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# CBDT Draft Guidelines on PE Profit Attribution – Not at Arm's Length with Treaty Provisions?

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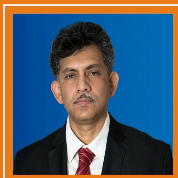

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The Central Board of Direct Taxes ("CBDT") has issued on 18th April, 2019, a recommendatory report on attribution of profits to permanent establishments ("PEs"), prepared by a Committee formed by the CBDT for the said purposes, inviting comments from various stake-holders within thirty days of such date of release, post which the CBDT may finalise its views on such issue, which are expected to be introduced through amendments to the provisions of the Income Tax Act, 1961 ("Act") and the Income Tax Rules, 1962 ("Rules").

This article analyses the recommendations made by the Committee; and also provides humble suggestions of the author to the CBDT for introducing guidelines for attribution of profits to PEs in a manner, which is fair and judicious; and also in line with the texture and fabric of the tax treaties signed by India with various countries ("Indian model tax treaties"). The official recommendations/ suggestions of the organisation to which the author belongs, would anyway be submitted by such organisation with the CBDT within the due date specified by the CBDT in this regard.

In summary, the Committee has said that arm's length principles under transfer pricing (TP) cannot be applied for attribution of profits to PEs under the Indian model tax treaties; and that a formulary approach needs to be adopted for such attribution, by applying the global operational profit margin of a foreign enterprise to the revenue derived from India, as further adjusted with reference to certain weightages relating to various factors, e.g. assets, employees, wages, etc.

No discussion is made in this article on the method of applying the formulary approach, as above, namely whether the assignment of various weightages is correct, etc., as the entire focus of this article is centred around the fundamental aspect of the very discarding by the Committee of the arm's length principle under TP for the purposes of attribution of profits to PEs under the Indian model tax treaties. The author lends his extremely humble views and suggestions to the CBDT for reconsideration of this fundamental aspect, which goes to the root of the subject of attribution of profits to PEs, for the detailed reasons provided in this article. In fact, as it would be evident upon gradual unfolding of this article, the Act itself provides for the application of arm's length principles under TP for the purposes of attribution of profits to PEs.

For an involved and meaningful discussion, the author deems it fit to first lay down the various justifications or reasons appended by the Committee while concluding that arm's length principles under TP cannot be applied for the purposes of attributing profits to PEs under the Indian model tax treaties; and thereafter to respectfully counter the same through necessary arguements.

Justifications/ reasoning of the Committee in disregarding the arm's length principles under TP

A. Article 7, dealing with attribution of profits to PEs, of the Indian model tax treaties are based upon that of the United Nations (UN) model of tax treaties, which more or less resembled Article 7 of the OECD Model Convention (MC), as it was in vogue prior to the amendments brought about in 2010.

B. The only differences so far as Article 7 is concerned, between the UN Model tax treaties and the OECD MC, as it stood prior to the amendments brought about in 2010, were that the UN model tax treaties contain the provisions of force of attraction (FOA) clause, as opposed to the erstwhile OECD MC; and further under the UN model tax treaties, there is an embargo on deductions being allowed in the hands of the PE for the purposes of computing profits attributable to it, for payments made to the head office (HO) or other parts of the foreign enterprise, of which it is a PE, for receipt of services, license of intangibles, etc., beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc., which embargo was not present in Article 7 of the erstwhile OECD MC

C. Article 7 of the OECD MC, as it existed pre 2010, the provisions of which are incidentally similar to that of the UN model tax treaties and also the Indian model tax treaties, barring the exceptions referred to in

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paragraph (B), as above, to the extent material for the purposes of the current discussions, provided that profits, for the purposes of attributing to the PE, would be those, which the PE 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 was a PE.

D. The amended version of Article 7 of the MC, namely post 2010, to the extent material for the purposes of the current discussions, provides that the profits, for the purposes of attributing to the PE, would be those, which the PE might be expected to make, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed (FAR) by the enterprise through the PE and other parts of the enterprise.

E. The Committee opined that there are three approaches for attributing profits to PEs, namely – (i) “supply approach”, which allocates profits exclusively to the jurisdiction where supply chain and activities are located; (ii) “demand approach”, which allocates profits exclusively to the market jurisdiction where sales take place; and (iii) “mixed approach”, which allocates profits partly to the jurisdiction where consumers are located and partly to the jurisdiction where supply activities are undertaken.

F. The Committee then went on to hold that the provisions of Article 7 of the revised OECD MC, namely post 2010, which advocate attribution of profits with reference to FAR analysis of the PE and other parts of the enterprise, fall under the “supply approach”, as discussed in paragraph (E), which, absent similar wordings both under the UN model tax treaties and Indian model tax treaties, cannot be applied for the purposes of attribution of profits under such latter models of tax treaties.

G. As it appears from the observations made by the Committee at various places in the report, that the Committee has equated the approach of profit attribution to PEs with reference FAR analysis, as synonymous with the arm’s length principles under TP, which as per the Committee, cannot be applied under the Indian and UN model tax treaties for the logic explained in paragraph (F) above.

H. The Committee then went to hold that Article 7 of both the UN and Indian model tax treaties; and also that of the OECD MC, as it stood pre 2010, prescribed a “mixed approach” towards attribution of profits to PE, as referred to in paragraph (E) above, which could only be achieved through the formulary method, albeit with proper safeguards, which the Committee felt that it had adequately ensured through the formula referred to earlier, being coined by the Committee as “fractional apportionment” under the overall umbrella of the formulary method.

I. The Committee drew necessary comfort on the applicability of the formulary approach for the purposes of attribution of profits to PE under the Indian model tax treaties, from decisions rendered by various High Courts of the country.

<u>Respectful submissions of the author for upholding the arm’s length principles under TP</u>

1. The common wordings of Article 7 of the OECD MC pre 2010; and also those of UN and Indian model tax treaties, barring the exceptions referred to in paragraph (B), as above, clearly provide that profits, for the purposes of attributing to the PE, would be those, which the PE 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 PE.

2. Now, determination of such profits under the hypothesis of the PE being a distinct and separate enterprise, dealing wholly independently with the enterprise of which it is a PE, is nothing but adherence with arm’s length principles under TP, which aim at analysing as to how third parties would have dealt in uncontrolled conditions, being the very philosophy of arm’s length principles under TP.

3. The differences between the wordings of Article 7 of the OECD MC pre 2010 and those of the UN model tax treaty, as referred to in paragraph (B) above, merely aims at curbing the applicability of the principles of arm’s length or TP only to such extents; and nothing beyond, namely without infringing upon the overall applicability of the principles of arm’s length and TP. The impact of such differences or exceptions has been discussed at a later stage in this article.

4. The view of the author that the provisions of Article 7 of the OECD MC pre 2010, actually embraced the principles of arm’s length under TP, stands vindicated by the commentary of OECD MC, explaining the need to introduce the amendments to Article 7 in 2010, on the lines discussed in paragraph (D) above.

5. At paragraph (3) of the revised commentary to Article 7 of the OECD MC, the OECD stated that the separate entity or arm’s length principles were already enshrined in the existing, namely pre 2010 OECD MC; and further that the OECD considered that it was sufficient to restate those principles with slight

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amendments and modifications for the main purpose of clarification.

6. With a view to provide greater certainty in the matter of attribution of profits to PE, the OECD released a detailed report or guidelines for attribution of profits to PEs in 2008 (“OECD 2008 PE report”), which relied upon the principles of arm’s length under TP through resorting to FAR analysis, which incidentally is the very life line of arm’s length principles under TP, without which the same cannot simply operate. The OECD further stated that the approach developed in the OECD 2008 PE report, namely adherence to arm’s length principles under TP through resorting to FAR analysis, was not constrained by either the original intent or historical practice and interpretation of Article 7 of OECD MC. The aforesaid averments find place at paragraphs (5) and (6) of the revised commentary to Article 7 of the OECD MC.

7. The OECD observed at paragraph (6) of the revised commentary to Article 7 of the OECD MC that there were differences between some of the conclusions of OECD 2008 PE report and the interpretation of Article 7 previously contained in the erstwhile commentary to the OECD MC. Incidentally, commentators who are well versed with the contents of the OECD 2008 PE report, would be aware that such differences related to the manner of acknowledging the internal dealings between the PE and HO or other parts of the enterprise of which it was a PE, namely whether or not there existed an embargo on deductions being allowed in the hands of the PE for the purposes of computing profits attributable to it, for payments made to the HO or other parts of the foreign enterprise, of which it was a PE, for receipt of services, license of intangibles, etc., beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc. In this connection, reference is invited to paragraphs (284) to (290) of the OECD 2008 PE report. In other words, while there has always been an express embargo in the said matter in Article 7 of the UN model tax treaties, there was room for debate in the said regard as per Article 7 of the OECD MC pre 2010.

8. The OECD thereafter went on to clarify at paragraphs (7) to (9) of the revised commentary to Article 7 of the OECD MC that in order to provide maximum certainty on how profits should be attributed to PEs, it was decided that the conclusions of the OECD 2008 PE report should be reflected in a new version of Article 7 of the OECD MC, which was ultimately effectuated through the amendment introduced in 2010, on the lines referred to in paragraph (D) above. Simultaneously, a revised commentary to Article 7; and also a fresh guideline on attribution of profits were prepared in 2010.

9. Thus, it would be evident from the aforesaid discussions that the concept of arm’s length principle under TP, for the purposes of attribution of profits to PEs, was merely made explicit in the revised version of Article 7 of the OECD MC, i.e. post 2010, while it already remained implicitly enshrined in the earlier version of Article 7 of the OECD, i.e. pre 2010, which incidentally matches both the UN and Indian model tax treaties, to the extent material for the purposes of the current discussions.

10. As stated earlier, the only substantive change that was brought about through the amendments to Article 7 of the OECD MC in 2010, was the allowability of deductions in the hands of the PE for payments made to the HO or other parts of the foreign enterprise, of which it was a PE, for receipt of services, license of intangibles, etc., even beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc., for which there was ambiguity in the earlier version of Article 7 of the OECD MC, i.e. pre 2010; and a complete embargo in Article 7 of the UN model tax treaties since inception.

11. Incidentally, paragraphs (2) and (13) of the commentary on Article 7 of the UN Model tax treaty, amongst others also endorse the application of arm’s length principles for the purposes of attribution of profits to PEs, particularly where the domestic legislation of a country authorises the determination of profits attributable to the PE on the basis of arm’s length principles.

12. Now, comes the most important aspect of the argument in favour of the application of arm’s length principles under TP for the purposes of attribution of profits to a PE under the Indian model tax treaties. Clause (iii), read with clause (iiia) of section 92F of the Act, recognise PE as an enterprise for the purposes of subjecting the same to the provisions of TP, namely arm’s length principles. Therefore, when the domestic tax legislation of India itself acknowledges the applicability of arm’s length principles under TP to PEs of foreign enterprises, the Committee perhaps fell in error in discarding such concept, as discussed above, quite apart from the fact that the justification provided by the Committee for such discarding, in the context of the texture of Article 7 of the Indian model tax treaties, also appears to be misplaced, as discussed in detail hereinbefore.

13. It is humbly submitted that perhaps there is no basis for the Committee concluding that the adoption of arm’s principles under TP through resorting to FAR analysis, yields to the “supply approach” for attribution of profits to PE, which purportedly allocates profits exclusively to the jurisdiction where supply chain and activities are located. The arm’s length principle under TP in practice aims to allocate profits amongst various enterprises within an MNE group, including PEs, which are hypothesised as distinct and separate enterprises, with reference to the FAR profiles of each such enterprise, without any bias whatsoever towards either the

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jurisdiction of the market or that of supply.

14. When the Committee proceeded to adopt the “mixed approach” for the purposes of attribution of profits to PEs, which purportedly allocates profits partly to the jurisdiction where consumers are located and partly to the jurisdiction where supply activities are undertaken, assuming for once that such “mixed approach” is correct, there is no basis to come to the conclusion that arm’s length principles under TP shall not be able to achieve such avowed objective of allocating profits to the jurisdictions of market and supply in a judicious and fair manner; and the only way to achieve such objective is to adopt a formulary approach, whether or not the same may be modified in any manner with the coinage of “fractional apportionment”, as above.

15. One respectfully reminds the Committee and the CBDT that in case the facts of the case so suggest, namely in a scenario where the entity placed in the jurisdiction of the market, whether in the form of a separate legal entity, i.e. a subsidiary company of the foreign enterprise; or a PE of the foreign enterprise, which is hypothesised as a distinct and separate entity to the foreign enterprise, contributes to unique or non-routine marketing intangibles, the arm’s length principles under TP do mandate the adoption of a profit split method, as against a “one sided” TP method of the likes of resale price method (RPM) or transactional net margin method (TNMM), for the purposes of allocating profits to such entity, placed in the jurisdiction of the market.

16. Of course, it goes without saying that if such selling entity, including a PE, whether in the form of a fixed place of business PE, branch or dependent agency, does not contribute to any unique or non-routine marketing intangibles, then a “one sided” TP method, namely either RPM or TNMM, should be adopted for determining the arm’s length amount of profits to be allocated to such entity.

17. On the comfort drawn by the Committee on the blessings received by the formulary approach for the purposes of attribution of profits to PE under the Indian model tax treaties by certain decisions rendered by various High Courts of the country, the author submits with responsibility, but due respect, that in all such cases, the taxpayers had never adopted any scientific approach with reference to arm’s length principles under TP for attributing profits to PE; and were more focussed on defending their positions of non-existence of PEs as per the facts and circumstances of the cases; and once such primary line of defence collapsed before the High Courts, then in absence of any sophisticated or scientific approach of attribution of profits having been placed by the taxpayers before the lower authorities, the High Courts, not being fact finding authorities, had no choice but to approve the formulary approach applied by the lower authorities, albeit with some modifications, wherever necessary. In most the cases, the High Courts had also observed the fact of such limitations faced by them, in their judgements.

18. Therefore, the discussions made in detail hereinabove, justify the position that Article 7 of the Indian model tax treaties, which resemble both Article 7 of the UN model tax treaty; and also that of the OECD MC pre 2010, to the extent material for the relevant purposes, approve and authorise the application of arm’s length principles under TP for the purposes of attribution of profits to PEs.

19. The only exception to the principles of arm’s length under TP, which may be read in the Indian model tax treaties, being more or less in line with the UN model tax treaties, would be the ones referred to in the discussions above, namely where any treaty signed by India contains the FOA clause; and also in the matter of allowability of deductions in the hands of the PE for payments made to the HO or other parts of the foreign enterprise, of which it is a PE, for receipt of services, license of intangibles, etc., beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc.

20. One may wish to also clarify as to what would be the import of the two exceptions referred to above. The FOA typically refers to a scenario where a foreign enterprise may have a PE in India, in the form of a branch, say engaged in the business of importing goods from its overseas HO; and selling the same to customers in India, in which case, the arm’s length profits commensurate to such distribution functions would be attributable to such PE of the foreign enterprise in India. In case the foreign enterprise also sells goods directly from its overseas location on an offshore basis to customers in India, without any involvement of the aforesaid PE in India, then under the FOA clause, the profits derived by the foreign enterprise from the sale of goods to customers in India, even without any involvement of the PE, shall be taxed in India as business profits under Article 7 of the relevant tax treaty. However, even by virtue of the FOA clause contained in the tax treaty, the Indian Revenue would have the rights to tax only the profits relating to the selling and distribution functions, which the PE would have otherwise carried out; and not the entirety of the profits accruing to the foreign enterprise, relating interalia to functions of research and development, manufacturing, etc., which would have never been carried out by the PE located in India under any circumstances. Thus the FOA clause under Article 7 of the tax treaty does not permit taxation of profits beyond what the PE should have earned had the sale of goods been effectuated through such PE. Therefore, there is no dispute to the fact that wherever Article 7 of any tax treaty signed by India contains an FOA clause, there would be deviation from the arm’s length principles under TP to such extent.

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21. The other exception to the principles of arm's length under TP, as expressly contained in Article 7 of the UN model tax treaties, is the embargo upon the allowability of deductions in the hands of the PE for payments made to the HO or other parts of the foreign enterprise, of which it is a PE, for receipt of services, license of intangibles, etc., beyond the actual cost incurred by the foreign enterprise on such services, intangibles, etc. Such express embargo is not difficult to fathom and apply. As discussed earlier, there was an ambiguity under the pre 2010 version of Article 7 of the OECD MC, as to whether, even in absence of any such express prohibition contained in Article 7, such embargo was latently existing in the texture of Article 7.

22. Now, Article 7 of some of the tax treaties signed by India contain such express embargo on similar lines as that contained in Article 7 of the UN model tax treaties, while Article 7 of the other tax treaties signed by India do not contain any such embargo, thus carrying the ambiguity of the like entrenched in the erstwhile version of Article 7 of the OECD MC, i.e. pre 2010. For the sake of the present discussions, even if one were to admit that India, being a developing economy, would prefer to read such embargo as existing in Article 7 of tax treaties signed by it, even in absence of any such express prohibition, then also, it is not difficult to carve out an exception from the principles of arm's length under TP, only to the said extent.

23. Thus, barring the said two exceptions, as referred to above, namely the FOA clause, in case Article 7 of any tax treaty signed by India contains the same; and also the embargo upon the allowability of deductions in the hands of the PE for payments made to the HO or other parts of the foreign enterprise, of which it is a PE, for receipt of services, license of intangibles, etc., there is no doubt or dispute whatsoever that Article 7 of the Indian model tax treaties approves the applicability of arm's length principles under TP for the purposes of attribution of profits to a PE, as also provided under the provisions of the Act, as discussed above.

24. The matter may also logically be explained through certain practical examples. Say, a foreign enterprise has a subsidiary company in India, carrying out selling and distribution functions, for which it reports a return of sales (ROS) of 1% in the books of account. Further, say, the arm's length profit margin, being ROS under TNMM, for the purposes of TP, computed with reference to comparable companies carrying out commensurate functions of selling and distribution, is 3%. In that case, the Revenue Officer would be within his rights to assess the Indian subsidiary company to tax with reference to such ROS of 3%.

25. Now, let us assume that the Indian subsidiary company, instead of carrying out the functions of selling and distribution of goods, carries out the functions of a marketing agent on behalf of the foreign enterprise, where it secures order or concludes contracts on behalf of the foreign enterprise, thus creating a dependent agent PE of the foreign enterprise. Assuming that the functions of the Indian subsidiary; and accordingly the assumption of risks by such subsidiary company, remain exactly the same as they would have been, had the Indian subsidiary company carried out business with the larger functional and risk profile of a full fledged buy-sell distribution company, then the incidence of tax on the dependent agent PE of the foreign company, constituted through the Indian subsidiary company in the capacity of an agent, which would be treated as a taxable entity under Article 7 of the Indian model tax treaty; or for that matter any other model of tax treaty; shall be determined as a proxy for the distribution functions, which would have otherwise been carried out by such subsidiary company.

26. Thus, in case the arm's length profit margin or ROS for such distribution functions carried out by the subsidiary company could be safely taken as 3% under a proper TP approach, albeit involving the applicability of a one sided testing under TNMM, absent the contribution by the Indian subsidiary company to any unique or non-routine intangibles, as say emanating from a robust FAR and comparability analyses, then it would be the most obvious conclusion that the same arm's length reward of 3% ROS should be granted to the dependent agent PE of the foreign enterprise through the application of the arm's length principles of TP, albeit by implication under Article 7, read with Article 9 of the tax treaty; and one would be surprised if a formulary approach, even if cushioned under "fractional apportionment", as coined by the Committee, would be applied for attributing profits to the dependent agent PE of the foreign enterprise, with all other facts and circumstances remaining the same.

27. The same principles would apply if the foreign enterprise carried out buy-sell distribution business in India through a branch office, constituting a PE in India, where the functional and risk profile of such branch PE, as emanating from a robust TP study, would have been exactly the same had the business been carried out by a subsidiary company of the foreign enterprise.

Therefore, in view of the aforesaid discussions, the author beseeches the CBDT to please reconsider the applicability of arm's length principles under TP for the purposes of attribution of profits to PE under the Indian model tax treaties. As mentioned earlier, the official recommendations/ suggestions of the organisation to which the author belongs, would anyway be submitted by such organisation with the CBDT within the due date specified by the CBDT in this regard.