COMMENTS FOR CENTRAL BOARD OF DIRECT TAXES

ON THE DRAFT PROPOSAL FOR AMENDMENT OF RULES FOR PROFIT ATTRIBUTION TO PERMANENT ESTABLISHMENT

Consumer Unity & Trust Society (CUTS) expresses its gratitude to the Central Board of Direct Taxes Committee ('the Committee'), Department of Revenue, Ministry of Finance for inviting comments and suggestions on the draft proposal for amendment of rules for profit attribution to permanent establishment (the draft Rules).

It may be noted that the comments submitted by CUTS International are restricted to the recommendations that are relevant to taxation of the digital economy. In particular, they pertain to the inclusion of user participation as a factor in apportioning profits that are derived from the source country.

SUBMISSIONS

Context

On the issue of profit attribution to a Significant Economic Presence (SEP) in a digital economy, the Committee has argued that user contribution can be considered a substitute to either assets or employees of a business. Here, the Committee has adopted the approach of the European Commission in their draft proposal on Common Consolidated Corporate Tax Base (CCCTB),[1] which prescribes a four-factor formula for apportioning profits, and assigns equal weightage to users alongside labour, assets and sales. However, the Committee has assigned different weights to different types of businesses, on the basis of their '*user intensity*'. The concept of *user intensity* has been taken from OECD Interim Report on Tax Challenges Arising from Digitalisation (OECD report).[2]

The Committee has recommended that in two specific cases, profits of a non-resident business attributable to operations in India will be calculated by a four-factor formula, with users being one of the factors. The two cases are:

(i) When the business connection is primarily constituted by the existence of users beyond a prescribed threshold

(ii) When users in excess of the prescribed threshold exist in India

Further, users are assigned a weight of 10% in cases of low and medium user intensity, and 20% in cases of high user intensity.

Comments

[1] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2F%2FEP%2F%2FNONSGML%2BCOMPARL%2BPE-608.035%2B01%2BDOC%2BPDF%2BV0%2F%2FEN

[2] https://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm

The public consultation by the Committee on this proposal is a welcome step, in context of the lack of clarity globally on various taxation challenges arising out of digitalisation. There is a need to develop a better understanding of how value is created in different types of digital businesses, and how nexus for that value can be established in source countries. The following are some points for the Committee's consideration.

1. Lack of clarity on SEP

The definition of SEP has received flak from many quarters, due to in-built ambiguity in the terms used. This needs to be resolved before further regulation is adopted in this sphere. In order to make an methodology workable and coherent, it must have a clear foundation. Additions of concepts like user intensity to the SEP definition may compound the complexity of the issue and lead to uncertainty in the business environment as well as legal burden.

2. Definition of user

At present, the term 'user' is not defined anywhere. The definition of Significant Economic Presence as provided in Explanation 2A under Section 9 of the Income Tax Act, mentions the term but does not define it. As noted in the OECD report, users may engage with businesses through a range of activities, including passive browsing, downloading data or software, providing ratings, leaving reviews, generating content and networking with other users. An e-commerce platform may have a huge number of users, but some of those users could just be engaged in browsing, others may be conducting purchases, and yet other may be writing reviews. In this respect, it is unclear which of these users will be considered while determining SEP, as well as for the application of the four-factor formula.

3. Design of four-factor formula

The Committee has adapted the four-factor formula prescribed in the CCCTB proposal, by including 'users' as a fourth factor. However, it should be noted that the factor specified in the CCCTB proposal is not 'users', but 'collection and use of personal data of online platforms and service users.' The rationale and implications of these two differing terminologies should be examined.

4. Classification of user intensity

The OECD report makes a broad classification of 'passive' and 'active' users, and further classifies active user participation into the three categories of low, medium and high intensity. However, the report also clarifies that this classification is merely illustrative and not comprehensive. In practice, it may not be possible to strictly classify every business into one of the three categories. There may be businesses that fall somewhere in the middle. Alternatively, there may be businesses in the same category that have very different characteristics. Therefore, the classification of businesses according to user intensity should be assessed further before it is adopted into law.

5. Implications of unilateral action

At present, there is no consensus among countries that are members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), on whether profits of a business can be attributed to user participation - whatever the user intensity. Some countries, including India, have already taken unilateral action in the broader sphere of digital taxation, with Equalisation Levy and SEP being two examples. Ahead of the OECD consensus that is due to emerge in 2020, it is important that these unilateral measures are informed by robust cost-benefit analyses. In particular, there is a need to exercise caution while introducing or changing thresholds and attributes for digital businesses, as these can have unintended consequences for India's economic relations with other countries.

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