail in the model tax conventions, along with the formal Indian position adopted in respect of them as well as the decisions of the Indian courts in matters involving profit attribution. The Committee also analyzed their economic impact for different economies and in particular their impact for Indian economy and tax collections. The Committee also took into account the views and opinions of academicians and experts as also some of the international practices prevailing or proposed to be adopted across the world, which can have relevance for the work of the Committee. The issues taken into account by the Committee, the areas of deliberations and the conclusions and recommendations arrived at by the Committee are contained in the rest of the Report.

1.4 Organization of the Report

12. The Report is organized in following sections in accordance with the order in which the Committee approached the issues. The second section begins with an overview of the taxation of business profits under the Act and the Indian tax treaties and analyzes their relationship in taxation of such profits. Section 3 explores the legal history of the international taxation rules related to attribution of profits, the evolution of different versions of Article 7 of model tax conventions and their implications for countries like India. Section 4 analyzes the economic basis for allocation of taxing rights in respect of business profits by looking at how economies contribute to business profits of multinational enterprises. Section 5 documents the various international practices for attribution of profits followed in different countries or regions, including those that are proposed and under consideration. Section 6 takes into account the views of academicians and experts regarding the relevance of sales as a factor that can be considered for allocating profits to a jurisdiction as well as their views on AOA. Section 7 reviews the Indian position on revised Article 7 of the OECD model tax convention and Indian views on additional guidance issues in respect of the same. Section 8 reviews the views taken by the courts in some cases on attribution of profits. Section 9 considers the observations and views of the Committee on the need for bringing greater clarity and objectivity in the process of profit attribution under Indian rules, and explores and lists possible approaches and options for this purpose along with their justification and merit. Section 10 considers the developments related to digital economy taxation and explores the possible options for defining the role of users in the profit attribution process. Section 11 summarizes the observations of the Committee and its recommendations on amending rule 10 of the Rules.

Section 2

Taxation of Business Profits under Income-tax Act, 1961 and Indian Tax Treaties

2.1 Taxation of Business Profits under Income-tax Act, 1961

13. Under section 5 of the Act, the global income of a resident⁷ in India is taxable in India. However, the taxability of income of a non-resident is limited to income that arises or accrues in India, is deemed to accrue or arise in India or is received or deemed to be received in India. Section 9 of the Act deals with income that is deemed to accrue or arise in India. As per clause (i) of sub-section (1) of the said section, “*all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India*” are deemed to accrue or arise in India, thereby elaborating upon the scope of income that would be taxable in India.

14. The concept of *business connection* is explained in Explanations 1 and 2 to clause (i) of sub-section (1) of section 9 of the Act, to which Explanation 2A⁸ has recently been added by the Finance Act, 2018 to explicitly include significant economic presence within the scope of business connection. Clause (a) of Explanation 1 states that in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the

⁷ The resident status is provided in section 6 of the Income-tax Act, 1961.

⁸ “*Explanation 2A.—For the removal of doubts, it is hereby clarified that the significant economic presence of a non-resident in India shall constitute “business connection” in India and “significant economic presence” for this purpose, shall mean—*

(a) *transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or*

(b) *systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means:*

Provided that the transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) *the agreement for such transactions or activities is entered in India; or*

(ii) *the non-resident has a residence or place of business in India; or*

(iii) *the non-resident renders services in India:*

Provided further that only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b) shall be deemed to accrue or arise in India.”

operations carried out in India. Clauses (b) to (e) of this Explanation provide the instances where income from certain specific activities will not be deemed to accrue or arise in India.

15. Explanation 2 explicitly includes the dependent agent within the scope of business connection. This explanation, which was in harmony with the erstwhile provisions related to dependent agent nexus in Paragraph 5 of Article 5 of the model tax conventions, has also been revised⁹ by the Finance Act, 2018, in accordance with the recommendations of Final Report on Action 7 of BEPS project, consequent revisions in the model tax conventions and India's position of the same.

16. Thus, where an enterprise has a business connection in India and the whole of its business is not exclusively carried out in India, only part of those profits are deemed to accrue or arise in India that is attributable to the business activities carried out in India. Under the Act, the income under the head "profits and gains of business or profession" is to be determined under the applicable provisions, and the taxpayers are required to maintain books of account and financial statements for this purpose.

17. However, where such books of account are either not maintained or it may not be possible to determine the actual profits from such books of account, the Assessing Officer can resort to secondary options prescribed in rule 10 of the Rules, which provides as under:

⁹ The revised Explanation 2 reads as under:

Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—
 - (i) in the name of the non-resident; or
 - (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
 - (iii) for the provision of services by the non-resident; or
- (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
- (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

“Determination of income in the case of non-residents.

10. In any case in which the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India or through or from any property in India or through or from any asset or source of income in India or through or from any money lent at interest and brought into India in cash or in kind cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax may be calculated :—

- (i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or*
- (ii) on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or*
- (iii) in such other manner as the Assessing Officer may deem suitable.”*

18. As can be seen, in cases where the actual amount of business profits taxable in the hands of a non-resident having a business connection in India is not accurately ascertainable, the Assessing Officer can determine such profits by either of the three methods provided in rule 10. While the first two methods are relatively specific, the third method allows the Assessing Office to apply any variation of the first two methods or any other method that he considers applicable in that case.

2.2 Application of Tax Treaties to Business Profits of a Non Resident

19. Section 90 of the Act empowers the Central Government to enter into agreement(s) with other States or specified territories for the purpose of avoiding double taxation. Similarly, section 90A of the Act authorizes a specified association in India to enter into such an agreement with a specified association of a specified territory subject to adoption by way of notification of the same by the Central Government. Sub-section (2) of both section 90 and 90A provide that in relation to the taxpayer to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that taxpayer. Thus, the provisions of the applicable tax treaty take precedence over the provisions of the Act to the extent they provide any relief to the taxpayer as compared to the provisions of the Act. Accordingly, business profits of a non resident covered by a tax treaty can be taxed under the Act only to the extent permissible under the applicable treaty.

The relevant provisions in tax treaties dealing with business profits are based on Article 5 and 7 of the model tax conventions.

20. Article 5 provides a definition of Permanent Establishment (PE). The two model conventions prepared by the OECD and the UN Committee of Experts differ in several aspects, with the UN model providing a somewhat wider scope of a taxable nexus that is constituted by PE. The definition of PE is primarily based on a fixed place of business, but also includes service or construction activities that are carried out beyond the specific duration, existence of a dependent agent that habitually concludes contracts or plays a principal role therein and collection of insurance premiums.

21. Significant changes in the definition of PE were recommended in the Final Report on Action 7 of the BEPS project, as a consequence of which Article 5 has now been amended in both OECD and UN model tax conventions. These changes can be summarized as under:

- Paragraph 4 of Article 5 has been amended to explicitly provide that certain activities listed in this paragraph will not give rise to a PE only if they are in the nature of preparatory and auxiliary activities. Anti-splitting rule has also been added.
- Paragraph 5 of Article 5 has been amended to broaden the scope of activities on the part of a dependent agent that will lead to its treatment as a PE.
- A new paragraph 4.1 providing an anti-fragmentation rule has been introduced which is aimed at preventing artificial avoidance of a PE status by getting different activities of a comprehensive business carried out by closely related entities.
- A new definition of closely related enterprises has been included for the purpose of this Article.

Once these changes come into effect in the applicable tax treaties, they can be expected to address the challenge of artificial avoidance of PE status, and thereby bring certain entities, which may have been able to artificially avoid taxation earlier, into the tax net.¹⁰

22. Article 7 of the model tax conventions and the tax treaties provide that the business profits of an enterprise of a Contracting State shall be taxed in the other Contracting State only to the extent such profits are attributable to the PE existing in that state. However, there exists a major difference in the approach between the OECD and the UN model tax conventions in the form of 'force of attractions rules' that are provided in paragraph 1 of Article 7 in the UN model

¹⁰ These changes can be brought into effect either through the amendment of a tax treaty consequent to bilateral negotiations, or by application of Articles 12 to 15 of the Multilateral Instrument prepared under Action 15 of the BEPS project and already signed by several countries including India, provided that both Contracting States in a tax treaty opt for making such amendments through the MLI.

tax convention¹¹. They include in profits attributable to the PE, profits derived from the sale of goods and services that are same or similar as the PE, even if those sale or business activities were undertaken not through the PE. The provisions of Article 7 and how they differ between the two model conventions are further elaborated in the next section in greater detail.

23. India has a tax treaty¹² network with 96 countries and the Indian tax treaties are largely based on the provisions of UN model tax convention with certain variations. The OECD model tax convention, developed by the OECD generally provides greater taxing rights to the country of residence of taxpayer.¹³ The UN model convention, developed by the UN Committee of Experts, attempts to balance this tilt to some extent by favoring the retention of greater 'source country' taxing rights (the taxation rights of the host country of investment) under the tax treaty as compared to those of the 'residence country' of the investor. This has long been regarded as an issue of special significance to developing countries, although some developed countries also seek this position in their bilateral treaties.

24. Article 7 provides that certain categories of business profits that are specifically covered by other provisions of the treaties shall be taxed in accordance with those provisions only. If business profits include income from immovable property (Article 6), international shipping and air transport (Article 8), dividend (Article 10), interest (Article 11), royalty and fee for technical services (Article 12)¹⁴, as well as income of artistes and sportspersons (Article 17) these are taxed according to their respective provisions and not in accordance with Article 7. Some of these categories of incomes can thus be taxed even in the absence of a PE in the Contracting State where they arise. If, however, profits include dividends, interest, royalties and fee for technical services connected with a PE, then Article 7 again takes precedence.

¹¹ Paragraph 1 of Article 7 of UN model tax conventions provides:

"1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise 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 as those effected through that permanent establishment."

¹² Double Taxation Avoidance Agreements are commonly referred as "tax treaties". These bilateral treaties are derived from provisions from standard Model Tax Conventions prepared by the OECD and the UN Committee of Experts, and usually vary significantly from either convention, depending upon the preferences of the sovereign Contracting States.

¹³ Developed countries, being exporters of capital and technology, favour greater taxing rights for the country of residence, resulting in a bias favouring them. The UN Model Tax Convention was therefore developed for tax treaties between developed and developing countries, which reduces this tilt to some extent.

¹⁴ Article 12 of OECD model tax convention does not include fees for technical services. However, in its 2017 update, the UN model has introduced a new provision as Article 12A providing for taxation of fees for technical services. Further, such income is included in the article dealing with royalty in most Indian tax treaties.

25. Thus, under most tax treaties, business profits derived by an enterprise are taxable exclusively by the state where it is resident, unless the enterprise carries on business in the other Contracting state (i.e., the source state) through a PE situated therein. This is also called the 'nexus' rule and is a threshold that determines the circumstances in which a foreign enterprise is considered to have a sufficient level of economic activity in a state to justify taxation in that state. This threshold generally requires a certain level of physical presence of the foreign enterprise in the taxing jurisdiction, either through a "fixed place of business" or through the actions of a 'dependent agent', 'service providers', 'construction activities' or a deemed PE as in the case of insurance. Consequently, except where separate distributive rules apply, as in Articles 6, 8,10, 11, 12, 13, or 17 of the model tax conventions, the taxing rights of the jurisdiction where such profits arise depend on a nexus or PE rule.

26. The concept of PE can be historically traced to the "Report on Double Taxation"¹⁵ prepared in 1923 by the four economist under the aegis of League of Nations. This term supplanted all its three predecessor terms - business establishment, industrial establishment and establishment, which were used in pre-World War-I tax treaties¹⁶. For example, in the tax treaty signed by Austria-Hungary and Prussia in 1899, the term "*business establishment*" was used and it was defined to include "*branch establishments, factories, depots, offices, places where purchases and sales are effected and other business facilities by which the owner, partner, manager, or other permanent representative carries on his normal business activities.*"¹⁷ Since the report by the four economists laid a greater emphasis on the economic allegiance of the business with the jurisdiction where it is to be taxed, the PE can be considered as an objective nexus threshold that serves as a reasonable proxy for the economic allegiance. The necessity of ensuring that taxing rights correspond with such economic allegiance was also emphasized in the BEPS project. The various recommendations made therein, including those in Action 7, are aimed at ensuring that the jurisdiction that has an economic allegiance with the business and thereby contributes to its profits should not be denied the right of taxing such profits by artificial arrangements.

2.3 Summary

27. To sum up, once it has been established that an enterprise satisfies the taxable threshold nexus of business connection under the Act as well as the taxable threshold nexus of PE under the applicable tax treaty, its profits become taxable in India. However, such profits are taxable only to the extent they are attributable under the relevant provisions of the Act as well

¹⁵ League of Nations Document E.F.S.73.F.19 Economic and Fiscal Commission, 'Report on Double Taxation' (1923).

¹⁶ John Huston & Lee Williams, Permanent Establishments: A planning primer (1993).

¹⁷ John Huston & Lee Williams, Permanent Establishments: A planning primer (1993).

as the tax treaty. Article 7 provides the applicable rules in the model tax conventions and the tax treaties, whereas the domestic law rules are contained in rule 10. The provision in Indian tax treaties is similar to Article 7 of UN model tax convention, and it has significant similarities with the pre-2010 version of Article 7 in OECD model tax convention except the force of attraction rule¹⁸ and the limitation of deductibility of expenses.¹⁹

¹⁸ UN Model Tax Convention provides for a “force of attraction” rule, under which, once the threshold of PE is achieved, all profits of the enterprise from a similar business derived from the other Contracting State become taxable in that State, even if they did not involve the PE. Thus, under the UN Convention, the PE is purely a threshold, and once achieved, all profits of the business in respect of which PE exists, become taxable in the source State, irrespective of any role of PE.

¹⁹ Paragraph 3 of Article 7 of UN Model Tax Convention provides that certain payments like royalty are not deductible as expense for determination of profits attributable to the PE under the direct accounting method.

Section 3

Evolution of the Three Different Standards of Article 7 in Model Tax Conventions & its Implications

3.1 Legal History of Article 7

3.1.1 The India Egypt Agreement

28. The first Indian tax treaty to have Article 7 on the lines of OECD Article 7 was the India Egypt Double Taxation Avoidance Agreement²⁰ and is reproduced below:

“BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State, through a permanent establishment situated therein. If the enterprise carries on business as aforesaid the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall, in each Contracting State, be attributed to that permanent establishment the profits which it might be 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 permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purpose of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment 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; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this article.

²⁰The DTAA between India and Egypt was signed on 20.2.1969 and entered into force on 30.9.1969

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the purpose of export to the enterprise of which it is the permanent establishment.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of the present article.”

This Article was based on Article 7 of the Draft OECD model tax convention of 1963. The first OECD draft double taxation convention was published in 1963. The first UN model tax convention was published much later in 1980. Thus, many Indian treaties during the sixties and seventies were based largely on the Draft OECD model tax convention, with specific variations to it as were preferred by India.

3.1.2 The 1960 OEEC Report and the 1963 OECD Draft Convention

29. The Organisation for European Economic Cooperation (OEEC) released a report in 1960 on the allocation of profits to PEs and associated enterprises. Annex A to the OEEC report contained the draft provisions to be inserted into a draft convention, and Annex E contained the related Commentary. The draft provision on the attribution of profits to PEs and the related Commentary were then embodied in the 1963 OECD Draft Convention (1963 Draft Convention), with a single change. Paragraph 3 of the 1960 OEEC Report stated that the PE had to be treated as dealing quite independently with the enterprise of which it is a part while the 1963 Draft Convention uses the term *wholly* independently.²¹ Article 7 of the 1963 Draft Convention provided as under:

“1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through, a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be 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 permanent establishment.

²¹Russo, Raffaele (ed.), *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings*, Amsterdam (2005): IBFD

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment 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; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.”

It has been noted in international tax literature that this was the first time that OECD dealt in specific terms with the issue of how the dealing between different parts of the same enterprise should be treated for tax purposes.²²

30. The Commentary to Article 7(2) of the 1963 Draft Convention, in accordance with the principles given by the League of Nations²³, states that if separate accounts are there then they must be taken into account when attributing profits to a PE. Paragraph 11 of the Commentary on Article 7 in the 1963 Draft Convention also clarified that there may be situations where the accounts need to be rectified and as an example, discusses the case of goods transferred from the head office in one state to a PE in another state at a price that is not at arm's length price.

²²Russo, Raffaele (ed.), *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings*, Amsterdam (2005): IBFD

²³The basic principles set forth by the League of Nation 1927 and 1928 drafts were that income from trade and profession is taxable only where permanent establishment (PE) is there and in case multiple PE are there then each jurisdiction will tax the income produced in its territory. There was an option for the Competent Authority to apportion income in cases where the accounts did not segregate income jurisdiction wise. The 1933 draft Convention was based on the principle that PE must be treated in the same manner as independent enterprises operating under the same or similar conditions thus encouraging determination of PE's taxable income based on separate accounting method.

In such a case, the Commentary recommends an adjustment to prevent the profits from being diverted from one state to the other.

31. Paragraph 13 of the Commentary on Article 7 in the 1963 Draft Convention also expressly states that Paragraph 3 of Article 7 constitutes a mere clarification of the arm's length principle²⁴ embodied in Paragraph 2 of Article 7. Paragraph 3 of Article 7 provides that general administrative expenses should be allocated to the different parts of an enterprise on the basis of an allocation factor. Here two things emerge -(i) the Commentary specifically refers to the 'arm's length principle' as being embodied in paragraph 2 of Article 7²⁵, and (ii) paragraph 3 immediately afterwards comes as a compromise and actual alteration of this principle in application to a PE. Paragraph 4 of Article 7 of the Convention recognizes apportionment of profits as per the customary practice. Paragraphs 22 to 25 of the Commentary on Article 7 further explains that a country may use the method of apportioning the total profits of the enterprise by reference to some formulae. It also gives the three categories of the criterion which can be used as the basis of such an apportionment. These three categories were the receipts of the enterprise, its expenses or its capital structure, depending on the business²⁶.

3.1.3 Subsequent Amendments in Article 7 by the OECD

32. The OECD published a proposal in 1974 and amended certain articles of the 1963 Draft Convention and the related Commentary and these changes are reflected in the 1977 and the 1992 OECD model tax convention and their commentaries. The only relevant addition in respect of the text of Article 7 was in paragraph 2, which expressly stated that the paragraph 2 applied "*subject to the provisions of paragraph 3*". Paragraph 11 of the 1977 Commentary and paragraph 12 of the 1992 Commentary on Art 7 of the OECD Model Convention clarified that this applies in particular with respect to interest, royalty and other similar payments²⁷.

²⁴ The arm's length principle is not the same as arm's length price. The Arm's length principle requires the existence of entities that are completely independent of each other, and thereby able to fulfill their primary objective of maximizing their own profits, without being affected by the impact of their actions on the profits of another enterprise. Since this is a condition that seldom gets satisfied in the real world, it would generally require that a PE that is not acting for maximizing its own profits is compensated for all unfavourable obligations that adversely affect its profits. Where it is not possible to do so, it may not be possible to apply Article 7(2) and attributable profits may have to be determined under Article 7 (4).

²⁵ Klaus Vogel, *Double Taxation Conventions*, Third edition (1998).; Art.7, M.No.71, and discussion contained in M.Nos. 64-71, pages 428-433

²⁶Russo, Raffaele (ed.), *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings*, Amsterdam (2005): IBFD

²⁷Russo, Raffaele (ed.), *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings*, Amsterdam (2005): IBFD

33. For reference, the OECD Commentary updated in 1977 regarding para 4 of Article 7²⁸ of OECD Tax Convention is reproduced below:

“It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can be fairly said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be

²⁸**Article 7(4)** Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacua that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down a rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.”

34. This commentary underwent a few revisions till 2010 but the sum and substance of it remained the same. In this commentary, the OECD recognized and acknowledged that apportionment of profits based on one of the criteria, i.e. receipts (or sales revenue), expenses and working capital, was a reasonable way of apportioning profits to the PE. This paragraph, numbered as paragraph 54 of the Commentary on Article 7 in the OECD Model Tax Convention 2008, is also relied upon and quoted in paragraph 19 of the Commentary on Article 7 of UN Model Tax Convention 2017, thereby indicating its acceptance by the UN Committee of Experts. Significantly, no country had documented any observation, reservation or position in respect of this paragraph in the OECD model tax convention, 2008, before it was omitted, indicating the existence of a very broad international consensus prior to 2010 about the principles laid down in this paragraph regarding the appropriateness of apportionment based on sales, expenses or working capital for attributing profits.

35. Thus, the OECD guidance provided in paragraph 54 of the Commentary on Article 7 in the 2008 version of OECD Model Tax Convention not only accepted apportionment based on either receipts, expenses or working capital, but also provided guidance on where one of them as the basis for apportionment could be considered preferable to another.

3.1.4 Revision of Article 7 by OECD in 2010 & the AOA

36. This OECD Commentary underwent few changes till Article 7 was modified in 2010 and new commentary was introduced. In 2008, OECD brought out a report on *Attribution of Profits to Permanent Establishments*. In this report, OECD provided for the 'Authorized OECD Approach' or the AOA as the approach preferred by OECD for attribution of profits to a PE under the new Article 7 in its model tax convention²⁹. Another report on the *Attribution of Profits to Permanent Establishments* was published by OECD in 2010 which focused on the interpretation and application of the revised and updated Article 7 in the model tax convention and was an amended and revised version of the 2008 report. In both the reports, the AOA was based on the 'separate entity approach', under which a PE is considered hypothetically as 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. However, unlike the guidance prior to 2010, the AOA requires that attribution of the profits to a PE should be undertaken on the basis of the functions performed, the assets used and the risks assumed. With this approach, the AOA attempts to determine the amount of profits attributable to the PE based on the *OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TP Guidelines), thereby equating the process of transfer pricing for the determination of arm's length price as analogous to the arm's length principle that is the basis of separate and independent entity approach.³⁰

37. The AOA recommends a two-step approach for determination of profits attributable to a PE:

²⁹ AOA provides options for application of the new Article 7 introduced in the OECD Model Tax Convention in 2010, which requires the profits to be attributable to PE in accordance with the principles developed in the OECD Transfer Pricing Guidelines in which the PE is first hypothesized as a *functionally separate entity* from the rest of the enterprise of which it is a part and then profits are determined by applying comparability analysis and FAR approach.

³⁰ The transfer pricing aims to determine the arm's length price, which is different from the profits derived by application of an arm's length principle between two entities. For instance, where a PE is controlled by the HO and made to act in a way that maximizes the profits of the enterprise as a whole but is detrimental to the profits of the PE as a supposedly separate entity, the conditions of arm's length principle enshrined in the separate entity approach would remain unsatisfied, even if all the transactions between the PE and the HO were priced at an arm's length.

- Step 1: A functional and factual analysis of the PE, aligned with a functions, assets and risks analysis (FAR Analysis), as recommended in TP guidelines
- Step 2: A comparability analysis to determine the appropriate arm's length return (price) for the PE's transactions, on the basis of the FAR analysis

38. The Indian tax treaties do not contain the revised version of Article 7 which prescribes profit attribution by way of FAR analysis. The original versions of Article 7 envisaged the PE to be taxed, so far as may be practicable, on profits that it would be expected to make if it was a distinct and separate entity. This would normally be achieved by determining profits in accordance with the applicable principles of accounting, where separate accounts are maintained for the PE, provided the PE functions as a separate entity in a manner that would maximize its own profits as a supposedly separate entity. Commentators like Klaus Vogel have referred to such determination as "*separate accounting*" or "*direct method*". However, substantial differences exist between the pre-revised Article 7 as it existed in the OECD model tax convention and the UN model tax convention even in the application of this direct method for determination of taxable profits³¹.

3.2 Differences between Article 7 in the pre-2010 OECD Model Tax Convention and the UN Model Tax Convention

39. Article 7 in the UN Model Tax Convention is derived from the pre-2010 version of Article 7 in the OECD model tax convention, with consequent similarities. The differences, however, are also very significant, and consist primarily in the form of 'force of attraction'³² rule in paragraph 1 of Article 7 and the 'limitation of deductible expenses' in paragraph 3 of the UN Model tax convention.

40. The 'force of attraction' provision significantly broadens the scope of profits attributable to a PE, by granting taxing rights to the country of source to tax profits derived by the enterprise from sale of goods or business similar to those sold by a PE, even if they are not effectively connected with the activities of the PE. Thus, under Article 7 of the UN model tax

³¹ Klaus Vogel, *Double Taxation Conventions*, Third edition, p. 428-433(1998)

³²The term 'force of attraction' which is part of UN Model Tax Convention refers to the levying of tax of the contracting country in case there is sufficient business presence (PE) and the entire business income is directly or indirectly related to the activities carried on through such PE. To put matters simply, if a business organization belonging to or a resident of country A has a permanent establishment in country B and carries on its activities through it, then the entire revenue generated in country B shall fall under its taxable domain irrespective of the fact whether all the activities are carried on in the country B through the said permanent establishment. In Article 7 of some of the Indian DTAAs, this principle exists and provides that an enterprises carrying on business through PE in other contracting state may be charged to tax in relation to the profits of such enterprise as is directly or indirectly attributable to that PE.

convention, once there is a PE undertaking a particular business or sale of particular goods, all profits derived by a foreign enterprise of the other contracting state from such business or sale can be taxed in that jurisdiction under this provision. For that business, it then becomes irrelevant as to whether the activities or functions of the supply chain are carried out by the PE or some other part of the foreign enterprise. In effect, it establishes the right of the country of source to tax all profits derived from such sales or business from within its territory.

41. Conceptually, this can also be seen as a recognition of the taxing right of the country of source to tax profits of a foreign enterprise derived from within its territory on the basis of the contribution made by it in facilitating the demand side factors, and by sustaining and facilitating the market from where the profits are derived. It also highlights the basic difference between the nature and purpose of Article 5 and 7, of which the former provides an essential nexus threshold of PE that must be satisfied for taxing any profits of the enterprise of the other Contracting State, but once such threshold is achieved, then by application of force of attraction rules, profits attributable to the PE and taxable in the jurisdiction includes profits from the same or similar business even if such business activities were not carried out or effectively connected with the PE.

42. The other significant difference between Article 7 of UN model tax convention and the pre-2010 Article 7 of OECD model tax convention is in the restriction of certain deductible expenses laid down in paragraph 3. The UN model provision restricts the deductibility of expenses like royalties, fees, commission or interest, while also prohibiting the taxation of any receipts of the PE from the head office on their account. The restriction of the deductibility of these expenses is in line with the economic reality of the business, since these payments are not operational expenses and actually represent a sunk cost for assets that are not owned by the PE and the subsequent rent on which, such as by way of royalty is not allocated to the PE. Where, however, the assets are owned by the PE, it is similarly prohibited for charging its cost from the head office. Thus, the rule ensures that actual profits of the enterprise derived by the PE from the country of source are subjected to tax therein, without any notional adjustments for sunk costs borne outside that tax jurisdiction.

43. A common feature of Article 7 in the OECD model tax convention prior to 2010 revision and the UN model tax convention is their acceptance of the right of the country of source to apply an apportionment method in accordance with its domestic laws, where so required. This is provided in the following words:

“...nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary;”

Thus, the pre-revised version of Article 7 in the OECD model tax convention as well as the Article 7 in the UN model tax convention clearly recognize the right of a contracting state to determine taxable profits attributable to a permanent establishment by way of apportionment. It is of course, expected that the attribution by way of such apportionment will be just, fair and in accordance with the overall intent of that provision.

3.3 Difference between Pre-revised and the Revised versions of Article 7 in OECD Model Tax convention

44. The most significant change introduced in Article 7 in the 2010 update of OECD Model tax convention is the introduction of functions, assets and risks or FAR analysis as the basis of the profit attribution, which was not there earlier. This change was significant from two different perspectives. First, it approximated the process of profit attribution with that of transfer pricing, thereby leading to an illusion that both of them are one and the same, and can be undertaken in an integrated manner by a common FAR analysis.

45. The second and the far more significant impact of this revision, particularly from the perspective of market jurisdictions, was to ensure taxation of profits solely on the basis of the contributions made by supply side factors while completely ignoring sales and thereby the contributions made by the maintenance of the markets and the demand side factors to profitability of a foreign enterprise. By attributing profits only on the basis of FAR, representing supply side factors, and excluding sales from the equation, the contribution of market jurisdictions to the profits derived by an enterprise from that jurisdiction stand completely ignored.

46. The other extremely significant change introduced by this revision was to omit the option of determining attributable profits by way of apportionment, as may be permissible under the domestic laws. This option, which existed in the paragraph 4 of the Article 7 of the model tax conventions till then, was omitted from the revised Article 7 of the OECD model tax convention. The practical significance of this change was that even in cases where accounts were not available or where they were not accurate, the determination of attributable profits was to be done by taking into account function, assets and risks, and more importantly, without taking sales into account.³³

³³ Unlike statement of accounts, which begins by taking sales or receipts into account, determination of attributable profits in the absence of any accounts by relying only on function, assets and risks would result in completely ignoring the importance of sales in determination of profits. It would also amount to profit determination completely on the basis of supply alone and ignore the role of demand, even though no profits can ever be generated in the absence of demand.

47. The combined effect of these changes has the effect of integrating transfer pricing and profit attribution into a single FAR driven exercise and omitting the option of profit attribution by apportionment. The most important effect of these changes, with immense consequences for all market jurisdictions, including those in developing countries, is the exclusion of sales as a basis for attributing profits. Given its importance in changing the balance of taxing rights between the country of source and the country of residence, it becomes essential to examine the implications of this change on the distribution of taxing rights and inter nation equity with reference to the basic tenets of public economics, tax policy, and relevant literature. The same is detailed in the next section.

3.4 Committee's Observations

48. **The Committee observes that at present three standard versions of Article 7 exist in tax treaties and model tax conventions, the two versions that existed in the OECD model convention before and after 2010 and the one that continues to be a part of UN model convention. The Committee further observes that one of the primary implications of the revisions introduced in Article 7 of the OECD model tax convention, of necessitating reliance upon FAR for profit attribution and excluding the option of apportion, was that in cases 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, and completely ignoring the sales receipts derived from that tax jurisdiction. This was a major deviation from the generally applicable accounting standards for determining business profits, where business profits cannot be determined without taking sales into account.**

Section 4

Economic Basis for Allocation of Taxing Rights in respect of Income from Business

4.1 Tax Base in Income Tax

49. In 'income tax' or 'corporate tax', the tax base consists of profits of the enterprise, which are determined by following the applicable laws and prevailing accounting standards. In economic theory there are two types of profits – economic profits and financial or accounting profits. Almost invariably, it is the financial profits, as determined from the accounts of the business that are subjected to tax under the tax laws governing taxation of income. Accounting profit is calculated according to the generally accepted accounting principles or accounting standards. In simple terms, such profit is a company's total revenue or sales receipts reduced by the explicit costs of producing goods or providing services. These explicit costs involve direct monetary movement and include expenses such as the cost of raw materials, employee wages, transportation, rent and interest on capital. Usually, accounting profit is limited to a particular time period, such as a fiscal quarter or year. Accounting profit computations are undertaken for the purpose of reviewing the financial outcomes of business and determination of profits, not only for the purpose of taxation, but also for the purpose of determining accumulated profits and making distributions out of it to the shareholders. Economic profits may not exactly be the same as financial profits, are not limited to accounting periods, are often difficult to measure objectively and hence usually not depended upon for the purpose of taxation.³⁴ What is actually subjected to tax, thus, is financial income which may not be the same as economic income. However, the starting point of both economic and financial or accounting profit is the same, i.e. revenue earned or sales.

50. The tax on income, whether of an individual or an enterprise also includes several streams of income in addition to the profits from a business, such as those arising from leasing of financial assets (interest and dividend), intellectual properties (royalty) or tangible movable or immovable property (lease rent charges), as well as appreciation of value of assets owned (capital gains). In accounting systems, all receipts, to the extent they are incidental to the business are generally treated as business receipts and the net taxable profits of the

³⁴ Economic profits are based on economic principles and not accounting standards. They can broadly be understood as the difference between sales revenue and the opportunity cost of all resources used or deployed in supply, including the capital and resources owned by the enterprise. As a result, there can often be significant differences – qualitatively as well as quantitatively between economic profit as defined by economists and the accounting profit determined by the prevailing laws and accounting standards.

enterprise are arrived at by deducting all business costs, including depreciation of assets, and payments made for borrowed assets.

51. In Income Tax or Corporate Tax regimes, the tax base is ‘business profits’, which can arise only when an economic good is sold to the consumer. Since no profits can ever arise to an enterprise merely by producing goods (which are not sold), the primary location where the value contributing to the business profits is created is the market where the consumer is located. This is a basic underlying principle that has always been recognized very clearly, right since the inception of the international taxation regime in the early 20th century, as evident from the following example in the report of four economists whose report to the League of Nations is considered as the conceptual basis for international taxation regime till date:

“The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities.”³⁵

This famous example only elaborates a simple principle that is always recognized by all businessmen, that it is the market and the demand for consumption that dictates production and not vice versa. In other words, profits are created by sales and not by inventories. Since it goes without saying, production is an equally essential element to business and no profits can be generated without production³⁶, it becomes clear that both production and sales are essential for the generation of profits. It also means that neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction.

4.2 The Concept of Value Creation and its Relevance

52. Often, a need is emphasized for allocating taxing rights to the jurisdiction where value is created. However, the concept of value is often not clearly elaborated to show how it is related to the different tax bases. For instance, in value added tax or VAT, where the tax base is value addition, it would be more logical to tax the transaction where value is created, and accordingly the adoption of destination based rule reaffirms the principle elaborated in the example of California oranges referred above. However, the tax base in income tax or corporate tax is not value addition, but business profits, and accordingly sales and supply both need to be taken into account as contributors to this tax base.

³⁵League of Nations Document E.F.S.73.F.19 Economic and Fiscal Commission, ‘Report on Double Taxation’ (1923)

³⁶ In case of trading business, procurement replaces production as an essential element.

53. At a more conceptual level, the question as to what constitutes ‘value’ has invariably vexed economists. There are different theories of value. The labour theory of value developed by Karl Marx asserts that the economic value of a good or service is determined by the total amount of socially necessary labour required to produce it. The Intrinsic theory of value characterizes value that an entity has in itself as well, for what it is, or as an end, and lays emphasis on the value that is created through the valuers’ attitude or judgements. The subjective theory of value notes that an item’s value depends on the consumer and a good’s value depends on the consumer’s wants and needs. It believes that consumer places a value on an item by determining the marginal utility, or additional satisfaction of one additional good, of that item and deciding what that means to them.

54. The contemporary textbooks on Economics use the theory that consumer's choices are evidence (revealed preference) that various products are of economic value. Conceptually, a good or service will only be produced if its cost does not exceed the consumer’s valuation and in the absence of market frictions, a market occurs and the good is traded at a certain price. Under perfect competition, this price equals both the marginal willingness to pay, i.e. the marginal consumer’s valuation of the good or service, and the marginal production cost. If the average consumer’s willingness to pay, reflecting the true value of the good or service, exceeds the market price, there is profit and welfare increases. So supply without demand cannot produce ‘value’. The significance of demand in the determination can also be understood by the fact that when the consumers have a greater ability to pay, consequent to the rise of disposable resources available with them, they are willing to pay more for the same good, and this willingness or the ability to pay more for the same goods increases the value of that good in the market, as objectively measured in terms of price. Thus, we can observe similar goods having different prices (denoting different values) in different economies – a phenomenon that is captured economically in the form of differences in “*Purchasing Power Parity*”.³⁷

55. As far as the intrinsic theory of value is concerned, it may be useful to take into account that the price volatility of goods, which is often observed in case of changes in supply shocks, does not allow such intrinsic value to be equated with price. The price can never exceed this supposedly intrinsic value, but can be much lower as the willingness of marginal consumer to pay reduces with the down-sloping demand curve. What is relevant here is the fact that tax based in income tax or corporate tax is business profits and not value, and business profits depend upon price and cost, and not the intrinsic value of a good.

³⁷ It also explains as to why even the most sophisticated goods have no value in a place where there are no buyers with an ability to pay. On the contrary, in cases of supply shock, the scarce goods can become extremely valuable if there are buyers with capacity to pay for them.

4.3 Factors that Contribute to the Business Profits of an Enterprise

56. The business profits of an enterprise can generally be understood as the surplus of its business receipts over its business expenses. The marginal profit and average profit of the enterprise can be different in the presence of sunk costs. The marginal profit is constituted by the surplus of price, which also represents the marginal revenue, over the marginal cost. The average profit, which actually forms the tax base in income tax and corporate tax regimes, is constituted by the surplus of total revenue over the sum of all costs, i.e. marginal cost and the corresponding portion of the sunk costs as can be reasonably assigned for the given period of operation. Thus, the business profits of an enterprise can be depicted by the following equation:

Profits of an enterprise = (Price per unit x quantity of units sold) – (Sum of marginal costs for all units + assigned sunk cost)

Thus, business profits which constitute the tax base in income tax and corporate tax regimes depend largely on two variables, sales revenue and costs. Sales revenue in turn, depends upon two variables, price per unit and the quantum of units sold.

57. The price of the goods as well as the quantum of the units sold depends upon both, demand and supply, and all factors influencing them. The demand is primarily dependent upon the ability of the consumers to pay, and its impact can be witnessed in the differential pricing for similar goods, as reflected in the concept of “purchasing power parity” that widely differs from one tax jurisdiction to another, and is proportional to the availability of resources at the disposal of consumers, as reflected by their per capita income. The income of the consumers is in turn dependent upon the general state of economy and its maintenance by the overall resources of the economy, including those financed by public funds. Any rise in demand leads to a rise in both price as well as quantum of sales, and thereby contributes to an increase in profits of businesses. The same is also true in respect of a non resident enterprise that is participating in that economy and earning sales revenue therein.

58. Value addition is an essential ingredient for production and supply, since no consumer will ever be willing to pay anything for a good unless it is supplied to him. The cost of adding value is important, since a reduction in costs leads to higher profits for the enterprise. Where the demand is taken as given for a quality of product, the addition of higher value within the supply chain for the same cost is equivalent to a fall in costs of value addition. Such improvements in supply amount to a reduction in marginal costs and result in the downward shifting of supply curve in a partial equilibrium model. In a perfectly competitive market, this would have the effect of fall in market price and increase in the quantum of sales. Since their mutual impact negates each other, the rise in profits will arise primarily from the lower marginal costs.

59. Thus, for the determination of profits of an enterprise, both demand and supply are essential, and the absence or inadequacy of either of them can make the enterprise unprofitable. The extent to which either demand or supply will impact business profits depends upon their respective price elasticity. The elasticity in turn depend upon several factors, like the nature of goods, the availability or otherwise of substitutes and compliments in that economy in respect of that good, which affect the demand, as well as the availability or otherwise of factors of production within the economy, which affect its supply. This standard market dynamics changes in cases of monopoly and oligopolies, which are able to obtain extra monopoly rents by artificially reducing their supply and hiking market price, which in turn is again limited by demand or, the ability of the consumers to pay. Thus, in such monopolistic markets, demand can have a greater role in determining business profits.

4.4 Committee's observations

60. **The Committee observes that business profits are contributed by both demand and supply of the goods, and hence a jurisdiction that contributes towards demand by facilitating the economy and the ability of their resident to pay or by maintenance of markets that enable sales as well as the jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. This gives rise to a valid justification of taxation by them of the profits to which their economies have contributed. Where, the economies of both Contracting States in a tax treaty contribute to the business profits, there exists sufficient economic justification for profits to be allocated among them in a manner that avoids double taxation.**

Section 5

Different Approaches to Profit Attribution & International Practices

5.1 Interaction of Treaties & Domestic Law for Attribution of Profits

61. Profit Attribution is one of the more complex subjects in International taxation. Once it has been established that a particular country is allowed to tax the profits of an enterprise, it is necessary to have rules for the determination of the relevant share of the profits that will be subjected to taxation. Profit attribution rules perform this function. The different approaches to profit attribution can be considered to be a spectrum with the supply side approach being at one end and the demand side approach being at the other end. However, it is important to note that the tax treaties prescribe only certain broad methodologies within which it is open for a Contracting State to apply its domestic laws, such as those relating to accounting standards, deductible expenses, deduction for sunk costs like depreciation as well as rules for apportionment, wherever permissible under the treaties.

5.2 Approaches for Profit Attribution

62. The Article 7 of the OECD Model Tax Convention and the AOA recommended by OECD is based on a purely supply side approach towards profit attribution³⁸, which attempts to completely neglect the role of demand in contributing to profits. The OECD approach seeks to allocate taxing rights to the origin jurisdiction as income is equated with the product of the employed production factors, addressing the location of firm inputs, i.e., the place where the goods supplied and the services rendered originated from.³⁹ Under this approach, the source of business profits is taken as the place where the firm employs its production factors for profit. As a consequence, location of the market and sales are completely neglected and ignored for taxable profit attribution purposes under this approach.

63. Conceptually, for profit attribution, the supply approach aims at locating the employed income producing factors (nexus) and evaluating their relative contributions to the business income generation (allocation). To discover the origin of income, for nexus establishment purposes, reference is essentially made to a 'functional and factual analysis', analyzing the functions performed (labor), the assets used (capital) and risks assumed. For allocation

³⁸Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), and Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', *Oxford Review of Economic Policy* 698 (2008)

³⁹Maarten Floris de Wilde, 'Sharing the Pie'; *Taxing Multinationals in a Global Market* (2015).

purposes, third-party transactions are typically evaluated by reference to the agreed selling prices. All contributions of demand and the markets are completely ignored in this approach, which forms one of its principal limitations, since mere production of a good cannot generate profits in the absence of demand.

64. At the other end of the spectrum, is the demand approach which directs the income items to the marketplace which is also sometimes called the ‘destination principle’. This approach addresses the notion that only demand creates value⁴⁰ i.e. a customer’s willingness to buy a product is taken as the exclusive source of value and income is assigned geographically to the location where the goods and services produced are sold. Under a purely demand based approach, business profits arising from an enterprise would only be taxable in the country where consumers are situated.

65. Destination-based (income) taxes allocate substantial taxing rights to the location where the entrepreneur obtains the revenues out of its profit-seeking activities. For instance, under such an approach, the ‘remote seller’ and the ‘e-tailer’ would be taxed solely in the countries where they sell their goods and the location of production is neglected for tax allocation purposes.

66. Conceptually, to discover the destination of income, for nexus establishment purposes, reference is essentially made only to the location of the customer under the demand approach, which, for instance, is essentially the case under sales only formulary apportionment mechanisms⁴¹. This approach has recently become popular in the United States, where many States have increased the attribution of sales in a three factor formula to 90% or even 100%.⁴² The original approach taken by the US States takes into account the demand based approach along with contribution of assets and manpower, representing supply, in a 3 factor formulary apportionment.

5.3 The Common Approaches in International Practices

67. Goods and services do not only need to be produced but they should be sold as well. Conversely, in order to be able to sell goods and services, they need to be produced first. Income generation requires both the supply and the sales. No income or profit can be generated when either supply or demand is missing. If seen from this perspective, both the

⁴⁰ Peggy B. Musgrave, ‘Principles for Dividing the State Corporate Tax Base’, in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984)

⁴¹ Maarten Floris de Wilde, ‘Sharing the Pie’; *Taxing Multinationals in a Global Market* (2015).

⁴² Danuse Nerudova, ‘Common Consolidated Corporate Tax Base – Sharing the tax base under formulary apportionment’ In Stavárek, D., & Vodová, P. (Eds.) *Proceedings of the 13th International Conference on Finance and Banking*. Karviná: Silesian university in Opava (2012).

place of production and the place of the market constitute sources of income⁴³. The supply-demand view of income reconciles the two ends of the spectrum and acknowledges that value is created through the interplay of both supply and demand⁴⁴. It accordingly distributes the income to the geographic locations of both production and the marketplace. It seeks to assign income geographically by addressing both its origin – the supply-side of income making reference to firm inputs, and its market – the demand-side of income making reference to firm outputs.

68. This view basically requires the identification, localization and evaluation of both production factors and the marketplace. These provide the stepping stones for discovering the income's geographical source. The supply-demand approach towards geographic profit attribution can be recognized, for instance, in the traditional formulary apportionment systems as adopted by various US states to apportion state income tax⁴⁵. The Canadian formulary allocation system to attribute corporate profits to the provinces and territories also shows evidence of acknowledging the supply- demand view of income⁴⁶. These formulary systems have been utilized within these countries for the purposes of dividing the income tax base to subnational levels of government.

69. The EU proposal for a Common Consolidated Corporate Tax Base or CCCTB introduced in 2016 proposes an allocation of taxes within the European Union on the formula of one third sales, one third assets, one-sixth manpower and one-sixth wages. Under traditional formulary apportionment mechanisms, the tax base is apportioned to both production and market states by means of a predetermined fixed formula reflecting both supply-side factors (payroll, assets) and demand-side factors (sales at destination). Formulary systems typically seek to divide tax entitlements between both the origin and the destination states by attributing parts of the profit to both the jurisdictions of production and utility. The allocation keys adopted for this purpose aim at approximating the geographic location of income by reference to some apportionment factors. Typically, these factors are payroll and assets at origin to reflect the

⁴³ Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', *Oxford Review of Economic Policy* 698 (2008), Ana Agúndez-García, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options', European Commission Directorate-General Taxation & Customs Union Working Paper 2006

⁴⁴ Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984)

⁴⁵ The traditional 'Massachusetts formula' equally-weights the factors of tangible assets and rental expense, sales and other receipts, and payroll

⁴⁶ In Canada [Sec. 402(3) Canadian Income Tax Regulations] the allocation of corporate profits to the provinces and territories takes place through a two- factor formula of payroll and gross revenue with equal weightage to both of them.

supply side of income, and sales at destination to reflect the demand-side of income⁴⁷. For a balance, both supply side and demand side factors need to be taken into consideration for the determination of profits.

5.4 International Practices of Apportionment of Profits

70. It may be observed that not many countries outside the developed world have been able so far to develop their own detailed guidance for profit attribution of PEs. In most cases, the attribution is done on the basis of past precedence, the applicable domestic law and specific facts and circumstances of that case.

71. The United States was one of the first countries to clearly define factors for attributing profits among different US States. For this purpose, a simple formula has been in use by the US States since a long time for determining profits attributable to that State. The formula, called the '*Massachusetts Formula*' provides that one third profits are to be attributed on the basis of sales, one third on the basis of payroll and one third of the basis of assets or property.

72. In the early part of the twentieth century, the separate accounting method was used in the United States to determine the geographic source of a taxpayer's income through segregation of the profits attributable to a state through identification of state-specific receipts, costs and expenses from the taxpayer's books and records.⁴⁸ Over the years, the method came under criticism as the multistate businesses expanded and increasingly dominated the economies of all states in which they produced, processed, stored and marketed a great number and variety of products and services. The separate accounting for integrated businesses became even less viable in practice and consequently, states embraced formulary apportionment as a method of attributing income to the state.⁴⁹

73. In the earliest US Supreme Court decision [*Underwood Typewriter Co. v. Chamberlain*, 254 US 113, 120-121 (1920)] addressing the propriety of the formulary apportionment method of income attribution, the Court approved the method in broad terms. Initially the formula employed was a single-factor property formula, but States gradually abandoned it for a three-factor formula that averaged the ratios of property, payroll and sales within the state to the totals throughout the business. This produced an equitable and workable division of the corporate net income among the states and by 1978, forty-three of the forty-five states (as well as the District of Columbia) that imposed corporate income taxes were using this equally

⁴⁷Maarten Floris de Wilde, 'Sharing the Pie'; Taxing Multinationals in a Global Market (2015).

⁴⁸G.T. Altman & F.M. Keesling, Allocation of Income in State Taxation (2d ed. 1950), 38.

⁴⁹J.R. Hellerstein, W. Hellerstein and J.A. Swain, State Taxation (2017 rev.), paras. 8.03 – 8.06, which describes the historical development of the USA states' taxation of corporate income in detail.

weighted three-factor formula.⁵⁰ However, this underwent a change when in 1978, the US Supreme Court sustained the constitutionality of Iowa’s single-factor sales formula in *Moorman Manufacturing Co. v. Bair* 437 US 267 (1978). The Court made it clear that federal constitutional protections for interstate commerce did not require judicial articulation and enforcement of uniform division-of-income rules, because it was to Congress, not the Court “*that the Constitution has committed such policy decisions*”. Furthermore, since 1978, the states have increasingly abandoned the equally weighted three-factor formula for formulas that give greater, if not exclusive weight to the sales factor. In 2017, less than one third of the states with corporate income taxes were employing the equally weighted three-factor formula, and only eight relied on it exclusively. The following table elaborates these practices:

Table 1: US State apportionment of corporate income (formulas for tax year 2017)⁵¹

	State	Formula for apportionment of Corporate tax (2017)⁵²
1	Alabama	Double weighted sales
2	Alaska	3 factor
3	Arizona	Sales/Double weighted sales
4	Arkansas	Double weighted sales
5	California	Sales
6	Colorado	Sales
7	Connecticut	Sales
8	Delaware	Double weighted sales
9	Florida	Double weighted sales
10	Georgia	Sales
11	Hawaii	3 factor
12	Idaho	Double weighted sales
13	Illinois	Sales
14	Indiana	Sales
15	Iowa	Sales

⁵⁰W. Hellerstein, A US Subnational Perspective on the “Logic” of Taxing Income on a “Market” Basis, 72 Bull. Intl. Taxn. 84/5 (2018), Journals IBFD

⁵¹Source: Federation of Tax Administrators, available at www.taxadmin.org. and W. Hellerstein, A US Subnational Perspective on the “Logic” of Taxing Income on a “Market” Basis, 72 Bull. Intl. Taxn. 84/5 (2018), Journals IBFD

⁵²The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown. Slash (/) separating two formulas indicates taxpayer option or specified by state rules. 3 factor = sales, property and payroll equally weighted; Double wtd sales = 3 factors with sales double weighted; Sales = single sales factor

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16	Kansas	3 factor
17	Kentucky	Double weighted sales
18	Louisiana	3 factor
19	Maine	Sales
20	Maryland	Sales/Double weighted sales
21	Massachusetts	Sales/Double weighted sales
22	Michigan	Sales
23	Minnesota	Sales
24	Mississippi	Sales/Other
25	Missouri	3 factor
26	Montana	3 factor
27	Nebraska	Sales
28	Nevada	No state income tax
29	New Hampshire	Double weighted sales
30	New Jersey	Sales
31	New Mexico	80% sales, 10% prop/payroll
32	New York	Sales
33	North Carolina	Quadruple weighted sales
34	North Dakota	3 factor
35	Ohio	No state income tax
36	Oklahoma	3 factor
37	Oregon	Sales
38	Pennsylvania	Sales
39	Rhode Island	Sales
40	South Carolina	Sales
41	South Dakota	No state income tax
42	Tennessee	Triple weighted sales
43	Texas	Sales
44	Utah	Sales
45	Vermont	Double weighted sales
46	Virginia	Double weighted sales/Sales
47	Washington	No state income tax
48	West Virginia	Double weighted sales

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49	Wisconsin	Sales
50	Wyoming	No state income tax
51	District of Columbia	Sales

From this, it can be observed that US domestic laws accepts sales, even in the absence of any other function, asset or risk, as sufficient factor for attributing at least 33.3% of the profits derived from those sales, and also permits US States to attribute a higher proportion of profits upto 100% on the basis of sales. In other words, the approach of the US States varies from a mixed approach that allocates profits on the basis of both demand and supply to one that is based exclusively on demand approach. None of the US States, however, follow a pure supply approach that ignores sales completely for profit attribution.

74. Canada also follows a system of formulary apportionment for apportioning or “allocating” corporate profit among provinces and about 45% of corporate taxable income is apportioned. If a company has a PE in a Canadian province and at least one PE outside that province, then the standard formula for allocation applies that gives equal weight to revenue and payroll factors. Besides this, there are industry specific formulas for insurance companies, railway, airline and shipping corporations.

75. Switzerland⁵³ uses apportionment to allocate profits for their sub-national corporation tax among Cantons. Three different methods can be used for computing the apportionment fractions attributed to the main tax residence and the permanent establishments forming secondary tax residences: the ‘direct’ method, the ‘indirect’ method and a combination or ‘mixed’ method. If the ‘direct’ method of apportionment is used, the aggregate apportionable income of the company is distributed among profitable subunits of the company in proportion to their separate accounting profits. The ‘indirect’ method of apportionment is similar to the practice of the US states and the Canadian provinces, and a company’s profits are apportioned according to the fraction of auxiliary factors such as turnover, payroll and sales that are located within a canton. The ‘mixed’ method combines the ‘direct’ and the ‘indirect’ method in a two-step procedure. First, the total apportionable income is apportioned on the basis of separate accounting results (direct method) to separate divisions of the company, which may be engaged in different lines of business. Subsequently, those part profits are distributed within the divisions to the different cantons using the ‘indirect’ method.

⁵³Stefan Mayer, Formulary Apportionment for the Internal Market (2009), IBFD

76. Germany⁵⁴ uses formulary apportionment to apportion the tax base of the trade tax between municipalities. The proceeds of trade tax are apportioned among the municipalities, which derive their taxing rights from higher levels of government.

5.5 The European Proposal for CCCTB

77. The European Commission with its Action Plan for a Fairer and Efficient Corporate Tax System,⁵⁵ relaunched its 2011 idea of a Common Consolidated Corporate Tax Base (CCCTB) in a two-step approach, with the publication on 25 October 2016 of two new interconnected proposals, for a common corporate tax base (CCTB), and for a common consolidated corporate tax base (CCCTB). The CCCTB promises a harmonized set of rules to determine the tax base, the consolidation of taxable profits at the EU level and formula-based apportionment. A comprehensive proposal has been placed before the European Council for issuing a Directive in which the profits derived from within Europe are attributed to different tax jurisdictions within EU on the basis of a simple formula, wherein one third profits are attributed on the basis of sales, one third on the basis of manpower and wages (one sixth on the basis of wages, and one sixth on the basis of number of personnel), and one third on the basis of the assets.

78. The rationale given by the European Commission for the adoption of CCCTB is countering tax avoidance by eliminating “*mismatches and loopholes between national systems, which companies currently can exploit to avoid taxation*”. The Commission suggests that the CCCTB would eliminate 70% of profit shifting for tax purposes. Another rationale given for CCCTB is to reduce the administrative burden as well as the compliance costs that companies face when dealing with 28 national tax systems, in particular the transfer pricing rules. The Commission has estimated that time spent on annual compliance could be cut by 8%, whilst the time taken to set up a subsidiary would decrease by up to 67%. The European proposal attempts a fair distribution between demand side factors in the form of 33.3% profits attributable for sales and 66.7% for manpower and assets, including those devoted to marketing.

5.6 Deemed Profit Method of China

79. China has a deemed profit method and deemed profit rates for different categories of business for taxing non-resident enterprises in the absence of accurate determination of taxable income on an actual profit basis.⁵⁶ There are three deemed profit methods which can be applied, for which formula to calculate taxable income has been prescribed -Total revenue

⁵⁴Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), IBFD

⁵⁵ EU COM (2015) 302 dated 17.6.2015

⁵⁶Guoshuifa [2010] No.19 (Circular 19), entitled the *Administrative Measures for the Collection of Corporate Income Tax on Non-Tax Resident Enterprises on a Deemed Basis*.

method, Cost plus method and Expenditure plus method. In cases where deemed profit methods are adopted, the profit rates ranges have been prescribed for different business sectors.

Table 2: China circular on Deemed Profit Method

Deemed profit method		
Deemed profit method	Applicable situation	Applicable formula to calculate taxable income
Total Revenue Method	Where the taxpayer can accurately calculate its revenue or the total revenue may be reasonably determined but the tax payer cannot accurately calculate its costs and expenses	Taxable income = total revenue x deemed profit rate
Cost Plus Method	Where the taxpayer can accurately calculate costs and expenses but cannot accurately calculate total revenue	Taxable income = total costs and expenses / (1-deemed profit rate) x deemed profit rate
Expenditure Plus Method	Where the taxpayer can accurately calculate its total expenditure but cannot accurately calculate its total revenue or costs	Taxable income = total expenses / (1-deemed profit rate - business tax rate) x deemed profit rate
Deemed profit rates		
Business		Deemed Profit Rate
Provision of engineering work, design and consulting services		15% - 30%
Provision of management services		30% - 50%
Provision of other services or business activities other than services		No less than 15%
If the tax authorities have evidence to support the case that a Non-TRE's actual profit rate is obviously higher than the above, a deemed profit rate higher than the high end of the range can be used to calculate the taxable income of the Non-TRE.		

80. The deemed profit method can be considered as an exercise where an enterprise is deemed to generate certain profits for the purpose of taxation and is taxed on them, either on the basis of revenue or on the basis of costs, depending on which can be more objectively determined. In practice, it seems likely that enterprises that are only selling in China and undertaking supply side activities elsewhere may be governed by the Total Revenue method, whereas enterprises that are primarily producing in China and selling their goods outside may be governed primarily on the Cost Plus method or the Expenditure Plus method. One significant

difference in this approach from the other approaches is that the deemed profits do not seem to be correlated with actual profits of the enterprise. It also seems that this deeming presumption in law is not subject to a factual rebuttal by the taxpayer claiming lower profits.

5.7 Committee's Observations

81. The Committee observes that there are three possible approaches for profit attribution— (i) the purely supply approach that allocates all business profits exclusively to the jurisdiction where factors of production are deployed and supply side activities are undertaken; (ii) the purely demand side approach that allocates all business profits exclusively to the jurisdiction where the consumer is located; and (iii) a mixed or a balanced approach that allocates profits between the jurisdiction where the consumers are located and the jurisdiction where factors or production are located and where supply side activities are undertaken. The analysis of international practices shows that among these the mixed approach is most commonly adopted, though there are also instances of purely demand approach, especially in certain US states. The purely supply side approach does not appear to be practiced within any of these countries.

82. The Committee also observes that the revision of Article 7 by OECD in 2010 amounted to a shift from a broader approach that permitted either of the three approaches followed under the domestic law of a Contracting State, to a purely supply approach, by seeking to determine profits exclusively with reference to functions, assets and risks, and thereby completely excluded the role of demand. This approach taken by the OECD is, however, not observed in international practices even among the OECD countries and regions, which either opt for a mixed approach or a purely demand approach.

Section 6

Views of Academicians & Experts on Profit Attribution

83. Differing views appear to exist among different experts on the issue of profit attribution. While some plainly take the OECD guidance for granted without putting it to any critical analysis, there are other experts and academicians who have been critical of the OECD approach of applying transfer pricing methods for profit attribution. Further, some highly renowned academicians and experts have endorsed the view that demand side factors, as represented by sales, are a valid basis for attribution of profits.

6.1 Views expressed by Prof. Klaus Vogel on Relevance of Sales

84. Klaus Vogel, who is considered an authority on international taxation, explains that sales are a valid basis for attributing profits. According to Vogel, it ***“cannot convincingly be denied that providing a market contributes to the sales income at least to same extent as providing the goods does. There is no valid objection, therefore, against a claim of the sale state to tax part of the sales income.”***⁵⁷ This view of Klaus Vogel is frequently quoted by various academicians and authors and does not appear to have been rebutted in literature. It indicates that profit attribution on the basis of sales (as practiced in US and proposed in EU) is accepted as justified.

85. Klaus Vogel in his 3rd edition book on Double Taxation Conventions again makes his stand clear by linking adoption of source principle to balance of trade, in the following words:

“If the flows of goods between the two countries involved-or rather, more accurately, the profits resulting from those flows -are balanced, the question of what principle should be applied when distributing taxation of profits is of relatively little significance and in such case adoption of the permanent establishment principle is recommendable because its practicable. But if the flows are in imbalance, the recipient State is justified in requiring to be allowed to participate in the taxation of the proceeds of the sales of the goods – in the same way as it participates where interest and royalties are involved. The same applies to services rendered by the enterprise.”⁵⁸

It may be mentioned here that the only objection of Dr. Vogel to this place of sale perspective is that it tends to adopt a taxation based on gross receipts.

⁵⁷Klaus Vogel, Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III), 16 Intertax 11, p. 401 (1988)

⁵⁸Klaus Vogel, Double Taxation Conventions, Third edition, p. 400(1998)

6.2 Views of Musgraves from Public Finance perspective

86. Peggy Musgrave, considered an authority in public finance worldwide, defines source entitlement as *“the notion that jurisdictions are entitled to tax the value added within their borders including that by non-resident factors, that is to share in the income accruing to non-resident factors and earned by them within the geographical area.”*⁵⁹ She gives two basic understandings of source that meet this definition and the two concepts form the core of her framework for expounding the relationship between separate accounting and formulary apportionment. The definitions for the concepts are *“The first is a supply approach which says that income has its source where the factor services which generate that income operate, a concept of value added origin. The second is a supply- demand approach which holds that market value is created through the interplay of supply and demand, by both blades of the Marshallian scissors.”* Peggy Musgrave argues that the pursuit of a supply-demand approach is a way to attain inter-nation equity.⁶⁰

87. Richard and Peggy Musgrave, have suggested taxation of “residual profits” (profits that are derived from the synergies created by units of the same multinational group of enterprises in different jurisdictions) in both the source as well as the resident country, and not in the resident country alone, on the ground of greater inter-nation equity. As pointed out by them and others, the principle of inter-nation equity demands “common source rules employing consistent methods of unitary combination and uniform formulary apportionment.”⁶¹

6.3 Views of Prof. Joseph Stiglitz & Other Contemporary Experts

88. **Prof Joseph Stiglitz**, a Nobel Laureate, who has also been the Economic Advisor to the US President and a Senior Advisor in World Bank, also endorses apportionment of profits on the basis of demand and supply side factors, as being preferable to the OECD approach of attributing profits on the basis of supply side factors (FAR) alone.

⁵⁹Peggy B. Musgrave, ‘Principles for Dividing the State Corporate Tax Base’, in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984)

⁶⁰ Peggy B. Musgrave, id., p. 234. With “Marshallian scissors”, she alludes to a quote by Alfred Marshall, *Principles of Economics: An Introductory Volume*, 8th ed. (1938) p. 348 (Book V, Chapter III, § 7): “We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production.”

⁶¹Musgrave, “Sovereignty, Entitlement, and Cooperation,” *Brooklyn Journal of International Law* ; Musgrave, “Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union,” in Sijbren Cossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (New York: Oxford University Press, 2000); and Nancy H. Kaufman, “Equity Considerations in International Taxation” (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1465-70 .

89. **Reuven S. Avi-Yonah**, of Michigan University, USA who has written several articles and is frequently cited and quoted by authors and academicians, has advocated that profits should be allocated on the basis of sales, property and manpower.⁶²In a recent paper, **Reuven S. Avi-Yonah and Zachee Pougá Tnhaga**⁶³ have argued that transfer pricing adjustments frequently lead to a residual profit that cannot be allocated under FAR based methods, because it results in cost savings that are inherent in the relationship of the group members to each other. They have also cited US case of Bausch and Lomb⁶⁴ to support their argument. They also argue that OECD's preferred method of applying the Profit Split Method (PSM) is to analyse the functions, assets and risks (FAR) of each member of the group. In the context of residual profits this method proves to be illusory because a functional analysis can only be applied to those functions that can be assigned to the group members', but residuals result from the relationship among the group members and hence cannot be captured by FAR.

90. **Prof Dr. Ulrich Schreiber**⁶⁵ from University of Mannheim opines that while MNCs can freely decide where to locate production, the decision where to serve their customers is far less flexible and hence profit attribution to sales location considerably reduces incentives to shift profits and investments to low -tax locations. He believes that decoupling of profits from investment locations and linking profits to points of sale will be a solution to the problem of tax competition and promote global tax neutrality.

91. Several authors, in particular those affiliated to **Tax Justice Network** have repeatedly and consistently advocated adoption of global formulary apportionment system for attributing profits on the basis of both demand and supply side factors. Stjepan Gadžo from University of Rijeka, Faculty of Law in his doctoral thesis on Nexus Requirements for Taxation for Non-Residents⁶⁶ has argued that strongest support for link of income source with the market state

⁶²Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*; Law & Economics Working Papers, 2009, University of Michigan Law School

⁶³Reuven S. Avi-Yonah, "Formulary Apportionment and International Tax Rules." In *Taxing Multinational Enterprises as Unitary Firms*, edited by S. Picciotto, 67-74. Brighton, UK: Institute of Development Studies, 2017.

⁶⁴ *Bausch & Lomb Inc. v. C.I.R.*, 933 F.2d 1084. B and L developed an unpatented technology that enabled it to manufacture contact lenses at a cost of \$2.50 per lens, when its competitors had costs of \$7.50 per lens. B and L contributed the knowhow to its Irish subsidiary, to enable it to manufacture the lenses. The question facing the US court was whether to accept B and L's view that the Comparable Uncontrolled Price (CUP) method should apply to determine the price charged by the Irish subsidiary to its parent for lenses based on a comparison with prices charged by independent lens manufacturers, despite the difference in production costs. The IRS argued that the residual profit from the know-how belonged to the US parent that developed it, but the court rejected that view because the residual profit inhered in the relationship between the parties. Had B and L Ireland been unrelated to its parent, the know-how would have been disclosed, the competitors would have used it, and the residual profit would have disappeared.

⁶⁵ U. Schreiber, *Sales-Based Apportionment of Profits*, 72 Bull. Intl. Taxn. 4/5 (2018), IBFD.

⁶⁶ Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (2018), IBFD

can be found in the “supply-demand approach” which takes into account the attributes of market and is based on the assumption that profits are generated through the interaction of supply and demand. He contends that jurisdictions in which consumers are located serve as a meaningful proxy in accordance with the doctrine of economic allegiance and revolutionary e-commerce developments indicate more active role of consumers on the supply side. Besides a number of authors have also raised several objections to the OECD approach and consider it theoretically as well as practically flawed. Kyle Pomerleau, Director of the US based non-profit organisation-Tax Foundation in his article in support of destination based tax system has written that fundamentally, corporate income taxes are prone to base erosion because they are levied on a base that is extremely hard to measure in today’s globalized world⁶⁷. He stresses on the fact that the location of production can be extremely difficult to figure out because in a globalised economy production processes stretch across numerous jurisdictions and include not only physical processes, but also intangible ones that are difficult to price. He gives the example of the production of the movie *Star Wars: The Force Awakens* to make his point. The movie used intellectual property (IP) located in the United States; actors from the United Kingdom and the United States; special effects developed in San Francisco, Singapore, London, and Vancouver; was shot in the UAE, the U.K., Iceland, and Ireland; and tickets for the movie were sold throughout the world. The question is: how much profit is to be attributed to each jurisdiction? If the traditional concept of the profit attribution to PE is applied in the above example, many countries may not get its share from the ticket sales even if the movie had record-breaking ticket sales in those countries. He advocates a destination based tax system because its base would be much easier to define than our current corporate tax base. Another key argument against the use of FAR for profit attribution in International tax literature is that it would be inappropriate for allocating business profits to PEs, particularly to PEs of highly integrated international enterprises since it does not reflect business reality, i.e. it does not recognize an international enterprise as an unitary business with a common profit motive⁶⁸. The rationale behind this is that the central feature of international enterprises is that they can achieve a higher net return by operating globally through PEs and associated enterprises (particularly subsidiaries) than through independent enterprises, because acting through PEs allows the internalization of costs and synergy in operations.

6.4 Committee’s Observations

92. The Committee observes that there is a wide acceptance among academicians and experts that demand side factors, as represented by sales can be a valid ground for

⁶⁷Kyle Pomerleau, “How destination based tax reduces tax-avoidance?” (2017) and is available at <https://taxfoundation.org/destination-based-tax-system-reduces-tax-avoidance>.

⁶⁸Kobetsky, Micheal. International Taxation of Permanent Establishments, Cambridge: Cambridge University Press 2011.

attribution of profits. On the question whether OECD approach for profit attribution (AOA) can be considered appropriate, there appear to be no agreement among experts and a number of international authors completely disagree with it, and have been critical of it. The Committee further notes that the OECD approach of revising Article 7 by adopting the purely supply approach of profit attribution and exclusion of sales as a contributing factor is neither supported by the views of renowned experts, nor has it been able to generate a theoretical basis that is supported by contemporary academicians and experts till date.

Section 7

Position of India on Inadequacies of Revised Article 7, AOA & FAR based Profit Attribution

7.1 The Benefit Principle of Taxation

93. 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 (including law and order, protection of property rights, enforcement of contracts, macroeconomic stabilization and public infrastructure) 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.

94. In case of a cross-border enterprise, where demand and supply are spread across two different jurisdictions, this virtuous cycle can be maintained only by a just and fair allocation of taxing rights to both states in a manner that does not lead to double tax burden. Tax paid in the jurisdiction where supply chain is located facilitate reduction of costs and make supply more efficient, whereas tax paid in the jurisdiction which contributes the demand would facilitate in promoting economic development there and consequential rise in demand, thereby leading to a virtuous cycle wherein all stakeholders continue to gain.

7.2 How Pure Supply Approach may Impact the Virtuous Cycle

95. In case of a cross-border enterprise, where demand and supply are spread across two different jurisdictions, if the taxing rights are restricted only to the country where the supply chain is located (as advocated by OECD approach), the market country would lose tax revenue, and will need to recover it from the local enterprises, thereby putting them at a tax disadvantage viz a viz the foreign enterprises. This would, on one hand, reduce their competitiveness and adversely impact them, and on the other hand, adversely impact the economic development of the country, thereby precipitating a downward spiral of economy, which in turn will also reduce the demand and thereby adversely impacts the profits of the foreign enterprises in the long run. This 'vicious cycle' will thus adversely impact all stakeholders including the foreign enterprises, and hence cannot be considered sustainable. As is apparent, for the sustenance of global economy and trade, it is essential that taxing rights are fairly

attributed on the basis of both demand and supply, and not restricted to the supply side alone as is advocated in AOA.

96. There are at least two significant reasons why AOA is detrimental to the interests of developing countries which also happen to be capital importing countries. First, the AOA is a pure supply approach that does not take into account the contribution of demand side factors to profits of the enterprise and instead allocates all such profits as residual profits to the head office, thereby artificially reducing the profits taxable in the developing countries, where the market and consumers are located. The second is the manner of recognition of intra-enterprise dealings specifically the deductions for notional payments between the PE and head office, in contrast to the approach in UN model tax convention, which disallows deductions for amounts “paid otherwise than towards reimbursement of actual expenses” by the PE to its head office. These factors reduce the profit attributable to the PE in a source jurisdiction under the AOA. There is a view among academicians that adoption of AOA leads to erosion of the tax base of developing countries which are mainly capital importing⁶⁹.

7.3 India’s Position of Revised Article 7 & AOA

97. The above discussion validates India’s position of not accepting the revised Article 7 in the OECD Model Tax Convention and the AOA providing guidance for its application. Apart from the fact that the OECD approach lacks sufficient theoretical justification and appears to be based on an unjustified arbitrary change of a well settled approach, it is also highly detrimental to the interests of developing countries (source countries), and hence, has not been accepted.

98. India has a consistent policy of adopting Article 7 on profit attribution in its tax treaties on the basis of the UN Model, which provides for balanced rights for source based taxation. India had made reservations against the pre-2010 Article 7 of OECD Model Tax Convention regarding the deduction of expenses only in accordance with its domestic laws, which have been documented in OECD Model in the section on ‘Positions of Non-OECD Economies’ since 2008.

99. India has made even stronger reservations against the revised Article 7, which have also been documented in the same section since 2010, as under:

*1.1 India reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update, subject to its positions on that previous version (see annex below). **It does not agree with the approach to the attribution of profits to permanent establishments in general that is reflected in the revised Article, in its Commentary and in***

⁶⁹ C. Gutiérrez Puente, Chapter 12: The UN Model and the BRICS Countries – Another View in Taxation of Business Profits in the 21st Century: Selected Issues under Tax Treaties – Essays in commemoration of IBFD’s 75th anniversary written by tax research staff of IBFD (C. Gutierrez Puente & A. Perdelwitz eds., IBFD 2013)

the consequential changes to the Commentary on other Articles (i.e. paragraph 21 of the Commentary on Article 8, paragraphs 32.1 and 32.2 of the Commentary on Article 10, paragraphs 25.1 and 25.2 of the Commentary on Article 11, paragraphs 21.1 and 21.2 of the Commentary on Article 12, paragraphs 27.1 and 27.2 of the Commentary on Article 13, paragraph 7.2 of the Commentary on Article 15, paragraphs 5.1 and 5.2 of the Commentary on Article 21, paragraphs 3.1 and 3.2 of the Commentary on Article 22 and subparagraph 40 a) of the Commentary on Article 24). (emphasis added)

100. In addition to India, several other countries, including some developed countries have also made reservations against this provision. The revised Article 7 of OECD Model Tax Convention has not been adopted by India in any of its treaties till date. Thus, India has consistently rejected the approach proposed by OECD in revised Article 7 of its 2010 update and its subsequent updates. As AOA is only a guidance on the application of this provision, it also stands rejected by India and other countries by their rejection of the revised Article.

101. The formulation of the OECD Model Tax Convention on Income and on Capital and its Commentaries has to be placed in the background of the preamble and provisions of Articles 1 and 2 of the OECD Convention 1960⁷⁰. The OECD model tax convention and its Commentaries have to be understood as instruments which are designed to promote the 'highest' economic growth and employment in member countries. The Article 1 of the Convention on OECD (1960) unequivocally formulates the main aim of the OECD as being promotion of policies designed to "achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries"⁷¹. Thus, applying Article 31 of Vienna Convention on the Law of Treaties (VCLT)⁷² ('ordinary meaning') to Article 1 of the Convention, it is apparent that the interests of member countries take precedence over the interests of non member countries in OECD decisions.

⁷⁰The Organisation for Economic Co-operation and Development (OECD) was formed in 1960 by way of a 'Convention on the Organisation for Economic Co-operation and Development'. This Convention entered into force in 1961 after being signed by twenty states in 1960.

⁷¹ Article 1 of OECD Convention 1960 is as under:

Article 1

The aims of the Organisation for Economic Co-operation and Development (hereinafter called the "Organisation") shall be to promote policies designed:

- (a) to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;*
- (b) to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and*
- (c) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.*

⁷²The VCLT is a treaty concerning the international law on treaties between states. It was adopted on 23 May 1969 and opened for signature on 23 May 1969. The Convention entered into force on 27 January 1980. India is not a signatory to this Convention.

102. During the follow-up work on Action 7, it was attempted to prepare guidance on profits to be attributable to PEs that are likely to come into existence due to the changes in Article 5 recommended by the Final Report on BEPS Action 7 on Preventing Artificial Avoidance of PE Status. The guidance developed by OECD on the basis of revised Article 7 and the AOA was explicitly rejected by India and several other countries on the ground that such guidance can become applicable only where the revised Article 7 of the OECD model tax convention has been incorporated in a particular tax treaty and cannot possibly have any implication for treaties that have not included such a provision. As the treaty application is governed by its provisions and not by the provisions in the model tax convention or guidance on their application, it is not possible to take a different view. The difference in approach of attribution of profits to a PE for the purpose of Article 7 has been recognized by March 2018 OECD report '*Additional Guidance on the Attribution of Profits to Permanent Establishments*' wherein it has been noted that tax treaties containing a version of Article 7 that does not require the use of the AOA may attribute profit using customary apportionment⁷³.

103. During the follow up work on Action 7 Report, the views and positions of India were communicated to the OECD, to clearly explain the position of India. These comments of India are summarized in following paragraphs.

103.1 It has been pointed out by India in its comments that profitability of an enterprise depends primarily upon the price of the good that it can obtain in a market, the quantity of goods it can sell, and the costs at which it can supply those goods. The difference between the "sales amount" and the "costs" creates the profits for the enterprise. The "price" and the "quantity of sales" result from an interaction between the demand for goods and supply of goods, as reflected in the simple demand-supply curve. The demand and the supply are, in turn, determined by particular factors.

103.2 Profits of an enterprise can be understood as the difference between the sales revenue and the cost of supply, and can be expressed as "*Profits = Quantity of items sold X (Price – Cost)*". Among the variables apparent from this equation that affect profits, 'costs' are completely dependent on supply side factors, but 'price' and 'quantity of sales' result from the

⁷³ Para 45 of the Report states that "*It should be noted that many tax treaties contain a version of Article 7 that does not require the use of the AOA. In cases governed by those treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might differ significantly from the AOA. This might be a function of the interrelation between the treaty and the domestic law of the jurisdiction where the PE is located (e.g., if the treaty expressly permitted the use of a customary domestic law apportionment approach, and domestic law contained such an approach). In other cases, the treaty might expressly prohibit the recognition of notional dealings between the PE and the non-resident enterprise of which it is a part (e.g., treaties with a version of Article 7 based on the United Nations Model Double Taxation Convention between Developed and Developing Countries). Therefore, the examples below should not be understood as representing the only appropriate approach to attributing profits to a PE*"

interaction of demand and supply, which is classically represented by the Demand Supply curves in the partial equilibrium model that is universally accepted as a part and parcel of the basic economic theory and remains the underlying basis of all economic analyses. Thus, profitability of an enterprise is dependent upon and contributed by both supply and demand side factors.

103.3 FAR Analysis applied for determination of Arm Length Price (ALP) can be appropriate for Transfer Pricing (TP), because TP is aimed at estimating an acceptable price for the intermediate good that is transferred across tax jurisdictions within an integrated supply chain. Consumer demand becomes a given variable when the issue at hand is limited to apportioning value addition among different parts of the supply chain.⁷⁴ However, for the purpose of profit attribution, application of FAR ends up apportioning all profits to the contribution from supply side only without taking into account the contribution of demand side factors to profits, and hence cannot be used for attribution of profits. It may be observed that developed countries, being exporters of capital and technology are likely to benefit by the adoption of FAR for profit attribution, and hence may prefer that approach.

103.4 The actual demand for goods, or the 'willingness to pay for a good', is directly dependent on the 'ability to pay' of the consumers. Higher disposable income leads to a higher 'willingness to pay' and, thereby, augments the market price as well as quantity of sales. The 'ability to pay' or the 'disposable income' of the consumers, in turn, is dependent exclusively upon local factors, such as, the state of the economy, efficiency of local markets, public goods and infrastructure, direct or indirect subsidy financed with public resources and other measures that strengthen that economy.

103.5 The disposable income and the factors determining it are completely independent from the marketing efforts of the supplier and constitute significant 'demand side factors' that contribute to the profits of an enterprise undertaking business therein. These demand side factors are completely independent from the supply side factors (such as functions performed, assets deployed or risks taken by enterprises in a supply chain). This contribution is also independent from marketing functions, which only modify preferences without contributing in any way to the disposable income or the ability of consumers to pay for the goods. Thus, the

⁷⁴In a Transfer Pricing, profits as well as the consumer demand contributing to it are assumed as given since the issue at hand is limited to apportioning value addition among different parts of the supply chain. In such an exercise, the profits and demand can be assumed to be static under a ceteris paribus assumption required for the limited purpose of dividing value addition within the different parts of the supply chain. However, in an exercise aimed at attribution of profits, profit is a variable, as are the factors contributing to it like demand and supply. Thus, relying exclusively on FAR in an exercise for the purpose of profit attribution changes this underlying assumption of a given demand under the ceteris paribus assumption to a radical presumption that demand is not relevant for generation of profits. Given the fact that profit is a difference between price and cost and price depends upon demand, a presumption that demand is not relevant for profits would be little more than an absurdity.

contribution of demand side factors is completely independent from the contribution of supply side factors like functions and activities of the enterprise. Under the AOA approach, this contribution of demand does not get recognized in the FAR analysis, leading to an underestimation of the profits attributable to the PE in the market jurisdiction.

104. These views of India regarding the inadequacy of TP oriented FAR analysis to accurately attribute profits to the PE in the market jurisdiction have been conveyed to other countries. India has also conveyed its view that the process of attribution of profits by using FAR analysis, developed as an exercise for determination of 'value' generated within the supply chain, leads to negation of the role of 'demand side factors' in the profitability of an enterprise, and hence cannot be considered appropriate, since the tax base in income tax or corporate tax is not value addition, but business profits, which depend on both price and cost, and thereby depend on both demand and supply and not supply alone.

105. This position of India on contribution of demand side factors to business profits have also been conveyed to the OECD during the work on Action 1 of BEPS to address the broader tax challenges of digital economy, and formed an important basis on which further work to tax digital economy on the basis of alternate criteria such as significant economic presence, final withholding tax or equalization levy is being undertaken. The views of India and other countries regarding the importance of demand and supply have been documented in the Note 1 to Chapter 2, 'Digitalisation, business models and value creation' of the OECD Report '*Tax Challenges Arising from Digitalisation-Interim Report 2018*'⁷⁵.

7.4 Other Relevant Issues

106. Another issue documented in the literature, which is not compatible with the AOA, is that of "synergy rents". These synergy rents can be considered as excessive profits that are derived from the 'comparative advantage' of different economies and are generated by coordination among different entities of a multinational enterprise (MNE) group spread over different jurisdictions. Synergy rents are considered one of the primary incentives for creation and existence of MNEs, and if a PE is to be considered as separate and distinct entity, it is to be expected that such an independent entity will seek a share in additional profits or synergy rents. Synergy rents are not captured in the FAR analysis, which erroneously assigns all residual

⁷⁵ "Among the different views, some countries specifically consider that corporate profits represent the excess of sales revenue (price multiplied by quantum of sales) over the costs of their supply and are a function of both demand and supply. Therefore, according to these countries, value created within the supply chain, representing the contribution of supply side, must be taken into account with the contribution of the demand for determining corporate profits attributable in a tax jurisdiction."

profits⁷⁶ to the resident country where MNE is situated, and thereby denies the market jurisdiction their fair share of taxes on those profits.

107. In the context of taxation of digital economy, there is a discussion going on that these residual profits can be allocated to reward the user created value to solve the problem of profit allocation to user jurisdictions. In its March 2018 position paper on taxation of digital economy⁷⁷, the UK Government has taken the position that active user participation creates value for certain digital businesses, and that jurisdictions in which users are located should be entitled to tax a proportion of those businesses' profits. The UK Government's view is that it is most likely that the value highly digitalised businesses derive from user participation sits with companies in the corporate group that receive residual profits of the business and to reflect this value 'some reallocation of the profits currently recorded by these companies to user jurisdictions is justified'. Some commentators have suggested 'applying arm's-length methods to allocate a routine return to tangible property, while allocating the residual profit to reflect the value of intangibles in excess of routine goodwill and going concern value'⁷⁸. However, the current AOA does not allow this and so if residual profit is to be allocated then modified profit split method will have to be applied. This shows that AOA denies market jurisdiction their fair share of profits.

108. The OECD approach of seeking profit attribution on the basis of FAR, usually by resorting to the analysis of comparable, also does not appear to be fully in accordance with the basic economic theory, which accepts the existence of an '*arms length price*' but does not accept the existence of an '*arms length profit*'. This is because, in economic theory, a competitive market is likely to witness one single price for a particular economic good but provides no conceptualization for similar profits of different competing enterprises in that market. On the contrary, the economic theory accepts that differences will exist between profitability of different enterprises participating in the same market, and explains it by the differences in the levels of their efficiency, with more efficient enterprises likely to be more profitable and less efficient enterprises expected to be less profitable, which then gradually exit the market. Thus, the OECD proposal for computing profits on the basis of comparable profits of other enterprises is also not in accordance with basic economic theory. Hence, while FAR analysis for estimating Arm's length price of a good or service can be considered to be somewhat in accordance with

⁷⁶ Profits after an arm's length rate of return.

⁷⁷HM Treasury 2018, Corporate tax and the digital economy: position paper update available at <https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper>.

⁷⁸ Australian Government Treasury Discussion Paper 2018, The Digital economy and Australia's corporate tax system, M Herzfeld 2018, 'News Analysis: Digital Optimism', *Tax Analysts*, 16 July 2018, p 5, referring to P Oosterhuis and A Parsons, 'Destination-Based Income Taxation: Neither Principled Nor Practical?', *Tax Law Review* (forthcoming).

the economic theory, its application for determination of profits does not appear to be based on any logical economic principle.

7.5 Committee's Observations

109. The Committee observes that the AOA approach restricts the taxing rights of the jurisdiction that contributes to business profits by facilitating demand, and thereby has the potential to break the virtuous cycle of taxation that benefits all stakeholders in the global economy. Instead, it can set a vicious cycle in place that is destined to lead to losses for all stakeholders. Thus, while AOA approach may be favorable to the interests of certain countries that are net exporters of capital and technology, it is likely to have a very significant adverse impact on all other stakeholders, especially the developing economies like India, which are primarily importers of capital and technology.

110. The Committee also observes that India has documented its disagreement with the revised Article 7 by not only reserving its right not to include it in its tax treaties, but also documented the rejection of the approach inherent in it. Further, India has consistently communicated and shared its view that since business profits are dependent on sale revenue and costs, and since sale revenue depends on both demand and supply, it is not appropriate to attribute profits exclusively on the basis of function, assets and risks (FAR) alone. Lastly, since the revised Article 7 recommended by OECD since 2010 onwards has not been incorporated in any of the Indian tax treaties, the question of applying AOA for attribution of profits does not arise.

111. The Committee takes into account the fact that the additional guidance issued by OECD with reference to AOA in respect of the changes in Article 5 introduced by the Action 7 of the BEPS project on Artificial Avoidance of Profit Attribution, cannot apply to Indian tax treaties, since they do not incorporate the revised Article 7 of OECD model tax convention in respect of which AOA has been developed as a guidance. Though this position of India has been clearly communicated to the OECD, the Committee considers that there may be a need for bringing further clarity on how the profits will be attributed to the PEs under the Indian tax treaties, especially in consequence to the changes introduced as a result of Action 7.

Section 8

Court Decisions on Profit Attribution

8.1 Approach of Courts: An Overview

112. The courts have adopted or approved different methods of attributing profits to PE, which range from relying on ad-hoc methods, formulary apportionment methods, activity performed basis and, in some cases, used the function, asset and risk approach. The courts have generally held that attribution of profits is an exercise that would depend upon the peculiar facts and circumstances of the case and should not be arbitrary but should be on a fair, equitable and on a rational basis. The Courts have also held that any finding on the question of profit attribution will involve some guesswork and the endeavour can only be to approximate and there cannot be great precision and exactness. The profit attribution has ranged from 0% in the case of SET Satellite to 75% in the case of Ansaldo Energia SPA involving EPC contract. Some of the cases are discussed for illustrative purposes to highlight the different approaches adopted under different cases.

8.2 Earliest Case laws prior to Pre-Independence Era

113. One of the earliest decision of the Supreme Court related to profit attribution was in the case of **Anglo French Textile Company Limited v. CIT [23 ITR 101 (SC)]** dating to the year 1952. It was a non-resident company manufacturing textile in India and as part of its business, bought cotton from, and sold textiles in British India (being the taxable territory) and partly outside British India. The entire profits from outside of British India were being received in British India. The issue before the court was whether income received in British India could be said to wholly arise in India and whether allocation based on business operation was required. On the issue of profit attribution, the Supreme Court stated that *“there should be allocation of income between various business operations of the assessee demarcating the income arising in the taxable territories (British India) in the particular year from the income arising without the taxable territories in that year”*. Accordingly, the figure of 10 % on British Indian sales was considered reasonable for attribution of profits on the basis of extent of operations carried out in British India.

114. Similar view was upheld by the Apex court in **Hukum Chand Mills Limited v. CIT [103 ITR 548 (SC)]** where company manufactured textiles in its mills at Indore outside British India and sold its goods to merchants in British India. The sales were made through brokers and agents in British India. On the basis of the facts of the case, 15 per cent allocation was considered reasonable for the operations relating to contracts undertaken in British India and for this emphasis was laid on then rule 33 of the Income Tax Rules, 1922 which was similar to

rule 10 of the Rules. Excerpts from the judgment stated, “The question as to what proportion of the profits of the sales arose or accrued in British India is essentially one of fact depending upon the circumstances of the case. In the absence of some statutory or other fixed formula, any finding on the question of proportion involves some element of guess work. The endeavour can only be to be approximate and there cannot in the very nature of things be great precision and exactness in the matter.”

8.3 Specific Case Laws: Profit Attribution to PE

115. In ***DDIT v. Nipro Asia Pte Ltd [TS-66-ITAT-2017(DEL)]*** the non-resident was a company incorporated in Singapore operating with a Branch Office in India. The Delhi Bench of the Tribunal held that the Assessing Officer correctly sought to apply rule 10 of the Rules for purposes of determining the profits attributable to a branch in respect of the marketing activities related to direct sales made by the head office, without a “correct” transfer pricing study report. The tribunal found 30% of the profits were attributable to the branch for its marketing activities in India and computed the profit rate as 10% of sales and profits attributable as 3% (i.e., 30% of 10%) on the total amount of sales made by the taxpayer whether made directly or through a branch in India.

116. In ***Nortel Networks India International Inc. [TS-355-ITAT-2014(DEL)]*** the Tribunal held the non-resident entity having a fixed PE and a DAPE as the hardware supplied by the non-resident was installed by the Indian subsidiary and contracts were pre-negotiated by it. The Tribunal upheld the profit attribution of 50% of profits of activities of the PE in India by applying rule 10 in view of the non-availability of India centric accounts.

117. In ***GE Energy Parts Inc. Vs ADIT [TS-34-ITAT-2017(DEL)]*** the Tribunal upheld AO’s calculation for determination of total profit from the sales made by GE overseas entities in India at 10% of sales applying rule 10(iii). For marketing activities, it restricted attribution to 26% as against 35% considered by AO. The Delhi High Court has also upheld the findings and the approach of the Tribunal regarding the attributability of income.

118. In the case of ***ZTE Corporation vs ADIT [(2016) 159 ITD 696 (Del)]*** the Tribunal held that almost entire sales function, including marketing, banking, after sales, were carried out by the PE in India and therefore 35% of the net global profits as per published accounts are attributable to the PE in India in respect of the hardware and software supplied to Indian customers. The Tribunal observed that for attribution of profits to PE, the most important aspect is the level of PE’s participation in the economic life of source country and it is primarily nexus between source country and the PE’s activities which produce the taxable income.

119. In the recent case of ***Daikin Industries Ltd [TS-274-ITAT-2018(Del)]*** the Delhi ITAT ruled that its wholly owned Indian subsidiary Daikin Air-conditioning India Pvt. Ltd (DAIPL) constitutes dependent agent PE (DAPE) for AY 2006-07. It held that the entire activities of identifying customers, negotiating and finalizing prices with customers in India etc. were done by DAIPL not only for the products sold as distributor, but also for direct sales in India by the non-resident. The Tribunal also noted that ratio decidendi of Morgan Stanley ruling would not apply as the case falls within the exception laid down by SC (i.e. if TP-analysis does not adequately reflect FAR of the enterprise, there would be a need to attribute profits to the PE for those functions/risks not considered). On attribution of profits to PE, ITAT applied rule 10 and in the absence of data relating to global profit of the India specific operations held 10% net profit rate as reasonable and held the net profit attributable to the marketing activities in India at 30% of the net profit so determined at 10% of sales in India. It also directed that the profit on the commission received by DAIPL should be reduced from the profit attributed to the DAPE.

120. In ***Galileo International Inc Vs. DCIT [(2011) 336 ITR 264 (DELHI)]***, the non-resident was in the business of computerized reservation system (CRS). Galileo US appointed unrelated distributor to market and distribute CRS to travel agents in India. The Tribunal held that Galileo US has a fixed place PE in India as the source of revenue is partially existent in the computer installed by Galileo US through its agents at Travel Agent's premises and the unrelated Distributor is functionally & financially dependent on Galileo US and hence there an agency PE. The Tribunal held that 15% of revenue accruing to Galileo in respect of bookings made in India was income accruing/arising in India and further, Galileo US may deduct remuneration paid to distributors. The same attribution ratio was followed in the cases of Amadeus Global Travel Distribution SA and Abacus International Pvt. Ltd, Singapore. It was held that though no guidelines were available as to how much should be income reasonably attributable to the operations carried out in India, the same had to be determined on the factual situation prevailing in each case and for that one has to look into the factors like functions performed, assets owned and risk undertaken by the PE in India vis-a-vis the taxpayer.

121. In ***CIT v Hyundai Heavy Industries Co Ltd [(2007) 291 ITR 482 (SC)]*** the apex court held that revenue and costs attributable to the installation activities of a PE in India have to be determined based on generally acceptable principles of accountancy. In this case the PE did not maintain books of accounts; and the foreign enterprise itself pleaded during assessment that Section 44BB of the IT Act read with CBDT Instruction 1767 should be applied while determining profits of PE, Therefore, Court held that the profit attributable to installation, commissioning activities etc. carried out by the PE in India was held to be 10% of the gross receipts on account of such activities in India (based on Section 44BB).

122. In ***Mannesman Demag Sack AG v ACIT [(2008) 119 TTJ 543 (Del)]*** the non-resident enterprise entered into a contract with an Indian company for supply of equipment, supply of designs and supervision of erection, commissioning and performance testing of the plant. The non-resident enterprise had a “supervisory PE” in India and the Tribunal held that the supervisory staff of the PE may have helped in the implementation of the designs and made use of them for effective installation and commissioning of the plant. It estimated 10% of the total receipts from designs as profits attributable to the “supervisory PE”.

123. In the case of ***Credit Lyonnais v ADIT [TS-523-ITAT-2013(Mum)]*** the Indian Branch of a foreign bank provided services to its foreign branches in relation to the credit analysis, capacity to repay loan and risk analysis of prospective borrowers. The AO determined the profits attributable to the Indian Branch as 25% of the total amount of interest, commitment fees and arranger fees received by the Foreign Branches. The Tribunal held that the interest earned by the foreign branches could not be attributed to the Indian Branch because the loan was provided by the foreign branches and the Indian Branch did not contribute to the loan and upheld the CIT (A)’s estimation of Indian Branch’s profit attribution at 20% but restricted it to only the fees charged by the foreign branches from their customers.

124. In ***Rolls Royce PLC Vs. DIT International taxation [339 ITR 147 (Del)]***, the Tribunal attributed profits on the basis of where the activity had taken place.

- Manufacturing operations for the offshore equipments supplied to Indian customers were undertaken outside India and 50 percent of the profits were attributed to the territory in which such operations were carried out (i.e in UK).
- Further, 15 percent of the profits were attributable to research and development activities undertaken outside India.
- Balance 35 percent of the profits were attributable to marketing and selling activities undertaken by Indian subsidiary.

The Delhi High Court approved 35% profits attributable to PE on account of marketing activities in India by the Tribunal. It also approved the reasoning given by the Tribunal that the profit attributed to manufacturing activity and R&D activities i. e. 50 per cent and 15 per cent respectively which were carried out outside India were not to be taxed in India.

125. In ***Linmark International (Hong Kong) Ltd v DDIT (2011) [TS-5853-ITAT-2010(DELHI)-O]*** the non-resident was a company incorporated in and a resident of Hong Kong and under service agreement with Linmark Development (BVI) Ltd. (BVI Co), a company incorporated in the British Virgin Islands was engaged to provide facilitation services in connection with buying of goods from various countries in Asia. It had set up LOs in India which acted as a coordinating agency. BVI Co received commission from its buyers, calculated on a fixed percentage of the value of the goods exported to its clients outside India; typically, in the range of 5-6% for its

services and the taxpayer was remunerated at 1% of the value of the goods. As a result of the information gathered during survey it was established that the BVI Co was a non-functional entity and did not play any role in the goods sourced from India as the employees of the Taxpayer directly corresponded with the customers and vendors. Furthermore, the Indian operations performed by the LOs in India had the effect that all business transactions, except formation of contracts, and was hence liable to be taxed in India. The AO attributed 90% of the commission earned by BVI Co to the LO for the purpose. On appeal the CIT (A) was of the view that significant functions in the procurement supply chain and related risks should be allocated to the Indian operations and the income attributable to India was determined at 72% of the commission earned by BVI Co. The Tribunal after examining the facts held that notwithstanding the nomenclature of a 'liaison office', the offices in India are carrying out real and substantive business operations of the taxpayer and, therefore, income accrues or arises in India and 50% of the commission of BVI Co was attributed to the Indian operations.

126. In the case of ***eFunds Corporation v ADIT [(2010) 42 SOT 165 (Del)]*** the Tribunal attributed profit of the US entity using a formula. In this case, the non-resident company entered into contracts with their clients for providing certain IT enabled services and then assigned or sub-contracted the same to eFunds India for execution. The Department had held the non-resident having a PE in India. In the facts of the case, the Delhi High Court and Supreme Court held that eFunds India did not form the PE of eFunds USA. However, the Delhi High Court endorsed the method of Tribunal for working out profit attributable to the PE which was:

- Step 1 Determine Proportion of assets of IA to global assets
- Step 2 Aggregate "global profits of foreign entity
- Step 3 Determine Profits attributable to India by applying the "proportion" in Step 1 to "global profits" in Step 2
- Step 4 Profits attributable to PE = Profits Determined in Step 3 (-) Profits of Independent Agent

127. In ***Convergys Customer Management Group Inc v ADIT [2013-TII-88-ITAT-DEL-INTL]*** the non-resident was engaged in the business of providing Information Technology (IT) enabled customer management services to its clients outside India. The AO held that CCMG had a PE in India in various forms viz-a-viz a fixed place PE, a service PE and a dependent agent PE and the Tribunal upheld the contentions of the AO and held that CISPL constituted CMG's PE. The AO had adopted headcount as basis for allocating revenue and expenses. The Tribunal rejected the approach and used customer revenue as a base to which the global operating income percentage was applied.

- Step 1- Compute global operating income/profit percentage of a particular line of business as per annual report of the US Co
- Step 2- This percentage should be applied to the end customer revenues with regard to the contracts/projects where services are procured from Ind co. The amount arrived at is the operating income/profits from the Indian operations
- Step 3- Operating income/profits from the Indian operations is to be reduced by the profit before tax of Indian Co. This residual profit which represents income of the taxpayer is to be apportioned between Head Office and PE of the taxpayer
- Step 4- Profit attributable to PE should be estimated on residual basis
- The residual profits were attributed to PE at the rate of 15%

128. In Formula ***One World Championship Limited (FOWC) case [394 ITR 80 (SC)]***, the Supreme Court held FOWC as having a fixed place PE in respect of the Grand Prix Motor Racing Event conducted at Buddha International Circuit (BIC) - owned by Jaypee - in India. It also held that Jaypee was under an obligation to withhold taxes on payments made to FOWC which was chargeable to tax in India on account of the existence of the PE and referred the matter to assessing officer (AO) to ascertain profit attribution based on the facts. The AO in the absence of any India centric accounts and other information from the FOWC, used rule 10 in the draft assessment order to calculate profit taxable in India by dividing the global operating profit in the year with the number of races carried out during the year. The taxpayer filed the objections against the draft order before the DRP. The DRP after examining the facts, used the profit contribution analysis consisting of nine factors of strategic vision and effective leadership, long term relationship to ensure participation, negotiation and contracting, race day liaison activities and accreditation management, brand management, R&D activities, legal and regulatory, logistics management and business support to calculate the Indian profit attribution. Weightage as given by the taxpayer was given to each factor and then the contribution of India PE in each factor was calculated. As a result of this exercise the profit contribution of the Indian PE was calculated to be 56% which was accepted by the taxpayer. For calculating the profit from India, the global profit ratio was applied to India centric revenue from the event which was calculated as sum of fee from Race Promotion Contract and total broadcasting revenue divided by number of races.

129. In case of ***DIT (Int taxation) v Morgan Stanley and Co. Inc. [(2007)292 ITR 416 (SC)]*** the Apex court held that for profit attribution no generalization possible. There is need to depend upon functional and factual analysis and the data placed by taxpayer to be examined in each case. It also held that in the context of a Service PE that payments of ALP extinguishes any further attribution of profits to H.O. if arm's length analysis is exhaustive of functions, assets and risks. In this case no further attribution was done beyond the ALP calculated.

130. In the case of ***Rolls Royce Singapore Vs. ADIT, [(2011) 202 Taxman 45 (Delhi)]*** the non-resident company rendered repair and maintenance services and supplied spares to customers in India. While the income from repairs was offered to tax as FTS, the income from *supply of spares* was claimed to be not taxable on the ground that it had accrued outside India. The AO, CIT(A) and Tribunal took the view that the non-resident had DAPE in India and income earned from supplying spare parts was taxable in India. The AO held that 25% of the profits on sales of spare parts were chargeable to tax which was reduced to 10% by the CIT (A) & the Tribunal. The attribution of 10% was upheld by the Delhi High Court. The High Court observed that If all the risk taking functions of the enterprise have not been taken into account, there would be a need to attribute profits to the PE for those functions/risks of the dependent agent that have not been considered.

131. In ***Hyundai Rotem Company vs ADIT [TS-612-ITAT-2012(Delhi)]***, a project office of Hyundai Rotem Company (Korea) provided liaisoning, coordination and administrative support services to its head office on a cost plus basis. The AO did not accept the cost plus methodology and instead determined the income attributable on the basis of rule 10 provided in the rules. The CIT (A) upheld the approach adopted by AO. On appeal before the Tribunal, it was held that rule 10 was to be applied in cases where the income of the PE could not be ascertained, and this was to be demonstrated by the AO before proceeding with rule 10. In cases where the TP Study already existed, it was warranted to first reject the TP Study on sufficient and reasonable grounds before computing attribution as per rule 10.

132. In the case of ***Arrow Electronics India Limited [TS-142-2017 (Bangalore ITAT)]*** the Tribunal upheld the profit attribution done by the AO to the Indian operations at 40%. The Tribunal upheld a sectoral weightage at 50:25:25 for functions performed, assets employed and risks involved; 10:90 towards assets and risks in the intra-sectoral ratio pertaining to LO and HO; and the final quantification of profits attributable to the LO and the HO at 40:60. In this case, Arrow Asia Pac Ltd., Hong Kong had set up a company in Singapore, Arrow Electronics India Limited. This Singapore based company had opened a liaison office in Bangalore after obtaining relevant approvals from the RBI. However, Arrow Group, in December 2002 incorporated a fully owned subsidiary in the name of M/S Arrow Electronics India Private Limited. The LO was established to be the Indian PE.

8.4 Committee's Observations

133. The Committee observes from the above discussion that the Courts have repeatedly endorsed the right of the Assessing Officer 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 also observes that in

several of these cases, the Courts have also upheld the right of India to attribute profits by apportionment, as permissible under Indian tax treaties.

134. The Committee notes with concern that very diverse methodologies seem to have been adopted in different cases in attributing profits to the PEs. In the view of the Committee, this may be a result of the wide scope of discretion accorded under rule 10 in terms of methodology for attribution of profits. Since lack of a universal rule can create uncertainties for taxpayers as well as result in more tax disputes, there appears to be a case for providing a simple and universally applicable rule to bring in greater certainty and predictability among the stakeholders and prevent avoidable tax litigation on this account.

Section 9

Need for Clarity in India's Approach on PE Attribution: Various Options for a More Specific Rules

9.1 Need for Greater Clarity and Objectivity

135. India's position in disagreeing with the revised Article 7, AOA and attribution of profits has been documented very clearly ever since the inception of this revision. The reasons for India's disagreement have also been consistently communicated and shared with other countries, as well as during the BEPS project and the follow up work on Action 7. Thus, India's position in this regard is very clear. Further, since India has not included the revised Article 7 in any of its tax treaties, there cannot possibly be any doubts on the fact that Indian tax treaties allow attribution of profits in a way that is different from the AOA, by resorting to the direct accounting method under Article 7 (2) and where that may not be possible, by apportionment of profits, as permitted under Article 7 (4) of the tax treaties.

136. However, since a wide scope of methodology is available for apportionment of profits under rule 10, there seems to be a lack of uniformity in the approaches adopted by Assessing Officers, with the consequently wide diversity in the methods that have been finalized by appellate authorities in different cases. As a result, there appears to be lack of a simple and uniform rule of profit attribution that can bring greater certainty and predictability for the taxpayers and reduce tax litigation on this account.

137. At times, guidance has also been sought by stakeholders explaining how the Indian position will be applied in case of different taxpayers in regard to profit attribution. It has also been felt that the guidance for profit attribution to PE under Indian domestic laws is not sufficiently detailed to provide tax certainty and predictability for the taxpayers. The demand for such clarity and objectivity has risen since the follow-up work in respect of profit attribution undertaken by OECD consequent to the Action 7 of BEPS project and rejection of OECD guidance by India. This is on account of the fact that AOA cannot possibly apply in Indian tax treaties since the revised Article 7 for which guidance has been developed under AOA does not even exist in Indian tax treaties, a position which is also noted by OECD paragraph 45 of its March 2018 report on profit attribution⁷⁹

138. While the Indian position on OECD guidance is fully justified and has not been objected upon, the issue of greater clarity and objectivity on profit attribution methodology under Indian tax treaties, including in respect of the changes introduced in Article 5 under Action 7 of BEPS

⁷⁹ Additional Guidance on Attribution of Profits to Permanent Establishments, BEPS Action 7 (OECD 2018)

project, remain largely unaddressed. Thus, to be able to avoid any criticism on account of lack of complete clarity in Indian rules, there seems to be a need for more precise rules of attributing profits to a PE in India.

9.2 Existing Rules & Approaches Adopted by Assessing Officers

139. Profit Attribution under Indian tax treaties and the Indian domestic laws follows a two step approach. Wherever the separate accounts of the PE are available and can be relied upon for determining the profits attributable to the PE, the profits derived from such accounts will be the profits attributable to the PE, as permitted under paragraph 2 of Article 7 of tax treaties, which permits attribution of profits on the basis of the direct accounting method, treating PE as a distinct and separate entity. All applicable provisions of the Act for computing income under the head 'profits and gains of business or profession' will apply for this purpose. Certain payments or notional payments made by the PE to head office that may not be deductible under the provisions of paragraph 3 of Article 7⁸⁰ as well as section 44C of the Act shall not be deductible for this purpose. Where profits can be reasonably attributed in this way to the PE, the same completes the process, and paragraph 4 of Article 7 or Rule 10 of the Rules need not be invoked.

140. However, where separate accounts of PE are either not maintained or cannot be relied upon for determination of profits attributable to the PE, it is permissible under paragraph 4 of Article 7 of the tax treaty for the Assessing Officer to resort to attribution of profits by way of apportionment. In the Indian domestic law, profit attribution by this method is governed by rule 10 of the Rules, which provides three options to the AO- the presumptive method, the proportionate method and the discretionary method. The rule 10 is reproduced as under:

Determination of income in the case of non-residents.

10. In any case in which the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India or through or from any property in India or through or from any asset or source of income in India or through or from any money lent at interest and brought into India in cash or in kind cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax may be calculated :—

(i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or

⁸⁰ Paragraph 3 of Article 7 of the UN model tax convention restricts the deduction of such payments. Tax treaties with similar provisions in Article 7 will apply accordingly.

(ii) on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or

(iii) in such other manner as the Assessing Officer may deem suitable.

141. There seem to be concerns among taxpayers, tax practitioner and officers of the department regarding uncertainty and unpredictability resulting from the Application of rule 10. The Committee in its meeting called for data related to profit attribution to PEs in India from the field formations with the objective to analyze the approaches adopted by different Assessing officers for attributing profits to the non-resident persons having PE in India. For this purpose, following information was sought from the officers in field formations, pertaining to AY 2010-11 to AY 2013-14:

- Number of cases in which PE has been accepted by the non-resident taxpayer and India centric accounts were found to be maintained, and how the profit was attributed in such cases
- Number of cases (other than above) in which Assessing Officer has held the non-resident taxpayer has a PE and how the profit was attributed in such cases

142. From the analysis of the data received from the major centers, including Mumbai, Chennai, Hyderabad, Bangalore, Kolkata, Ahmedabad and Delhi, it was observed that there is little uniformity among the Assessing Officers in the manner of methods for profit attribution and application of rule 10. The results of this analysis reaffirm that the wide scope of discretion in respect of application of methods under rule 10 prevents any uniform approach regarding attribution of profits from coming into existence, and this may be resulting in concerns about lack of clarity and objectivity among stakeholders. This lack of a uniform and consistent approach may also be a major factor contributing to tax disputes and litigation, with resultant locked revenue and avoidable costs of litigation.

143. After taking into account the details elaborated in the preceding sections and the analysis referred above, the Committee unanimously arrived at a view that there is a need to consider possible options that can be adopted as a simple, uniform and consistent method of profit attribution under rule 10, for the purpose of bringing in greater clarity, predictability and objectivity in the process of attribution of profits and reducing tax disputes and litigation on this account. The Committee observed that any options considered for this purpose, must be in accordance with India's position and views and must address its concerns. Accordingly, the Committee considered the possible options, the details of which are elaborated in the following paragraphs.

9.3 Possible Options for a Uniform Method of Apportionment

144. It has been India's consistent position that demand side factors, as represented by sales, should be taken into account for attribution of profits to an PE, alongside the supply side factors, which are represented by payroll and property in the formulary apportionment followed by USA (within its states); by manpower, wages and assets in CCCTB proposed in EU; and by function, assets and risk in the AOA. It has been India's consistent position that profit attribution must take into account contribution of demand side factors, which are represented by sales. Thus, any specific rules for Profit Attribution under Indian laws would need to include them.

145. It is also worth observing that the option of attributing profits by way of apportionment is available in paragraph 4 of Article 7 of UN model tax convention as well as the pre-2010 OECD model tax convention, and most of the Indian tax treaties based on them. This provision, gives the right to the source country to tax profits on the basis of apportionment, as under:

*4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, **nothing in paragraph 2 shall preclude Contracting State from determining the profits to be taxed by such an apportionment as may be customary**; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.*

(emphasis added)

Thus, it can be observed that attribution of profits by way of apportionment is well within the mandate under most of the tax treaties entered into by India.

9.4 The Option of Formulary Apportionment

146. One of the most talked about options for attributing profits on the basis of apportionment consists of formulary apportionment using a three factor formula, which in addition to sales, also takes into accounts manpower or wages or payroll denoting human activities as the second factor and assets or property as the third factor. This approach is largely the one which is adopted in a formulary apportionment by US, and is also proposed to be adopted by EU, apart from being advocated by a large group of academicians, experts and NGOs, including the Tax Justice Network.

147. However, such formulary apportionment requires availability of complete information about the country wise sales revenue as well as the deployment of manpower and assets, which

is not easily available. Although under the recently agreed norms of Country-by-Country (CbC) reporting, relevant information is to be shared about MNEs whose turnover exceeds the threshold limit set for CbC reporting (750 Million Euros) but for the MNEs with smaller turnover, this information will still not be available, even under CbCR. Further, it is not fully clear at this stage as to whether even the information received under CbCR can be used for attribution of profits. In view of the difficulties faced by tax administrations around the world in obtaining such information from the local entities, the unavailability of information is likely to practically limit the option of applying formulary apportionment.

9.5 The Option of Fractional Apportionment by a Uniform Method

148. Fractional Apportionment is permissible under paragraph 4 of Article 7. In essence, it differs from formulary apportionment followed by the US States and proposed by EU in that it does not necessitate consolidation of profits of the enterprise from different tax jurisdictions, and can be determined by determining only those profits that have been derived by the enterprise from India and thereafter apportioning them on the basis of certain factors. This approach is also permissible under rule 10, frequently applied in India and in principle, has been upheld as being permissible by the courts.

149. However, since wide discretion is available under rule 10 regarding the method of such apportionment, different cases end up with different methodologies with frequent tax disputes and litigation. Thus, prescription of a uniform method under rule 10 for fractional apportionment could be a possible option for bringing greater clarity and objectivity in attribution of profits.

150. Since it has been India's consistent position that profits are contributed independently by demand and supply, the apportionment would need to be based on factors representing demand as well as supply, and sales would need to be included in it as a proxy for contribution of demand side factors. From the international practices, literature and the Indian case laws, there appears to be considerable merit in following the three factor approach of sales, manpower and assets, with equal weight assigned to each of them.

151. The merits of this approach can be listed as under:

- It takes into account the contribution of demand as well as supply to the profits of the enterprise, and thereby reasonably allocates profits to the jurisdiction where the consumers and market are located as well as where the factors of production are located and where activities on supply side are conducted.

- By allocating one third to sales and two third to supply side, it accommodates the role of marketing activities, which would be represented by manpower and assets. Thus, it equitably distributes taxing rights between demand and supply jurisdictions.
- This method uses a three factor formula which has a long precedence in international practices, and is also proposed in recent times by European Union.
- The method is relatively simple and thereby avoids the more complicated methods often resorted to in Indian cases that often become a subject matter of disputes and litigation.
- As it is based primarily on business operations in India, it avoids the need for extensive country by country information that may be required for consolidation of profits of the enterprise.

9.6 An Option for Attribution on the basis of Demand & Supply

152. The Committee also explored the option for attribution of profits on the basis of supply side factors by resorting to Functions, Assets and Risks (FAR) as advocated by OECD in AOA, along with demand side factors represented by Sales. The members were of the view that this option can have application in case of a PE that comes into existence by the presence of an Indian subsidiary, which is separately taxed in India on its own income⁸¹, as in the case of a Dependent Agent PE or a PE that comes into existence on the basis of stewardship (a term coined by the Hon'ble Supreme Court in the case of *DIT vs. Morgan Stanley & Co. Inc, [2007] 292 ITR 416 [SC]*) provided by the employees of the foreign enterprise. In such cases the supply side factors in India are represented by the Indian subsidiary, and to the extent that it is remunerated for its contributions on an arms' length basis, the profits of that Indian subsidiary can be considered as representing the profits derived from the contribution of supply side factors in India. To the extent that these profits are already taxed in India (in the hands of the Indian subsidiary) they need not be included again in the profits of the PE that comes into existence and which is distinct from the Indian entity.

153. Thus, in such a case, where the activities of an Indian subsidiary contributing to the business of the foreign enterprise lead to the creation of a PE in India, the profits need to be attributed to the PE only in respect of demand side factors, or sales, as the supply side factors

⁸¹ The subsidiary being a different entity, has a business different from that of its associated or closely related enterprise. Since both derive profits from the Indian operations, both can be taxed separately, provided the non-resident enterprise has a PE in India. Where such PE maintains separate accounts from which taxable profits can be determined, that would suffice. However, where the PE does not maintain any separate accounts, the profits attributable to the PE can be the difference between profits derived from Indian operations and the profits that are already brought to tax in the hands of the Indian subsidiary. Where, there are no sales in India, and only the supply side activities are carried out by the Indian subsidiary which has been remunerated for such activities on an arm's length basis, using a FAR analysis, no additional profits may be brought to tax following the principle laid down by the Hon'ble Supreme Court of India in the case of *DIT vs. Morgan Stanley & Co. Inc, [2007] 292 ITR 416 [SC]*

have already been taken into account in the taxable income of the Indian entity. Further, once its transactions with its associated enterprises are subjected to 'arms' length price' determination under section 92C of the Act by way of FAR analysis, they can be considered as appropriate representation of the profits contributed by supply side factors in India.

154. Accordingly, where the profits of Indian subsidiary are arrived at after the function, asset, risk analysis and are subjected to tax in India, they can be taken as the Indian profits contributed by the supply side, and no further attribution to the PE may be required in respect of supply side factors. In such cases, the attribution of profits to the PE would then be required only in respect of the contribution of the demand side factors. Following the consistent approach of allocating one third profits on the basis of sales, as in the case of US, EU and proposals advocated by various academicians, the Committee was of the view that the weightage of attribution on the basis of sales can be kept at 33%. It is felt that this would adequately represent the contribution of demand side factors in India that contribute to profits of foreign enterprise from doing business in India, and can be considered as an option for attribution of profits in cases where the profits of the Indian subsidiary are already being subjected to tax in India on the basis of FAR analysis.

155. The same result can also be obtained by taking the total profits from Indian operations and deducting the profits already taxed in the hands of the Indian subsidiary. Like the earlier approach and the principle laid down by Hon'ble Supreme Court in Morgan Stanley, this achieves the objective of avoiding double taxation of the same income in the hands of two different entities that may have been part of an integrated business and hence share the tax liabilities in respect of profits arising from such business.

156. However, there can be cases where there is no Indian subsidiary in India, and no part of the profits derived from India are being subjected to tax in the hands of any entity other than the PE, the profits will then need to be attributed taking into account both the demand as well as supply side factors. Following the international practices and literature, 33% of the profits derived from India can be attributed to sales, representing the contribution of the demand side factors. The remaining 67% in such cases would be presumed to have been contributed by supply side factors. Out of these, only the contributions to supply made within India can be taken into account for attributing profits of the PE in India. A significant proportion of supply side activities in such cases are likely to be outside India. The exact proportion of the supply chain functioning in India may need to be determined on the basis of specific facts and circumstances of the case.

157. The Committee members were of the view that it is also important to lay down the methodology for determination of supply side factors in order to avoid any ambiguity. The

committee recommended that the supply side factors should be determined on a methodology similar to the one adopted in CCCTB i.e. by taking a combination of one-third assets, one-sixth wages and one-sixth manpower. In cases, where this information is not available the AO should determine the supply side on pro-rata basis taking into account the factual matrix of the case within the overall cap.

158. Following this option, a minimum of 33% of the profits derived from sales in India will invariably be attributable to the PE on the basis of sales. Thus, in case of a PE deriving profits from sales in India, where no part of these profits have been taxed in the hands of any Indian entity, the profits attributable to such PE would need to be determined by the Assessing Officer, but may not be less than 33% of Indian profits if no profit is to be attributed to India on account of factors other than sales.

159. The profits derived from India would need to be defined for the purpose of clarity. In the absence of separate accounts of Indian operations, an option that is also frequently practiced and sustained by the Courts in several cases as discussed earlier, could be to determine such profits by applying the global profit margin⁸² on the Revenue generated from customers within India, as under:

$$\text{Profits derived from India} = \text{Revenue derived from India}^{83} \times \text{Global operational profit margin}^{84}$$

160. However, this leads to a possibility that where the global operations are resulting in operational losses, there may be no profits under this rule, even when Indian operations may be profitable. This is a concern that may need to be addressed by a specific rule to protect India's revenue interests. Economically, addressing this concern by a specific rule would be justified since an enterprise is likely to continue its operations in India only if it finds such operations profitable. Addressing these concerns by a targeted rule would also be justified since a similar possibility in case of Indian resident enterprises and non-resident companies is addressed by way of Minimum Alternate Tax (MAT).

⁸² As discussed in Section 4, the marginal profits and average profit of an enterprise is different in the presence of sunk costs. The average profit which forms the tax base in the corporate tax regimes, is constituted by the surplus of total revenue over the sum of all the costs i.e. Marginal cost + corresponding portion of the sunk cost. In 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.

⁸³ *Revenue derived from India* includes 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.

⁸⁴ As discussed above EBITDA margin (Earnings before interest, taxes, depreciation and amortization) of a company is to be taken as the *global operational profit margin*.

161. Thus, it may be preferable to place a floor rate of “profits derived from India”. After detailed discussion on the possible rate that can be set up as a floor, the Committed came to the conclusion that a minimum rate of 2% of gross revenue or turnover derived from Indian operations would be justified and sufficient for protecting the revenue interests of India.

162. The Committee also examined the situations in which the new rule will be applicable. The members were of the view that the provisions of the new Companies Act, 2013 has made it compulsory for the foreign companies operating in India to maintain India centric financial statements⁸⁵. The definition of ‘foreign company’ is quite wide in the Companies Act 2013 and therefore, the modified rule will be used only in those situations where there are no India centric financial statements or where the books of account have been rejected under the appropriate provisions of the Act or where for some specific reason that is recorded by the AO, the accounts do not adequately reflect the profits that can be attributable to the PE as an independent and separate entity.⁸⁶

163. In practice, this method can be applied in the following steps:

- (i) By determining the profits derived from Indian operations of the enterprise. Where the enterprises is incurring global losses, or its global operational profit margin is less than 2%, the profits derived from India will be taken at 2% of the revenue or turnover derived from India.
- (ii) By apportioning the profits from Indian operations of the enterprise to the PE on the basis of the three factors of sales (33% weight) and manpower and assets (together 67% weight).
- (iii) By deducting any profits from Indian operations of the enterprise, any profits that may have already been taxed in India (for instance, in the hands of an Indian subsidiary which gives rise to the PE of the enterprise in India)

⁸⁵The Companies Act 2013 clearly defines a foreign company under Section 2(42). A foreign company is any company or body corporate incorporated outside India which a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and b) conducts any business activity in India in any other manner. The scope of definition of the foreign company has been expanded under the new Act. The foreign company has to prepare financial statements and submit them to RoC.

⁸⁶ An instance of such a situation may be where the Headquarter of the enterprise has entered into an agreement with a PE that is commercially so detrimental to its profitability that it is unlikely to be entered into by any independent and separate entities.

9.7 Summary of Committee's Observations

164. After taking into account the preceding details and the analysis of methods for profit attribution, the Committee unanimously agreed that there is a need to consider possible options that can be adopted as a uniform method of profits attribution by apportionment under rule 10, in accordance with India's position and views. Accordingly, the Committee considered the possible options.

165. Regarding the option of Formulary Apportionment, the Committee was of the view that since it requires an apportionment of consolidated profits of the enterprise derived from different jurisdictions, it may not be feasible due to practical constraints in obtaining details related to operations in other jurisdictions.

166. The Committee considered the option of Fractional Apportionment based on apportionment of profits derived from India and observed that such an approach is permissible under paragraph 4 of Article 7 of Indian tax treaties as well as rule 10 of the Rules and being based largely on information related to Indian operations, is also practicable. For this purpose, the Committee found considerable merit in a three factor method based on equal weight accorded to sales, representing demand, and manpower and assets, which represent supply including marketing activities.

167. In view of the principle laid down by the Hon'ble Supreme Court in the case of DIT Vs Morgan Stanley, as well as the need to avoid double taxation of such profits in the hands of a PE as well as an Indian subsidiary participating in the integrated business, the Committee arrived at a view that profits derived from Indian operations that have already been subjected to tax in India should be deducted from the apportioned profits. The Committee observed that in a case where no sales takes place in India, and the profits that can be apportioned to the supply activities have already been taxed in the hands of an Indian subsidiary, no further taxes would need to be paid by the PE.

168. The Committee observes that the profits derived from India need to be defined objectively, and considers that the same can be arrived at by multiplying the revenue derived from India with the global operational profit margin. However, acknowledging the contribution of market jurisdictions, where the enterprise is having global losses or where its global operational profit margin is less than 2%, the same can be arrived at by deeming the global operational profit margin to be 2%.

Section 10

Profit Attribution in Significant Economic Presence Nexus

10.1 Taxable Nexus based on Significant Economic Presence

169. Vide Finance Act 2018, a new nexus in the form of Significant Economic Presence (SEP) has been introduced in the Act. This explicitly clarifies that ‘business connection’ that constitutes a threshold nexus for the taxation of the profits of a non-resident enterprise in India includes significant economic presence.

170. The new Explanation 2A to clause (i) of sub-section (1) of section 9 defines SEP in case of a non-resident enterprise by the following:

- A threshold based on local revenue: *“any transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed”,* and
- A threshold based on number of local users: *“systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India, through digital means”.*

171. These thresholds create a direct tax liability in India irrespective of whether the agreement for such transactions or activities has been entered in India, the non-resident has residence or place of business in India or the non-resident renders service in India. Further thresholds are yet to be provided in the rules. For its effective working, it is important that the principles of profit attribution to SEP are clarified.

10.2 The Role & Relevance of Users

172. The ease with which transactions can be conducted across digital, telecommunication or similar networks by the digital enterprises conducting their business through such networks have created new opportunities for enterprises to get activities that create value and profits for the enterprise to be carried out by a new category of third parties that may not be paid in financial terms, but are provided digital goods or services as part of the contract undertaken with them, so as to incentivize them to undertake activities that lead to profit for the enterprise. It may be pointed out that this new business model has now become possible due to revolutionary advancements in communication and availability of automated processes for entering into contracts, which allows enterprises to enter into such contracts with a very large number of individuals in other tax jurisdictions to undertake activities on the digital platform provided by

these enterprises, on which these individuals, often referred to as “users” undertake activities that lead to value creation and profits for the digital enterprises⁸⁷.

173. It is also significant to note that in all cases of an activity ascribed to an enterprise that is carried out by an individual, such individual carries out the activity (that leads to creation of value and profits for the enterprise) primarily for its own benefit which may be available to her as salary, fees, contractual payments, rights or other non-financial valuables. Given this analogy, the so called ‘users’ whose activities create value and profits for the enterprises, without being directly remunerated financially, may not be very different from the other individuals like employees, contractual workers or vendors and accordingly, the activities carried out by ‘users’ need to be treated at par with the activities carried out by such other individuals.

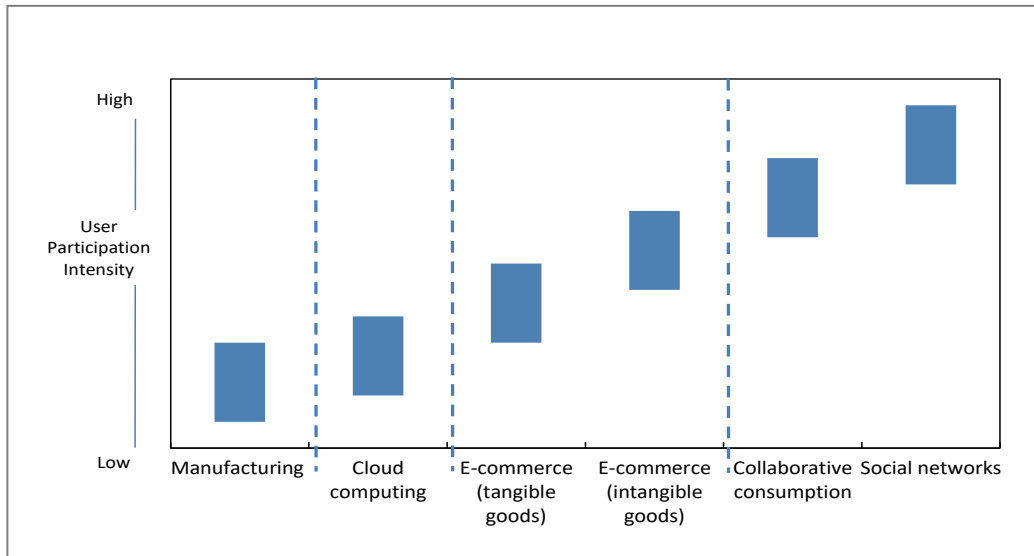
174. Thus, it is apparent that user data and user participation contribute to value and profits for the business, which needs to be taken into account for attributing profits, once the minimum nexus threshold of taxable presence by SEP or otherwise, as required by the Act and the relevant tax treaties, is satisfied. This value can be created through generation of content, the depth of engagement, the contribution to creation of brand, network effects and externalities⁸⁸. These significantly impact and contribute to the income and profits of the digital enterprises.

175. The 2018 OECD Report on *Tax Challenges arising from Digitalisation* divides user participation in two broad categories: active and passive. Passive user participation does not necessarily require the user to enter any information, but data is collected by the company, for example through cookies even after the user is no longer on the specific platform of the business but using other websites. Active user participation involves an explicit action. Examples of active engagement range from bookmarking a page to creating and uploading a video or post. For characterising the active user participation, the Report gives three broad categories where the participation can be low, medium or high depending on the value of the user action. These categories do not correlate with the extent of digitalisation i.e. not all highly digitalised businesses are purely based on data and user participation to the same extent and for many of the

⁸⁷ In a report, commissioned by the French government and published in 2013 Task Force on Taxation of the Digital Economy: Report to the Minister for the Economy and Finance, the Minister for Industrial Recovery, the Minister Delegate for the Budget and the Minister Delegate for Small and Medium-Sized Enterprises, Innovation and the Digital Economy, authors Pierre Collin and Nicolas Colin argue that this feature of digital economy equates to the provision of “free labour” by users to e-commerce providers, blurring the dividing lines between production and consumption.

⁸⁸ The examples of such value creation could be Youtube, Instagram and Tripadvisor, Snapchat (its stock lost \$1.3 billion after Kylie Jenner’s tweet about Snapchat’s new redesign), Airbnb and Facebook respectively for each of the listed types of value created by users.

businesses other characteristics of digitalisation such as scale without mass are also important (e.g., cloud computing). The categorisation is represented in the figure below⁸⁹:



10.3 Committee's Observations

176. The Committee, after detailed deliberation, considered the various aspects of users' contribution in the digital economy and also the fact that the role of user has blurred the traditional demand and supply functions. Taking these factors into consideration, the Committee arrived at a unanimous view that user contribution can be a substitute to either assets or employees, and supplement their role in contributing to profits of the enterprise. However, putting users together with either manpower or assets can pose significant challenges in distributing their respective shares within the assigned weight for their category (i.e. 33% for manpower or 33% for assets). Accordingly, the Committee found it reasonable that for business models in which users contribute significantly to the profits of the enterprise, they 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 of sales, manpower and assets.

177. The Committee also noted that in its recent amendment of the 2016 proposal for CCCTB⁹⁰, the European Commission has now proposed a new four factor formula, that includes users as the fourth factor, in addition to sales, manpower/wages and assets and is given equal weight of 25% as given to other factors.

⁸⁹Tax Challenges Arising from Digitalisation-Interim Report 2018 (OECD)

⁹⁰The amendment proposal was moved in July 2017 and is available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2F%2FEP%2F%2FNONGML%2BCOMPARL%2BPE-608.035%2B01%2BDOC%2BPDF%2BV0%2F%2FEN>. It was approved by the European Parliament on 15.3.2018.

178. The Committee considered the option of following the approach of the EU in CCCTB and assigning users the same weight as other three. However, the Committee also considered that different weights are to be ascribed to different categories of digital businesses depending upon the level of user intensity. The Committee decided to assign a 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 Committee also decided that since the users carry out the work of employees and are also assets to the company, the relative weightage of employees and assets will be adjusted downwards, keeping the weightage of sales fixed at 30% in both the cases.

Section 11

Conclusions & Recommendations of the Committee

179. After detailed analysis of the issues related to attribution of profits, existing rules, their legal history, the economic and public policy principles relevant to it, the international practices, views of academicians and experts, relevant case laws and the methodology adopted by tax authorities dealing with these issues, Committee concluded its observations, which are summarized in following paragraphs.

11.1 Summary of Committee's Observations & Conclusions

180. The business profits of a non resident enterprise is subjected to the income-tax in India only if it satisfies the threshold condition of having a business connection in India, in which case, profits that are derived from India from its various operations including production and sales are taxable in India, either on the basis of the accounts of its business in India or where they cannot be accurately derived from its accounts, by application of rule 10, which provides a wide discretion to the Assessing Officer. Where a tax treaty entered by the Central government is applicable, its provisions also need to be satisfied for such taxation. As per Article 7 of UN model tax convention (which is usually followed in most Indian tax treaties, sometimes with variations), only those profits of an enterprise can be subjected to tax in India, which are attributed to its PE in India, and would include profits that the PE would be expected to make as a separate and independent entity. Under the force of attraction rules, when applicable, it would include profits from sales of same goods as those sold by the PE that that are derived from India without participation of PE. Profits attributable to PE can be computed either by a direct accounting method provided in paragraph 2 or by an indirect apportionment method provided in paragraph 4 of Article 7.

181 An analysis of Article 7 and its legal history shows that there are three standard versions. The Article 7 which exists in UN model tax convention is similar to the Article 7 as it existed in the OECD model convention prior to 2010, except that the UN model tax convention allows the application of force of attraction rules and restricts deduction of certain expenses payable to head office by the PE. This Article in the OECD model convention was revised in 2010. Under the revised article the profits attributable to the PE are required to be determined taking into account the functions, assets and risk, and the option of determining them by way of apportionment has been excluded.

182. One of the primary implications of the 2010 revision of Article 7 by OECD was that in cases 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, completely ignoring the sales receipts derived from that tax jurisdiction. This amounts to a major deviation, not only from the rules universally accepted till then, but also from the generally applicable accounting standards for determining business profits, where business profits cannot be determined without taking sales into account.

183. Economic analysis of factors that affect and contribute to business profits makes it apparent that profits are contributed by both demand and supply of the goods. Accordingly, a jurisdiction that contributes to the profits of an enterprise either by facilitating the demand for goods or facilitating their supply would be reasonably justified in taxing such profits. The dangers of double taxation of such profits can be eliminated by tax treaties. If taxes collected facilitate economic growth in that jurisdiction, the demand for goods rises, which in turn also benefits the taxpaying enterprise, resulting in a virtuous cycle that benefits all stakeholders. On the contrary, if the jurisdiction is unable to collect tax from the nonresident suppliers, it would be forced to collect all the taxes required from the domestic taxpayers, which in turn would reduce the ability of consumers to pay, reduce their competitiveness, hurt economic growth and the aggregate demand, resulting in a vicious cycle, which will adversely affect all stakeholders including the foreign enterprises doing business therein.

184. Broadly, possible approaches for profit attribution can be summed in three categories— (i) supply approach allocates profits exclusively to the jurisdiction where supply chain and activities are located; (ii) demand approach allocates profits exclusively to the market jurisdiction where sales take place; (iii) mixed approach allocates profits partly to the jurisdiction where the consumers are located and partly to the jurisdiction where supply activities are undertaken.

185. The mixed approach appears to have been most commonly adopted in international practices, though in some cases, demand approach has also been favored. In contrast, supply side does not appear to have been adopted anywhere, except in 2010 revision of Article 7 of the OECD model convention, which requires determination of profits without taking sales into account. As a consequence, the contribution of demand to profits is completely ignored.

186. A purview of academic literature and views suggests a wide acceptance in theory that demand, as represented by sales can be a valid ground for attribution of profits. There also exists a diversity of views among academicians and experts on the validity of the revised OECD approach for profit attribution contained in the AOA. A number of international authors disagree with it, and many have been critical of this approach.

187. The AOA approach can have significant adverse consequences for developing economies like India, which are primarily importers of capital and technology. It restricts the taxing rights of

the jurisdiction that contributes to business profits by facilitating demand, and thereby has the potential to break the virtuous cycle of taxation that benefits all stakeholders. Instead, it can set a vicious cycle in place that can harm all stakeholders.

188. The lack of sufficient justification or rationale and its potential adverse consequences fully justify India's strongly worded position on revised Article 7 of OECD model convention, wherein India has not only found it unacceptable for adoption in Indian tax treaties, but also rejected the approach taken therein. This view of India, that since business profits are dependent on sale revenues and costs, and since sale revenues depends on both demand and supply, it is not appropriate to attribute profits exclusively on the basis of function, assets and risks (FAR) alone, has been communicated and shared with other countries consistently and on a regular basis.

189. Since, the revised Article 7 of OECD model tax convention has not been incorporated in any of the Indian tax treaties, the question of AOA being applicable on Indian treaties or profit attributed therein cannot arise. For the same reason, additional guidance issued by OECD with reference to AOA in respect of the changes in Article 5 introduced by the Action 7 of the BEPS project on Artificial Avoidance of PE Status, also does not have any relevance to Indian tax treaties. This, however, means that India cannot depend on OECD guidance and gives rise to a need for India to consider ways and means for bringing greater clarity and objectivity in profit attribution under its tax treaties and domestic laws, especially in consequence to the changes introduced as a result of Action 7.

190. An analysis of case laws indicates that the courts have upheld the application of rule 10 for attribution of profits under Indian tax treaties. In several such cases, the right of India to attribute profits by apportionment, as permissible under Indian tax treaties, has also been upheld by the courts. The judicial authorities do not appear to have insisted on a universal and consistent method. They have also upheld the wide discretion in the hands of Assessing Officer under rule 10 of the Rules, but corrected or modified his approach for the purpose of ensuring justice in particular cases. Thus diverse methods of attributing profits by apportionment under rule 10 of the Rules are in existence. In view of the Committee, the lack of a universal rule can give rise to tax uncertainty and unpredictability, as well as tax disputes. Thus, there seems to be a case for providing a uniform rule for apportionment of profits to bring in greater certainty and predictability among taxpayers and avoid resultant tax litigation.

191. A detailed analysis of methods adopted by tax authorities for attributing profits in recent years also highlight similar diversity in the methods adopted by assessing officers for attribution of profits, which reaffirms the need to consider possible options that can be consistently adopted as an objective method of profits attribution under rule 10 of the Rules, and bring greater clarity, predictability and objectivity in this exercise. Any options considered

for this purpose, must be in accordance with India's official position and views and must address its concerns.

192. Accordingly, the Committee considered some options based on the mixed or balanced approach that allocates profits between the jurisdiction where sales take place and the jurisdiction where supply is undertaken. The Committee did not find the option of formulary apportionment method apportioning consolidated global profits feasible, in view of the practical constraints in obtaining information related to jurisdictions outside India. Thus, Committee considers that it may be preferable to adopt a method that focuses on Indian operations primarily and derives profits applying the global profitability, with necessary safeguards to prevent excessive attribution on one hand and protect the interests of Indian revenue on the other.

193. The Committee found the option of Fractional Apportionment based on apportionment of profits derived from India permissible under Indian tax treaties as well as rule 10, and relatively feasible as it is based largely on information related to Indian operations. Out of various possible options of apportioning profits by a mixed approach, Committee found considerable merit in the three factor method based on equal weight accorded to sales (representing demand) and manpower and assets (represent supply including marketing activities).

194. After taking into account the principle laid down by the Hon'ble Supreme Court in the case of DIT Vs Morgan Stanley, and the need to avoid double taxation of profits from Indian operations in the hands of a PE, which is primarily 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 takes 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.

195. In this option, in order to ensure objectivity and certainty, profits derived from India need to be defined objectively. The Committee considers that the same can be arrived at by multiplying the revenue derived from India with global operational profit margin⁹¹. However, the Committee also noted the need to protect India's revenue interests in cases where an

⁹¹ In order to avoid any doubt the *global operational profit margin* is the EBITDA margin (Earnings before interest, taxes, depreciation and amortization) of a company

enterprise having global losses or a global profit margin of less than 2%, continues with the Indian operations, which could be more profitable than its operations elsewhere. In view of Committee, the continuation of Indian operations justifies the presumption of higher profitability of Indian operations, and in such cases, a deeming provision that deems profits of Indian operations at 2% of revenue or turnover derived from India should be introduced.

196. After taking into account the developments in taxation of digital economy and the new Explanation 2A, inserted by the Finance Act, 2018, explicitly including significant economic presence within the definition of business connection, the Committee considered it necessary to take into account the role and relevance of users in contributing to the business profits of multidimensional business enterprises. Users can be a substitute to either assets or employees, and supplement their role in contributing to profits of the enterprise.

197. After considering various aspects of users' contribution the Committee came to the conclusion that user data and activities contribute to the profits of the multidimensional enterprises, and there is a strong case of taking them into account, per se, as a factor in apportionment of profits derived from India by enterprises conducting business through multidimensional business models where users are considered crucial to the business. The Committee concluded that for such enterprises, users 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 of sales, manpower and assets.

198. Although a recent amendment of the 2016 proposal for CCCTB has proposed assigning a weight to the users that is equal to other three factors of sales, manpower and assets, the Committee found it preferable to assign a relatively lower weight of 10% to users in low and medium user intensity models and 20% in high user intensity models at this stage, with the corresponding reduction in the weightage of employee and assets except for sales being assigned 30% weight in apportionment in both the fact patterns. Given the rapid expansion of digital economy and the ongoing developments related to rules governing its taxation, it may be necessary to monitor the role of users and their contribution to profits in future and accordingly assess the need for considering a review of the weight assigned to users in subsequent years.

11.2 Recommendations

199. In view of the above, the Committee makes the following recommendations:

- (i) Rule 10 may be amended to provide that in the case of an assessee who is not a resident of India, has a business connection in India and derives sales revenue from India by a business all the operations of which are not carried out in India, the income from such business that is attributable to the operations carried out in India and deemed to accrue or arise in India under clause (i) of sub-section(1) of section 9

of the Act, shall be determined by apportioning the profits derived from India by a three equally weighted factors of sales, employees (manpower & wages) and assets, as under:

Profits attributable to operations in India =

$$\text{'Profits derived from India'}^{92} \times [S_I/3 \times S_T + (N_I/6 \times N_T) + (W_I/6 \times W_T) + (A_I/3 \times A_T)]$$

Where,

S_I = sales revenue derived by Indian operations from sales in India

S_T = total sales revenue derived by Indian operations from sales in India and outside India

N_I = number of employees employed with respect to Indian operations and located in India

N_T = total number of employees employed with respect to Indian operations and located in India and outside India

W_I = wages paid to employees employed with respect to Indian operations and located in India

W_T = total wages paid to employees employed with respect to Indian operations and located in India and outside India

A_I = assets deployed for Indian operations and located in India

A_T = total assets deployed for Indian operations and located in India and outside India

- (ii) The amended rules should provide that 'profits derived from Indian operations' will be the higher of the following amounts:
- a. *The amount arrived at by multiplying the revenue derived from India x Global operational profit margin, or*
 - b. *Two percent of the revenue derived from India*
- (iii) The amended rules should provide 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 exist in India. In such cases, the income from such business that is attributable to the operations carried out in India and deemed to accrue or arise in India under clause (i) of sub-section (1) of section 9 of the Act, shall be determined by apportioning the profits derived from India on the basis of four factors of sales, employees (manpower

⁹² "Profits derived from India" = Revenue derived from India x Global operational profit margin as referred in paragraph 159.

& wages), assets and users. The users 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 weight of 30%, as under:

Profits attributable to operations in India in cases of low and medium user intensity business models=

$$\text{'Profits derived from India'} \times [0.3 \times S_i/S_T + (0.15 \times N_i/N_T) + (0.15 \times W_i/W_T) + (0.3 \times A_i/3A_T)] + 0.1]$$

In case of digital models with high user intensity, the users should be assigned a weight of 20%, while the share of assets and employees be reduced to 25% each after keeping the weight of sales as 30%, as under:

Profits attributable to operations in India in cases of high user intensity business models =

$$\text{'Profits derived from India'} \times [0.3 \times S_i/S_T + (0.125 \times N_i/N_T) + (0.125 \times W_i/W_T) + (0.25 \times A_i/3A_T)] + 0.2]$$

- (iv) The amended rules should also provide that where the business connection of the enterprise in India is constituted by the activities of an associate enterprise that is resident in India and the enterprise does not receive any payments on accounts of sales or services from any person who is resident in India [or such payments do not exceed an amount of Rs. 10,00,000] and the activities of that associated enterprise have been fully remunerated by the enterprise by an arm's length price, no further profits will be attributable to the operation of that enterprise in India.
- (v) However, where the business connection of the enterprise in India is constituted by the activities of an associate enterprise that is resident in India and the payments received by that enterprise on account of sales or services from persons resident in India exceeds the amount of Rs. 10,00,000 then profits attributable to the operation of that enterprise in India will be derived by apportionment using the three factors or four factors as may be applicable in his case and deducting from the same the profits that have already been subjected to tax in the hands of the associated enterprise. For this purpose, the employees and assets of the associated enterprise will be deemed to be employed or deployed in the Indian operations and located in India.

200. The Committee recommends the amendment of rule 10 accordingly. The Committee also recommended that an alternative can be amendment of the IT Act itself to incorporate a provision for profit attribution to a PE.

