Explanation of Pillar 1 of the Proposal of the Inclusive Framework of Nexus and Allocation *(referred to as the new taxing right)*

AND

Practicalities of the Draft Rules of Attribution of Profits to PE

13 July 2019

Taxation of the digital economy - Where we are and where next

2013: BEPS Action Plan announced

2015: Action 1 Report delivered

2017: G20 agreement for delivery of interim report in 2018 and final report in 2020

2018:

Mar: Interim report delivered

July-Dec: Proposals for long-term solution discussed in task force

2019:

Jan: Policy paper

Feb: Public consultation document issued

Mar: Public consultation

May - IF meeting (approval of Programme of Work)

June - G20 meeting

2020: Final Report

Program of Work-May 2019

- The OECD, released on May 31, 2019 a program of work that, would fundamentally alter the longstanding rules that govern the international taxation of all large MNEs, not just those that might consider themselves "digital companies."
- The program of work calls for "a solution to be delivered in 2020," a time frame the 129-member IF acknowledges is "extremely ambitious," and would require "the outlines of the architecture" to be agreed to by January 2020.
- The program of work, describes a two-pillar approach that could form the basis for consensus.
    - **Pillar 1** is focused on revising the rules for allocating income to market jurisdictions and moving beyond the arm's length standard, as well as the related nexus/PE rules that would broaden the circumstances in which an MNE's contacts with a country would grant that country income taxing rights.
    - **Pillar 2** focuses on establishing a global minimum tax along with a backstop regime that would deny deductions or impose withholding in cases of certain payments to low-tax jurisdictions.

We have in the ensuing slides discussed in detail Pillar 1 and Pillar 2 of the program of work.

Pillar 1

Overview

Two key design features of any long term solution

New nexus unconstrained by physical presence

- Historically, rules governing nexus have focused on a business' physical presence.
- Increasing ability of businesses to participate in economic life of countries without an associated or meaningful physical presence.
- Develop new nexus rules capturing a novel concept of business presence in a market jurisdiction reflecting the transformation of the economy(e.g. role of intangibles, data and user participation).

Revised profit allocation rules

- Proposals share common assumptions
  - suggestion that existing transfer pricing rules are complex and uncertain (e.g. significant disputes around LRDs)
  - not adapted to capture value created by remote participation in a country (e.g. role of intangibles, data and user participation)
- Proposals share some common design features:
  - Consider the total profit of a business
  - Contemplate using simplifying conventions
- Three different possible methods articulated so far

Overview of the revised profit allocation methodologies

Modified residual profit split (MRPS)

- MRPS would allocate a proportion of a group's non-routine profit to market jurisdictions.
- This approach would require the identification of non-routine profit to be allocated between market jurisdiction using an allocation key.
- Splitting routine and non-routine profits and developing an appropriate allocation key could prove challenging.

Fractional apportionment (FAM)

- FAM would apply to both routine and non-routine profits.
- This approach may also take into consideration the overall profitability of the MNE group in determining the profit to be divided (which would then be allocated between countries using an allocation key).
- Integrating these rules with existing transfer pricing rules would be complex and could give rise to double taxation.

Distribution-based approaches

- Explore simplified approaches that would meet taxpayers and tax administration demand for greater certainty and administrability.
- Possible approach would involve guaranteeing a minimum return for marketing and distribution activities (incl. routine returns), together with adjustments based on a group's overall profitability (incl. non-routine returns).

Pillar 1: Numerical Illustrations

Modified Residual Profit Split – Numerical Illustration

Step 1: Determination of total profit of the MNE Group:

The Profit & Loss account of an MNE Group has been hypothesized below:

Particulars	Amount (USD)
Revenue in Jurisdiction A	20
Revenue in Jurisdiction B	30
Other Revenue	50
Total Revenue	100
Marketing Intangible Cost	10
R&D Intangible Cost	18
Other Cost	44
Total Cost	72
Total Profit	28

Step 2: Determination of routine profit of the MNE Group and removal of the routine profit from the total profit determined in Step 1 above:

The profits attributable to the routine functions of the MNE Group based on transfer pricing principles have been identified as USD 8. Hence, the profit left after removal of routine profit is USD 20 (28-8).

Step 3: Determination of non-routine profit attributable to the MNE Group:

Separating the routine profit from the total profit of an MNE Group, leaves the MNE Group with a residual non-routine profit of USD 20 (28-8)

***Step 4: Allocation of the non-routine profit to market jurisdictions based on an appropriate allocation key*:**

We hypothesise that intangibles have created a unique and valuable contribution in developing sales in the market jurisdictions and accordingly the cost in developing the intangibles (i.e. marketing and R&D) can be the basis of the value generated to market jurisdiction and therefore could be an appropriate allocation key for allocating non-routine profit to market jurisdictions.

Particulars	Amount (USD)
Total Non-Routine Profit	20
Profit associated with Marketing Intangible (20*1/3)-Jurisdiction A	7
Profit associated with R&D Intangible (20*2/3)- Jurisdiction B	13

Fractional Apportionment Method – Numerical Illustration

Step 1 - Determine the total profit to be of the MNE group to be divided:

Drawing on the similar hypothesis as specified in Step 1 of MRPS method in previous slide, the total profit of the MNE Group to be divided is determined as USD 28.

Step 2 – Select the appropriate allocation keys:

This step envisages selection of an appropriate allocation key to allocate the total profit. Allocation keys that could be explored include employees, assets, sales, and users, etc.

Step 3 - Apply the selected allocation keys to allocate a fraction of the profit to the jurisdictions:

After identifying the appropriate allocation keys and assigning weights to them, a fraction of profits is allocated to various market jurisdictions, on the following basis:

Jurisdiction A

	Value in USD			
Particulars	**Sales**	**Employees**	**Assets**	**Users**
Jurisdiction A (a)	20	10	20	100
Global (b)	100	50	200	1000
Proportion ((a/b)*100) (c)	20	20	10	10
Weights (d)	1/3	1/6	1/3	1/6
Total percentage attribution under the proposed approach				15%
Profit Attributable to Jurisdiction A [28*15%]				4.2

Jurisdiction B

	Value in USD			
Particulars	**Sales**	**Employees**	**Assets**	**Users**
Jurisdiction B (a)	30	5	50	400
Global (b)	100	50	200	1000
Proportion ((a/b)*100) (c)	30	10	25	40
Weights (d)	1/3	1/6	1/3	1/6
Total percentage attribution under the proposed approach				27%
Profit Attributable to Jurisdiction B [28*27%]				7.5

Distribution-based Approach – Numerical Illustration

Step 1: Assumption of a baseline profit

We have hypothesized the baseline profit as 3 percent of local sales for the purpose of our analysis.

Step 2: Calculate the Adjusted Baseline Profit ('ABP')

Adjust the base profitability of 3% with industrial/ market factors. Proposed that where the group profitability exceeds 12 percent, the baseline profit would be adjusted to increase the base profit by around 20 percent of the increase. A corresponding calculation will have to be done in case of decreased group profitability as well. The group profitability in our hypothesis is 28 percent.

Hence, the adjustment to the baseline profit in this illustration shall work as under: 3%+20% * (28-12) = 6.2% (approx.)

Step 3: Adjusting the ABP to the local marketing spend to arrive at the profit allocation percentage

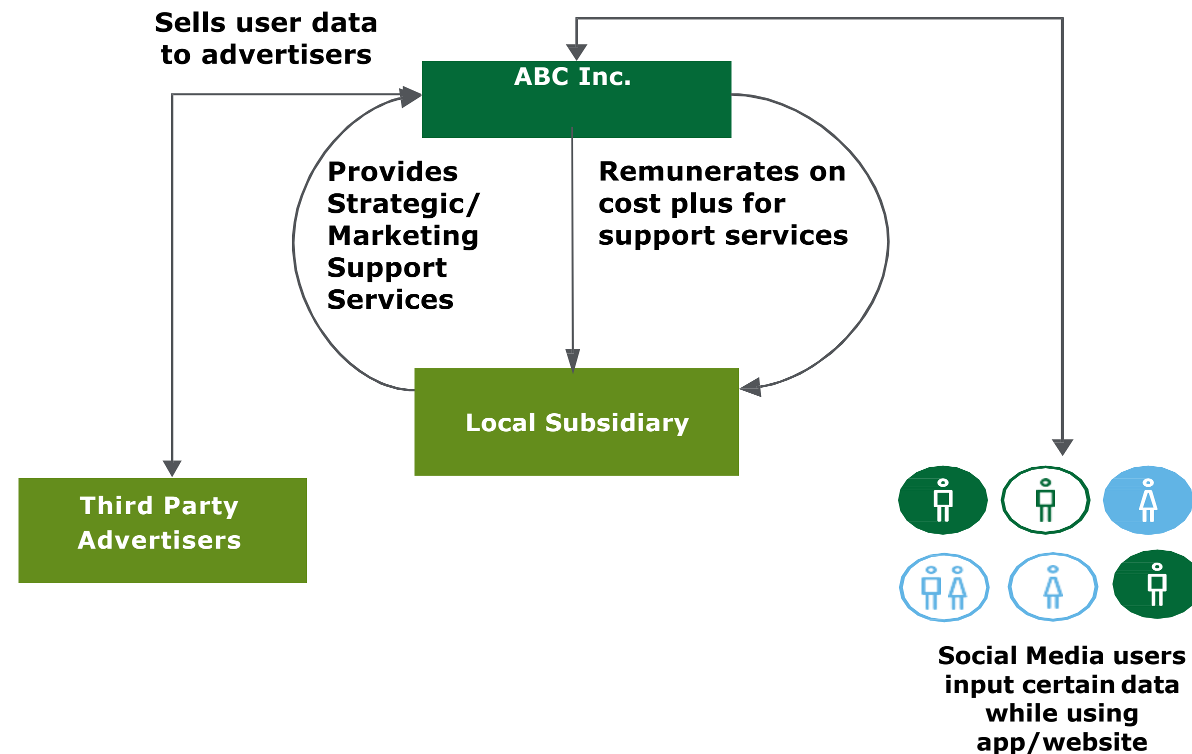
An increase or decrease (of 20%) would be carried out to the adjusted baseline profit as determined in Step no. 2 above, depending upon the local jurisdictional marketing spend working out to higher or lower that 10% of the sales target. Let us assume the following marketing spends:

Particulars	Local Marketing Spend [a]	Local Revenue [b]	Difference to the effect of 10% of Local Revenue [c=a-(b*10%)]	Difference adjusted to 20 percent [d=c*20%]	Percentage of profit to be allocated [ABP+d]
Jurisdiction A	8	20	6	1.2	7.4
Jurisdiction B	2	30	-1	-0.2	6.0

Pillar 1:
Digital Case Studies

Case study 1: Social Networking Entities (Ex. Facebook, LinkedIn)

- Social networking site is characterized by user interaction over an online platform.
- User interaction provides marketing opportunities to other online businesses and corresponding advertising revenue to the social networking entities.
- User engagement is critical in this model and the market reach is achieved with no significant tangible presence in a jurisdiction.
- Based on user interaction, an algorithm which is developed/ owned by the IP owner analyses user data to reveal patterns, trends relating to human behavior and interactions, using data processing software like big data, etc.
- Entities usually set up a local subsidiary in a particular market jurisdiction with an aim to perform strategic or local marketing support services like website management, local advertising functions, etc.
- Local entities receive an arm's length remuneration for the local marketing support services rendered.



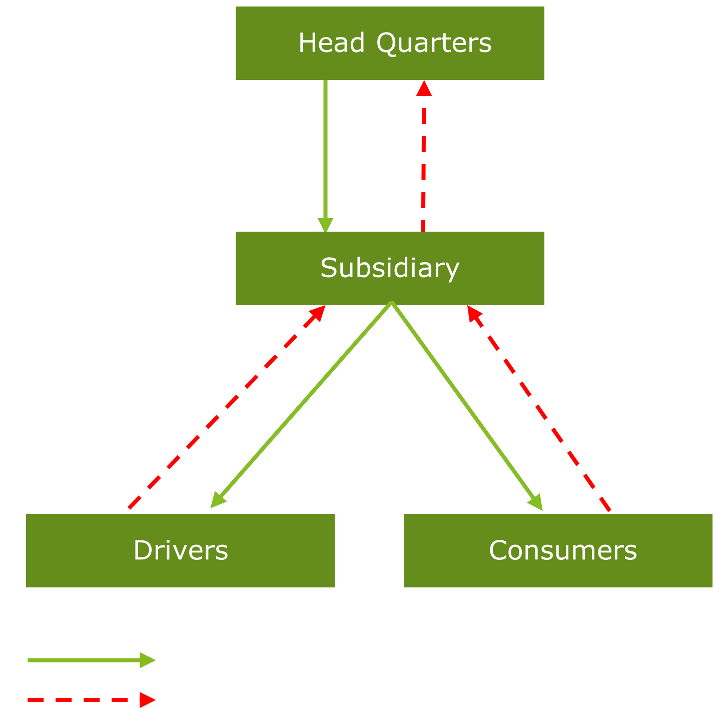
Possible Value Creators:

- Technological Platform
- Users/User Interaction
- Data Generated

Appropriate Profit Allocation Method?

Case study 2: Logistic Companies without Cars (Ex. Uber, Ola)

- Logistic companies without cars operates through an application on the mobile device which connects service consuming users and service rendering users for the purpose of rendering specified services.
- The platform sets standards for service rendering users to engage in the platform by defining their requirements.
- The platform monitors their active hours and location details real time in the platform to render specified services to service consuming users.
- Service consuming users through applications on their mobile device key in their personal data followed up by request for specified services on the platform.
- The app matches service consuming users request for specified services with service rendering users present on the platform to create value for each other.
- On completion of the service delivery, the fee is directly charged by the platform itself to the service consuming user's bank card / credit card.
- The applications also provide for rating and review system wherein the users are allowed to provide feedback about each other and about the interaction of users with the platform.
- This feedback acts as a mechanism for allocating further specified service requests between two set of users.
- The local jurisdictional entities would be responsible for providing access to the platform to the contracted drivers, and the customers; and regional marketing & sales, driver support and customer support services and billing management.
- They are compensated on an arm's length basis for their activities and no additional compensation is forthcoming due to lack of existence of a permanent establishment.



Possible Value Creators:

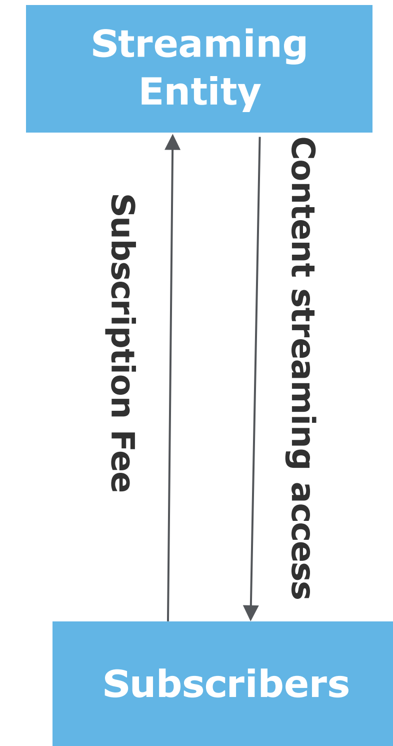
- Service Consuming Users
- The Platform
- Service Rendering Users

Applicable Profit Allocation Method?

Case study 3: Digital Media Streaming Entities (Ex. Netflix, Spotify)

Business Model

- Global streaming content providers allow subscribers to watch TV shows, movies, documentaries and more on a wide range of Internet-connected devices.
- This video streaming on- demand companies operates on a subscription-based model, which is also the primary source of revenue.
- The subscribers pay for a monthly subscription plan and are given access to stream shows, movies, documentaries and other content available on Apps in the quality (SD, HD, Ultra HD) they pay for.
- These entities give the subscriber legal access to a huge movies and TV shows database and the best-personalized suggestion algorithm along with a seamless service without the interruption of advertisements.
- The streaming service is supported on a widest range of devices including PCs, TVs, mobiles, and gaming consoles.
- Research suggest that customers in various jurisdictions are not billed by their local entity (however the name of the local entity is appearing on the bills of the customers) instead they pay to the parent company/particular group company
- Locally there exist a distribution entity that functions primarily as a limited risk distributor. This entity is responsible for entering into subscription contracts for streaming content online with end user subscribers or certain strategic partners.
- Another entity, is responsible for purchasing the license with respect to particular content (i.e. video/ audio content that has already been produced) or newly produced content. Once the license is purchased, it is immediately transferred to its parent entity overseas. The license rights do not at any point of time vest with the local entity.
- The entity receives an assured return arm’s length return for undertaking such functions.



Possible Value Creators:

- Technological Interface
- User Viewing Pattern
- Content

Applicable Profit Allocation Method?

Overview of new nexus rules

- IF will explore ways to revise the nexus rules to render the new profit allocation rules applicable in a far broader context than the current nexus/PE rules.
- The new rules will likely involve having a remote taxable presence even without a traditional physical presence and a new set of standards for identifying when a remote taxable presence exists.
- The approaches considered to implement new nexus rules include the following:
  - Amendments to the definition of a PE in Article 5 (Permanent Establishment) of the OECD Model Convention, along with potential changes to Article 7 (Business Profits) of the convention.
  - Potential changes to Article 9 (Associated Enterprises) of the convention to allow market jurisdictions to exercise taxing rights over the measures of profits allocated to them under the new nexus and profit allocation rules.

Other technical issues

In exploring these three methods, the IF will also examine other technical issues, such as:

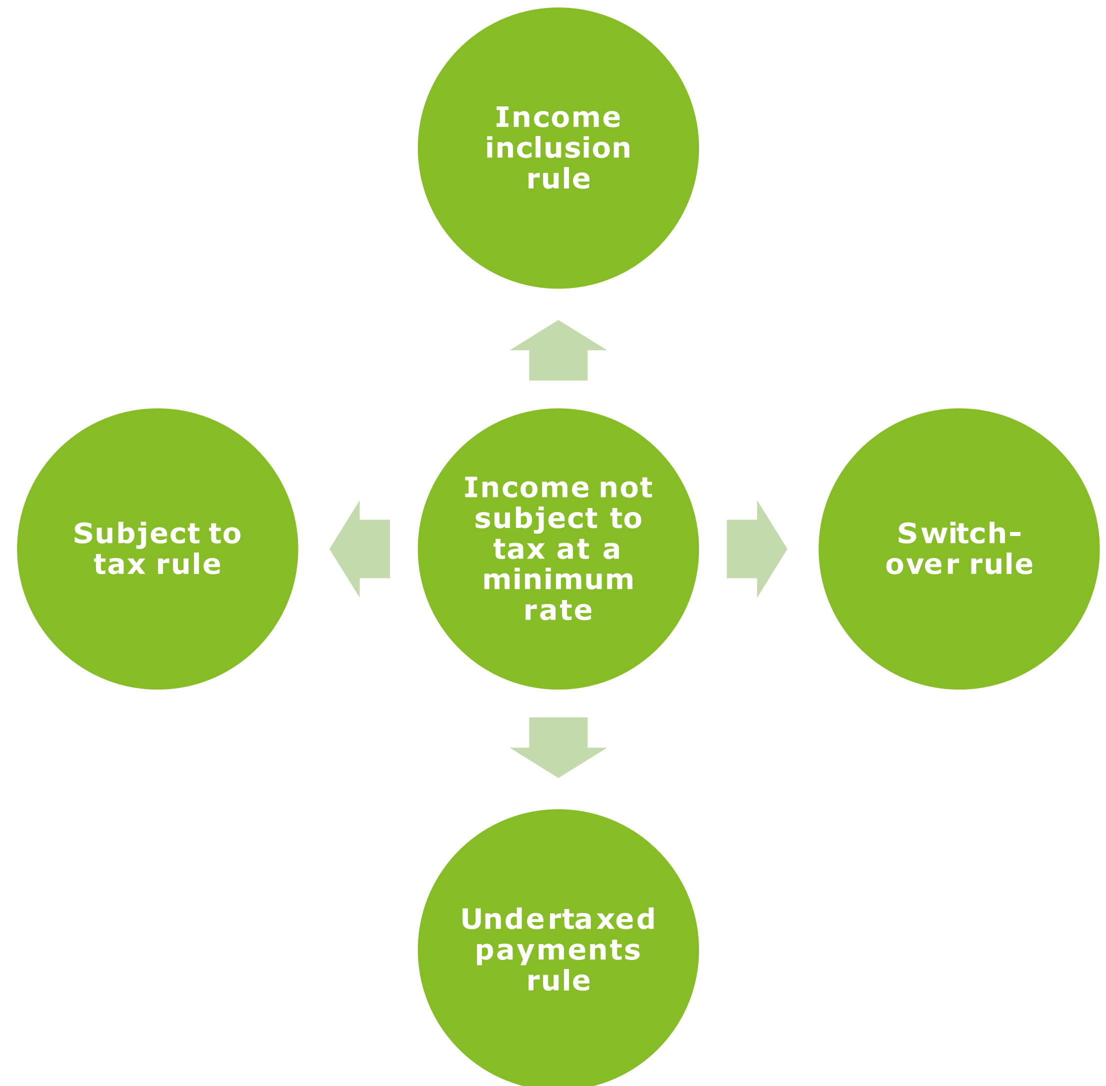
- The new taxing right may be limited to particular types or sizes of business.
- It may be necessary to segment groups on a business line or regional basis.
- Any new profit allocation rules must also take account of losses.
- Novel approaches and instruments may be required to eliminate double taxation, as well as to ensure effective and coordinated implementation of the new taxing right.

Pillar 2

Overview of the GloBE proposal

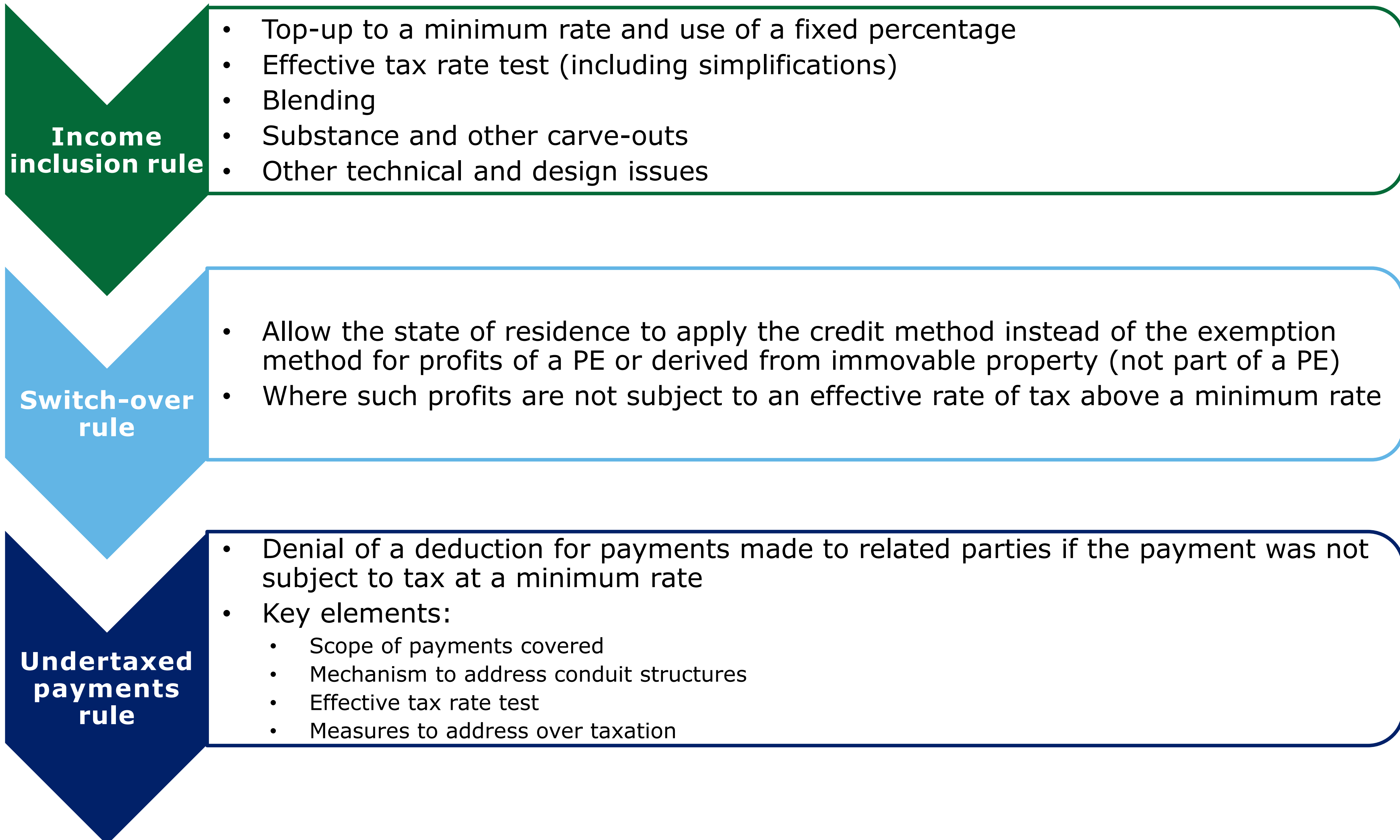
Rationale given for Pillar 2

- Provide jurisdictions with the ability to "tax back" group profits that are subject to a low effective rate of tax
- Multilateral solution to avoid uncoordinated rules increased complexity and risk of over-taxation.
- Reduce pressure on developing countries to grant tax incentives
- Address profit shifting risk from intangibles but not ring-fenced to digital economy
- Recent tax policy developments (e.g. GILTI)
- IF members agreed to explore on a without prejudice basis



Overview of the GloBE proposal

From parent's perspective



Overview of the GloBE proposal

From parent's perspective

Subject to tax rule

- Domestic law and treaty changes that allow for imposition of source country taxation when the income is not subject to a tax at a minimum rate
  - Consider broader policy questions
  - Focus on interest and royalties

Co-ordination, thresholds and compatibility

- Co-ordination between the four different rules
- Co-ordination with other international rules including Pillar 1
- Possible use of thresholds and carve-outs
- Compatibility with international obligations and EU fundamental freedoms
- Emphasis on simplification, avoidance of double taxation and minimizing compliance and administration costs

Next steps

- The program of work presented and approved by G20 finance ministers during their meeting on June 8-9, 2019 in Fukuoka, Japan.
- OECD Working Parties will meet throughout the remainder of 2019 to consider the relevant technical issues and a report on the progress of work is expected in December 2019.
- Consideration will be given to holding further public consultations to gather business feedback as the various proposals are refined.
- A recommendation for a unified approach on nexus and profit allocation and the key design elements of the global minimum tax will be submitted to the BEPS IF for agreement at the beginning of 2020.
- Work will continue to reach agreement on the policy and technical details, with a final report due by the end of 2020.

CBDT proposal on attribution of profits to PE

Proposal on attribution of profits to permanent establishment

CBDT Committee-constitution and mandate

Background

- Lack of clear guidance/computation mechanism leading to disputes and protracted litigations
- It was considered essential to undertake necessary measures to bring **clarity, consistency and predictability in the domestic attribution rules, that are permissible under the treaties**

Mandate of the Committee

Considering the above, the CBDT constituted a committee with following Mandate:

- *Examine existing scheme of profit attribution to PE under Article 7 of Double Taxation Avoidance Agreements ("tax treaties")*
- *Examine contribution of demand side and supply side factors in profit attribution*
- *Recommend the changes needed in Rule 10 of the Income-tax Rules, 1962 ("IT Rules") to provide specific rules on how profits are to be attributed to a non-resident person having PE in India*

Proposal on attribution of profits to permanent establishment

Attribution of profits to PEs - Tax Treaties Framework

Position under Indian Tax Treaties

- Article 7(1) of Indian Tax Treaties states that only those profits of the non-resident enterprise shall be taxed in India which are attributable to the PE of such enterprise in India
- Article 7(2) of most Indian Tax Treaties mandates the attribution of profits to a PE on the basis that the PE is a 'distinct and separate' enterprise. This is in line with UN MC and the pre-2010 OECD MC
- Pre-2010 OECD and UN Commentary on Article 7 describe the 'distinct and separate' enterprise approach as corresponding to the 'arm's length principle'
- Most Indian Treaties also contain Article 7(4) which allows apportionment method for profit attribution provided:
  - this is customary in the domestic law and
  - its results are in accordance with the principles of Article 7 (i.e. 'distinct and separate' enterprise approach)
- Pre-2010 OECD MC was revised in 2010 as regards Article 7:
  - Specific application of FAR analysis for 'distinct and separate' enterprise approach was incorporated in Article 7(2), and
  - Article 7(4) allowing apportionment method was deleted
- India has reserved the right to use the pre-2010 OECD / UN MC version of Article 7. It has not accepted the authorized OECD approach to attribute profits based on FAR analysis.

Proposal on attribution of profits to permanent establishment

Attribution of profits to PEs - Tax Treaties Framework

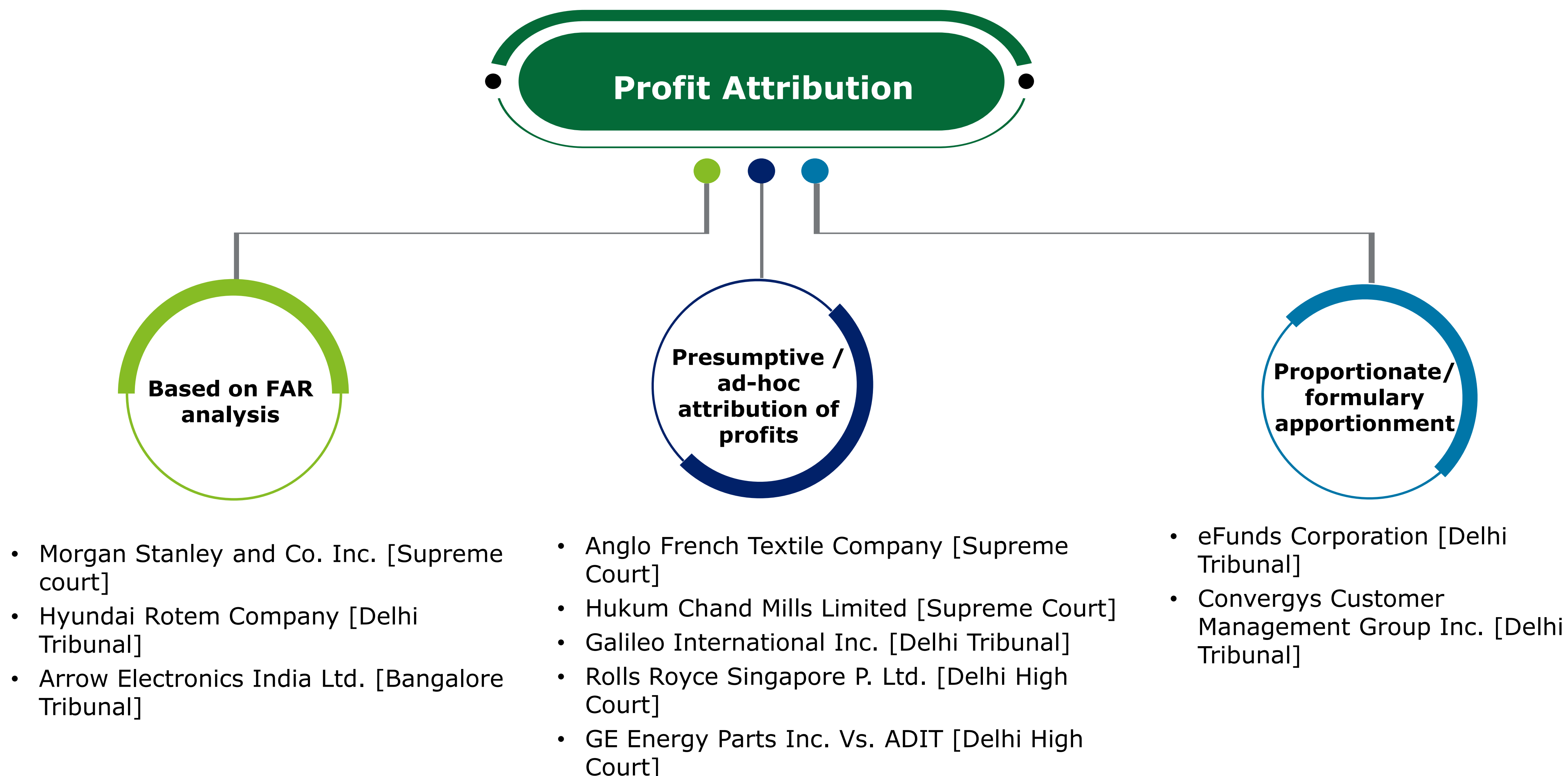
Position under Domestic law

- Section 9 of the domestic law provides that in case a non-resident has a 'business connection' in India, only that income of the non-resident will be taxed in India which is attributable to Indian operations
- Finance Act, 2018 has also introduced the concept of 'Significant Economic Presence' ("SEP") as a factor which would lead to a business connection, if prescribed threshold of users/ revenue is exceeded. The threshold is yet to be prescribed. The SEP provision will apply only in non-treaty situations
- For profit attribution under the domestic law, Rule 10 provides that in case,
  - profits attributable to a business connection cannot be definitely ascertained,
  - the tax authorities may resort to any of three methods viz. percentage of turnover (presumptive), proportionate or discretionary method
- Finance Act, 2001 introduced TP provisions in the domestic law. TP provisions incorporate the definition of PE as an 'associated enterprise' of the non-resident. Transactions between a PE and its non-resident HO are therefore subject to TP provisions
- CBDT has also clarified* the applicability of the 'arm's length principle' /TP for attribution of profits to an IT-enabled BPO unit if it constitutes a PE in India. Further, India's APA scheme# recognizes that attribution of profits can be determined by application of TP principles and accepts APA applications for attribution of profits

* CBDT Circular 5/2004 # Advance Pricing Agreement Guidance with FAQs – Q23

Profit attribution to Permanent Establishment

Indian jurisprudence on attribution of profits



Based on FAR analysis

- Morgan Stanley and Co. Inc. [Supreme court]
- Hyundai Rotem Company [Delhi Tribunal]
- Arrow Electronics India Ltd. [Bangalore Tribunal]

Presumptive / ad-hoc attribution of profits

- Anglo French Textile Company [Supreme Court]
- Hukum Chand Mills Limited [Supreme Court]
- Galileo International Inc. [Delhi Tribunal]
- Rolls Royce Singapore P. Ltd. [Delhi High Court]
- GE Energy Parts Inc. Vs. ADIT [Delhi High Court]

Proportionate/ formulary apportionment

- eFunds Corporation [Delhi Tribunal]
- Convergys Customer Management Group Inc. [Delhi Tribunal]

Rule 10 upheld primarily in cases where the taxpayer did not produce any analysis / TP study did not reflect all functions performed by the PE

Proposal on attribution of profits to permanent establishment

Attribution of profits - Concern and approaches

The main problem – absence of statutory guidance

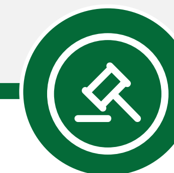
- Profits attributable to operations in India are taxable in India
- In a situation where few (say two) functions of a business are performed in India and few (say three) functions are performed outside India, how to attribute profits to the functions?
- If total profit is 100 should the allocation be 50:50, 40:60, 30:70 or any other ratio?

Approaches under the domestic law to tax cross border businesses

- Taxation based on profits determined as per India centric books of accounts
- Presumptive taxation : Section 44B, section 44BB, section 44BBA etc.
- Taxation on gross basis : Section 115A
- Rule 10 methods (significant discretion to tax authorities)

Approach of judicial authorities

- Issues resolved on the basis of high level subjective presumptions
- At higher level reluctance to indulge in "further guess work"



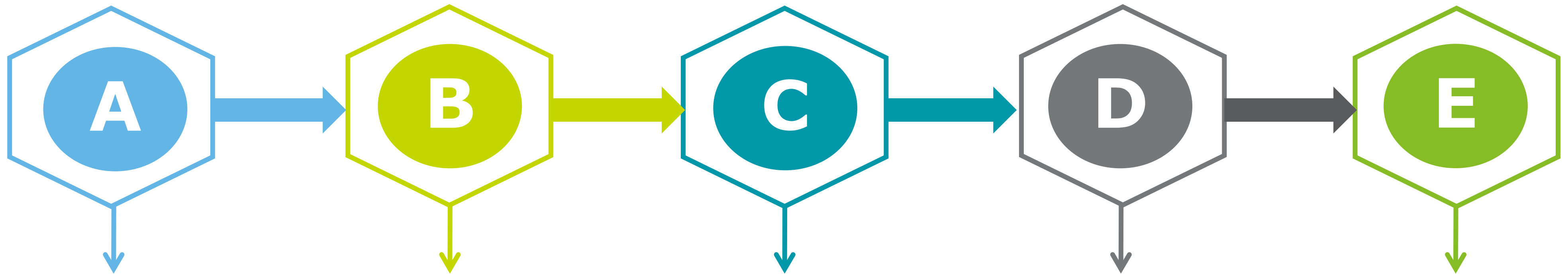
Proposal on attribution of profits to permanent establishment

CBDT Committee - Key Proposals

- The Committee acknowledged the need for a simple and universally applicable rule for profit attribution.
- Emphasized that business profits are contributed by both demand and supply side, hence, profits should be allocated to market jurisdiction as well.
- Discusses different approaches to profit attribution – (1) 'supply based approach'; (2) 'demand based approach'; and (3) 'mixed or balanced approach' (based on both demand / supply);
- Rejects functional, asset and risk ("FAR") approach by underlining India's reservation on OECD Model Convention as amended in 2010, and commentary.
- Prescribe formula based approach, outlines two possible methods:
  - Formulary approach requires apportionment of global profits; given the constraints in availability of relevant details, this approach may not be practically feasible
  - Fractional apportionment may be consequently followed *(refer next slide for recommendations)*
- Considers that the fractional apportionment method can be applied in treaty cases since Indian Tax Treaties do not follow FAR based approach and permit use of an apportionment based approach

Proposal on attribution of profits to permanent establishment

CBDT Committee - Key Proposals



De-minimus profits to be attributable

'Profits derived from India' to be higher of:

a) amount arrived at by multiplying the ***revenue derived from India*** with Global operational profit margin (Earning before interest, depreciation and tax "EBIDTA") or

b) 2% of revenue derived from India

3-factor based fractional approach

Equal weights (i.e., one-third) to be accorded to sales, employees (manpower and wages) and assets.

4-factor based approach for digital businesses

Existence of SEP/Digital businesses

- Low and medium user intensity:
  - Weight of 10% to be assigned to users, and
  - 30% each to above-mentioned three factors (sales, employees and assets)
- High user intensity:
  - Weight of 20% to be assigned to users,
  - 30% to sales; and
  - 25% each to employees and assets

Reduction of profits taxed in the hands of AE

In computing the attributable profits, profits earned by an AE in India and charged to tax (in its hands) shall be reduced.

No attribution in specified cases

No attribution in cases where business connection is constituted by activities of AE resident in India, and

- Quantum of sales /services do not exceed INR 1 mn or no payment is received, and
- activities of the AE are remunerated on an arm's length basis

Proposed Rule 10 to be applied in limited situations where accounts are not available

Profit attribution to Permanent Establishment

Recommendation of the committee - Formula based attribution

Profits attributable to PE proposed to be determined based on the following formula#

$$= Profits\ derived\ from\ India \times \left\{ \left(\frac{SI}{3 \times ST} \right) + \left(\frac{NI}{6 \times NT} \right) + \left(\frac{WI}{6 \times WT} \right) + \left(\frac{AI}{3 \times AT} \right) \right\}$$

where,

'Profits derived from India' = Revenue derived from India x Global operating profit margin

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

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

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

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

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

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

AI = assets deployed for Indian operations and located in India

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

For digital businesses, a variant formula (with weightage to users) has been prescribed (refer previous slide)

Proposal on attribution of profits to permanent establishment

Merits of FAR based approach

FAR facilitates taxation based on value creation

Demand as a value driver

- Reference to PE being " *a distinct and separate enterprise engaged in **the same or similar activities*** " under the Tax Treaties and "*only so much of income as is attributable to the **operations carried out in India***" under the Act.
- Return for market when it is not owned or controlled by any enterprise : in nature of "rent" or "market access fee"?

Merit of a FAR based analysis

- FAR analysis compensates for activities resulting in capturing more market/higher sales (by giving a sales based return) : Encourages value based taxation-"inherent objective of BEPS proposals"
- TP principles also permit two sided method (Profit Split), which can sufficiently remunerate any significant marketing function or IP
- Attributing group synergy– Covered in two sided analysis

Notional Taxation

- Economic analysis based on local comparables adequately factor in the local market characteristics/return (e.g. location savings)
- Additional return for market - leads to artificial taxation?

Proposal on attribution of profits to permanent establishment

Key discussion Aspects

Whether Rule 10 or the application of TP provisions is customary in the Indian Context?

Relevance of India's reservations to the revised Article 7 in 2010 OECD MC?

Whether Article 7(4) is subject to Article 7(2) and can be used only in cases where profits cannot be attributed under a separate entity hypothesis?

Whether the proposal to use the apportionment based method even in treaty cases will lead to treaty override? For SEP, would the formula have relevance in treaty cases?

Proposal on attribution of profits to permanent establishment

Computational aspects

Revenue derived from India

- Defined to include all receipts arising or accruing or is deemed to accrue or arise from India, chargeable under the head profits and gains of business or profession
- May be understood to include all sales whether effected through a PE or not (expanding nexus?) : Clarification required that only the sales effected through a particular PE will be considered for formula

Users

- Separate weightage for users: is not the user base reflected in revenue?
- Differentiating Active vs Passive users

Global Profits

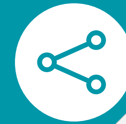
- The term "Global operational profit margin' needs to be explained to clarify:
  - Profit of the enterprise vs profit of the group (attribution of return for IPs owned by principals?)
  - Profit of business group/segment vs profit of all segments in the group
- 2% minimum profits proposed: Contrary to economic realities

Proposal on attribution of profits to permanent establishment

Computational aspects

Use of EBIDTA

- Use of EBIDTA margin proposed on the assumption that the PE does not own any capital or hold any assets : proposition debatable especially in the case of highly leveraged or asset intensive industries
  - Can an Industry specific formula be looked upon?
- In addition there may be instances where PE owns any asset or deploys borrowed funds for Indian operations or relies substantially on fixed assets located in head office ("HO") jurisdiction
- Inconsistency with treaties (providing for apportionment of "total profits" vis-a-vis "notional profits") - Profit before Taxes a better reflective ?

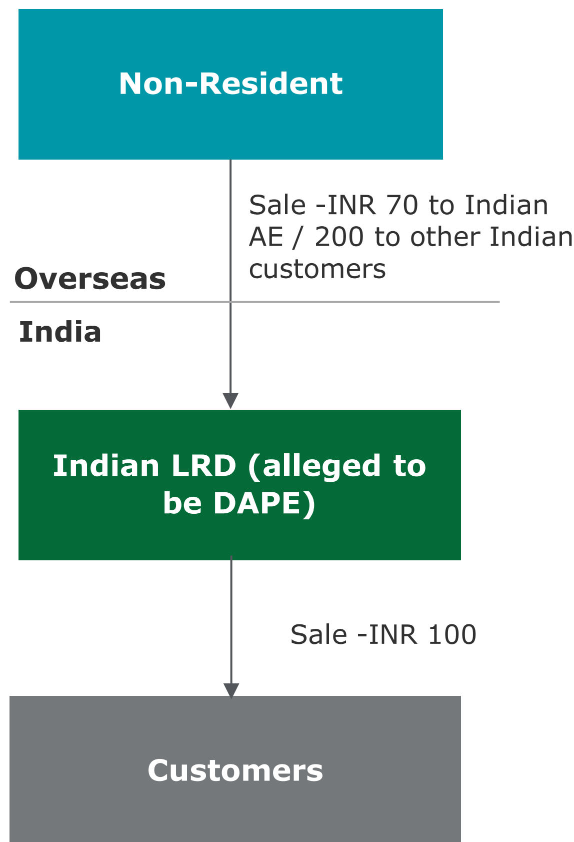


Employees, Assets and Users

- Clarification required for determination of employees and assets "with respect to Indian operations" located in and outside India : Likely challenge in cases of common employees and assets
- Legal vs economic assets : many IPs may not be recorded in books
- A single formula for all industries may not capture the industry specific niceties
- In certain cases, the employees and assets of the associated enterprise will deemed to be employed or deployed in the Indian operations and located in India – would increase supply side weightage in India

Profit attribution to Permanent Establishment

Illustrative example 1



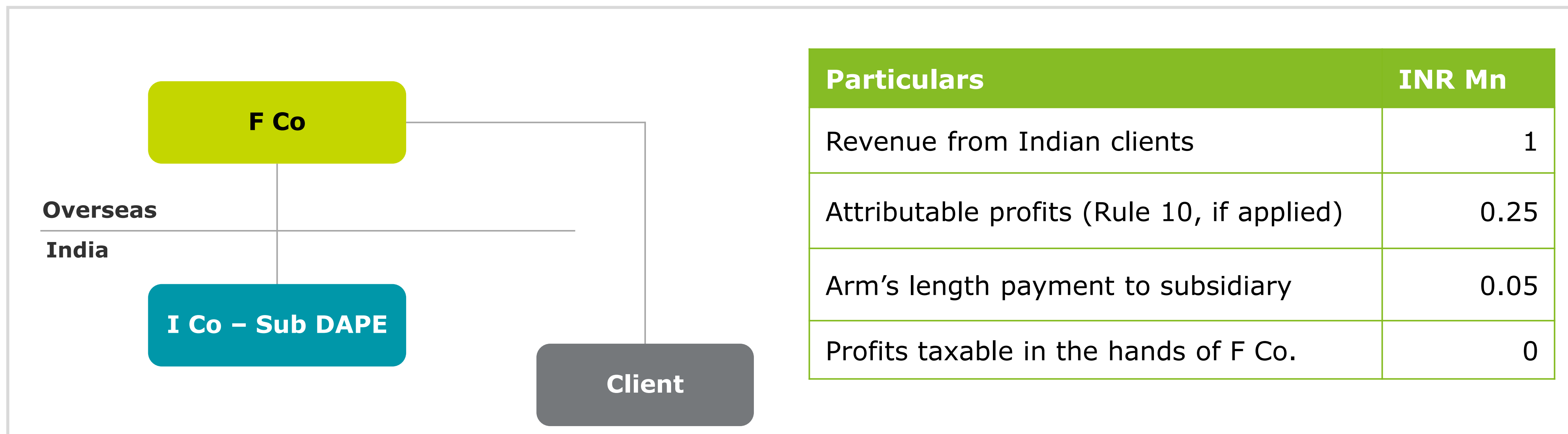
Particulars	Number
Employees	Sales-India-15, Outside India-5 (not India specific) R&D and manufacturing-Outside India-50
Employee cost	Sales-India-INR 1500, Outside India-INR 1000 (not India specific)) R&D & manufacturing-INR 5000
Assets	Sales assets- India INR 500, Outside India INR 500 (not India specific) R&D and manufacturing assets-Outside India-INR 2000
Profitability/EBITDA	India-2%, Global-10%

- Revenue derived from India- 70 or 100 or 270?
- "employees located overseas with respect to Indian operations - NIL, 5, a proportion of 5 or proportion of 55
- Assets deployed for Indian operations located outside India"?
- Consideration of economic value of intangible assets?
- **Result 1-** 100*10% * (1/3+(1/6*15/20)+(1/6*1500/2500)+(1/3*500/1000)=7.25, i.e. 7.25% of sales **[only sales people without proportion]**
- **Result 2-** 100*10% * (1/3+(1/6*15/70)+(1/6*1500/7500)+(1/3*500/3000)=4.58, i.e. 4.58% of sales **[manufacturing and sales people without proportion]**

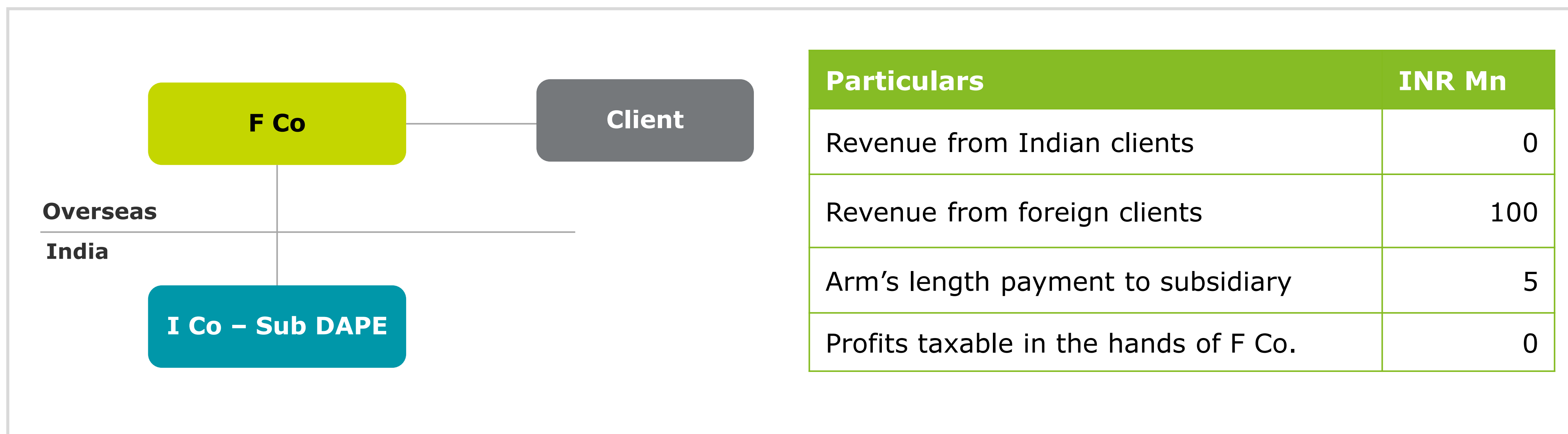
***Several combinations can arise in the application of formula**

Profit attribution to Permanent Establishment

Illustrative examples 2 and 3



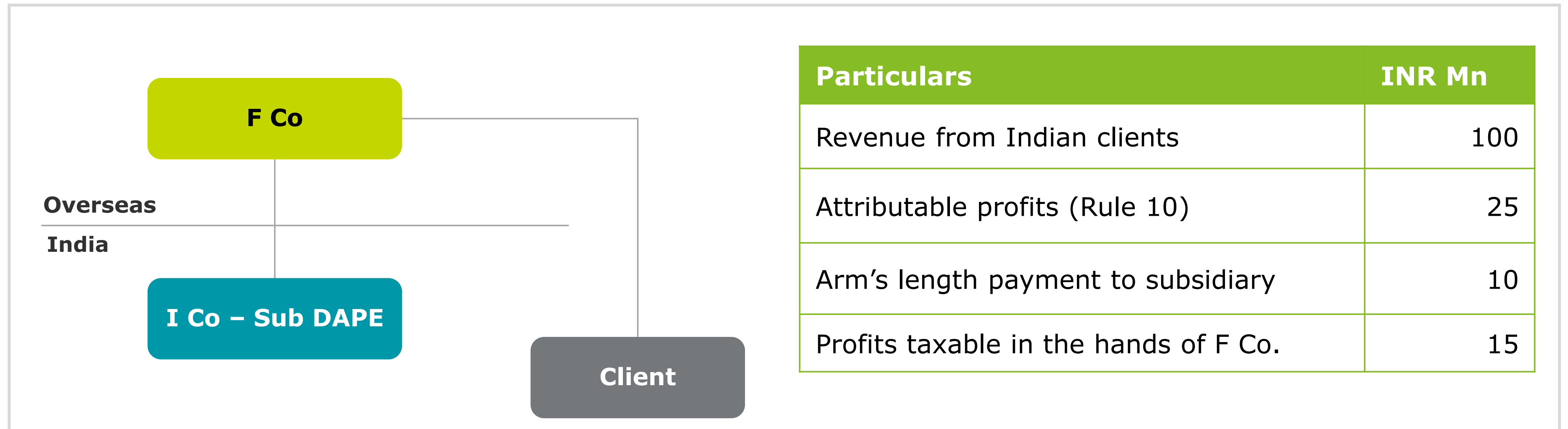
Particulars	INR Mn
Revenue from Indian clients	1
Attributable profits (Rule 10, if applied)	0.25
Arm’s length payment to subsidiary	0.05
Profits taxable in the hands of F Co.	0



Particulars	INR Mn
Revenue from Indian clients	0
Revenue from foreign clients	100
Arm’s length payment to subsidiary	5
Profits taxable in the hands of F Co.	0

Profit attribution to Permanent Establishment

Illustrative examples 4



Particulars	INR Mn
Revenue from Indian clients	100
Attributable profits (Rule 10)	25
Arm’s length payment to subsidiary	10
Profits taxable in the hands of F Co.	15

Proposal on attribution of profits to permanent establishment

Summary and way forward

- The CBDT has taken a key step for addressing the uncertainties in relation to profit attribution exercise
- The CBDT proposal presently a public consultation document on which comments have been sought and submitted by various stakeholders
- The legal and practical/computational aspects highlighted by the stakeholders would need to be considered for finalization of proposals
- Important to build in safeguards that tax authorities do not routinely resort to application of fractional apportionment approach under proposed Rule 10 by rejecting separate entity approach /financials of PE.
- Taxpayers should assess the impact of proposals on their businesses and the proactive measures to avoid double taxation
- Bilateral APAs and Mutual Agreement Procedures will assume more significance