Article 7 - Business profits

C.A. Bhavin Shah
6 December 2014
The Journey Ahead

1. Tax Treaties - Some Basic Concepts
2. Article 7 of the UN Model
3. Force of Attraction
4. Judicial precedents
5. Key takeaways
Tax Treaties – Some Basic Concepts

- Source vs. Residence conflict
- Tax treaties entered into primarily to address the issue of double taxation
- Business with India vs. Business in India
- Option available to the taxpayer – Act or Tax Treaty, whichever is more beneficial
- Relief under Tax Treaty not available if GAAR invoked
- UN Model and OECD model commentaries – aids to interpretation of Tax Treaties
Specific income taxed under Article 7 in case of PE
Article 7 of the UN Model
Framework of UN Model – Article 7

Residence State

Enterprise

Source State

Art 5: Constitution of PE

Art 7: Taxation of PE

Article 7(1) - Charging provision

Article 7(2) – Basis of profit attribution

Article 7(3) – Expense deduction

Article 7(4) – Apportionment of profit (if customary)

Article 7(5) – Same method year by year – consistency

Article 7(6) – Residual Article
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

(a) that permanent establishment;

(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or

(c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment

No rate specified in Article 7
Article 7(1) – Charging provision

Key Provisions

- Existence of PE must for attribution
- Only profits attributable to such PE is taxable in the source country
- PE test for each source of income
- Principle of ‘force of attraction’ present in UN Model
- Business should be carried on:
  - Preparatory activities do not trigger attribution

‘Force of attraction’ rule not present in OECD Model Convention
Does exist in the US Model Convention
Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
... Article 7(2) – Basis of profit attribution

Approaches to determine profit

- Functionally separate entity or Relevant business activity
- Recommended approach - Functionally separate entity
- However, judicial precedents in India appear to adopt ‘Relevant business activity’ approach
- Thrust on accounts and contemporaneous documentation
In the determination of the profits of a permanent establishment, there shall be **allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred**, whether in the State in which the permanent establishment is situated or elsewhere. However, **no such deduction shall be allowed in respect of amounts, if any, paid** (otherwise than towards reimbursement of actual expenses) by the permanent establishment **to the head office of the enterprise or any of its other offices**, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, **no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged** (otherwise than towards reimbursement of actual expenses), by the permanent establishment **to the head office of the enterprise or any of its other offices**, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.
**Article 7(3) – Expense deduction**

**In determining profits of a PE**

- Deduction shall be allowed for expenses (including executive & general administrative)
- Incurred for the PE
- Incurred in or outside the source country
- In accordance with and subject to limitations of domestic law (appearing in most of the Indian tax treaties)

**No deduction (except reimbursement of actual expenses)**

- Amount paid by PE to the HO or to any other offices of the enterprise:
  - For use of patents or other intangible rights in the form of royalties or other similar payments
  - For specific services performed or for management in the form of commission
  - For interest on internal debts (exception for banking enterprises)
- Similarly, income received by PE from HO for aforesaid purposes shall be ignored
Article 7(3) – Transactions with self

Examples include:
- Supply of goods by HO to branch
- Chargeable services rendered by HO to branch, etc.

In support of ‘separate entity’ approach (i.e. denying ‘transaction with self’ concept)
- CBDT Circular no. 649 dated March 31, 1993
  - Payment of fees for technical services by an Indian PE to its head office
- CBDT Circular No. 740 dated April 17, 1996
  - Payment of interest by an Indian PE to its head office
- Bank of Tokyo Mitsubishi UFJ Ltd. [49 taxmann 441 (Delhi- Trib.)]
- Dresdner Bank decision (105 TTJ 149) (Mum)

Against ‘separate entity’ approach (i.e. supporting ‘transaction with self’ concept)
- Sumitomo Mitsui Banking Corporation (Mumbai Special Bench)
- However, payment of interest by an Indian PE to its head office is deductible (in light of beneficial tax treaty provisions)
In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
• Source Country has been given right to apply apportionment method
  - If it is customary in the source country
  - Profits are apportioned to various parts of the enterprise to ascertain profits attributable to the PE
• Result of such apportionment method shall be in line with article 7(2) and 7(3)
• UN Commentary recognizes following 3 methods of Apportionment
  - Receipts of the enterprise
  - Expenses of the enterprise
  - Capital structure of the enterprise
For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

- The profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
- Mere Clarificatory Provision
- Applies only to profit attribution method and not to treatment within the method
- Change allowed only if good and sufficient reason
- Essentially prohibits changes every year
Article 7(6) – Residual Article

Where profits include items of *income which are dealt with separately in other Articles* of this Convention, then the provisions of those Articles shall *not be affected* by the provisions of this Article.

Priority of specific article over the general article

In case profits include any income which is chargeable under any specific article, the same shall be dealt with by that specific article.
Force of Attraction – Concept

Rationale

- Principle of Force of Attraction is primarily concerned with taxation of business profits in Source country
- Prevent tax evasion / avoidance through artificial contracts / business arrangements
- Identification of business transactions - source based taxation

Types of Force of Attraction

- **General force of Attraction**: All profits derived in Source State taxable as profits of the PE whether or not through PE
- **Restricted Force of Attraction**: Profits derived through PE as well as profits from sale of goods / activities same or similar to that of PE directly carried out by the HO in the Source country taxable as profits of PE
- **No Force of Attraction**: Only profits derived through PE taxable
The expression ‘**same or similar**’ has not been defined in any tax treaties

Dictionary meaning could be a good guide

‘**Same**’ - resembling in every aspect / Identical

‘**Similar**’-

- Oxford - of the same kind in appearance, character, or quantity, without being identical
- Law Lexicon – Partial resemblance and may also denote same in all essential particulars
- Custom laws – “although not alike in all aspects, have like characteristics….”

### Concept of Same or Similar

<table>
<thead>
<tr>
<th>Items of comparison</th>
<th>Whether criteria of similarity satisfied</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer &amp; Copying machines</td>
<td>No</td>
<td>Both are office machines but they are designed for different purposes</td>
</tr>
<tr>
<td>Copying Machines &amp; Scanners</td>
<td>Yes</td>
<td>Almost inter-changeable products</td>
</tr>
</tbody>
</table>
“General” Force of Attraction

F Co. -> PE

Direct sale of **Laptops** in India

Direct sale of **pharmaceuticals** in India

PE -> Customers
Sells **Laptops** manufactured by F Co.

Customers

Outside India

India

Taxability of transactions “**independent**” of PE is called “**FORCE OF **
**ATTRACTION**”; Having a PE is prerequisite
“Restricted” Force of Attraction…

F Co.

Similar

Outside India

India

Sells **Desktops** manufactured by F Co.

Sells **Laptops** manufactured by F Co.

Customers

Commercially interchangeable and under the same brand name

PE
... “Restricted” Force of Attraction

Article 7(1)(b) restricts its scope to sale of ‘same’ or ‘similar’ goods only
Example: Article 7(1) of India USA DTAA

“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 (a) that permanent establishment ; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment ; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.”

Some other countries having similar Force of Attraction rule.

Cyprus  Denmark  Indonesia  New Zealand  Italy
Force of Attraction – Examples

India-Germany DTAA (Motive of Tax Avoidance)

In respect of paragraph 1 of Article 7, profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment, may be considered attributable to that permanent establishment if it is proved that:

(i) this transaction has been resorted to in order to avoid taxation in the Contracting State where the permanent establishment is situated and

(ii) the permanent establishment in any way was involved in this transaction.
E-Funds Corporation v/s DCIT [2014] (364 ITR 256) (Delhi)

- Only assets and activities of e-Fund India can be taken into consideration for attribution of profits.
- Activities which were not undertaken by e-fund India and the assets of the offshore entities cannot be taken into account or attributed for computing income of the offshore entities taxable in India.
Supreme Court of India

Facts

• Activities outsourced by Morgan Stanley and Company (‘MS Co’) to Indian group entity, Morgan Stanley Advantages Services Pvt. Ltd (‘MSAS’):
  - Equity / fixed income research
  - Account reconciliation;
  - IT enabled services, etc

• MS Co. staff visited India for monitoring/quality control (stewardship)

• MS Co. staff deputed to MSAS
  - MSAS reimburses salary cost to MS Co.
  - Employees deputed continue to be employed with MS Co., which pays salary to the deputees outside India
• PE definition under section 92F(iii) of the Act is inclusive so as cover various types of PE under DTAA such as Service PE, Agency PE, Construction PE, etc.
• Profits of PE determined based on what an independent enterprise under similar circumstances might be expected to derive
• Profits of MS Co. which have economic nexus with PE attributable
• AE that constitutes PE and is remunerated on arms length basis taking into account all risk taking functions of the multinational enterprise – no further attribution
• If TP analysis does not adequately reflect functions performed / risks assumed by the enterprise – there would be need to attribute profits for those functions / risks
Rolls Royce PLC v. DIT (IT) [2011] (339 ITR 147) (Del HC)…

**Facts**

- RRIL’s liaison office (‘LO’) carried out activities only in respect of RR Plc
- LO’s key responsibility includes securing orders and solicit request for quotation/purchase orders for RR Plc’s products
- The employees of RR Plc visit India frequently and use premises of the LO
- Employees of RRIL participate in meetings with customers where significant matters regarding contracts with RR Plc are discussed and decisions are taken
- RR Plc on various occasions designated RRIL as sole contact point in respect of certain customers (eg. to send orders/quotations/acceptances, etc)
- RRIL marketed certain after sales/other services provided by RR Plc to present/potential customers of RR Plc
- RRIL provided certain advise/recommendations to RR Plc as regards certain customer proposals
Rolls Royce PLC v. DIT (IT) [2011] (339 ITR 147)(Del HC)

Ruling:

- All profits directly and indirectly attributable to the PE to be considered
- However, under Article 7(4) of the Treaty, apportioning could be on appropriate basis
- Since no specific P&L provided, computation to be under Rule 10
- 50% of profits to be attributed to manufacturing
- 15% of profits to be attributed to R&D
- 35% of profits to be attributed to marketing
- Only marketing done in India
- Hence profits to be attributed to India – 35%

Profit Attribution

YES

Fixed Place & Agency PE was Upheld
Set Satellite (Singapore) Pte Ltd v. DCIT [2008] (307 ITR 205) (Mum HC)…

Sing Co
(Business of creating, marketing & distributing TV channels)

Agency Agreement

India Agent
(dependent)

Fee

Customers
(Advertisers)

Arms length remuneration

Existence of an Agency PE
...Set Satellite (Singapore) Pte Ltd v. DCIT [2008] (307 ITR 205) (Mum HC)

Ruling:

CBDT Circular 23 of 1969 is applicable to SET Singapore since:
- it’s business activities in India where wholly channeled through its agent (SET India);
- the contracts to sell (the ad slots) are made outside India; and the sales are made on a principal to principal basis

Thus, if commission to SET India fully represents the value of the profit attributable to its service - it should prima facie extinguish the assessment.

Under Article 7(2) profit attributable to a PE would be the profit it might be expected to earn it were a separate and independent entity carrying out similar activities – i.e. the arm’s length profit

Dependant agent paid commission @ 15% - Circular 742 recognizes that Indian agents of FTCs generally retain 15% as service charges

Since, commission paid to SET India is at arm’s length - no further profits can be attributable to its activities in the hands of SET Singapore’s PE in India in terms of Circular 23 r.w. Article 7(2)

Considering the Morgan Stanley judgment, if the correct arms length price is applied then nothing further would be left to be taxed in the hands of the FCo

Whether principle laid down holds good even after withdrawal of Circular 23?
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
Given facts of the case CIS constitute Fixed Place PE of CCM

Approach to arrive at attributable profits laid down by Tribunal
- 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. This residual is now attributable between USA and India
- Profit attributable to PE should be estimated on aforesaid residual.

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.
Key takeaways

- Transactions with self
- PE - A dynamic concept given emergence of economic and technological advancements
- Attribution trends in Indian judicial precedents
- Attribution – very contentious in practice
- Attribution vis-à-vis arm’s length payments
- Robust documentation necessary to defend
Article 9 - Associated Enterprises
Article 9(1) – Associated Enterprises

- Where:
  
  (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
  
  (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

- and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Emphasis on Related Party Transactions

Result: Permits the Tax Authorities to re-write the transactions between related enterprises if arm’s length principle not followed in inter-company dealings and make transfer pricing adjustments to arrive at the correct tax liability of the transacting entities.
Article 9(2) – Associated Enterprises

- Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and **the profits so included are profits which would have accrued to the enterprise of the first-mentioned State** if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

Permits the Tax Authorities to allow corresponding adjustments to eliminate economic double taxation. Presence of this Article in a DTAA enables a taxpayer to opt for the Mutual Agreement Procedure (more commonly known as MAP)

Increased importance after introduction of the Advance pricing regime in India.
Article 9(3) – Associated Enterprises

- The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

Restricts availability of corresponding adjustment in only genuine cases
Thank You