

The Permanent Establishment Principle

Introduction.....

Taxation of Non - Resident

- ☐ Twin basis of Taxation
 - ☐ Residence
 - ☐ Source
- ☐ Charge of Tax only under Domestic Law
- ☐ Treaties to
 - ☐ Avoid double taxation
 - ☐ Share revenues
- ☐ Application of
 - ☐ Procedural Law
 - ☐ Substantive provisions

Introduction.....

Scope of Total Income – Non-Resident – Sec 5(2)

□ Taxable income of non-residents include:

- Income received or deemed to be received in India
- Income which accrues or arises in India
- Income which is deemed to accrue or arise in India

Introduction.....

Income deemed to accrue or arise in India – Sec 9(1)

- ☐ Through **Business Connection**, property, asset or source of Income or transfer of capital asset situated in India
- ☐ Salary
- ☐ Dividend
- ☐ Interest
- ☐ Royalty
- ☐ Fees for Technical Services

Introduction.....

Business Connection

- ❑ Connection with India [Section 9(1)(i)]
 - Business connection – Business operations in India
 - Property in India
 - Asset/source of income in India
 - Transfer of capital asset in India
 - Territorial nexus is the guiding principle
- ❑ Existence of Dependent Agent (Explanation 2 to Sec 9(1)(i))
 - Authority to conclude contracts
 - Habitually maintaining and delivering the goods
 - Habitually secures orders wholly & almost Wholly
- ❑ Independent agent do not trigger taxation (Proviso to Explanation 2)

Introduction.....

Income deemed to accrue or arise in India

- “ in the case of a business of which all the operations are not carried out in India, the Income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India”

- Explanation 1(a) to Section 9(1)(i)

Permanent Establishment

PE – What is it?

- ❑ A defined concept (in DTAA).
- ❑ The key test which determines the right to tax business profits in the source state.
- ❑ Simple in theory, difficult in application.

Significance of PE

Why this concept is required

- ❑ Allocation of taxing jurisdiction for business profits.
 - Business profits taxed exclusively in the state of residence of the enterprises unless there is a “permanent establishment in the other state.....Article 7(1)
- ❑ Taxation of employees (183-day rule)
- ❑ Treatment of dividend, interest, royalty & capital gains
- ❑ Domestic law provisions – Business Connection v PE
- ❑ The concept of PE is narrow than the Business Connection
- ❑ Non-discrimination

Structure of Article 5 (OECD Model) – A Quick Overview

Para 1 Basic Rule

Para 2 Illustrative list of PEs

Para 3 PE in relation to Construction/Installation projects/Furnishing of Service

Para 4 List of Exceptions – Activities which is not PE

Para 5 Dependent agents may be a PE

Para 6 Independent agents not a PE

Para 7 Associate Enterprises - Control of a subsidiary does not constitute a PE

Article 5 – Para 1 – Basic Rule.....

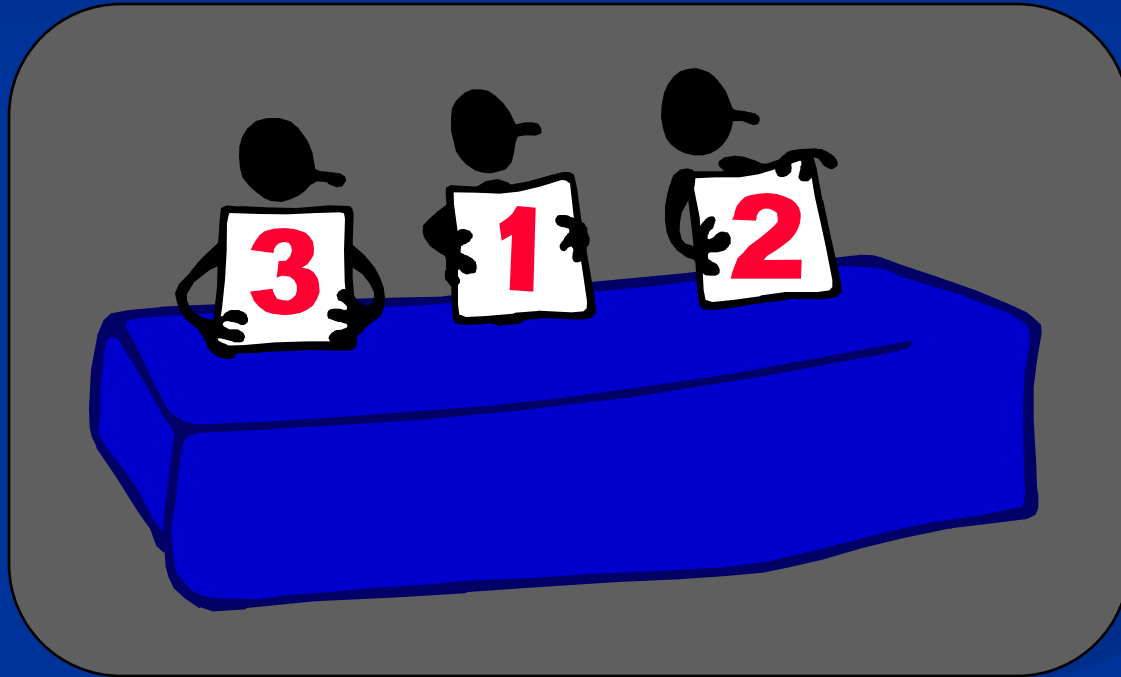
“For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

Main Features:-

- ☐ The existence of an enterprise
- ☐ Its carrying on a business
- ☐ Existence of place of business
- ☐ Which if fixed
- ☐ Through which the business is carried on

3

Conditions Must Be Met For A PE To Exist



Article 5 – Para 1 – Basic Rule.....

Condition 1: A place of business

- ☐ Any premises, facilities or installation used for carrying on the business
- ☐ whether or not used exclusively for that purpose
- ☐ It may also include machinery or equipment.
- ☐ Space should be at enterprise's disposal – It may be owned, rented or leased.
- ☐ Even illegal occupation could constitute a PE.
- ☐ A place that constitutes a coherent whole commercially and geographically.
(India has reservation – discussed later)

Article 5 – Para 1 – Basic Rule.....

Condition 2: Fixed Place of Business

- ❑ Two critical components of fixed:
 - A specific geographical spot (the “location Test”)
 - A certain degree of permanence at each geographical spot (the “duration test”)
- ❑ It does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site
- ❑ An isolated activity cannot lead to establishment of a fixed base PE as the ingredients of regularity, continuity and repetitiveness are essentially missing.

Article 5 – Para 1 – Basic Rule.....

Some examples:

- ☐ Ships used as Museum, Restaurant etc. and located at a certain place
- ☐ Oil rigs firmly anchored to the sea bed and repeatedly used for a certain work or for the same principle
- ☐ An automatic vending machine, gaming machine at a fixed place and operated and maintain by enterprise or its dependent agent

Article 5 – Para 1 – Basic Rule.....

Condition 3:- Carry on the business through the PE

- ❑ Must carry on the business of the enterprise (wholly or party) through the PE
- ❑ Place of business must 'serve' the business activity and not be 'subject to' it.
- ❑ Activity need not be of productive character (OECD Commentary)
- ❑ "Activity" would be satisfied by having personnel (Employee or dependent agent) at the fixed place of business.
- ❑ "Activity" would also be satisfied by having fully automatic equipment – Say Fully Automatic pumping stations or Gaming or vending Machines.
- ❑ Leasing tangible property or arranging finance through a fixed place of business can be a PE

Article 5 – Para 1 – Basic Rule.....

Some Judicial Precedence:

- ❑ The residence of a country manager was held to be a fixed place of business as the same as an office address [Sutron Corporation, 268 ITR 156 (AAR)]
- ❑ An office space of 3 X 6 metres was held to be fixed place of business [Motorola Inc & Others, 95 ITD 269 (Del)]
- ❑ The diving offshore vessel functioning **within a defined area** (defined geographical location) was held to be a fixed place [P. No. 24 of 1996, 237 ITR 798(AAR)]
- ❑ However, a moving vessel performing repairs of submarine pipelines in India was held as No constituting a PE. [Subsea Offshore Ltd.. 66 ITD 296 (Mum)]
- ❑ Conducting of golf tournament in India for a week's duration does not lead to existence of a fixed base PE in India. [Golf in Dubai, LLC, 306 ITR 374 (AAR)]

Article 5 – Para 1 – Basic Rule.....

Commencement and Cessation of a PE

- ☐ PE comes into existence, as soon as the foreign enterprise commences business activities through a fixed place.
- ☐ The time spent to establish the fixed place of business should be excluded.
- ☐ A PE ceases to exist when the foreign enterprise disposes the fixed place of business.
- ☐ A PE ceases to exist when the business activities being carried out through it cease or terminate.
- ☐ Temporary closure or interruption of operations – No cessation of PE

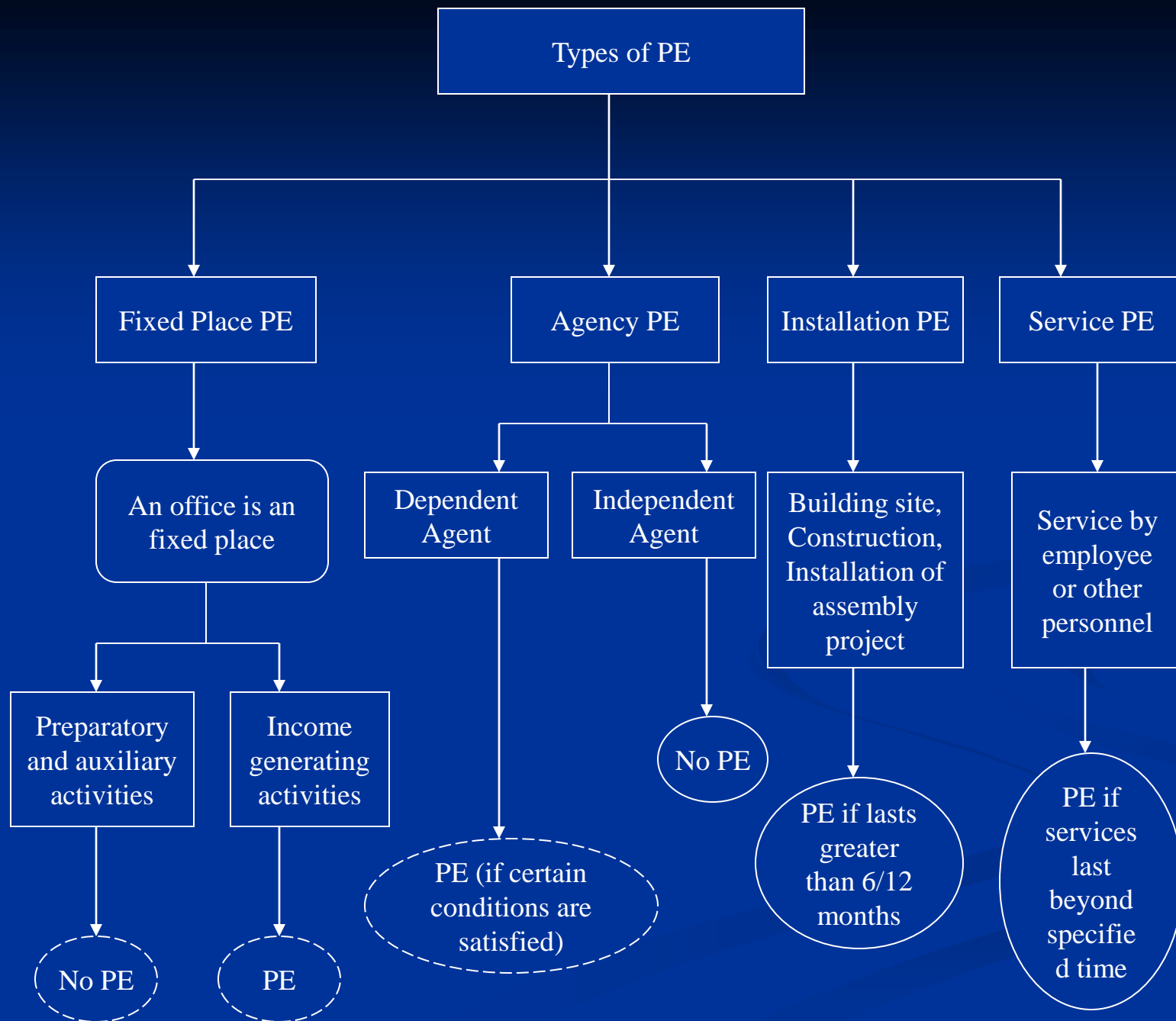
Article 5 – Para 1 – Basic Rule.....

Types of PE Exposure in the absence of Fixed place of Business:

Cross Border Transaction/Services may cause following type of PE exposures:

- ☐ Service PE.
- ☐ Construction PE.
- ☐ Agency PE.

Discussed by separate slides



Article 5 – Para 1 – Basic Rule.....

Meaning of PE as per judicial precedence :

The concept as explained by Andhra Pradesh High Court in C.I.T. V/s. Visakhapatnam Port Trust (144 ITR 146.....162):

“The words ‘permanent establishment’ postulates the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be such as that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country”.

Article 5 – Para 1 – Basic Rule.....

Meaning of PE as per judicial precedence :

Extract from (Subsea Offshore Ltd. - 66 ITD 296... 303, 304)(Mum - ITAT)

- ❑ “.....it seems to be evident that permanent establishment denotes some place of fixed nature with permanency, and it does not include in its ambit a moving vessel which operates near a fixed place and which does not belong to the assessee.”
- ❑ Assessee's vessel being in India only for 2 1/2 months cannot be said to be of enduring continuity nor could it be said in this case that there was a virtual projection of the assessee into the soil of India

Article 5 – Para 1 – Basic Rule.....

Meaning of PE as per judicial precedence :

Extract from (P. No. 24 of 1996 - 237 ITR 798... 805)(AAR)

- ❑ “It seems to the authority that the expression “fixed place” envisages the possibility of locating, identifying or pointing out to a definite place as the place from which a business is carried on and does not import a requirement that the place of business should be stationary and not moving”.

Article 5 – Para 1 – Basic Rule.....

Indian reservation on OECD Model Commentary for Article 5 – Para 1

Para 8 - “*where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties **through a fixed place of business maintained by an enterprise of a Contracting State in the other State**, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. However, the same will not constitute a permanent establishment of the lessor if it is done **without maintaining for such letting or leasing activity, a fixed place of business in the other State** provided the contract is limited to the mere leasing of the equipment*

India's Positions:

India does not agree with the above interpretation; it is of the view that tangible or intangible properties by themselves may constitute a permanent establishment of the lessor in certain circumstances. [Para 26]

Article 5 – Para 1 – Basic Rule.....

Indian reservation on OECD Model Commentary for Article 5 – Para 1

India further does not agree with the interpretation given in Paragraph 5.3 & 5.4 of the commentary; it is of view that these examples could also be regarded as constituting Permanent establishment. [Para 25].

OECD says that to constitute a single place of business, presence of both commercially and geographically coherence is necessary.

Para 5.3 - By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business.

Para 5.4 - Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business.

Article 5 – Para 1 – Basic Rule.....

Indian reservation on OECD Model Commentary for Article 5 – Para 1

India further does not agree with the interpretation given in Paragraph 10 of the commentary; it is of view that ICS equipment may constitute Permanent establishment of lessor in certain circumstances. [Para 27] This is in line with reservation of India given in Para 26.

Para 10 says that *“The business of an enterprise Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment **does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises.** A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.”*

Article 5 – Para 1 – Basic Rule.....

India's Position on OECD Commentary on E Commerce

Para 42.2 of OECD Commentary says that “Whilst a location where automated, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a “place of business” as there is no “facility such as premises or, in certain instances, machinery or equipment” as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.

India does not agree with the above interpretation and holds the view that website may constitute a permanent establishment in certain circumstances. [Para 33]

Article 5 – Para 1 – Basic Rule.....

India's Position on OECD Commentary on E Commerce

Para 42.3 of OECD Commentary says that “The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site..... **the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement.** However, if the enterprise carrying on business through a web site has the server at its own disposal.....the place where that server is located could constitute a permanent establishment of the enterprise.....”

India does not agree with the interpretation and holds the view that, depending on the facts, an enterprise can be considered to have acquired a place of business by virtue of hosting its website on a particular server at a particular location. [Para 34]

Article 5(2) - Illustrative list of PEs

“2. The term “permanent establishment” includes especially:

- a) a place of management;
- b) a branch;
- c) an office;
- d) a factory;
- e) a workshop, and
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.”

As appearing in OECD Model Convention

Article 5(2) - Illustrative list of PEs

- ❑ OECD & UN model are identical.
- ❑ However, following additional clause may be find in the DTAA's entered by Indian with various countries:
 - Reference of “Store or other sales outlet”
 - Reference of “Warehouse”
 - Reference of “A place of exploration of natural resources” (Philippines)
 - Reference of “a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on”
 - The provision of services or facilities in connection with or supply of plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils

Article 5(2) - Illustrative list of PEs

- ❑ The list contained in 5(2) is only indicative and not exhaustive.
- ❑ Places mentioned in 5(2) must satisfy the requirements of 5(1) to constitute a PE
- ❑ An office for a short period in a fair or exhibition would not constitute a PE

Article 5(2) - Illustrative list of PEs

Relationship between Article 5(1) and Article 5(2)

OECD model treaty Commentary :-

On Article 5(2) – *“This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, as constituting a permanent establishment. As these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, “a place of management”, “a branch”, “an office”, etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.”* [Para 12]

Notable observation on the commentary by member country:

*“ **Italy** does not adhere to the interpretation given in paragraph 12 above concerning the list of examples of [Art. 5(2)]. In its opinion, these examples can always be regarded as constituting a priori permanent establishments.”* [Para 43]

India, as a Non-Member Country, also does not adhere to the interpretation and given the same opinion as Italy. [Para 28].

Article 5(2) - Illustrative list of PEs

Some Judicial precedence:

- ❑ In case of Micoperi SPA Milano (82 ITD 369), Mumbai Tribunal held that a project office constitutes a PE since expenses are incurred on account of telex, telephone, postage etc. out of rupee receipts by a project office.
- ❑ However, Delhi Tribunal in BKI/HAM VOF (70 TTJ 480) held that a project office does not carry on a business at all and is merely a support office existing solely for the purpose of facilitating the performance of a contract; hence it is not a PE.
- ❑ Andhra Pradesh High Court, in case of Vishakhapatnam Port Trust (144 ITR 146), held that a representative office would not constitute a PE.
- ❑ In case of Motorola Inc. (95 ITD 269) and Western Union Financial Services Inc. (101 TTJ 56), it was held that a liaison office would not constitute a PE.
- ❑ However, In UAE Exchange Centre LLC (268 ITR 9), depending upon the facts of the case, AAR ruled that an Indian liaison office of a foreign enterprise was a PE.

Article 5(2) - Illustrative list of PEs

Sales Outlet

- ❑ Premises used as a sales outlet or for receiving or soliciting orders is covered.
- ❑ Many variations are found in Indian DTAA's in considering sales outlet as PE.
 - India/Japan: *“a store or other sales outlet”*.
 - India/US: *“a store or premises used as a sales outlet”*.
 - India/Singapore: *“premises used as a sales outlet or for soliciting and receiving orders”*
- ❑ Many Indian DTAA's does not having a reference of “Sales outlet” in Article 5 (2) definition like Indo DTAA with Bangladesh , Brazil, Bulgaria, China, Cyprus, Greece, Hungary, Indonesia, Korea , Mauritius, Nepal, Singapore, South Africa, Sri Lanka, Thailand, UAE etc.

Article 5(2) - Illustrative list of PEs

Indian reservation on Article 5 – Para 2 of OECD Model Convention

India reserves the right to add to paragraph 2, additional subparagraphs that would cover.

- ❑ a sales outlet and a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on [Para 3];
- ❑ a warehouse in relation to a person supplying storage facilities for others.
[Para 4]

Article 5(3) - Installation PE

“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.”

“Permanent/Fixed Place of Business” element replaced
by test of minimum length of time. (Period test)

Article 5(3) – Installation PE

- ❑ A building site or construction or installation project” includes:
 - construction of roads, bridges or canals
 - renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals
 - Laying of pipelines
 - excavating and dredging
 - installation of new equipment in an existing building or outdoors
 - onsite planning and supervision of the construction of a building

[OECD model treaty commentary, para 17]

Article 5(3) – Installation PE

Measurement of the time period

- ❑ A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established (eg. a planning office is installed).
 - ❑ It continues until the work is complete or permanently abandoned.
 - ❑ A site should not be regarded as ceasing to exist when work is temporarily discontinued – for example, due to:
 - bad weather
 - shortage of material
 - labour difficulties

[continued.....OECD model treaty commentary, Para 19]

Article 5(3) – Installation PE

Measurement of the time period

□ General contractors and subcontractors:

- “If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.”

[OECD model treaty commentary, para 19]

Article 5(3) – Installation PE

Measurement of the time period –

In case of Scattered Project

- ❑ In some project, due to its nature, contractor's activity has to be relocated continuously or at least from time to time, as the project progresses.
- ❑ This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid.
- ❑ Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project.
- ❑ In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial.
- ❑ The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

[OECD model treaty commentary, Para 20]

Article 5(3) – Installation PE

Measurement of the time period

- ❑ 12 Months time applied to each individual site or project.
- ❑ Activities may extend over more than one Calendar year or Assessment year.
- ❑ Time taken for unconnected projects should not be considered for 12 month period.
- ❑ Legal Acts are excluded in calculating the time limit.
- ❑ Beginning of the minimum period.
 - Business Activity is started on the spot. P.E. exits from day one

Article 5(3) – Installation PE

Measurement of the time period

- ☐ End of the minimum period
- ☐ Same principles apply that govern the beginning
- ☐ Trial run is included in the minimum period
- ☐ After sales services is either sufficiently Connected with the building, installation or assembly work - PE
- ☐ Auxiliary services subsequent to a fully completed assembly or installation project - No PE.

Article 5(3) – Service PE

UN Model:

- ❑ “The term “permanent establishment” also encompasses:
 - (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
 - (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.” **(A concept of Service PE)**

Article 5(3) – Service PE

UN MODEL:

- ❑ U.N. Model covers a broader range of activities than O.E.C.D. Model
- ❑ U.N. Model convention goes beyond the “Fixed Place of Business” concept
- ❑ U.N. Model also include
 - An Assembly project and
 - Supervisory Activities
- ❑ 6 Months Test instead of 12 months

Article 5(3)(b) – Service PE

UN Model - Para 3(b)

- ❑ Not included in O.E.C.D Model convention.
- ❑ Deals with furnishing of services including consultancy services
- ❑ Services are provided by enterprise/its employees/Personnel engaged by it
- ❑ Time Limit of 6 months within any 12 month period
- ❑ Service activity should be in the nature of connected project
- ❑ Services may be rendered to an associated enterprise of the service provider or a third party service recipient
- ❑ The number of days calculation is based on man days
- ❑ It is important to evaluate the requirements of Article 12 before examining the service PE clause

Article 5(3)(b) – Service PE

- ❑ What is Stewardship?
- ❑ What is Secondment?
- ❑ What is Deputation?

Article 5(3)(b) – Service PE

Stewardship – A special Feature

- ❑ Stewardship services are rendered to protect the interest of the customer / principal
- ❑ Stewards are typically not involved in the day-to-day management or in rendering the services undertaken by the service provider
- ❑ Their function is essentially of quality control and ensuring confidentiality
- ❑ Usually, the foreign enterprise does not receive fees from the recipient of such services and the cost of the personnel performing these services are also borne by the foreign enterprise
- ❑ Given the above, stewardship activities do not lead to the constitution of a service PE

Article 5(3)(b) – Service PE

Secondment– A special Feature

❑ The typical features of a secondment are:

- An employee of enterprise X in State X is seconded to enterprise Y in State Y; he continues on the payroll of enterprise X
- Employee resides and renders services in State Y; he reports to enterprise Y
- The employee may continue to be paid by enterprise X who in turn is reimbursed by enterprise Y

❑ Critical parameters in determining the existence of a PE or otherwise

- Commercial justification
- Enterprise which exercises control over the employee
- Existence or otherwise of a lien on employment with enterprise X for the employee.

Article 5(3)(b) – Service PE

Deputation – A Special Features

- ❑ The typical features of deputation are:
 - An employee of enterprise X in State X is deputed to enterprise Y in State Y; he shifts to the payroll of enterprise Y
 - Employee resides and renders services in State Y; he reports to enterprise Y
 - Salary of the employee is paid by enterprise Y
- ❑ It may be possible to demonstrate that the employee does not retain a lien on his employment with enterprise X
- ❑ Deputation may not be preferred since:
 - Employees are keen to retain a lien
 - Continuity of social security / provident fund / mortgage could be affected
 - Position of the employee within the organization could be affected
 - The period for which the services of the employee are required could be short

Article 5(3)(b) – Installation/Service PE

- ❑ Lots of variation among Indian DTAA's in respect to Installation PE & Service PE
- ❑ Need to care of each word of DTAA while applying the same.
- ❑ Some Indian DTAA's do not have a reference of "Installation" in Article 5 (3) definition like Indo DTAA with Bangladesh , Israel , Kenya , Libyan Arab Jamahiriya , Malta , Mauritius , Mongolia, Morocco ,Nepal , Oman ,Philippines ,Qatar, Tanzania ,Thailand ,Trinidad and Tobago ,UAE ,Uganda , Vietnam, Zambia etc...

Article 5(3)(b) – Installation/Service PE

- ❑ Some Indian DTAA's do not have a reference of “supervisory activities” in Article 5 (3) definition like Indo DTAA with Bangladesh , Brazil, France, Greece, Libyan Arab Jamahiriya, Malaysia Nepal, Netherlands, Qatar, Sri Lanka, Slovenia etc.
- ❑ Some Indian DTAA's do not have a reference of “concept of service PE” in Article 5 (3) definition like Indo DTAA with Austria, Brazil, France, Malaysia, Netherlands etc.
- ❑ Some Indian DTAA's do have a reference of “concept of service PE” in Article 5 (3) definition but do not have the “concept of Service to associated enterprises” like Indo DTAA with Thailand, UAE, Sri Lanka, Norway, Indonesia, China etc.

Article 5(3) – Installation PE/ Service PE

Indian reservation on Article 5 – Para 3 of OECD Model Convention

- ❑ *India* reserves the right to replace “construction or installation project” with “construction, installation or assembly project or supervisory activities in connection therewith” and reserves its right to negotiate the period of time for which they should last to be regarded as a permanent establishment. [Para 11.1].
- ❑ *India* reserve the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services through employees or other personnel engaged by the enterprise for such purpose but only where such activities continue for the same project or a connected project for a period or periods aggregating more than a period to be negotiated. [Para 13].

Article 5(3) – Installation PE/ Service PE

Indian reservation on Article 5 – Para 3 of OECD Model Convention

- ❑ **Para 18** - “The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it.....”

India's Positions

- ❑ *India* do not agree with the words “The twelve month test applies to each individual site or project” found in paragraph 18 of the Commentary. They consider that a series of consecutive short term sites or projects operated by a contractor would give rise to the existence of a permanent establishment in the country concerned. [Para 20]

Article 5(3) – Installation PE/ Service PE

Indian reservation on Article 5 – Para 3 of OECD Model Convention

- ❑ *India* does not agree with the interpretation given in paragraphs 42.14 and 42.15 of the OECD Commentary that a service permanent establishment will be created only if services are performed in the source State. It is of the view that furnishing of services is sufficient for creation of a service permanent establishment. [Para 35].
- ❑ *India* does not agree with the interpretation given in paragraphs 42.18 and 42.46 of the OECD Commentary, it is of the view that taxation rights may exist in a state even when services are furnished by the non-residents from outside that State. It is also of the view that the taxation principle applicable to the profits from sale of goods may not apply to the income from furnishing of services. [Para 36].

Article 5(3) – Installation PE/ Service PE

Indian reservation on Article 5 – Para 3 of OECD Model Convention

- ❑ *India* does not agree with the interpretation given in paragraphs 42.19 of the OECD Commentary that only the profits derived from services should be taxed and the provisions that are included in bilateral Conventions which allow a State to tax the gross amount of the fees paid for certain services is not an appropriate way of taxing services. [Para 37].
- ❑ *India* does not agree with the conclusions given in paragraph 42.22 of the Commentary that taxation should not extend to services performed outside the territory of a State; that taxation should apply only to the profits from these services rather than to the payments for them, and that there should be a minimum level of presence in a State before such taxation is allowed. [Para 38].
- ❑ *India* does not agree with the interpretation given in paragraph 42.31; it is of the view that for furnishing services in a State, physical presence of an individual is not essential. [Para 39].

Article 5(4) - List of Exceptions

“Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

Article 5(4) - List of Exceptions

- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.”

Article 5(4) - List of Exceptions

- ❑ Deems certain kinds of fixed place of business not to be permanent establishments (see sub-paragraphs (a) to (f) above)
- ❑ **Policy rationales:**
 - Such places are remote from profit making and attribution of income would therefore be problematic and artificial
 - An enterprise should have the opportunity to develop in a new market without immediate liability to local taxation
- ❑ A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises.
- ❑ Certain Indian DTAA's has no reference of word "delivery" in sub paragraph 'a' & 'b' in list of exceptions

Article 5(4) - List of Exceptions

What is preparatory or auxiliary?

- ❑ The terms are not defined – facts needs to be examined
- ❑ If the activity of the fixed place of business:-
 - forms an indispensable and significant part of the enterprise as a whole
or
 - are identical with the general purpose and object of its parent,
- ❑ then such activities would not be regarded as preparatory or auxiliary in character.

Article 5(4) - List of Exceptions

Preparatory or auxiliary character may include

- ☐ Provision of IT enabled services by a BPO for its foreign clients [Morgan Stanley - 292 ITR 416 - SC]
- ☐ Providing a communications link between suppliers and customers, eg., through a call centre

Preparatory or auxiliary character may NOT include

- ☐ Managing a part of an enterprise
- ☐ Supervision or control of performance of a contract

Article 5(4) - List of Exceptions

- ❑ In Galileo International Inc, 19 SOT 257 (Del), it was held that the booking function was operated in India which directly contributed to the earning of revenue, the activities carried out by the assessee in India were in no way of preparatory or auxiliary character.
- ❑ In Rolls Royce, 19 SOT 42 (Del), it was held that a foreign company availing support services from an Indian Wholly Owned subsidiary had a PE in India in the form of fixed place as well as an agency PE.

Article 5(4) - List of Exceptions

Indian reservation on Article 5 – Para 3 of OECD Model Convention

“India with other Non-member country reserves their position on paragraph 4 as they consider that the term “delivery” should be deleted from subparagraphs a) and b).”

Article 5(4) - List of Exceptions

Indian reservation on OECD Model Commentary for Article 5 – Para 4

OECD Commentary – Para 23

Subparagraph e) provides that a fixed place of business through which the enterprise exercisesExamples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character

India's Positions on the Commentary:-

India does not agree with the interpretation given above. It would not include scientific research in the list of examples of activities indicative of preparatory or auxiliary nature [Para 29]

Article 5(4) - List of Exceptions

Indian reservation on OECD Model Commentary for Article 5 – Para 4

OECD Commentary – Para 25

“A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph a) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph e) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.”

Article 5(4) - List of Exceptions

Indian reservation on OECD Model Commentary for Article 5 – Para 4

India does not agree with the interpretation given in paragraph 25.

- ❑ It is of the view that when an enterprise has established an office (such as a commercial representation office) in a country, and the employees working at that office are substantially involved in the negotiation of contracts for the import of products or services into that country, the office will in most cases not fall within paragraph 4 of Article 5.
- ❑ Substantial involvement in the negotiations exists when the essential parts of the contract – the type, quality, and amount of goods, for example, and the time and terms of delivery are determined by the office.
- ❑ These activities form a separate and indispensable part of the business activities of the foreign enterprise, and are not simply activities of an auxiliary or preparatory character.

Article 5(5) - Dependent Agency

“Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

Article 5(5) - Dependent Agency

Generally, a dependent agent will constitute a PE and an independent agent will not result in a PE.

- ❑ an agent who has and habitually exercises authority to conclude contracts constitutes a permanent establishment
- ❑ agent must be dependent
- ❑ contracts must relate to the profit making activity of the enterprise - “the business proper of the enterprise

Article 5(5) - Dependent Agency

What is “Habitually Exercise”?

- ❑ Requirement that an agent must “habitually” exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory
- ❑ The extent and frequency of activity necessary to conclude that the agent is “habitually exercising” contracting authority will depend on
 - the nature of the contracts and
 - the business of the principal.

Article 5(5) - Dependent Agency

What is “Authority to conclude contracts?”

- ❑ As long as the agent has an authority to conclude contracts which are **binding on the enterprise**, it is not necessary that he should enter into contracts “literally” in the name of the enterprise; the case would be covered within this Article even if those contracts are **not actually in the name of the enterprise** [see *Galileo International Inc.*, 19 SOT 257 (Del)]

Article 5(5) - Dependent Agency

What is “Authority to conclude contracts?”

❑ It is the actual authority which is relevant. An agent may be considered to possess actual authority when he solicits and receives orders but does not formally finalize them and the principal regularly approves and the orders are sent directly to a warehouse from where goods are delivered by the principal.

➤ In *TVM Ltd., 237 ITR 230 (AAR)*, the Mauritian company had an Indian subsidiary through which it was carrying out some of its activities. Although it was its subsidiary, it did not have authority to conclude contracts. Only the Mauritian company had the authority. Based on the facts of the case, the Authority ruled that there was no PE in this case

Article 5(5) - Dependent Agency

Notable points:

- ❑ No requirement for the dependent agent to have a fixed place of business
- ❑ Employees of the enterprise can be dependent agents if they meet the requirements of paragraph 5 (habitually exercise authority to conclude contracts etc.)
- ❑ Paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State.
- ❑ If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

Article 5(5) - Dependent Agency

Notable points:

- ❑ Many Indian Tax Treaties contain provisions whereby if an agent habitually secures orders wholly or almost wholly for the principal, he would constitute a PE, e.g., DTAA with UK, USA, Germany, Japan, and Singapore.
 - However, DTAAs with France, Israel, Mauritius and the Netherlands do not contain such provisions
- ❑ **Delivery Agent**
 - Article 5(4)(b) of the India-UK Treaty provides that an agent (other than an independent agent) who habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise results in a permanent establishment.

Article 5(5) - Dependent Agency

Indian reservation on Article 5 – Para 5 of OECD Model Convention

- ❑ India with other Non-Member country reserve the right to treat an enterprise as having a permanent establishment if a person acting on behalf of the enterprise habitually maintains a stock of goods or merchandise in a Contracting State from which the person regularly delivers goods or merchandise on behalf of the enterprise. [Para 17]
- ❑ India reserves the right to treat an enterprise of a Contracting State as having a permanent establishment in the other Contracting State if a person habitually secures orders in the other Contracting State wholly or almost wholly for the enterprise. [Para 17.1]

Article 5(5) - Dependent Agency

Indian reservation on OECD Model Commentary for Article 5 – Para 5

What is Authority to Conclude Contract?

India does not agree with the interpretation given in paragraph 33 of the commentary.

- ❑ It is of the view that the mere fact that a person has attended or participated in negotiations in a State between an enterprise and a client, can in certain circumstances, be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise.
- ❑ India is also of the view that a person, who is authorized to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts. [Para 31]

Article 5(6) – Independent Agent

- ❑ “An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.”

- ❑ An agent will not constitute a PE of its principal if he is “an agent of an independent status”, i.e.,
 - legally and economically, he is independent of the enterprise on whose behalf he acts, and
 - When acting on behalf of the enterprise, he acts in the ordinary course of his business.

Article 5(6) – Independent Agent

What is Ordinary Course of Business – Judicial Precedence

- ❑ A newspaper company, collecting advertisements for other foreign newspapers, acts in the “ordinary course” of its business when it enters into solicitation agreement with foreign principals [*Al Nisr Publishing, In re*, 239 ITR 879 (AAR)]
- ❑ The department of Posts accepts money orders for transfer of funds within India, Engaging itself in the same type of business with international ramifications, i.e., money transfer services across international borders, is just an extension of its business and hence, is in the “ordinary course of its business” [*Western Union Financial Services Inc.*, 101 TTJ 56 (Del)]

Article 5(6) – Independent Agent

What is Ordinary Course of Business – Judicial Precedence

- ❑ A local custodian providing custodial services to various FIIs is acting in “ordinary course” of its business in providing such agency services since it is not a special business done exclusively for a single FII.
 - *Fidelity Advisor Series - 271 ITR 1 (AAR)*
 - *XYZ / ABC Equity Fund- 250 ITR 230 (AAR)*

- ❑ An entity, that produces television software (A) and which licenses its software to a broadcasting entity (B), acts in the “ordinary course of its business” when it solicits advertisements for B and is able to factually prove that such solicitation is incidental to its (A’s) business of producing television programmes (*TVM Ltd., 237 ITR 230 (AAR)*]

Article 5(6) - Independent Agent

Indian reservation on Article 5 – Para 6 of OECD Model Convention

- ❑ India reserve the right to provide that an insurance enterprise of a Contracting State shall, except with respect to re-insurance (other than in the case of India), be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other state or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 6 applies.
- ❑ India reserves the right to make it clear that an agent whose activities are conducted wholly or almost wholly on behalf of a single enterprise will not be considered an agent of an independent status.

Article 5(7) - Associate Enterprises

“The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.”

- ❑ The article clarifies that a company is not deemed to have a PE in the other state merely because it controls, or is controlled by, a company that is resident of the other state.
- ❑ Each company constitutes an independent legal entity.
- ❑ Mere existence or possibilities of existence of close relationships is not sufficient to constitute a PE [TVM Ltd., 237 ITR 230 (AAR)]

Article 5(7) - Associate Enterprises

- ❑ Mere fact that the subsidiary company is managed by its parent or that the parent exercise control over activities of its subsidiary and desires stringent financial reporting, does not constitute the subsidiary a PE of the parent.
- ❑ However, if the activities of the subsidiary on behalf of the parent are within other provisions of Article 5 then the subsidiary may become a PE of the parent [P - 8 of 1995 - 223 ITR 416 (AAR)]
 - a) Say a subsidiary would be regarded as PE of parent, if it has habitually exercised in the other country, an authority to conclude contracts for sale of goods on behalf of the parent.
- ❑ DTAA with UAE has no such clause

Article 5(7) - Associate Enterprises

Motorola Inc. - 95 ITD 269 - Delhi ITAT

Facts of the case:

- ❑ In this case a foreign telecom equipment supplier had a wholly owned subsidiary in India.
- ❑ The Indian subsidiary provided marketing services to the foreign company and the foreign company reimbursed the cost plus profit.
- ❑ The foreign company exported telecom equipment to Indian telecom operators and the Indian subsidiary provided installation services under direct agreements with the operators in relation to the equipment supplied by the foreign company.
- ❑ The foreign company represented to the operators that it will not dilute its shareholding in the Indian subsidiary below 51% without the permission of the telecom operators.
- ❑ The accounts of the Indian subsidiary showed a loss from installation activity

Article 5(7) - Associate Enterprises

Motorola Inc. - 95 ITD 269 - Delhi ITAT

The Tribunal held as follows:

- ❑ There was ample scope for the foreign company to control and monitor Indian subsidiary's activities in India.
- ❑ The installation charges were directed by the foreign company to its Indian subsidiary to be so fixed that they were not commensurate with the services rendered by the Indian subsidiary.
- ❑ Part of the price for installation was diverted to the foreign company as the price of supply of the telecom equipment.
- ❑ The distinction between the foreign company and the Indian subsidiary got blurred with the result that when the Indian telecom operators were dealing with the Indian subsidiary, they were in fact dealing with the foreign company.
- ❑ The Indian subsidiary was the virtual projection of the foreign company in India and constituted a PE of the parent in India.



ARTICLE 7

BUSINESS PROFITS & Attribution of the same

Article 7 – Business Profit

A Quick tour of rules mentioned in Article 7 (OECD Model)

- Para 1 -** Part I - Existence of PE & attribution of Profits to business of such PE
Part II - Force of Attraction Rule (UN Model)
- Para 2-** Principle of Distinct and separate enterprise approach.
- Para 3-** Principles of Computation of income of PE
- Para 4-** Source country can follow principles of apportionment if customarily followed
- Para 5-** No allocation of profits for mere purchase of goods for the enterprise.
- Para 6-** Says consistent use of Attribution method.
- Para 7-** Given priority to other article if profits include income taxable under other article like CG, FTS, Royalty etc

Article 7(1) – Part I – Normal Provision

“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 that permanent establishment.”

❑ Existence of PE is must in other state.

➤ Until an enterprise of one state sets up a PE in another state it should not properly be regarded as participating in the economic life of that other state to such an extent that it comes within the jurisdiction of that other state's taxing rights.

❑ Business should be carried through such PE.

❑ Profits from the date of set up of the PE.

❑ Only profits attributable to such PE are taxable in the source country.

Article 7(1) – Part I – Normal Provision

- ❑ Attribution may result in profits being attributed to PE even though the enterprise as a whole has never made profits; conversely, it may result in no profits being attributed to a PE even though the enterprise as a whole has made profits.
- ❑ Profits not defined – the term has a broad meaning and include all income derived in carrying an enterprise.
- ❑ No guidance on scope of ‘profits of the enterprise’
 - ❖ Normally Two approaches for interpreting ‘profits of the enterprise’
 - Relevant business activity’ approach
 - Functionally separate entity’ approach

Article 7(1) – Part I – Normal Provision

❑ Relevant Business Activity Approach

- Approach emerges from country practices – no reference in Article 7 or commentary
- Relevant business activity – business activity in which PE has participation or it undertakes
- ‘Profits of enterprise’ refers to profits of the whole enterprise from ‘relevant business activity’
- Relevant business activity approach places a limit on profits attributable to PE – attributable profits cannot exceed profits earned from relevant business activity

Article 7(1) – Part I – Normal Provision

❑ Functionally Separate Entity Approach:

- Consistent with arm's length principle
- Easily administrative since determination of enterprise's world wide profits (from relevant business activity) not required
- It is neutral to the resident status.
- From the perspective of consistency, the “functionally separate entity” approach is preferred because it mirrors the type of analysis that would be undertaken if the PE were legally distinct and separate.
- Functionally separate entity approach adopted as Authorized OECD Approach (AOA) for profit attribution

Article 7(1) – Part I – Normal Provision

❑ Whether Such Profits may also be taxed in the country of residence?

➤ Scope of Expression “May be taxed”

Article 7(1) – Part I – Normal Provision

Some Judicial Precedents:

- ❑ SRM Firms (208 ITR 400 – Mad HC) – Taxable only in PE Country i.e. Malaysia.
- ❑ Laxmi Textile Mills Ltd. (245 ITR 521 – Mad HC) – Taxable only in PE Country i.e. Sri Lanka.
- ❑ PVAL Kulandagan Chettair (267 ITR 654 – SC) – Taxable only in source country.

Article 7(1) – Part I – Normal Provision

Para 1 of Article VII (*Business profits*) of India Bangladesh specifically provides that:

“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, then so much of the profits of the enterprise as is attributable to that permanent establishment **shall be taxable only in that other Contracting State.**”

Article 7(1) – Part II – Force of Attraction – UN Model

“The profits.....
.....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.”



Discussed Separately

Article 7(2) – Distinct and separate entity approach

“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 the 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) – Distinct and separate entity approach

- ❑ Profits attributable to PE would be the one it would have earned if
 - Such PE is a distinct & separate enterprise.
 - PE is engaged in same or similar activities operating under same or similar conditions.
 - PE is dealing wholly and independently with the enterprise of which it is a PE
- ❑ Transactions between the enterprise and PE are considered as transaction between two separate entities.
 - Internal transfer of assets could also get subject to tax.
 - The transaction should be at arm's length.

Article 7(2) – Distinct and separate entity approach

Can the principle of “Profit from self” be applied?

- ☐ Mitsui Bank Ltd. v. IAC (35 TTJ 426) (Mumbai) – Applied.
- ☐ ABN Amro Bank v. CIT (98 TTJ 295) (Cal-SB) – Applied
- ☐ CBDT Circular 649 of March 31 1993 – Not Applied.
- ☐ CBDT Circular 740 of April 17 1996 – Not applied in case of banking companies.

Article 7(2) – Distinct and separate entity approach

- ❑ Computation of income will be governed by Domestic law.
- ❑ The amount on which the enterprises will be taxed in the source state (after attribution of profits) will not, for a given period of time, be exactly the same as the amount of income with respect to which the other state will have to provide relief.
- ❑ Variations between the domestic laws of the states like depreciation rates, the timing difference in recognition of income and deductibility of certain expenses may result in a different amount of taxable income in each state.
- ❑ In case separate accounts are being maintained, naturally they will form the starting point for any processes of adjustment if required to produce the amount of profits that are properly attributable to the PE.
- ❑ However, such accounts, records, documentation etc must satisfy certain requirements in order to be considered to reflect the real facts of the situation between Enterprises and its deemed PE.

Article 7(2) – Distinct and separate entity approach

Whether any adjustment is required in determining the profits realized by PE?

Two Step Approach

The first step of that approach requires the identification of the activities carried on through the PE. This should be done through a functional and factual analysis.

The second step requires that remuneration of any such activities will be determined by applying by analogy the principles developed for the application of the arm's length principle between associated enterprises by reference to the functions performed, asset used and risk assumed (FAR Analysis) by the enterprises through the PE and through the rest of the enterprises.

Article 7(2) – Distinct and separate entity approach

- ❑ Attribution of Profits in case PE comes in existence due to activity of dependant agent (Agency PE):
- ❑ OECD Commentary (Para 26)
 - Dependent agent and enterprise constitute two separate potential taxpayers
 - Activities undertaken by the dependant agent both on its own account and on behalf of the enterprises will be determined by Functional & factual analysis.
 - Dependent agent's own income or profits from activities that it performs *on its own account* for the enterprise
 - Deemed PE will be attributed assets & risks of the enterprise relating to functions performed by dependent agent *on behalf of* the enterprise, with supporting capital
 - Profits will be attributed to the deemed PE on the basis of those assets, risks and capital

Article 7(2) – Distinct and separate entity approach

Indian context

Morgan Stanley (AAR 661 of 2005)

- ❑ Payment of arm's length remuneration by a foreign enterprise to its dependent agent extinguishes the tax liability of the foreign enterprise in India.
- ❑ On final appeal before supreme court, Hon'ble SC says that since remuneration was supported by a transfer pricing analysis, no further income can be attributed to the Indian PE. (292 ITR 416)

SET Satellite (106 ITD 175/Mum/ITAT).

- ❑ Dependent agent and dependent agent PE are distinct entities.
- ❑ Income of the foreign company may be taxed even where it pays an arm's length remuneration to its dependent agent in India.

Article 7(3) – Principle of computation of Income of PE

“In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes 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.**”

Article 7(3) – Principle of computation of Income of PE

- ❑ Broad guidelines for determination of profits of PE
- ❑ 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 laws
 - ❑ No deduction shall be allowed for any amount paid by PE to the HO or any other offices of the enterprise (other than reimbursement of actual expenses)
 - For use of patents or other rights in the form of royalties, fees or other similar payments

Article 7(3) – Principle of computation of Income of PE

- ❑ Is Paragraph 2 & Paragraph 3 conflicts each other? Arm's Length Vs Actual Price
- ❑ Paragraph 3 provides a rule applicable for the determination of the profits of the PE, Paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.
- ❑ Paragraph 3 only determines expenses attributable to the PE, Conditions for deductibility of expenses to be determined by domestic law.
- ❑ The deduction allowable to the PE for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the PE. (OECD Commentary)

Article 7(3) – Principle of computation of Income of PE

OECD Commentary Provides that

- ❑ In case of intangible property, cost shall be apportioned over various parts of the enterprise without any mark-up.
- ❑ In case of services provided by HO being general in nature and for the enterprise as a whole, cost shall be charged at actual without any mark-up.
- ❑ However, group company providing support services shall be at arm's length.
- ❑ As regards internal debts, interest shall be ignored except in case of banking enterprise.
- ❑ No part of the profits of PE can be said to be attributable to management function of the enterprise.

Article 7(4) – Apportionment Method by Source Country

“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.”

Article 7(4) – Apportionment Method by Source Country

- ❑ 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 the principles contained in this Article.
- ❑ Applicable where profits is being attributed not on the basis of separate accounts or by making an estimation of arm's length price as envisaged in Paragraph 2, but simply by apportioning the totals profits of the enterprise by reference of some formula

Article 7(4) – Apportionment Method by Source Country

Three categories were discussed by OECD in its commentary which may be a criterion commonly used for apportionment of profits, if it is customary and well accepted by country concerned:

- ❑ On the basis of Receipts (say turnover or commission) of the enterprises:

Ex: Insurance Companies Profits – Basis – Premium received country wise.

- ❑ On the basis of expenses (say wages) of the enterprises:

Ex: Labour based Manufacturing Companies: Basis – Cost of labour.

- ❑ On the basis of its Capital Structure (say working capital):

Ex: Banking & financial concerns – Basis – Total Working Capital.

Article 7(5) – No Attribution to Purchase

- ❑ No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
- ❑ In case where enterprises established in source state only for the purpose of purchasing activities, such an organization will not be a Permanent establishment as per exclusion provided in Article 5(4)(d). So question of attribution of profit does not arise.
- ❑ The paragraph is concerned with a permanent establishment which, although carrying on other business, also carries function of purchase for its head office.

Article 7(5) – No Attribution to Purchase

- ❑ The benefits will not be available if PE carries out some process on purchased goods before exporting them outside India.
- ❑ Some DTAA's (Belgium, UAR, Zambia etc.) specifically provides that the goods should be for the purpose of exports to the enterprises.
- ❑ Benefits in line with Explanation 1(b) to section 9 (1)(i) of the Act:
 - ❑ *“in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.”*
- ❑ What if Purchase of goods from other countries?
- ❑ What if Purchase for other enterprises?

Article 7(6) – Consistency in Attribution Method

- ❑ “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”.
- ❑ Method of attribution once used should not be changed merely because in a particular year some other method produces more favorable results.
- ❑ This paragraph gives an assurance of continuous and consistent tax treatment.
- ❑ Method can be change for good and sufficient reasons.”

Article 7 (7) – Specific Article vs. General 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.”

Specific Articles (Article on Interest, Dividend, Royalties, FTS, Capital Gain etc.) bring back the said income to Article 7. Is it creates some confusion?

For eg. - Article 7(7) of the Singapore DTAA having the view that those incomes which are subject to taxation under other specific articles of a tax treaty such as interest, royalty, fees for technical services etc are taxed as per such specific articles only. The tax treatment remains unaffected even if the taxpayer has a PE in other contracting state unless such income is effectively connected/attributable to such PE [Article 12(6)].

Article 7 (7) – Specific Article vs. General Article

For example – Singapore DTAA

Article 7(7) has following text:

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

Article 12(6) has following text:

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.”

Article 7 (7) – Specific Article vs. General Article

Some Judicial Precedence:

AAR in case of **Morgan Stanley & Co. International Ltd. (292 ITR 416)** held that as the volume of the transactions of purchases and sales of derivatives was huge, the income from trading in derivatives was not capital gains, but business income. It also observed that as the applicant did not have any PE in India, the income earned from transactions of purchases and sales of derivatives would not be taxable in India.

However, AAR in case of Fidelity Northstar Fund held that the income of a foreign Institutional Investor (“FII”) would be characterized as capital gains and not business income. The ruling was based on the grounds that FIIs may legally only invest in shares and not trade in shares.

India's position on Article 7 of OCED and its commentary

India with other non-member countries like Albania, Argentina, Brazil, Chile, Malaysia, Russia, Vietnam etc. reserve the right to maintain in their conventions a specific article dealing with the taxation of “independent personal services”. Accordingly, reservation is also made with respect to all the corresponding modifications in the Articles and the Commentaries, which have been modified as a result of the elimination of Article 14 **[Para 2.1 to the Positions of Non-Member Country on Article 7 and its commentary of OECD Model Tax Convention (2008)]**

Even, Italy & Portugal, members of OECD countries, has same reservation. [Para 78]

India's position on Article 7 of OCED and its commentary

Please note that Separate Article on “independent personnel services” was available in OECD model convention which was deleted from 2000. The effect of deletion of Article 14 is that income derived from profession services or other activities of an independent character is now dealt with under Article 7 as Business Profits.

At present DTAA's entered with Bangladesh, Brazil, Greece, Indonesia, Libya, Mauritius, Nepal, Sri Lanka, Thailand, UAE etc. by India has no separate Article on Independent Personal Services and hence covered under Rule of Article 7 only in line with OECD model.

India's position on Article 7 of OCED and its commentary

Position on Para 3 of Article 7

Indian with other non-member countries like Armenia, Lithuania and Slovenia reserve the right to add to paragraph 3 a clarification that expenses to be allowed as deductions by a Contracting State shall include only expenses that are deductible under the domestic laws of that State [Para 7 to the Positions of Non-Member Country on Article 7 and its commentary of OECD Model Tax Convention (2008)].

India's position on Article 7 of OCED and its commentary

What if payments are deferred until after the PE has ceased to exist?

- ❑ **India with Chile as a Non-member country reserve** the right to amend Article 7 to provide that, in applying paragraphs 1 and 2 of the Article, any income or gain attributable to a permanent establishment during its existence may be taxable by the Contracting State in which the permanent establishment exists even if the payments are deferred until after the permanent establishment has ceased to exist. [Para 4.2 to the Positions of Non-Member Country on Article 7 and its commentary of OECD Model Tax Convention (2008)]
- ❑ Even, USA who is a member of OECD countries has same reservation. [Para 79]
- ❑ Consistent with view given in Van Oord Dredging - 106 TTJ 889 – ITAT (MUM)

Article 7 v. Article 9 – Profits allocation Rules

- ❑ Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both Enterprises are member of the same group of enterprises or are under the same effective control (Mainly Holding – Subsidiary Relation) are dealt with in Article-9 separately.
- ❑ Article 7 is concerned with transactions between parts of the same legal entity
- ❑ Article 9 is concerned with transactions between separate, but related entities
- ❑ However Both Article 7 & Article 9 is based on Arm's Length Principle

Attribution of Profits

What Act Says.....

Attribution of Profits

Instances of attribution of income – Clarification by CBDT

- ❑ No income will be deemed to accrue or arise in India if a Non-Resident sells goods to Indian customer (including Indian subsidiary) provided that:
 - The contracts to sell are made outside India
 - The sales are made on a principal-to-principal basis and at arm's length
 - The non-resident exercises no control over the business of the resident (the subsidiary does not act as an agent of the parent company)
- ❑ Non-resident's sales to Indian customers through an agent in India, income assessed restricted to profits attributable to the agent's services, provided:
 - The non-resident's principal business activities channeled through such agent
 - The contracts for sale made outside India
 - Sales made on a principal-to-principal basis

..... CBDT Circular No. 23 dt. July 27, 1969

Attribution of Profits

Instances of attribution of income – Clarification by CBDT

- ❑ If agent's commission fully represents value of profit attributable to his services – prima-facie extinguishments of assessment
- ❑ If there be a business connection in India, the whole of the profit accruing or arising from the business connection is not deemed to accrue or arise in India. It is only that portion of the profit which can reasonably be attributed to the operations of the business carried out in India, which is liable to income tax

..... CBDT Circular No. 23 dt. July 27, 1969

Attribution of Profits

Business Connection – No activities/operations in India

- ❑ Even if there is a business connection, no income is taxable in India if no business activities/operations were carried out in India
 - Carborendum Co. (108 ITR 335) (SC)
 - Toshoku Ltd. (125 ITR 525) (SC)
 - Fried Krupp Industries (128 ITR 27) (Mad)
 - CIT v. Dunlop Ltd. (201 ITR 534) (Cal)
 - Qantas Airways Ltd. (251 ITR 264)
 - Asia Satellite Telecommunication Co. Ltd. v. DCIT (85 ITD 478) (Del)
- ❑ Operations confined to the purchase of goods in India for the purpose of export not taxable

Mere Business Connection not sufficient for triggering taxation

Attribution of Profits

Business Connection – No activities/operations in India

- ☐ Export Commission – Not taxable in India
- ☐ As non-resident agent operates outside the country, no part of the income arises in India.
- ☐ Since the payment is usually remitted directly abroad it cannot be held to have been received by or on behalf of the agent in India

CBDT Circular Nos. 23 dated 23.7.1969 and 786 dated 7.2.2000

Attribution of Profits

Exclusions – No Trigger for taxation

- ❑ Mere purchase of goods from India
 - Existence of agent for purchases need not affect taxation if arms length payment is made to him
- ❑ Sale of goods outside India (including in CIF basis)
- ❑ Subsequent performance of guarantee in India
- ❑ Sale to Indian subsidiary on principal-principal basis
- ❑ Formation of contract in India
- ❑ Conclusion of loan agreement in India

Attribution of Profits

- ❑ Under Rule 10 when the Revenue authority is of the opinion that the actual amount of income accruing or arising to any non-resident person whether directly or indirectly, cannot be definitely ascertained, such income may be taken as:
 - Such percentage of the turnover so accruing or arising as the Revenue authority may consider to be reasonable;
 - An amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act) as the receipts so accruing or arising bear to the total receipts of the business; or
 - In such other manner as the Revenue authority may deem suitable

Attribution of Profits

Methods of Attribution

- ❑ Determination of actual profits if it can be ascertained
- ❑ Methods prescribed in rule 10 are not accurate methods (these involves estimation and subjectivity)
- ❑ Can be followed only when the AO is of the opinion that profits cannot be definitely ascertained

Rule 10 is the method of Last Resort

Attribution of Profits

Methods of Attribution...

☐ Presumptive Method [Rule 10(i)]

- Ad-hoc profits is estimated as attributable to the PE

☐ Proportionate Method [Rule 10(ii)]

- Proportionate profits based on world income is attributed to the PE
- Difficult method as World income of the enterprise is to be computed under the ITA before applying proportionate method
- In case of different businesses relevant business income be considered
- Iraqi Airways v. IAC, 23 ITD 115 (Del ITAT) [If world a/cs, Rule 10(ii) be applied]

Attribution of Profits

Methods of Attribution...

❑ Discretionary Method [Rule 10(iii)]

- Attribution – some other methods (may be combination of above 2 methods)
- Netherlands Steam Navigation Co. Ltd. v. CIT, 74 ITR 72 (SC)

Rule 10 involves estimation and subjectivity Litigious in nature

Judicial thinking on attribution of profits

Operations in India	Profits determined by tax authorities	Profits approved by the Courts
Execution of deals, procurements of orders, etc by agents in India	10%	10%
Use of word 'Intercontinental' in India	20%	5%
Conclusion of contract of purchasing agent in India	75%	10%
Conclusion of loan agreement in India	100%	0%
Procurement of raw materials from India	10%	10%
Performance of Guarantee in India after sale of goods outside India	20%	0%
Supervision of execution of purchase contracts from India	25%	25%
Canvassing orders and securing import / export license in India	7.5%	0%

Attribution of Profits

Methods of Computation of Business Income under Domestic tax law

❑ Computation Method

- Gross Profit v. Net Profit Method
- Business income is computed as per provisions of sections 28 to 44DA (Accounts to be maintained u/s. 594 of Cos. Act)
- Provisions of ITA applicable [Sections 40(a), 44AB, 40A(2)(b), 43B, 44D, 44DA, 32, etc.]
- MAT applicable to foreign companies
- Tax exemptions and deductions

❑ Presumptive Method

- Income is computed on presumptive basis
- Provisions of sections 28 to 44 not applicable
- Application in specific types businesses/assesses
- It is not in line with the principles laid down in Article 7(2)

Attribution of Profits

Computation of Income

- ☐ Computation or presumptive method can be followed to compute taxable income
- ☐ Under Computation Method only profits attributable to PE taxable in source country
- ☐ Books of account maintained by PE to be considered to work out actual income attributable to PE
- ☐ In the absence of books or rejection thereof Rule 10 can be applied (Results should be in line with Article 7)
- ☐ Tax rate applied as applicable to foreign companies

Attribution of Profits

Computation of Income

- ❑ Almost all expenses are deductible in accordance with and subject to domestic tax laws
 - In case of Branch, Head Office expenses are subject to section 44C
 - Payments to HO for various purposes are not deductible (Rent, fees, commission, royalties-Depending on treaty language)
 - Receipts from HO for similar purposes are ignored
 - Payments between bank branch and HO deductible
 - Reimbursement of actual expenses to HO is deductible

Attribution of Profits

Presumptive Methods under Domestic Tax Laws

Sections	Nature of Business	Extent of Taxable Income
44B	Shipping business	▪ 7.5% of gross revenue
44BB	Business of Exploration	▪ 10% of gross revenue
44BBA	Business of Aircraft	▪ 5% of gross revenue
44BBB	Turnkey Power Projects	▪ 10% of gross revenue

Head Office Expenses – Section 44C

- ❑ HO expenses include executive and general administrative expenses
- ❑ CBDT Circular dated July 5th, 1976 suggests that the section applies only to non-residents having a branch in India
 - Applicability in case of a PE other than a branch?
- ❑ Circular 643 requires that branch deduct TDS from payments to HO (ABN Amro Bank v. CIT (98 TTJ 295)(Cal-SB))
- ❑ The section presupposes carrying on of part of business outside India
 - Applicability in case of a PE other than a branch?
- ❑ Applicability in respect of expenses incurred by any other group offices other than head office outside India?
- ❑ There is no legal requirement to debit HO expenses to Indian books for deduction of the expenditure
- ❑ Whether Sec.44C applies in case Art 7(3) does not prescribe restriction as per domestic tax laws?

Taxation of Royalties / FTS in a PE situation

- ❑ If no PE in India-FTS Royalties taxable on gross basis u/s 115A / Tax Treaty
 - Agreement made on or before May 31, 1997 - @ 30%
 - Agreement made after May 31, 1997 - @ 20%
 - Agreement made on or after June 1 2005 - @ 10%
- ❑ If PE exists in India – FTS / Royalties taxable on net basis u/s 44DA
- ❑ Salient features of Sec. 44DA
 - Royalty / FTS received from Govt. or Indian concern
 - Section 44DA applies to any non-resident and not only to foreign companies
 - Agreement is made after 31-03-2003
 - Business is carried out in India through a PE or professional services are provided from the fixed place of profession
 - Right, property or contract for which Royalty / FTS arises is effectively connected with the PE or fixed place of profession
 - Deduction under section 44C would continue to be available
 - Non-resident claiming benefit of S 44DA are required to maintain and get their accounts audited.

Force of Attraction Principle

Force of Attraction

1. What it means ?
2. When an enterprise has a PE in the source country it expenses itself to the entire gamut of income from same or similar activity.
3. Principle of neutrality in taxation
4. Protection against Tax Avoidance

Force of Attraction

Article 7 (1) – OECD Model

“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 that permanent establishment.”

“OECD Model Does not support the FOA Rule”

Force of Attraction

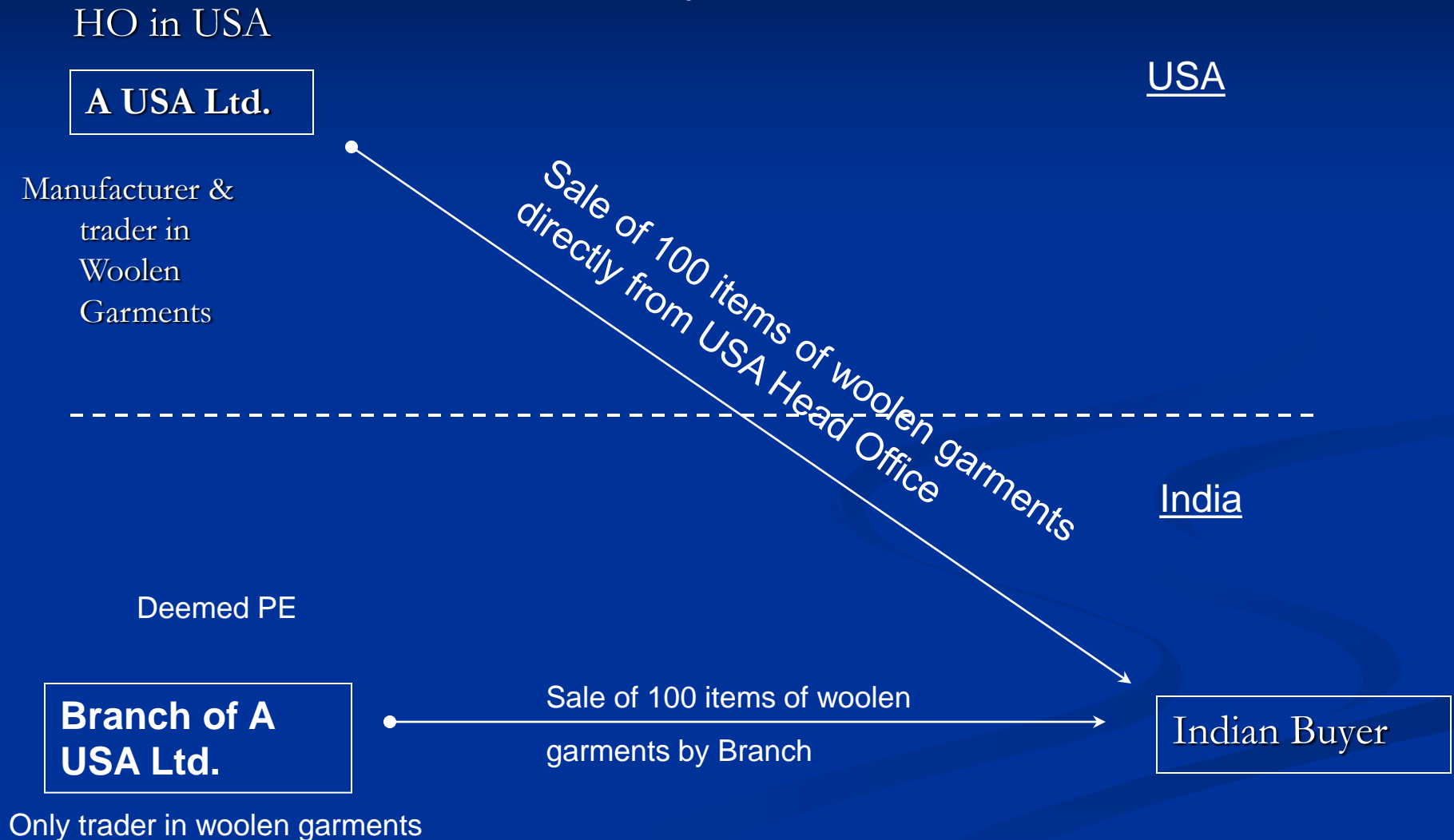
Article 7 (1) – UN Model

“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 effected through 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”

Force of Attraction

Example



Example

- ❑ A USA Ltd. is a manufacturer & Trader of woolen garment in USA.
- ❑ Having a Branch in India for trading purpose only.
- ❑ A USA Ltd. might simply pass the business of Branch India to HO in USA. By doing it the profits of Branch in Country India may be reduced.
- ❑ Now, as FOA clause presents in India-USA DTAA.
 - A Ltd is a USA resident & having a PE through Branch in India
 - Sale of goods by Branch/PE of A in India
 - Sale of similar goods by HO from USA directly in India.
- ❑ Therefore, FOA rule seeks to tax the profit in India derived by A USA Ltd. by supply the woolen garments directly from USA to the Indian buyer.

Force of Attraction

- ❑ Scope of Article 7 of UN model is wider.
- ❑ If DTAA provisions are on the basis of OECD Model, FOA rule cannot be invoked
 - Hyundai Heavy Industries Co. Ltd. – 291 ITR 482
- ❑ The FOA Rule assumes that the PE has played some role & accordingly given the taxing right to source country.
 - Para 1 & 7 of Article 7 of Indo-USA is worth noting.

Force of Attraction

□ Recognition of Principle of FOA by OECD

➤ Para 10 of Commentary has discussed:

“..... The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention.....”

Force of Attraction

Reservations by Mexico (OECD member country) in favor of FOA Rule

*“**Mexico** reserves the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise carried out directly by its home office situated in the other Contracting State, provided that those goods and merchandise are of the same or similar kind as the ones sold through that permanent establishment. The Government of Mexico will apply this rule only as a safeguard against abuse and not as a general “force of attraction” principle; thus, the rule will not apply when the enterprise proves that the sales have been carried out for reasons other than obtaining a benefit under the Convention.” [Para 83]*

Force of Attraction

Non-Member Country observation in OECD commentary (Argentina, Morocco, Thailand)

“Argentina, Morocco and Thailand reserve the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise which are the same as or of a similar kind to the ones sold through a permanent establishment situated in that State or from other business activities carried on in that State of the same or similar kind as those effected through that permanent establishment. They will apply this rule only as a safeguard against abuse and not as a general “force of attraction principle”. Thus, the rule will not apply when the enterprise proves that the sales or activities have been carried out for reasons other than obtaining a benefit under the Convention.” [Para 3] - Right to Proved Otherwise)

Force of Attraction

Position of India on OECD Commentary of Article 7 related to FOA rule

- ❑ **India** does not agree with the interpretation given in paragraph 25 which support the No FOA rule.

Paragraph 25 of Commentary on Article 7 of OECD Model Tax Convention (2008) says that:

“where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.”

Force of Attraction

❑ India's DTAA's having FOA Rule

Following are the DTAA's which follow the UN model and do contain FOA rules (Means FOA can be invoked in these DTAA's):

DTAA with Australia, Belgium, Canada, Cyprus, Denmark, Finland, Italy, Kenya, Romania, Spain, Thailand, USA etc.

❑ India's DTAA's having no FOA

Following are the DTAA's which are based on the OECD model and do not contain FOA rules (Means FOA can not be invoked in these DTAA's):

DTAA with Armenia, Austria, Bangladesh, Botswana, Brazil, Bulgaria, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Japan, Jordan, Korea, Malaysia, Mauritius, Nepal, Netherlands, Russia, Singapore, South Africa, Sweden, Swiss Confederation, Syria, UAE, UK etc..

Force of Attraction

- ❑ India's DTAA's having no FOA Rule due to scope clarification.

Following are the DTAA's which are based on the OECD model and do not contain FOA rules *as scope has been clarified.....*

DTAA with China, Malta, Morocco, Oman, Ukraine, Vietnam etc.

Force of Attraction

Article 7(1) of the DTAA with China

“The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries 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 Contracting State but only so much of them as is directly or indirectly attributable to that permanent establishment.

The provisions of this paragraph shall, however, not apply if the enterprise proves that the above activities could not have been undertaken by the permanent establishment or have no relation with the permanent establishment. “

Force of Attraction

Article 7(1) of the DTAA with Oman

*“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 Contracting State but only so much of them as is attributable **directly or indirectly** to that permanent establishment.*

*The words “**directly or indirectly**” mean, for the purposes of this Article, that where a permanent establishment takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then notwithstanding that other parts of the enterprise have also participated in those transactions, there shall be attributed to the permanent establishment that proportion of profits of the enterprise arising out of those contracts as the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole.”*

Force of Attraction

Exemption from 'FOA Rule' – If proved otherwise

- ❑ Certain DTAA's (Sri Lanka, Cyprus and Zambia) which are based on UN model provide that if it can be proved that the Permanent Establishment has not played any role in the direct business of the HO then the FOA rule need not be applied.

***Article 7(1) of the DTAA with Cyprus** specifically provides that “the FOA does not apply if the enterprises prove that such sale or activity [as mentioned in 7(1)(b) & 7(1)(c)] could not have been reasonably undertaken by the permanent establishment”. The same benefit is also appearing in the **DTAA with Sri Lanka**.*

Force of Attraction

- Similarly Article 7(2) of the DTAA with Zambia provides that

“If an enterprise of a Contracting State, which has a permanent establishment in the other Contracting State, sells goods or merchandise of the same or similar kind as those sold by the permanent establishment or renders services of the same or similar kind as those rendered by the permanent establishment, the profits of such activities may be attributed to the permanent establishment unless the enterprise proves that such sales or services are not attributable to the activity of the permanent establishment”.

Force of Attraction

No FOA “for other activity”

□ DTAA with Indonesia & New Zealand

Article 7(1) of the DTAA with Indonesia & New Zealand does not contain a clause dealing with ‘other activities’ i.e. Article 7(1)(c) as appearing in UN model is missing in these DTAAs Accordingly, if the enterprises earns income from certain activities (other than sale of goods or merchandise) carried on without involving the Permanent establishment in the other Country then such income would not be considered as attributed to the Permanent Establishment even if the Permanent Establishment is engaged in the same activities.

Force of Attraction

Article 7(1) of the DTAA with Indonesia

“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.”

Article 7(1) of the DTAA with New Zealand

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

Force of Attraction

Some Indian Courts Decisions

ROXON Ltd. - 291 ITR 275 (ITAT – Mum)

Article 7(1) of Indo-Finland 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 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”

Force of Attraction

ROXON Ltd. - 291 ITR 275 (ITAT – Mum)

Facts of the case :

- a) As a member of consortium given the job of design, manufacture, deliver erect, test & commission bulk handling facility at Nava Sheva park (NSPT)
- b) Supplied equipments to be used at NSPT, India
- c) Had a PE in India due to installation/ construction assignment with NSPT

Findings :

- a) PE comes into existence after the supply was made.
- b) Nothing to show that supply was not at arm's length.
- c) Not same or similar in nature.

Force of Attraction

HYUNDAI HEAVY INDUSTRIES CO. LTD. - 291 ITR 482 - SC

Facts of the case :

- ❑ The Assessee “Hyundai Heavy Industries Co. Ltd.” was a non-resident foreign company incorporated in South Korea.
- ❑ DTAA referred was Indo-Korea DTAA. DTAA contained Article 7(1) on the liens of OECD Model.
- ❑ Korean Company had entered into agreement with ONGC for designing, fabrication, hook-up & Commissioning of South Bassein Field Central Complex Facilities in Bombay High in two parts:
 - Fabrication of the platforms in Korea
 - Installation & Commission of the same in India.

Force of Attraction

HYUNDAI HEAVY INDUSTRIES CO. LTD. - 291 ITR 482 - SC

Article 7(1) of Indo-Finland 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 that permanent establishment.”

Force of Attraction

HYUNDAI HEAVY INDUSTRIES CO. LTD. - 291 ITR 482 - SC

Findings :

The profit earned on supplies of fabricated platforms could not be attributed to the P.E. in India as the installation P.E. emerged only after the contract concluded.

Sale of equipment is finalized before the installation stage.

The setting-up of the permanent establishment, in such a case, is a stage subsequent to the conclusion of the contract. It is as a result of the sale of equipment that the installation permanent establishment comes into existence.

Nothing to show that supply was not at arm's length.

The above judgment also support the view expressed by the Mumbai Tribunal in case of Roxon OY, as discussed in last slide.

Force of Attraction

Some Indian Courts Decisions

SUMITOMO CORPN.

114 ITD 61

Protocol existed providing for the role played by the PE and taxation
to the extent
effectively connected to the PE

No FOA – in Article 12 (5) of Indo-Japan DTAA.

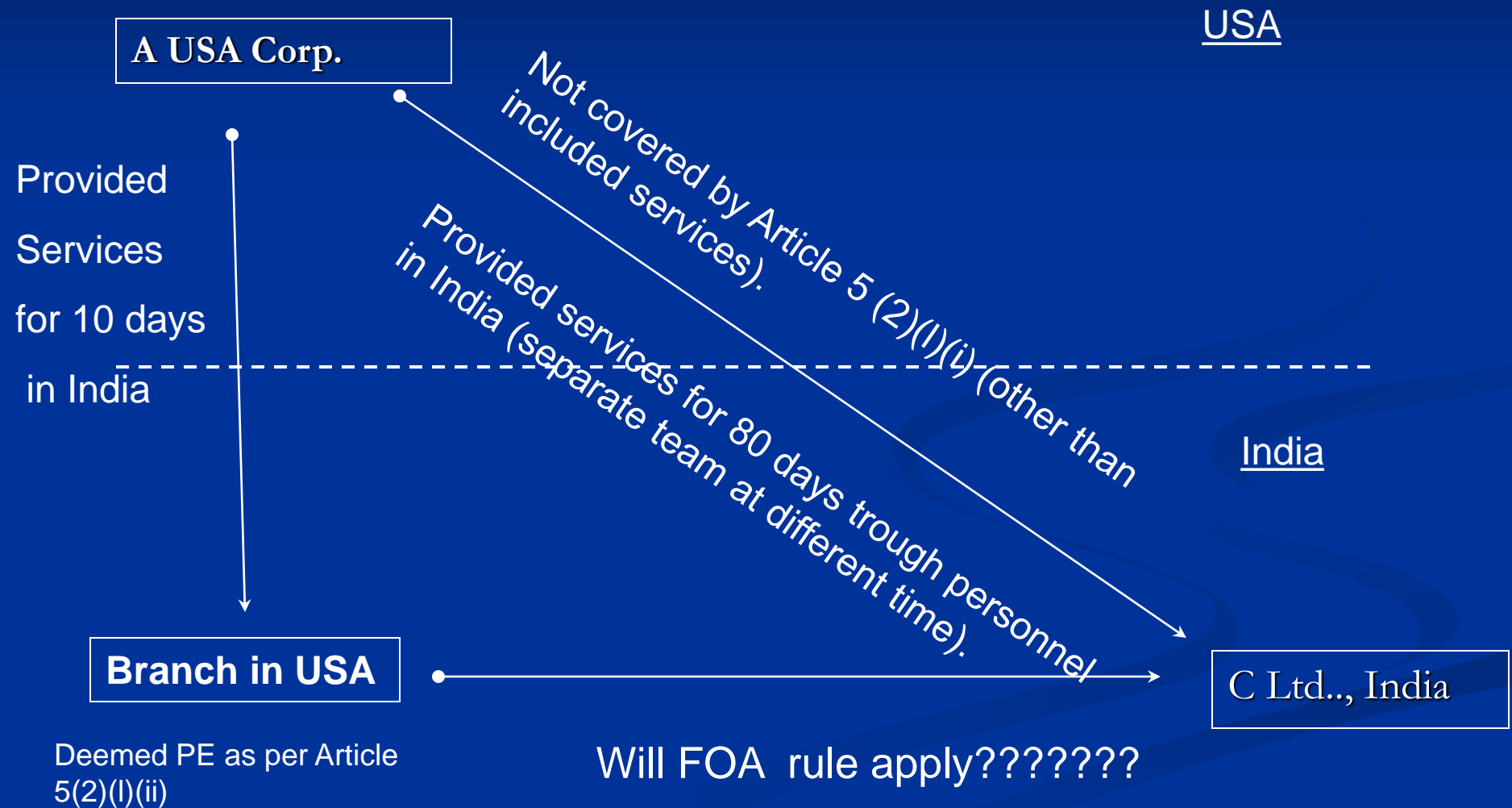
SNC LAVALIN/ACRES INC.

110 TTJ 13

FOA gets attracted.

Force of Attraction

QUESTION ???????????



Article 5 & 7

Some Judicial Precedence:

❑ Business Connection vs. PE

- CIT v. R.D. Aggarwal and Co. [56 ITR 20]
- Motorola Inc. and Others v. DCIT [96 TTJ 1]
- CIT v. Hindustan Shipyard Ltd. [109 ITR 158]

❑ Liaison office vs. PE

- UAE Exchange Centre LLC [AAR] [268 ITR 9]

❑ Branch not separate from Parent Company

- CIT v. Stewart & Lyods of India Ltd. [165 ITR 416]

❑ Dependent Agent vs. Independent Agent

- Al Nisr Publishing In re [AAR] 239 ITR 879]
- Sutron Corporation, In re [AAR] [268 ITR 156]
- Dun & Bradstreet, In re [AAR] [272 ITR 99]

❑ Subsidiary Company vs. PE

- CIT v. United Breweries [89 ITR 17]

Article 5 & 7

Some Judicial Precedence:

- ❑ Motorola (95 ITD 269)
- ❑ Galileo International Inc. [19 SOT 257(Del)]
- ❑ SET Satellite (106 ITD 175/ITAT/Mumbai)
- ❑ Clifford Chance (82 ITD 106/Mumbai)
- ❑ Rolls Royce Plc. (113 TTJ 446/ITAT/Delhi)
- ❑ Ishikawajima [288 ITR 408(SC)]
- ❑ Anglo French [25 ITR 27(SC)]

Article 5 & 7

Some Judicial Precedence:

- ❑ UAE Exchange Centre – 2009-TIOI-84-HC-DEL-IT
- ❑ Western Union Financial Services – 2006-TIOL-58-ITAT-DEL
- ❑ Epcos AG – 28 SOT 412
- ❑ Nike Inc. – 2008-TIOL-255-ITAT-BANG
- ❑ Knowerox Education (India) Private Limited – 301 ITR 207
- ❑ Fugro Engineers BV – 26 SOT 78
- ❑ Cholamandalam MS General Insurance Co. Ltd. – 309 ITR 356
- ❑ Worley Parsons Services Pty. Ltd. – 2009-TIOL – 11- ARA – IT
- ❑ Ansaldo Energia SPA – 2009-TIOL-62-HC-MAD-IT

THANK YOU