Attribution of Profits to Permanent Establishment

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Agenda

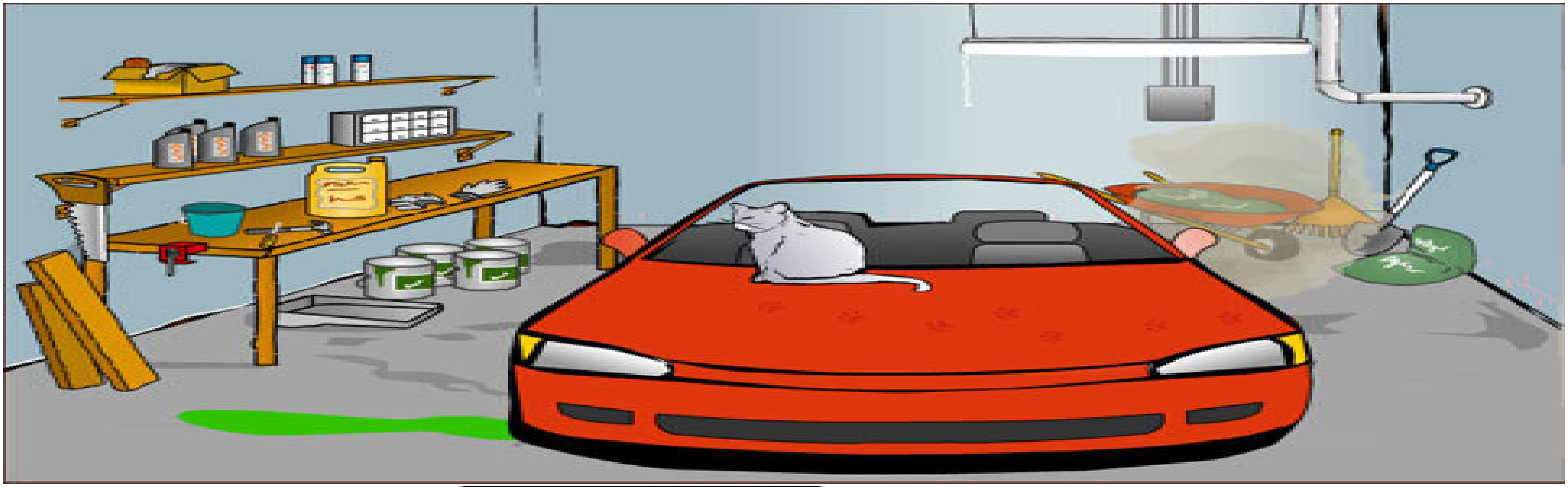
- Backdrop – Why Attribution
- OECD MC & Report on attribution of profits
- Attribution under the Act
- Force of Attraction principle
- Judicial Precedents in India
- Case Studies

Pay a portion of my garage rent

Mr. A
(Tax Authority)

Why?

Mr. B
(MNC)



- Bonnet of your car is within my garage
- Your spares usually lie in my garage
- Your mechanic uses my garage for repairing your vehicle

OOPS!!!

Backdrop- Why Attribution?...

- Residence Country – generally taxation of global profits

- Right of source country to tax profits of foreign enterprise operating in its jurisdiction – when Permanent Establishment ('PE') exists i.e. Source Based Taxation
  – Only those profits which are attributable to PE in the source country

Attribution of profits – one of the biggest controversy

OECD MC & Report on attribution of profits

Broad framework of Article 7

- Purpose
  - – Allocates taxing rights with respect to the business profits of an enterprise of a contracting state to the extent that these profits are not subject to different rules under other Articles of the Convention
- Existence of PE
  - – As a general rule, until a enterprise of one State sets up a PE in another State, it should not properly be regarded as participating in the economic life of that other State and accordingly the business profits of that enterprise may not be taxed by that other State;
  - – limits the right of one contracting state to tax the business profits of enterprises of the other contracting state
- Underlying Principles
  - – The separate entity and arm's length principle governs the attribution of profit under this article

Function and Risk analysis are imperative for attribution of profit to PE

Report of attribution of profit to PE – 2010

Report divided into four parts:

Parts	Particulars
Part I	General considerations for applying the Authorised OECD Approach (AOA) to PEs
Part II	Special considerations for applying the AOA to PEs of Banks
Part III	Special considerations for applying the AOA to PEs of enterprises carrying on global trading of Financial Instruments
Part IV	Special considerations for applying the AOA to PEs of Insurance Companies

OECD Approach

- OECD Report on Attribution of profits has considered two approaches:-
  - Relevant business activity approach
    - Profit attribution cannot exceed profits of the enterprise as a whole from the activity in which PE has participation
  - Functionally Separate Entity approach
    [as used in Set Satellite (ITAT) decision - later overruled by Mumbai High Court – based on Morgan Stanley Ruling]
    - Profits attributable to PE ~ even if for the enterprise as a whole, there is loss or no profit
- OCED selected "Functionally Separate Entity" approach as its AOA

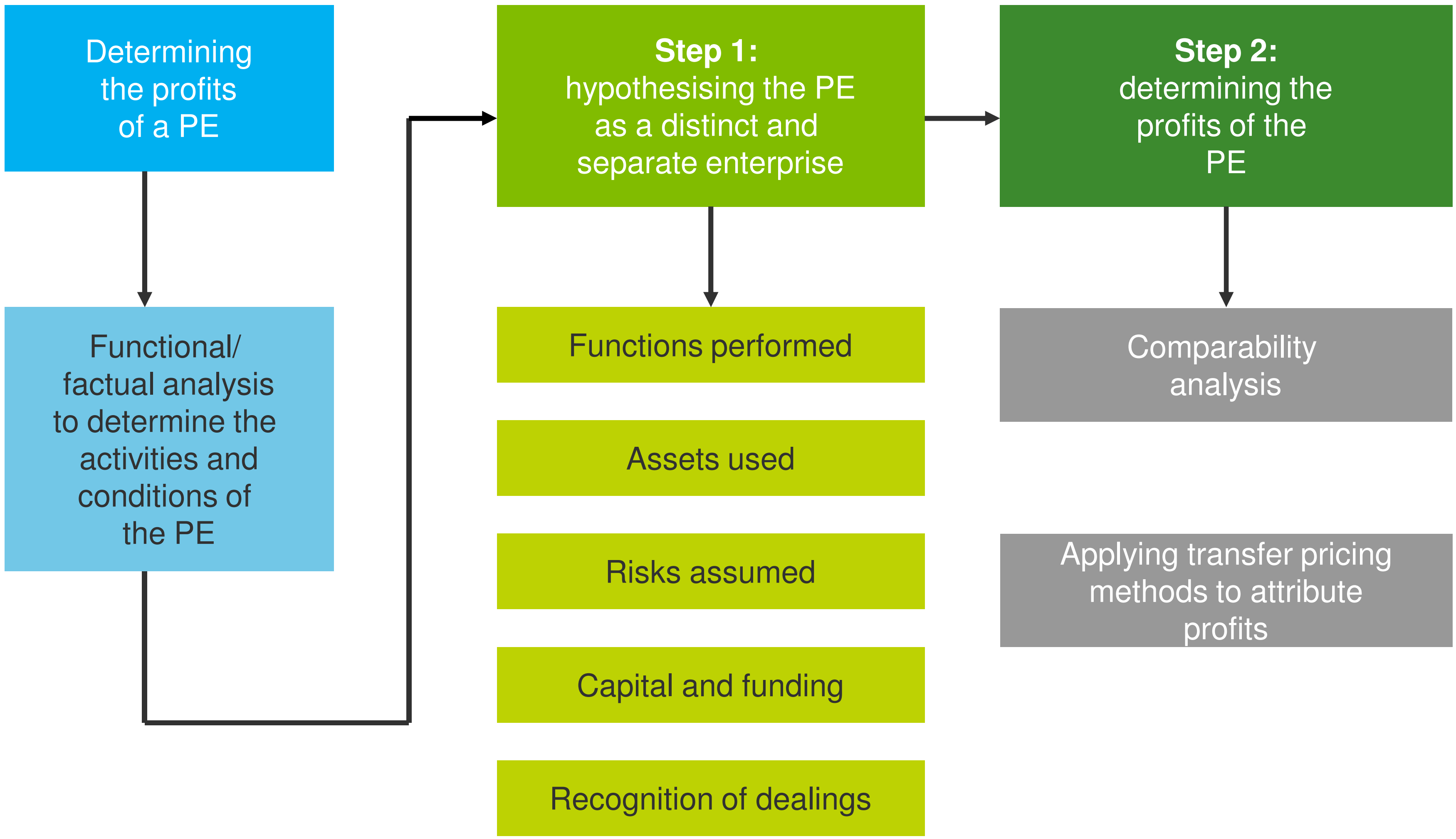
OECD MC follow "Functionally Separate Entity" approach

OECD Approach

- **Basic Principle of "Functionally Separate Entity" approach**
  - Fiction that PE is a separate enterprise & deals independent
    - from the rest of the enterprise
    - Other person (related or not)
  - Applying the Arm's length principle

- **The authorised OECD approach contains two steps:**
  - Step One:
    - hypothesise the PE as a separate and distinct enterprise
    - Functional and factual analysis
    - Attribution of assets
    - Attribution of risks
    - Attribution of 'free capital' and funding
    - Recognition of dealings
  - Step Two:
    - Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis

OECD Approach



Step 1(i): Functions performed/activities of the PE

Functional and factual analysis

- Identify all activities and responsibilities of the enterprise that are associated with PE
  - Functions performed by PE in its jurisdiction on its own account
  - Functions performed by PE on behalf of other part(s) of enterprise
  - Functions performed by other parts(s) of enterprise on behalf of PE

Fixed place PE

- Activities to be determined by analysis of ‘fixed place’ ~ examine functions performed at ‘fixed place’

Dependent agent PE

- Examine functions undertaken by the agent on behalf of the enterprise

Step 1(ii): Attribution of assets

- Legal ownership concept cannot be used to determine assets owned by PE ~ Notion of 'economic ownership' introduced to attribute assets to PE

- Attribution of economic ownership may depend on type of asset and type of business in which assets are used

- In case of '**tangible assets**', economic ownership is determined by 'place of use'
  - E.g.: physical assets used by branch such as computer system, branch premises, etc.

- Criteria for attribution in the case of '**Intangible assets'**
  - who undertakes active decision-making for taking on and management of risks related to intangibles

Step 1(iii): Attribution of risks

- Between associated enterprises, risks are assigned based on contracts
- Between head office and PE, enterprise as a whole bears risks
- However, under AOA risk may be assigned to PE despite absence of contractual arrangement
- PE to be assigned risk for which the significant function are performed by personnel of PE at PE’s location
  - E.g.: PE to be assigned risks arising from negligence of employees engaged in functions performed by PE

Step 1(iv): Attribution of free capital and funding

- Enterprises require capital to fund day to day business

- Sources of capital
  - Equity
  - Retained Profits
  - Borrowing

  Equity capital

  Debt

- As the interest expense is deductible for tax purposes, it is necessary to ensure an appropriate attribution of the enterprise's 'free capital' to a PE in order to ensure an arm's length attribution of profits to the PE

- Direct relationship between risk and capital ; capital provides cushion against crystallization of risks into actual losses

- OECD report merely provides guidance on principles for capital attribution – the exact approach to be determined based on the facts and circumstances

Step 1(v): Recognition of dealings

- In fully hypothesising the PE as separate entity, it is necessary to identify and determine the nature of its internal "dealing" with the rest of the enterprise

- Just as an associated enterprise enters into "controlled transaction", PE undertakes "dealings" with the rest of the enterprise

- "Dealings" impact functions, assets and risks of PE and hence to be considered for profit attribution

- Examples of dealings:
  - PE uses services rendered by head office
  - PE uses assets owned by enterprise
  - PE provide services to the enterprise

Step 2: Determining the profits of the PE

- PE should obtain an arm’s length return for it’s functions, taking into account the assets used & risks assumed in the same manner as would a comparable enterprise

- Profits should be attributed to the PE by applying methods described under OECD’s TP guidelines

Documentation requirement

- By analogy, the guidance on transfer pricing documentation contained in OECD guidelines to apply to attribution to PE

- Onus of documentation on the taxpayer

- Dual documentation requirement in case of PE
  - Documentation relating to existence, characterization and terms of “dealing”
  - Transfer pricing documentation to test whether profit attribution is consistent with the arm’s length principle

Attribution under the Act

Business Profits - Domestic Law

- A non-resident is chargeable to tax under the ITA only in respect of income received or deemed to be received or accruing or deemed to accrue or arise in India

- Under the ITA, all income accruing or arising, whether directly or indirectly, through or from any **business connection** in India, is deemed to accrue or arise in India *(Section 9(1)(i) of the Act)*

- ‘Business connection’ is defined under the ITA in an inclusive manner to include activities carried out through a dependent agent [Explanation 2 to section 9(1)(i)]

- 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 operations carried out in India ~ [Explanation 1(a) to section 9(1)(i)]

Methods for Attribution of Profits – Domestic Law

Rule 10

- If the Assessing Officer ('AO') is of the opinion that the income accruing or arising to the non–resident, whether directly or indirectly, through or from any business connection in India cannot be definitely ascertained, the amount of such income may be calculated:

i. *Presumptive Method:* ad-hoc percentage of turnover accruing or arising in India; or

ii. *Proportionate Method:* $\dfrac{\text{Total world income} \times \text{Indian receipts}}{\text{World receipts}}$

iii. *Discretionary Method:* any other manner as the AO may deem suitable

Methods for Attribution of Profits – Domestic Law

Sections	Nature of Business	Extent of Taxable Income
44B	Shipping business	7.5% of gross revenue
44BB	Business of Exploration of mineral oils	10% of gross revenue
44BBA	Business of Aircraft	5% of gross revenue
44BBB	Turnkey Power Projects	10% of gross revenue

Force of Attraction Principle

Force of Attraction – OECD Model

Article 7 (1) – OECD Model

"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."

……OECD Model Does not support the FOA Rule (US Model supports the FOA Rule)

Force of Attraction – UN Model

Article 7 (1) – UN Model

"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;
- sales in that other state of goods or merchandise of the same or similar kind as those effected through permanent establishment; or
- other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment"

Force of Attraction - Indian tax treaties

- Following tax treaties contain force of attraction clause
  - Australia, Belarus, Canada, Cyprus, Czechoslovakia, Denmark, Finland, Indonesia, Italy, Kenya, Mongolia, New Zealand, Poland, Romania, Sri Lanka, Spain, Thailand, USA

- Types of FOA clauses in the tax treaties

Specific force of attraction	Normal force of attraction
Need of role to be played by PE	Automatically attributable if activities are same/similar
Business reasons for not routing the direct business of HO through PE	No specific requirement of role to be played by PE
E.g.: Cyprus, Sri Lanka	

‘Direct or indirect’ attribution

- In some of the tax treaties the phrase “directly or indirectly” attributable to PE ' is used
  - Bulgaria, China, Malta, Oman, Singapore, Switzerland, UK, Uzbekistan, Ukraine, Vietnam
  - Singapore, Vietnam, Uzbekistan, Ukraine, Malta and UK tax treaties defines the term ‘directly and indirectly’
  - Does it widen the scope of Article 7 ?

- As per India-Vietnam tax treaty, “directly or indirectly” means where a PE has active role in negotiation of the contracts

Judicial Precedents

Attribution of Profits – Case Laws

Case Law	Principles
Morgan Stanley and Co Inc. [Supreme Court]	✓ Existence of 'economic nexus' as opposed to legal and financial nexus important for income attribution ✓ PE to be considered as a distinct and independent enterprise for profit attribution ✓ No further attribution required if PE is compensated at arms' length ✓ Compensation to PE – based on FAR analysis and adequate transfer pricing documentation
SET Satellite (Singapore) Pte. Ltd [Bombay High Court]	✓ Attribution based on FAR analysis ✓ No further attribution required if dependant agent PE is compensated at arms' length
BBC Worldwide Ltd [Delhi Tribunal]	✓ Reliance placed on Set Satellite and Morgan Stanley ✓ No further attribution required if PE is compensated at arms' length

Attribution of Profits – Case Laws

Case Law	Principles
Galileo International Inc. [Delhi Tribunal]	✓ Income attributable to Indian operations of non-resident – determined on the basis of FAR analysis ✓ No distinction between DAPE and DA ✓ 15% of income - deemed to be attributable to the PE, since the PE was remunerated at a higher rate, no further attribution made ✓ No further attribution if DA is compensated at arms' length ✓ Consistent with SET Satellite
Rolls Royce [Delhi Tribunal]	✓ Fixed place PE and Agency PE - based on survey findings ✓ Extent of profit attribution to PE - (arbitrary guesswork) ➢ Manufacturing – 50 percent ➢ R &D – 15 percent ➢ Remainder 35 percent profit for marketing support attributed to PE

Attribution of Profits – Case Laws

Case Law	Ruling
Rolls Royce (Contd)	✓ Since separate accounts for PE were not available, Rule 10 of the Income-tax Rules (Rules) applied ✓ No reference to transfer pricing principles for attribution of profits (Morgan Stanley) ✓ Rule of thumb applied for attribution
Nortel Networks India [Delhi Tribunal]	✓ The entire business activities of the foreign entity were managed by Indian entity which acted as a service provider and sales outlet ✓ The employees of Group companies visited India in connection with the contract indicating that the business of the foreign entity was carried on in India through the premises of the Indian entity ✓ Since all activities were carried out by Group companies in India on behalf of the foreign entity, 50% of global profits should be attributed to the PE

Attribution of Profits – Case Laws

Case Law	Ruling
eFunds [Delhi Tribunal]	✓ A PE exists under the Tax Treaty in respect of the back office operation and software development services being carried out by eFunds India ✓ Steps for attributing profits to PE 1.Determination of proportion of Indian assets to global assets, including assets of eFunds India. 2. Aggregation of global profits of the group (inclusive of eFunds India profits). 3. Working of total profits attributable to India out of global profits in same proportion as (1) above 4. Aggregation of India attributable profits of group (X) 5. Less: eFunds India profits (Y) 6. Profits attributable to PE of Taxpayers (Z = X – Y) Under this formula, eFunds India is determined not have been compensated at arm's length. Consequently, relying on the Morgan Stanley decision, additional profits should be attributed to the PE

Attribution of Profits – Case Laws

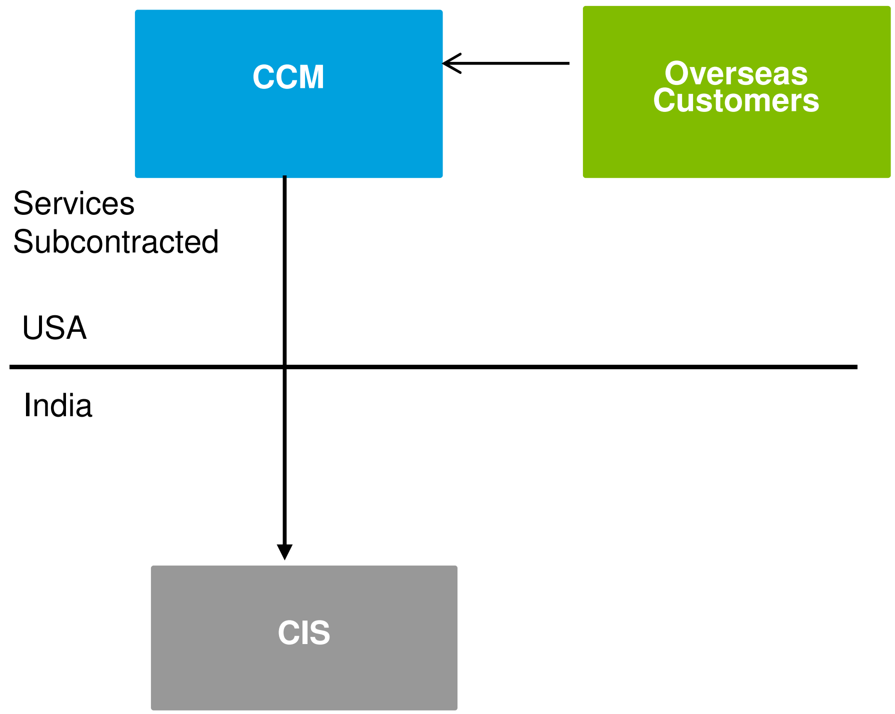
Case Law	Ruling
Clifford Chance [Special Bench]	✓ Reaffirmed that the amendment by Finance Act, 2010 with retrospective effect would be applicable only to income in the nature of interest, royalty and FTS and would not be applicable to business income ✓ the scope and ambit of profits indirectly attributable to a PE were to be read as per the relevant DTAA in determining the extent of profits which would be attributable to a PE
WNS North America [Mumbai Tribunal]	✓ Management and marketing services rendered are not taxable as ‘Fees for Included Services’ ✓ The condition of business activity carried on in the other State where the PE is situated is not satisfied because the marketing and management services in question are provided outside India ✓ Article 7(1) gives a clear understanding that the force of attraction rule is applied only in respect of the business carried on by an enterprise of Contracting State in the other Contracting State through PE as well as without involvement of PE

Convergys Customer Management Group Inc.. – Delhi Tribunal

Facts

- CCM was a company incorporated in the USA

- CCM procured services from CIS on principal to principal basis :
  - IT enabled call centre services
  - Back office support services ;
  - CCM staff visited CIS for supervision/direction and control
  - CCM also provided certain hardware and software assets on free of cost basis to CIS



Convergys Customer Management Group Inc. – Delhi Tribunal

Fixed Place PE was Upheld

Profit Attribution

YES

- Relying on the CBDT Circular No. 5 of 2004, Supreme Courts decision in case of Morgan Stanley and OECD Guideline, the Tribunal held that no further profits can be attributed to a PE once an arm's length price has been determined
- However, the taxpayer had submitted that it does not prepare India specific accounts, therefore the attribution of profits on the basis as disclosed in the TP study for assets and software cannot be accepted.
- Further in the facts and circumstances of the case PSM was not the correct method for attribution of profits to the taxpayer's PE in India.
- Departmental observation that further attribution was required for entrepreneurial services for managing risk related to the service delivery performed in India by CCM was held to be completely without any basis.

Convergys Customer Management Group Inc. – Delhi Tribunal

Fixed Place PE was Upheld

Profit Attribution | YES

- The Tribunal held that department's methodology was not acceptable and made the following observations:

  With regard to Revenue's approach in considering revenue of CCM as a multi-national enterprise as the starting point, :

  – Revenue of taxpayer cannot be considered as revenue of the PE
  – Department ought to have considered the expenditure incurred outside India for arriving at the profit of CCM with regard to the contracts wherein services have been procured from CIS
  – Provisions of Section 44C of the Act having been invoked in attributing income of the taxpayer without allowing the cost incurred to earn the revenue outside India (thereby attributing the entire receipts) was incorrect.

Convergys Customer Management Group Inc. – Delhi Tribunal

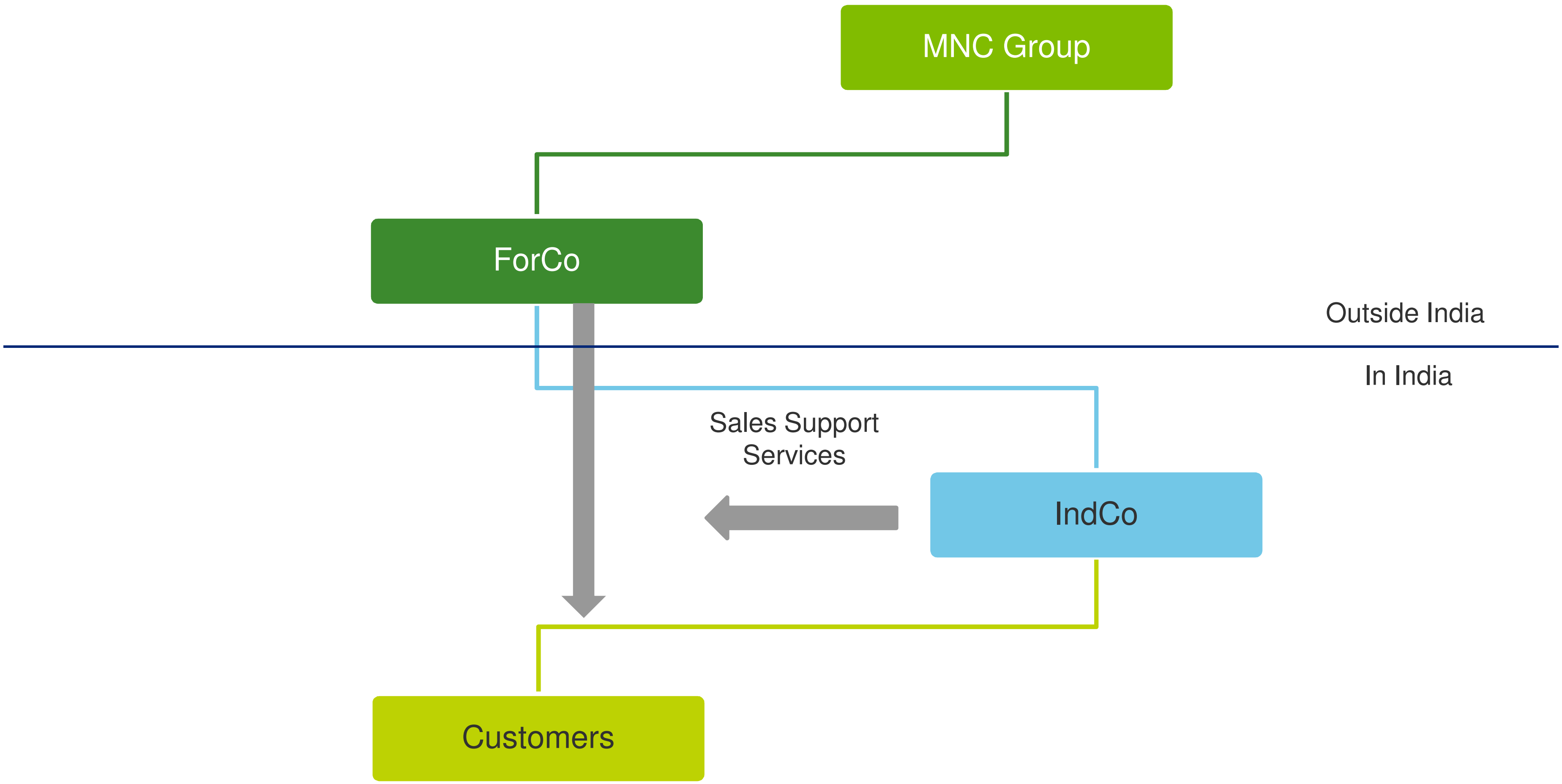
Fixed Place PE was Upheld

Profit Attribution → YES

- The Tribunal prescribed the correct approach to arrive at attributable profits as under:
  - Computing global operating income percentage of the customer care business as per annual report
  - Above percentage to be applied to the end-customer revenue with regard to contracts/projects subcontracted to CIS to arrive at operating income from Indian operations.
  - The operating income from India operations to be reduced by the profit before tax of CIS to arrive at profit attributable to Indian PE
  - Estimation of profit based on above residual profit
- For the purpose of attribution on residual profits, reliance was placed on two Supreme Court rulings that had dealt on profit attribution to Indian PEs. In the case of Anglo French Textile Co, 10% attribution was held reasonable and in Hukum Chand Mills Ltd., 15% attribution was held reasonable. The Tribunal held that the adoption of the higher figure of 15% for attribution of the Taxpayer's PE will meet the ends of justice.

Case Studies/ Some Practical Examples

Case Study I - Business Structure



Functional profile of IndCo

IndCo: Functional and Risk Profile

- Independent support service provider for sales in India
- Solicit orders on price & terms laid down by ForCo
- Provide market information
- Undertake market research on competition & pricing
- Prepare & suggest future business plans
- Draft strategic, operational, marketing and sales plans
- Act as a forum for customer grievances
- Provides assistance in inventory management
- Provide administrative assistance to conduct promotions/marketing events
- Track sales target achievements by customers
- Follow up with customers for payment
- Cannot accept orders on behalf of ForCo
- Does not hold product inventory
- Does not undertake bad debts and product risk

Functional profile of ForCo

ForCo: Functional and Risk Profile

- Determines price, terms and conditions for sale
- Authority to accept/reject order(s) submitted by IndCo
- No order binding until accepted by ForCo
- Shipment of products to Indian customers
- Training sales personnel of IndCo
- Investment in working capital- primarily of Inventory and Accounts Receivable
- Market fluctuation risks undertaken
- Bad debt risks borne
- Inventory Risks borne:- Procurement, Holding and Breakages
- Legal and Economic Ownership of Brands

Summarized FAR analysis

FAR	ForCo	IndCo
Functions		
Product ordering		√√
Marketing – sales force		√√
Marketing / advertising strategy		√√
Inventory Management		√√
Delivery / Shipping Management		√√
Debt management and collections		√√
After Sales Support		√√
Assets		
Brand	√√	
Property, plant and equipment (distribution)		√√
Inventory	√√	
Receivables	√√	
Risks		
Inventory Risk	√√	
Credit Risk	√√	
Foreign Exchange Risk	√√	

If PE ~ Attribution of Profit to ForCo as per OECD Approach

- Step I – Functional Analysis of PE

FAR	ForCo	IndCo	PE
Functions			
Product ordering		√√	√√
Marketing – sales force		√√	√√
Marketing / advertising strategy		√√	√√
Inventory Management		√√	√√
Delivery / Shipping Management		√√	√√
Debt management and collections		√√	√√
After Sales Support		√√	√√
Assets			
Brand	√√		
Property, plant and equipment (distribution)		√√	
Inventory			√√
Receivables			√√
Risks			
Inventory Risk			√√
Credit Risk			√√
Foreign Exchange Risk			√√

If PE ~ Attribution of Profit to ForCo as per OECD Approach

- Step II: Undertake comparability analysis to reward FAR of the PE
  - Characterisation: Distributor
  - Comparable Search for Distribution Companies
  - Arrive at final comparable companies to arrive at profits attributable to PE

Case study II – Dependent agent PE Attribution of profits to dependent agent PE

Facts of the case

- ABC India(‘ABC’) is s an indirect subsidiary of XYZ PLC (‘XYZ’)
- ABC predominantly provides procurement related support services and marketing support services to Group companies. As part of its activities, ABC coordinates with Indian counterparties for XYZ
- As the above transactions are between associated enterprises (‘AEs’), they are covered by the Indian Transfer Pricing (TP) legislation. It is therefore necessary for ABC to receive an arm’s length service fee for the said services provided to XYZ
- The arm’s length service fee receivable by ABC needs to be determined based on an analysis of the functions performed, assets employed and risks assumed by both ABC and XYZ (‘FAR analysis’)

Extent of exposure if PE created

Profit attributable to ABC's activities = Mean margin earned by comparable companies. Since XYZ's trading sales in India are to third parties, XYZs margins itself can be the starting point, if its purchases from other entities are at arm's-length

Compute XYZ's profit from sales in India

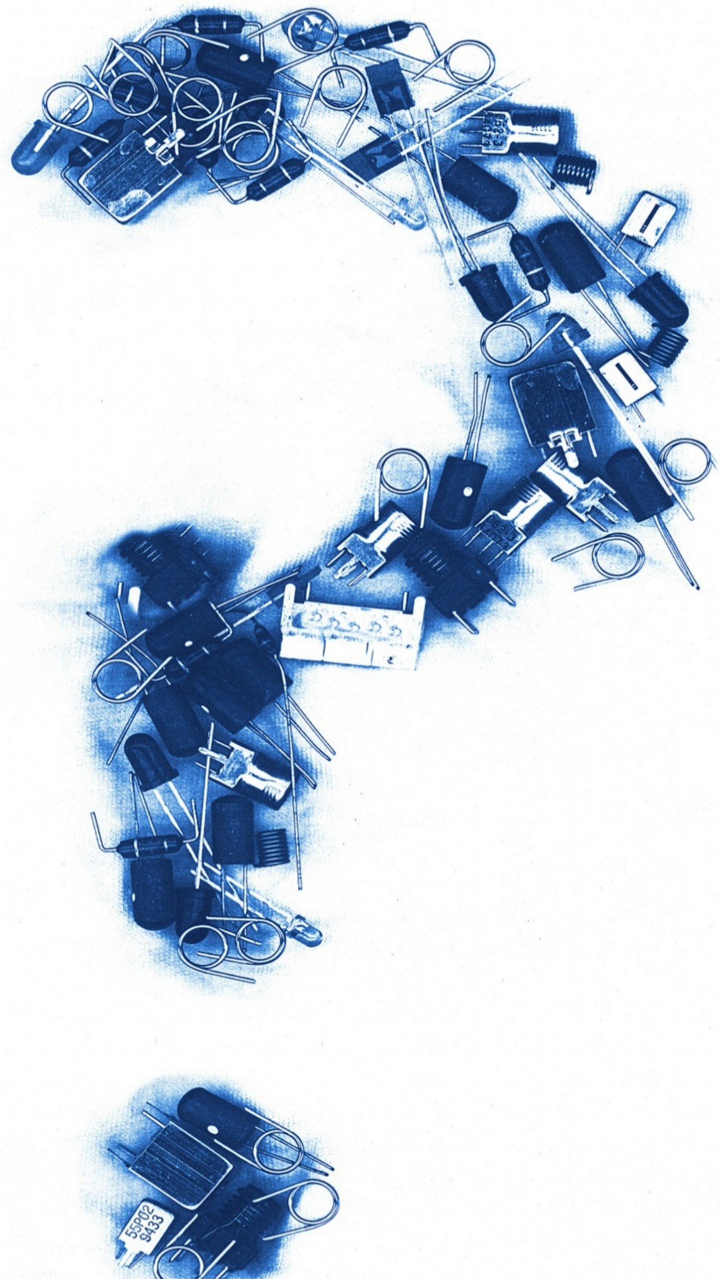
Allocate XYZ's profit from sales in India to ABC's activities based on:

- Relative contribution of various value drivers (functions carried out in India v. outside India) (Refer Illustration in subsequent slide)
- Relative contribution can also be judged from the salary cost of ABC's employees, as compared to relevant salary cost of the employees of the overseas XYZ entity (proportionate to the value of deals in India, v. outside India)

Less: Service fee already paid ABC = PE profit taxable in India @ 42%

Extent of exposure if PE created (contd.)

Value drivers	XYZ	Weightage on a scale of 1 to 5	ABC	ABC Weightage on a scale of 1 to 5
Functions				
A. **Strategy formation**				
Formulate, develop, implement market strategies	✔ ✔ ✔ ✔	4	✔	1
B. **Contracting with customers**				
Exploring business with potential customers in India / Preliminary discussions with potential buyers	-	0	✔ ✔ ✔ ✔ ✔	5
Financing, tender evaluation/ proposal	✔ ✔ ✔ ✔	4	✔	1
Negotiation and conclusion of contracts	✔ ✔ ✔ ✔	4	✔	1
C. **Sourcing of goods and inventory management**	✔ ✔ ✔ ✔	5	-	0
D. **Distribution & Logistics**	✔ ✔ ✔ ✔	4	✔	1
Assets and infrastructure				
Full-fledged trading capacity, comprising front, mid and back office operations	✔ ✔ ✔ ✔	4	✔	1
Risks				
Market risk	✔ ✔ ✔ ✔	4	✔	1
Credit risk	✔ ✔ ✔ ✔	4	✔	1
Inventory risk	✔ ✔ ✔ ✔	4	✔	1
Forex fluctuation risk	✔ ✔ ✔ ✔	4	✔	1
Total		41		**14**
Percentage		75%		25%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Thank You

Mehul K. Shah