**Institute of Chartered Accountants of India**
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# Attribution of profits to permanent establishments (PEs) for conventional and digital economies

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# Agenda

# Profit attribution to PE – Indian Model tax treaties

- Article 7 of Indian model tax treaties :
  - Profits attributed to PE as if distinct & separate enterprise, engaged in same or similar activities under same or similar conditions; dealing wholly independently with enterprise of which it is a PE.
  - Additional stipulations in certain tax treaties based on Article 7 of UN Model – (1) Force of Attraction; and (2) Expenses chargeable to PE limited to actual expenditure incurred.
- Indian Revenue had expressed reservations with Authorised OECD Approach for attribution of profits to PE, on the basis of functions, assets & and risks (FAR) analysis under transfer pricing (TP).
- In May, 2019, Indian Revenue Board (CBDT) released public consultation draft prepared by a Committee, which proposed introduction of formulary approach for attribution of profits to PE even under tax treaties.

# CBDT Committee report on profit attribution to PE

- CBDT Committee's understanding :

| | | |
|---|---|---|
| 1 | Supply approach | Allocates profits exclusively to jurisdiction where supply activities take place. |
| 2 | Demand approach | Allocates profits exclusively to market jurisdiction where sales take place. |
| 3 | Mixed approach | Allocates profits partly to market jurisdiction; and partly to supply jurisdiction. |

- CBDT Committee's observations/ recommendations :
  - Article 7 of post 2010 OECD MC is based on Supply Approach.
  - Article 7 of Indian and UN Model tax treaties resemble Article 7 of pre 2010 OECD MC (barring few exceptions), which does not approve arm's length principles under TP.
  - Mixed approach for attribution of profits to PE through formulary approach (global net profit percentage to Indian sales), with safeguards in form of weightages on account of sales, assets, employees & wages (fractional apportionment).

# Arm’s length principles & attribution of profits to PE …. (1/2)

- Concept of arm’s length principles under TP (distinct & separate entity approach) is enshrined in Article 7 of Indian and UN Model tax treaties; and also of pre-2010 OECD MC.

- Amendment to Article 7 of OECD MC in 2010 was necessitated for removing ambiguity around deductions in hands of PE for arm’s length payments to head office (HO) for royalties, service fees, interests, etc.

- Overall concept of arm’s length principles made explicit in Article 7 of post 2010 OECD MC; earlier latently implicit in pre 2010 OECD MC.

- Article 7 of Indian and UN Model tax treaties contain minor deviations from arm’s length principles on account of force of attraction clause (if applicable) and embargo on deduction in hands of PE for payments to HO for royalties, service fees, etc, beyond cost in hands of HO.

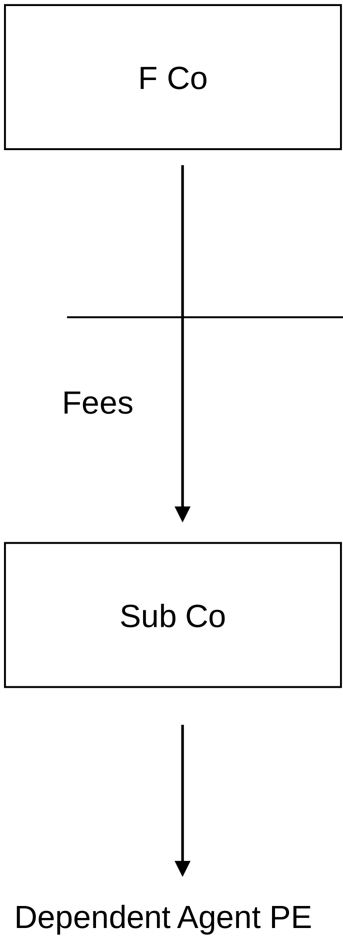
- Various methods under arm’s length principles (including profit split in case of contribution of unique intangibles by both parties) can achieve objective of Mixed Approach.

- Indian domestic tax legislation approves application of arm’s length principles under TP for attribution of profits to PEs.

# Arm's length principles & attribution of profits to PE …. (2/2)

- Say Indian subsidiary distributor needs profit margin of 3% return on sales (ROS) for complying with arm's length principles under TP, having regard to its FAR profile :
  - Then if similar functions are carried out by PE (branch/ dependent agent) with identical FAR profile, ideally same 3% ROS should logically suffice attribution of profits to PE.
  - Application of formulary approach with respect to global profit margin (say 20%), which may be driven by superior technology, would result in attribution of profits to PE @ 20% ROS.
- Apathy towards arm's length principles has been created amongst Regulators by MNCs applying the same inappropriately thus far ➔ BEPS Actions 7 to 10 contain safeguards for its implementation

# Agency PE – case study on attribution of profits …. (1/4)




- Functions triggering agency PE under Article 5 ➔ securing/ concluding contracts
- Functions triggering attribution of profits to agency PE (Article 7) ➔ significant people functions (SPF) for assumption of risks & ownership of capital
- SPF for inventory & debtors ➔ monitoring of inventory; credit rating of debtors, etc.
- Article 5 enables Revenue to examine probable SPF for attributing profits (Article 7)
- If Sub Co does not perform SPF ➔ no additional profit attribution in hands of agency PE of F Co beyond commission/ fees received by Sub Co as agent

# Agency PE – case study on attribution of profits …. (2/4)

- F Co directly sells products worth US$ 100 million to independent customers in host country.
- All selling activities in host country undertaken by Sub Co ➔ F Co has no presence in host country other than through Sub Co.
- Marketing, including strategies, product ordering, delivery, after sales support functions, etc are undertaken by Sub Co.
- Sub Co is remunerated on a full cost plus mark-up (15%) model for its agency services.
- Total costs of Sub Co is US$ 10 million ➔ mark-up @ 15% is US$ 1.50 million.
- Inventory & debtors management also undertaken by Sub Co in host country ➔ inventory & debtors are owned by F Co under all circumstances.
- F Co has suffered US$ 1 million on account of bad debt; and US$ 1 million on account of inventory obsolescence, relating to business in host country.

# Agency PE – case study on attribution of profits …. (3/4)

FAR Analysis

| Functions, Assets & Risks | F Co (HO) | Sub Co (Agent) | F Co (Agency PE) |
|---|---|---|---|
| Functions – | | | |
| • Product ordering | | ✓ | ✓ |
| • Marketing – sales force | | ✓ | ✓ |
| • Marketing/ advertising strategy | | ✓ | ✓ |
| • Warehousing / inventory management | | ✓ | ✓ |
| • Delivery / shipping | | ✓ | ✓ |
| • Debt management & collections | | ✓ | ✓ |
| Assets – | | | |
| • Inventory | ✓ | | ✓ |
| • Receivables | ✓ | | ✓ |
| Risks – | | | |
| • Inventory risk | ✓ | | ✓ |
| • Credit risk | ✓ | | ✓ |
| • Foreign exchange risk | ✓ | | ✓ |

# Agency PE – case study on attribution of profits …. (4/4)

Profit & Loss Account of Agency PE

US$ million

| | | |
|---|---|---|
| Turnover | | 100.00 |
| Less : COGS (balancing figure) | | 88.50 |
| Gross Profit [Remuneration received by Sub Co : 10.00 + (15% of 10.00)] | | 11.50 |
| Less: Costs & losses | | |
| Operating cost of Sub Co | 10.00 | |
| Bad debts | 1.00 | |
| Stock obsolescence | 1.00 | 12.00 |
| Net Loss | | 0.50 |

- If arm's length ROS for comparable distributors is 2%, then TP adjustment of US$ 1.50 is to be made in hands of Agency PE of F Co.
- OECD has suggested that for convenience, adjustment of US$ 1.50 may also be made in hands of India Sub Co.
- Unilateral APAs have adopted such convenient approach.
- There is no stated position of Indian Revenue in this regard.

# BEPS Action 1 – Unified Approach under Pillar One ….. (1/2)

- Public Consultation Paper released by OECD in October, 2019.
- Attempt to merge concepts of “user participation”; “ marketing intangibles”; and “significant economic presence” into a single Unified Approach.
- Proposes to enlarge rule of “nexus” to introduce concept of digital PE, beyond physical presence.
- Digital PE may operate even where foreign enterprise may otherwise have presence in host jurisdiction, either through itself; or separate legal entity, e.g. acting as distributor.
- Three tier approach proposed for allocation of profits :
    - “Amount B” ➔ profits for actual functions carried out in host jurisdiction, for which OECD proposes fixed return, as proxy for arm’s length return for baseline routine distribution functions.
    - “Amount C” ➔ additional profits for actual functions performed in host jurisdiction, beyond baseline routine functions, for which fixed return may be proposed under Amount “B”.
    - “Amount A” ➔ Profits attributable to digital PE.
- “Amount B” and “Amount C” were already allocated to host jurisdiction for actual functions performed therein, through arm’s length principles under TP, “Amount A” proposes new profit allocation norms.
- Further work expected from OECD before finalisation of nexus rules, profit allocation norms, etc.

# BEPS Action 1 – Unified Approach under Pillar One ….. (1/2)

- “Amount A” ➔ Profits attributable to digital PE :

  a) Ascertain global profits of MNE group with reference to business line and/ or region/ market.

  b) From global profits under (a), fixed percentage (as may be prescribed by OECD) for all routine returns (manufacturing, procurement, distribution, etc.) performed by MNE group across the world, to be deducted.

  c) Residual profits [(a) – (b)] would be split to marketing jurisdictions across the world, by applying a fixed percentage (as may be prescribed by OECD) with reference to industry, business line, etc.

  d) Residual profits determined under (c ) would then be allocated to digital PE of each marketing jurisdiction with reference to an allocation key, which could be sales.

- OECD believes that existing arm’s length principles under TP cannot address allocation of profits to digital PE.

# Unified Approach under Pillar One – open ended questions

- Scope of digital PE ➔ should it apply only to technology driven businesses; and not to technology enabled businesses ?

- While digital PE is needed in today's highly digitised, whether arm's length principles under TP can address allocation of profits to digital PE, instead of resorting to formulary approach ?

- Since OECD agrees that trade intangibles, created through R&D functions, would not be attributed to digital PE, would marketing intangibles be the only value driver that may be attributed to digital PE ?

- If marketing intangibles may be the only value driver to be attributed to digital PE, why residual profit split method under arm's length principles of TP would not be able to allocate profits to digital PE ?

- How would profits (ideally routine) be attributable to digital PE, relating to procurement of data through social networking apps ?

- In case of no consensus amongst countries relating to digital taxation, would countries gradually move towards levying tax by overriding tax treaties through unilateral actions, as temporary or permanent solutions; and if yes, would it defeat "convergence" under overall BEPS initiative ?

# Thank you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