



Bombay Chartered Accountants' Society

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17th May 2019

To,
The Secretary (FT&TR) –I(1)
Ministry of Finance,
Central Board of Direct Taxes
New Delhi

Dear Sir,

Ref.: Proposal No. F. No. 500/ 33 / 2017 – FTD.1 dated 18th April 2019

Subject: Comments and Suggestions with regard to Amendment of Income-tax rules relating to Profit Attribution to Permanent Establishment as per Rule 10 of the Income-tax Rules, 1962 (“the Rules”).

This is with reference to captioned Proposal inviting suggestions regarding amendment of Income-tax rules for the purpose of profit attribution to Permanent Establishment (“PE”) as mentioned in Rule 10 of the Rules.

At the outset, the International Taxation Committee of the Bombay Chartered Accountants Society congratulates the Finance Minister and the CBDT for considering critical aspect of profit attribution, thereby setting an example that the Indian law evolves with dynamic business models and consists of a set of rules that match the need of the hour.

Under Article 7 in the Indian treaties, profits are to be attributed to PE as if it were a distinct and separate entity on the basis of PE accounts and where such accounts are not available to enable determination of profit attributable to the PE, it can be determined under domestic law for which assessing officer has to restore to Rule 10 of the Rules. Therefore, now CBDT, through above mentioned proposal, has invited comments and suggestions on following:

- 1 *Position adopted by India in rejecting AOA approach of OECD model convention, as it is not appropriate to attribute profits exclusively on the basis of FAR alone;*
- 2 *Need to have uniform rule for apportionment of profits to bring certainty among stakeholders and avoid litigation;*

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- 3 Adoption of mixed approach for profit attribution wherein profit allocates partly to jurisdiction where consumers are located and partly where supply activities are undertaken;
- 4 Adopting four factor method based on weight accorded to sales, manpower & assets and users (for digital business) under mixed approach (also referred as "Fractional Apportionment Method" or hereinafter also referred as "fractional formula").

Our suggestions below are after recognizing significance of issues in attribution of profit to PE as well as need to bring certainty and predictability in tax regime. Therefore, while we welcome the provisions, we have our suggestions and comments on above which are as follows:

1. APPLICABILITY OF THE FRACTIONAL APPORTIONMENT METHOD

1.1 On one hand in Para 190 of report it is stated that, *"there seems to be a case for providing a uniform rule for apportionment of profits to bring in greater certainty and predictability among taxpayers and avoid resultant tax litigation."* and in clause (v) of para 199 of section 11.2 of the report the Committee recommends that *"where the business connection of the enterprise in India is constituted by the activities of an associate enterprise that is resident in India and the payments received by that enterprise on account of sales or services from persons resident in India exceeds the amount of Rs. 10,00,000 then profits attributable to the operation of that enterprise in India will be derived by apportionment using the three factors or four factors as may be applicable in such cases and deducting from the same the profits that have already been subjected to tax in the hands of the associated enterprise"*

SEP

1.2 Whereas, on the other hand, the Report in Para 162 states that *"The Committee also examined the situations in which the new rule will be applicable."* It further states that, *"The definition of 'foreign company' is quite wide in the Companies Act 2013 and therefore, the modified rule will be used only in those situations:*

- a) *where there are no India centric financial statements;*
- b) *where the books of account have been rejected under the appropriate provisions of the Act;*
- c) *where for some specific reason that is recorded by the AO, the accounts do not adequately reflect the profits that can be attributable to the PE as an independent and separate entity."*

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1.3 The final recommendation in para 199 of section 11.2 of the report does not clearly provides for circumstances under which Fractional apportionment method can be invoked by Assessing Officers

1.4 RECOMMENDATION-:

1.4.1 Rule may clearly provide circumstances under which Assessing Officer can invoke fractional apportionment method. Considering the rationale discussed in the para 5 of section 1.1. of the report, fractional apportionment method should be invoked only when any of the conditions mentioned in clause (a) to (c) of para 1.2 above is applicable in case of taxpayer.

1.4.2 Since wide powers are given to assessing officers in applying fractional apportionment method it is recommended to provide specific guidelines under which Assessing Officer can reject books of accounts and consider inadequacy of profit attributed to PE before invoking fractional apportionment method. Hence such recommendations are arbitrary and susceptible to misuse.

1.4.3 Also, approval mechanism of higher authority viz. Principal CIT/Approving Panel is recommended to have checks and balances before application of fractional apportionment method, but still we believe clarity in recommendation is essential.

1.4.4 Emphasis should be placed upon Assessing Officer to pass a detailed speaking order before rejection of books of accounts similar to the emphasis entrusted upon Assessing Officer in case of forming an opinion about inadequacy of profit attributed to PE (as stated in para 162 of the Report).

1.4.5 An opportunity of being heard should be provided to taxpayer before rejecting books of account or forming opinion on inadequacy of profit attributed to PE and before invoking of fractional apportionment method.

2. DEFINING TERM INDIAN OPERATIONS

2.1 The term “Indian operations” is not defined under the proposed Rule. Although the phrase “operations in India” referred in Explanation 1(a) to sec. 9(1)(i), it is not defined under the Income tax Act and therefore, the Phrase “Indian operations” is not clearly defined. This may lead to the following consequences:

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- 2.1.1 From the weights and Fractional formula given, there could be both supply and demand side factors outside India in respect of Indian operations. The operations in India could have demand-side factors located outside India, which are deemed to have been considered in the Fractional formula resulting into higher attribution of profit to Indian Operations and likewise manpower or assets located outside India may be attributable to Indian operations which are excluded in fractional formula, resulting into lower attribution of profit to Indian operations.
- 2.1.2 Logically, these factors located in or outside India could affect the attribution of profit to Indian operations. However, differentiating between these factors could lead to new Pandora's box of litigation as recommended fractional formula is silent about this aspect of apportionment.

2.2 RECOMMENDATIONS

- 2.2.1 The terms "Indian Operations" should be clearly defined under the amended Rules.
- 2.2.2 Apportionment mechanism of demand side or supply side factors located outside India which are related to Indian operations should also be articulated in the Fractional formula and if consciously such factors are to be excluded, it should be explicitly provided under the proposed Rules.

3. PROFIT ATTRIBUTION IN CASE OF SIGNIFICANT ECONOMIC PRESENCE UNDER SUB-CLAUSE (a) OF EXPLN 2A

3.1 REVENUE ALONG WITH OTHER FACTORS

- 3.1.1 Action 1 on Addressing Tax Challenges in a Digital Economy adopted by the G20 (which includes India) recognises that revenue alone cannot be a factor for determining existence of a SEP and various other factors should be considered. Such other factors could be (i) existence of a **user base** and the **associated data input**, (ii) **volume of digital content** derived from the jurisdiction, (iii) billing and collection **in local currency** or with a local form of payment, (iv) maintenance of a **website in a local language**, responsibility for the **final delivery** of goods to customers or (v) the provision by the enterprise of **other support services** such as after-sales service

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or repairs and (vi) maintenance or **sustained marketing and sales promotion** activities, either online or otherwise, to attract customers.

- 3.1.2 However, the fractional apportionment of profits working for a business connection arising out of a "significant economic presence" due to transactions with respect to goods, services or property above the threshold to be prescribed stipulate neither digital factors (like local domain name, local web site or local payment options) nor user based factors (like the monthly active users (MAU) measure, number of contracts concluded online, volume of data collected from users, etc).
- 3.1.3 We suggest that the fractional apportionment working as recommended in the Draft Report may be suitably amended to incorporate the digital and user factors.
- 3.2 If user factor is not applicable for cases falling in sub-clause (a) of Explanation 2A, the working of fractional apportionment for business connection as well as for cases of SEP under sub-clause (a) would be the same. This would result in profit attribution in all cases once the threshold to be prescribed is crossed even where there exists no business connection.
- 3.3 If user factor is to be applied for cases falling in sub-clause (a) of Explanation 2A, then our observations are as under:
- 3.3.1 In the context of digital economy, the draft Report recommends user contribution to be given due weightage as the fourth factor for apportionment apart from sales, employees and assets [para 176 of the Report]. It is not clear whether existence of users is necessary in cases falling under sub-clause (a) of Explanation 2A. The same may be clarified.
- 3.3.2 The Report states that 'user contribution can be a substitute to either assets or employees' [Para 176]. Whether existence of users without employees or assets in India is sufficient to constitute Indian operations may be clarified.



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4. MODIFICATIONS UNDER FRACTIONAL APPORTIONMENT FORMULA

- 4.1.1 "Revenue derived from India", being the basis of fractional formula application should be well defined.
- 4.1.2 Weights applied under the fractional formula may differ Industry wise, therefore it is recommended to obtain inputs from affected Industries and/or Economist and can structured application of weights on the basis of Industry specifications.
- 4.1.3 Where global profit margin is not less than 2%, adoption of a floor rate of 2% irrespective of the Industry to which the business of the non-resident belong to may lead to skewed outcomes. A 2% operating margin may be either too low or too high depending on the Industry. Therefore, we recommend restricting the adoption of deemed global profit margin of 2% only for Digital businesses. Alternatively, if the underlying basis or study conducted for arriving the standard rate of 2% is provided for detailed study and evaluation, it will enable evaluation of cause and effect relation with respect to specific industry.
- 4.1.4 It is inconceivable that business makes profits all the time. The draft recommendations states that MNEs are likely to continue operations in India only if they are profitable [para 160]. However, enterprises world-over, do incur losses. If MNE incurs losses in their operations in India, they may not continue to operate in the future and may not be eligible for set-off of losses incurred. To levy a minimum tax on such enterprises may be unjustified.
- 4.1.5 Report is suggesting 2% profit margin for the purpose of MAT calculation; MAT principally levies tax on profit available for shareholder in-spite of loss as per tax provisions. However, same principle may not be applicable on a global loss-making corporation. Therefore, applicability of MAT tax on deemed profit of 2% in case of global loss may be revisited.

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4.1.6 Since the profit attributable to India operations is at the EBIDTA level, a deduction of interest on India-specific borrowing and depreciation on assets located in India would not be available. This is unfair. It may be pointed out that any interest paid on borrowings used in India is deemed to accrue or arise in India [sec. 9(1)(v)] and there is no base erosion by allowing such a deduction. On the other hand, by denying the deduction, there is economic double taxation. On similar logical inferences deduction of expenses incurred by PE on amount paid/payable to HO where tax is already withheld should be allowed as a deduction from profit attribution to PE as per fractional formula.

We request you to kindly take into considerations our suggestions while finalising the income-tax rules to be issued.

Yours Faithfully,

For Bombay Chartered Accountants' Society

Sunil Gabhawalla

President – BCAS

Mayur Nayak

Chariman – International Tax Committee – BCAS

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