India’s fractional apportionment proposals are an ‘invitation to chaos’

Taxpayers are concerned that India’s proposal to introduce a fractional apportionment model could lead to double taxation and a subsequently higher number of mutual agreement procedure cases.

The Central Board of Direct Taxes (CBDT) has concluded its consultation on a proposal to move towards fractional apportionment. If implemented, India would join the growing list of countries like France and Italy trying to outflank the OECD on digital tax reform because the proposal is a step up from the country’s significant economic presence (SEP) concept.

This increases the risk of double taxation and disputes for taxpayers at the worst possible time and, therefore, any foreign multinational with a permanent establishment (PE) in India might have to rethink its position if the proposal is implemented.

“These [proposals] do not seem workable since they paint all transactions with the same brush,” said Jimmy Spencer, CFO at Chemtex Group. “They’ve not considered how different businesses operate. Each one has a different set of parameters.”

Spencer described the proposed rules as a “fresh invitation to chaos”.

“The international tax infrastructure in India is ill-equipped for this,” Spencer told *TP Week*. “There are too many transfer pricing legacy cases pending in the courts.”

Fractional apportionment is different to the standard formulary model that applies in India today because the former does not require the global profits of multinational companies to be consolidated in order to determine the local tax base.

Much like formulary apportionment, however, the new allocation model will use key factors, such as sales, employees and assets, as part of its profit attribution rules to cover both supply and demand.

The FAR controversy

Although the proposal may widen the tax net, the amendments would keep India outside international treaty norms, thus risking double taxation.

The OECD and the UN have designed their tax treaty models to include the function, asset and risk (FAR) analysis as a condition for formulary models.

However, the Indian authorities have long been sceptical of the FAR analysis and left it out of their tax treaties, but the latest proposal explores the possibility of using this analysis in a unique way for the supply-side factors (employees and assets), establishing a hybrid analysis between fractional apportionment and the FAR analysis.

“What they’ve done – because they think the OECD approach is insufficient – is come up with their own way of attributing profit which is not like the FAR analysis,” said Amit Maheshwari, managing partner at Ashok Maheshwari and Associates.

“The aim is to assign equally to each of these factors, but there will likely be a fourth factor, namely users,” Maheshwari told *TP Week*. “We’ll have to see if it’s high-user intensity or low-user intensity.”

The problem is that these factors might not cover every business model perfectly. Some fear that the implementation will lead to a series of trial and error situations.

“Not every business model correlates with the sales, manpower and assets model since each company has a different dynamic,” Spencer explained. “These guidelines are a non-starter.”

“In my forty-plus years in industry, I’ve seen overseas companies bear most of the risk and liabilities of everything from technology licenses to operational cost guarantees rather than pass it on to the Indian entity,” he said.

In the past, the Indian government was concerned that the FAR analysis would work against Indian businesses because of the country’s dependence on capital imports. The authorities hope is that the demand-side weights (sales and users) will counteract this impact.

“It will be interesting to see how the FAR analysis of the depreciation and amortisation would be distinguished to attribute profits towards the dependent agent permanent establishment [DAPE] by following the dual entity approach,” said Amit Gupta, director of tax at Dell in Singapore.

However, Gupta is concerned that the changes to profit attribution rules are a step towards formulary apportionment in all but name. “This could result in more MAPs under existing tax treaties to avoid double taxation,” he said.

Any change to profit attribution rules can raise the threat of double taxation. In the case of fractional apportionment, it may lead to mismatches of profit allocation on cross-border operations. This could lead to taxpayers losing their tax credits in their country of residence.

Silver lining

Although taxpayers are generally worried about the proposals and the new issues it may create, Gupta would address the imbalance in the OECD digital tax proposals that only takes the supply-side into account, and also "one silver-lining" in India's proposal.

There is an exception for cases where the company has no sales in India and the Indian subsidiary is compensated for its losses at an arm's-length rate.

As such, Arvind Singal, head of tax at RBS India, alongside Nitin Kapoor, associate director at the company, argue the new rules could help reduce the number of disputes.

"Given the complexity around attribution of income to PEs in India, the Indian government's efforts to bring uniformity in the approach are commendable," the duo write in an article for the May/June double issue of *International Tax Review*.

"This will not only bring certainty but will also help to curtail the arbitrary modes adopted by the tax authorities when attributing income to a multinational company's Indian PEs."

If the proposals spell more controversy for taxpayers, the next obvious question is how to mitigate the risk of disputes. Lengthy TP disputes are one of the biggest challenges facing multinationals operating in India, and the launch of the APA programme was a conscious effort to reduce the amount of controversy.

Taxpayers may engage in APAs because they are worried about the introduction of the earnings before interest, taxes, depreciation and amortisation (EBITDA) clause that conflicts with arrangements based on the cost-plus method or the transactional net margin method (TNMM).

"The APAs agreed with the Indian tax authority on either cost-plus or TNMM may be higher than the EBITDA margins obtained by the overseas company," Spencer explained.

"After considering all of the above, I can't see how the EBITDA clause is going to be useful except for loss-making companies open to controversy on 2% of their notional EBITDA," Spencer said.

But the APA process has "completely slowed down", Spencer added.

The tax authority is likely to struggle to fast track APA talks and prevent further disputes once India adopts fractional apportionment.

The Indian government has taken BEPS as its starting point and set the SEP as its own standard. It is now moving towards a controversial apportionment model while the world searches for a clear road-map on taxing the online economy. These rules may clear the way for new challenges for taxpayers in India, but they might also set a problematic global precedent.