

Article 7 of the OECD Model Convention Part II

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Article 7 – Brief Overview

Distributive Principle - Article 7 (1)

Attribution – Article 7(2)

Deductions – Article 7(3)

Customary Method – Article 7 (4)

Exclusion – Article 7(5)

Consistency – Article 7(6)

Exceptions – Article 7(7)

Article 7(2)

- 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)

- Central directive for attribution of profits to a permanent establishment
- As if PE had dealt with an entirely separate enterprise
 - Arm's length principle
- To be applied in each Contracting State
 - Unique double taxation relief
 - Variations in domestic tax laws of each state
 - Absent in DTAA with Belgium, UK and Finland
 - Impact?

Article 7(2) – Break up

- 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.

Profits of a PE

- Starting point
 - Trading accounts
 - No construction of hypothetical profit figures in vacuum
 - Agreements between head office and PE
 - Accounting records and contemporaneous documentation
 - Start with real facts and make adjustments

Distinct and separate

- For determining adjustments
 - Necessary to determine profits that PE would have made as a distinct and separate enterprise
- 2 step approach
 - First step
 - Identification of activities carried on through the PE
 - Functional and factual analysis
 - Second step
 - Remuneration for such activities by applying arm's length principles
 - By reference to the functions performed, assets used and risk assumed

Same or similar

- Same or similar activities
 - Provision of supplies and services
 - To independent customers or to other branches of the same enterprise
 - Activities actually exercised
- Same or similar conditions
 - Compared only with those of an unrelated enterprise
 - Services provided to another branch of the enterprise which benefits the whole enterprise
 - Not comparable with unrelated enterprises
 - Attribution of profits may fail

Wholly independent

- Dealing wholly independently
 - Absolute hypothetical independence
 - Should in no way differ from a legal independent subsidiary
 - Contractual agreements as if they were between completely unrelated enterprises
 - Remuneration in respect of services agreed between PE and its head office taxable
 - Restricted independence
 - PE was no more than a part of the enterprise
 - Actually could not transact business with each other
 - Notional contracts could not be assumed
 - Mid way

Art 7(2) r.w. Art 7(1)

- Profits actually realised only taxable?
 - Second sentence of Art 7(1)
 - If the enterprise carries on business in the other contracting state through a PE situated therein, the profits of the enterprise may be taxed in the state of the PE
 - Profits attributable to the PE must at the same time be profits made by the enterprise
 - Profits from intra-enterprise sales should not be attributable to a PE unless such sales also generate a benefit for the enterprise as a whole
 - No element of profit attribution before it has been realised by the enterprise as a whole
 - Attribution under ALP only with the fact that the enterprise is one single legal and economic entity

Art 7(2) – Indian DTAAAs

- Profits attributable should be those which the PE earns dealing independently with the enterprise of which it is a PE
 - Also provide for transactions with ‘other enterprises with which it deals’ - Australia, Bangladesh
 - Also provides for transactions with ‘other enterprises controlling or controlled by or subject to the same common control as the enterprise’ – USA
- Use of ‘reasonable method’ allowed
 - Relaxation of separate entity approach
 - Art 7(4) – ‘customary method’ omitted in certain DTAAAs

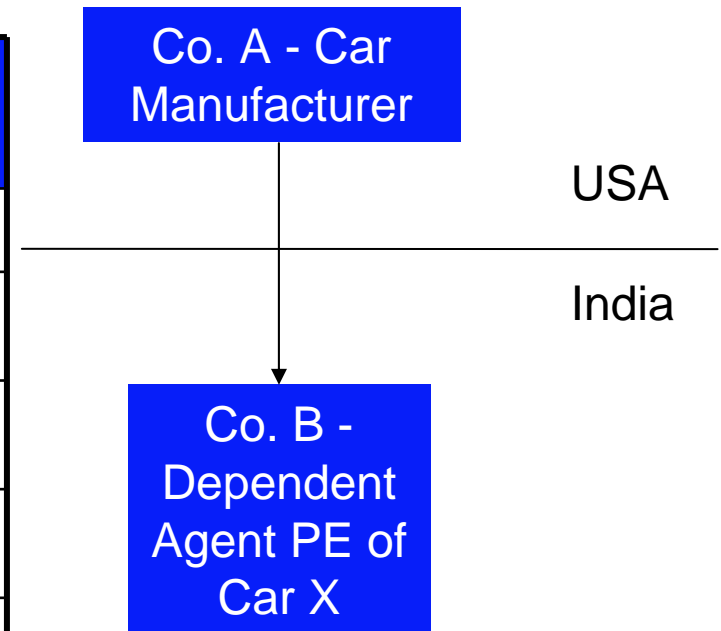
Attribution to specific PEs

- Construction PE
 - Goods supplied by other parts of the same enterprise not taxable
 - Services performed outside the country where PE is situated not taxable
- Dependent Agent PE
 - 2 separate potential tax payers
 - Agent for his own activities on a principal to principal basis
 - Dependent Agent PE for activities of the enterprise conducted through the agent

Dependent Agent PE

Case Study

Particulars	A	B
Sales	600	0
Costs	-400	0
Commission	-60	60
Agency expenses	0	50
Profit	140	10



Payment to B is at arm's length

Issue: What is the profit attributable to tax in India as per DTA?

Dependent Agent PE

- Profits attributable beyond Arms length payment to Dependent agent?
 - Once a transfer pricing analysis is made, no further attribution to PE
 - DIT v. Morgan Stanley and Co Inc (2007) 292 ITR 416 (SC)
 - CBDT Circular no 23 dated 23rd July 1969
 - CBDT Circular no 5 dated 28th September 2004
 - Galileo International Inc v. DCIT?
 - There could be profits attributable even after a deduction of an arm's length reward for the agent
 - Authorised OECD approach, OECD Commentary July 2008 - Para 26
 - DDIT v. SET Satellite (Singapore) Pte Ltd (2007) 106 ITD 175 (Mum.)
 - Rolls Royce Plc v. DDIT – India UK DTA
 - Bikaner Textile Merchant Syndicate Ltd. - Domestic law

Article 7(3)

- 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)

- Article 7(3) and 7(2) – “Subject to the provisions of paragraph (3)”
 - Clarifies the general directive laid down in Article 7(2); or
 - Modifies the arm’s length principle?
 - Reconciliation can create difficulties
 - No difference of principle:
 - Article 7(3) – rule for determining profits
 - Article 7(2) – profits so determined should correspond to profits of a separate and independent enterprise
 - Phrase not present in certain DTAAAs
 - UK, Syria, and United Arab Republic
- Allowance is to be made for expenses wherever incurred, that were incurred for the purposes of the PE
 - Article 7(3) deals with which expenses should be attributed
 - Does not deal with deductibility – domestic law

Article 7(3) – UN Model

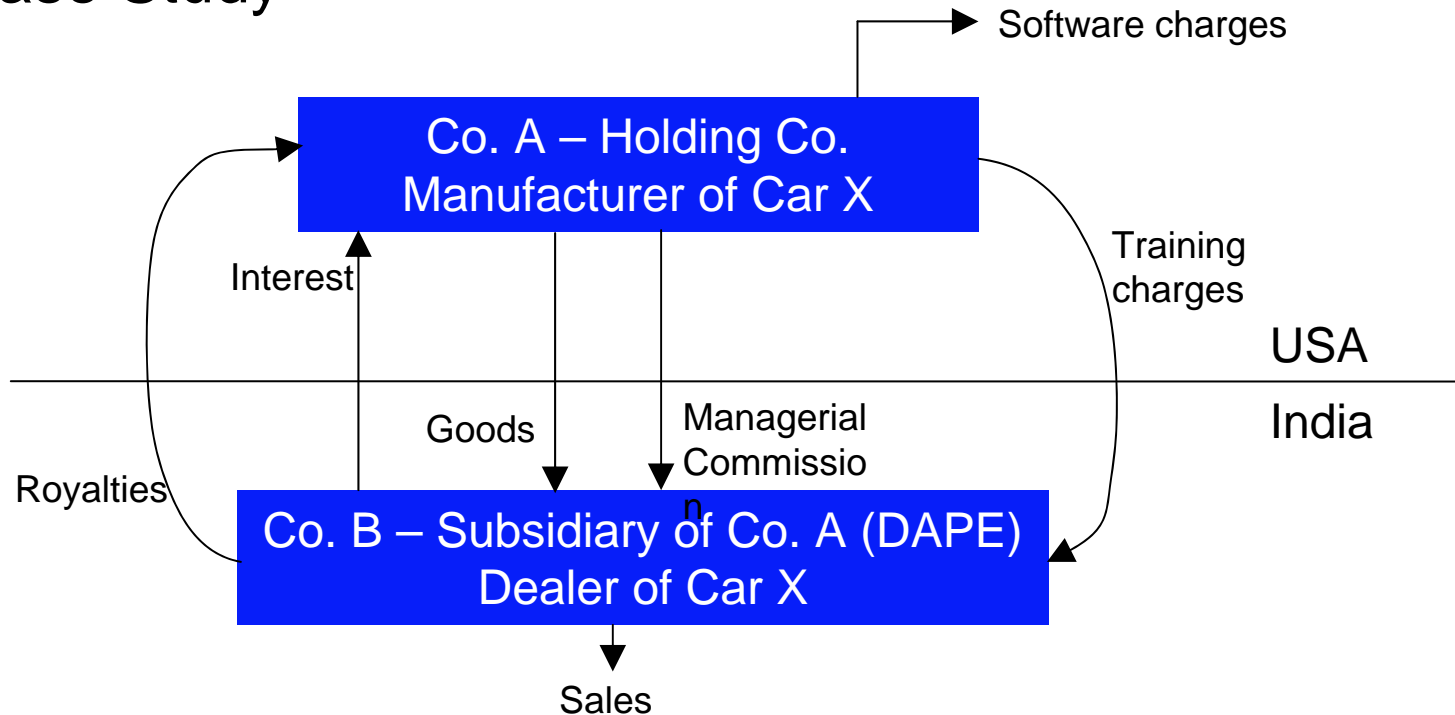
- In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
- However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

Article 7(3) – UN Model - Principle

- Payments by a PE to its HO or receipts from HO are mutual adjustments of the same person
- PE can deduct expenses incurred by HO specifically on behalf of PE
 - Includes reimbursements of actual expenses
- General activities where PE is not concerned
 - Not deductible

Expenses and costs

- Case Study



1. Profits are marked up on transfer of goods and services from HO to PE
2. Software charges are paid for common use of the enterprise and PE
3. Managerial commission is based on profits of subsidiary
4. Interest paid is for internal loans given to Subsidiary

Issue: What are the profits and expenses attributable to PE in India as per DTA?

Expenses and costs

- Costs
 - Incurred for mutual benefit
 - Directly incurred to realise profit
 - Incurred to rationalise costs
- Goods
 - Allocation of profit
 - Exceptions – for temporary use
- Intangible rights
 - Extremely difficult to allocate ownership
 - Costs of creation or acquisition to be attributable to all parts which use them without mark up
- Services
 - Specific services providing real advantage – with mark up
 - General management expenses – without mark up

Expenses and costs

- Good management
 - Theoretically – part of profits to be attributed
 - Practically – as a whole - No account should be taken
- Interest
 - Internal interest not to be recognised
 - Except for banks
 - Interest on debts actually incurred
 - Attribution of “free” capital and interest bearing debt
- Confusion?
 - ABN Amro Bank – Payment of interest by PE to HO not an allowable expenditure
 - Dresdner Bank – Interest earned by PE from HO taxable in India

Expenses - deductibility

- As per domestic tax law
 - OECD Commentary
 - Technical explanation to Indo-US treaty – S. 44C
 - CBDT circular no 5 dated 28th September 2004
 - CBDT circular no 649 dated 31st March 1993 – FTS
 - CBDT circular no 740 dated 17th April 1996 - Interest
- Judicial precedence
 - Would not apply in absence of phrase- “in accordance with the provisions of and subject to limitations of the taxation laws of the contracting state”
 - ABN Amro Bank NV, Degremont International
 - Applied only to certain expenses
 - Mitsubishi Heavy Industries Ltd., Banque National De Paris
 - Taxable income to be determined as per provisions of ITA
 - Morgan Stanley and Co Inc

Expenses - deductibility

- Judicial precedence
 - Section 44BB for oil exploration, etc. not applicable
 - Able to substantiate expenses – Micoperi SpA (82 ITD 369)
 - Foramer S A (52 ITD 115)
 - Section 44D prohibiting deduction of any expenditure on royalties or fees for technical services connected to PE
 - Applied in
 - AAR in Ericsson Telephone Corporation India AB (224 ITR 203)
 - AAR in ABC (P No. 13 of 1995) (228 ITR 487)
 - Not applied in
 - Boston Consulting Group 93 TTJ 293
 - Essar Oil Ltd. (7 SOT 216)
 - Cray Research India Ltd.
 - Rolls Royce Industrial Power Ltd.

Article 7(4)

- Insofar 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 of total profits
 - Various formulae
 - In accordance with Article 7
 - Not appropriate method
 - Where customary
- Customary methods
 - Computation
 - Presumptive
 - Proportionate
 - Rule 10

Article 7(5)

- 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.

Article 7(5)

- Mere Purchases
 - Sole purchase activity not a PE
 - Paradox?
- PE which has purchases for enterprise as one of its activities
 - Purchases for onward selling and for third parties not covered
- Goods or merchandise
 - Capital goods?
 - Services?
 - Money
- Purchases from COS or other countries?
 - Explanation (b) to Section 9(1)(1)
 - Aramco Overseas Company Bv (2010-TIOL-14-ARA-IT)
 - Ikea Trading (Hong Kong) Ltd (2008-TIOL-23-ARA-IT)
- Not in line with ALP
 - Absent in UN Model

Article 7(6)

- 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.

Article 7(6)

- Merely clarificatory
- Applies only to profit attribution method
 - Not to treatment within the method
- Change allowed if good and sufficient reason
 - Essentially prohibits changes every year

Article 7(7)

- 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.

Article 7(7)

- ‘Profits’ include all types of incomes
- Gives priority to special distributive rules
 - To the extent that such income accrues ‘outside a PE’
- Characterisation of incomes under ITA not changed
- Article 6 vs. Article 7(7)
 - Income from natural resources

Thank You

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