

Article 7 of the OECD Model Convention Part I

Presented at the BCAS ITF II Study Group
on 9th September 2010

Contents

- Article 7 – Brief Overview
- Article 7(1)
- Article 7(1) – First Sentence
- Profits of an Enterprise
- Article 7(1) – Second Sentence
- Enterprise vs. Enterprise of a Contracting State
- Force of Attraction
- Domestic Attribution Principle
- Other provisions

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(1)

- 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.

Article 7(1) – First sentence

- The first sentence:
 - 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.
- Complete Distributive Rule
 - Right to tax profits of an enterprise lie clearly with the COR
 - Unless enterprise carries on business through a PE
 - Participating in Economic life of the other state to such an extent that it comes within the jurisdiction of that other state's taxing rights

Article 7(1) – First sentence

- What are the ‘profits of an enterprise’ for the purposes of Article 7(1)?
 - Before going to attribution
 - Model Commentary:

Confirms that the right to tax does not extend to profits that the enterprise may derive from that State otherwise through the PE

 - No force of attraction
 - Business Profits only?

Profits of an Enterprise

- 2 broad interpretations:
- Relevant business activity
 - Referring only to the profits of the ‘business activity’ in which the PE has some participation
 - Attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity

Profits of an Enterprise

- Relevant Business Activity Approach:
 - Different views
 - Broad or narrow
 - Product line vs. function
 - Exclusivity of function
 - Period variations

Profits of an Enterprise

- Functionally separate entity approach
 - The profits to be attributed to the PE are the profits that the PE would have earned at arm's length as if it were a 'distinct and separate' enterprise
 - Permits profits to be attributed to the PE, even though no profit has yet been realised by the enterprise as a whole

Profits of an Enterprise

- Functionally separate entity approach
 - Does not impose any profit limitation
 - Not required to determine enterprise's world-wide profits
 - Does not depend on performance of activity
 - Mirrors analysis under Article 7(2)
 - Neutral as to whether the activity is carried on by a resident or a non-resident enterprise

Profits of an Enterprise

Case Study on Relevant Business Activity Approach to determine profits

Co. X a car manufacturer, has 2 types of cars it sells – Car A and Car B. It has a PE in India because of its dependent selling agent for Car A.

What should be the profits for purposes of Article 7(1)?

Functions	Car A	Car B
Design	-20	-10
Purchase	-30	-20
Manufacturing	-40	-30
Marketing	-50	-10
Distribution & Sale	100	120
Profit	-40	50

1. Distribution Activity of Car A?
2. Distribution Activity of Co. X?
3. All activities for Car A?
4. All activities of Co. X?

Article 7(1) – Second sentence

- The second sentence:
 - 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.
- Right to tax in State of PE
 - Does not extend to profits of enterprise that are not attributable to the PE
 - Rejects ‘Force of Attraction’ rule

Article 7(1) – Second sentence

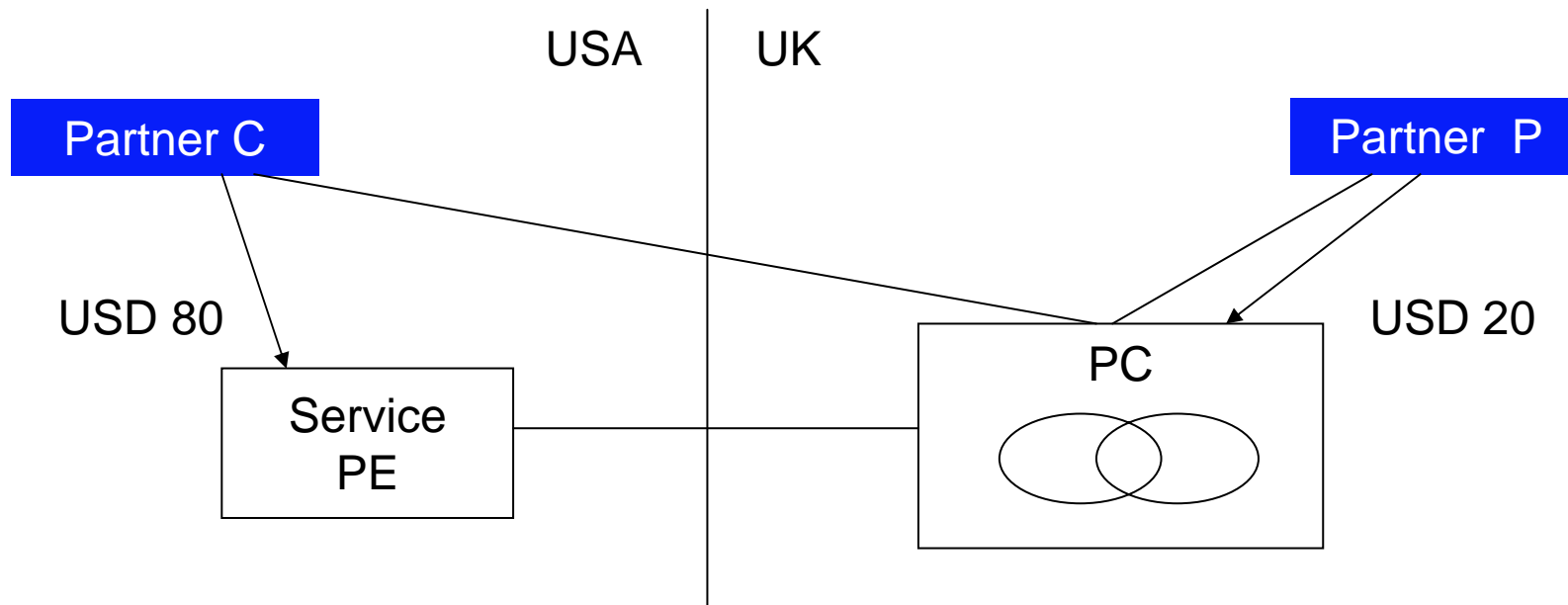
- ‘Enterprise’ v. ‘Enterprise of a Contracting State’
 - What is to be taxed under Article 7?
 - An entity or an activity?
 - the term “enterprise” applies to the carrying on of any business - Article 3(1)(c)
 - the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State - Article 3(1)(d)

‘Enterprise’ v. ‘Enterprise of a Contracting State’

- Case Study – Taxability of Transparent Partnership
 - UK partnership firm Pilfered Chance (PC) has 2 Partners, P and C, sharing equally. P is resident of UK, while C is a resident of US.
 - While conducting PC’s business, C has constituted a Service PE in US because of his presence exceeding the threshold limit as per US-UK DTAA.
 - PC has made profits of USD 100, USD 20 due to activities of P in UK and USD 80 due to activities of C in US.
 - Both US and UK treat Partnerships as transparent entities.

'Enterprise' v. 'Enterprise of a Contracting State'

- Case Study – Taxability of Transparent Partnership



Issues:

1. Would USA give treaty benefit to PC's PE in USA?
2. What would be the amount of profits taxable in USA and UK?

‘Enterprise’ v. ‘Enterprise of a Contracting State’

Issue 1:

- A partner’s share in the partnership’s enterprise can be deemed to be an ‘enterprise’ under Article 7
- A partner’s share in the profits of a partnership’s PE can constitute a PE of the partner himself
 - Klaus Vogel on Double Taxation Conventions (Article 7, B.II.2 (f), Pgs. 407-409)

Issue 2:

- Profits of a transparent partnership’s PE can be attributed to both partners
 - The Application of the OECD Model Tax Convention to Partnerships (Example 12)

‘Enterprise’ v. ‘Enterprise of a Contracting State’

- Issue 2:

Attribution of profits of PC

Share	Taxable in USA	Taxable in UK
C's share in US profits	40	0
P's share in US profits	40	40
C's share in UK profits	10	10
P's share in UK profits	0	10

ITF-II Group Discussion

Force of Attraction

- Anti tax-avoidance rule
- OECD Model – Rejects FOA
 - Separate PEs for each source of profit
- UN Model supports limited FOA
- US Model – had General FOA rule. Revised model rejects FOA

Force of Attraction

- Clauses used for applying FOA
 - sales within that other Contracting State of goods or merchandise of the same or a similar kind as those sold, or other business activities of the same or a similar kind as those carried on, through that permanent establishment.
 - Directly or indirectly attributable to the PE.

Force of Attraction – Indian view

- FOA present in many Indian treaties
- Indian Judicial Precedents
 - Roxon OY (103 TTJ 891 [2006])
 - SNC Lavalin/Acres Inc. (15 SOT 1 [2007])
 - Sumitomo Corpn. (110 TTJ 302 [2007])
 - Linklaters LLP
(ITA No 4896/Mum/03 Date 16/07/2010)
 - SET Satellite (Singapore) Pte Ltd. (108 TTJ 445 [2007])

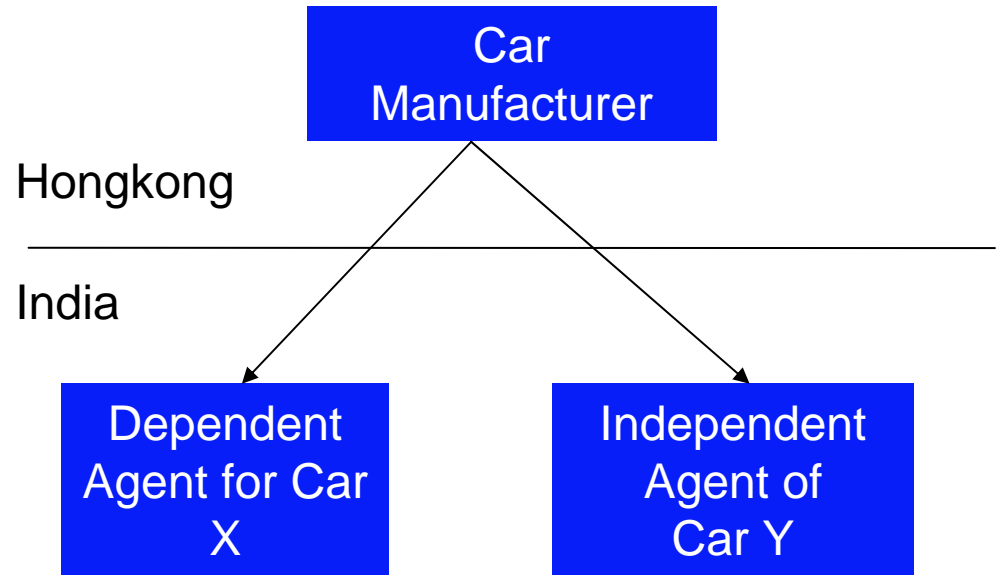
Domestic Attribution Principle

- Section 9 – Incomes deemed to accrue or arise in India
- Section 9(1)(i)
 - all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India
- Explanation 1 to Section 9(1)(i)
 - 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

Attribution u/s. 9(1)

Case Study

- Co. A is a car manufacturer in Hongkong
- It does business of selling Car X through its Dependent Agent in India
- It also does business of selling Car Y through an Independent Agent in India.

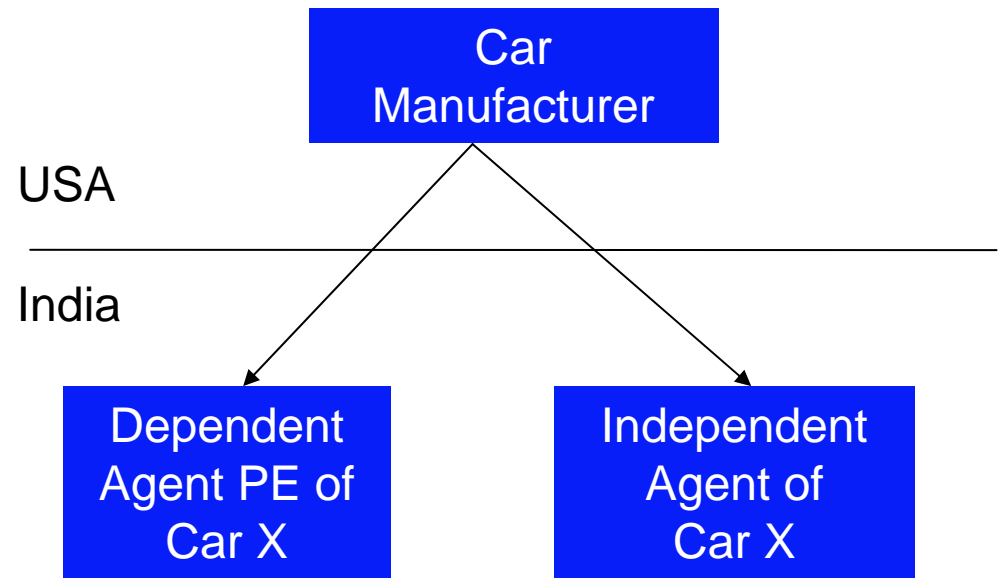


Issue:

What is the profit attributable to tax as per Section 9 in India?

Section 9 v. FOA

- Does Section 9 restrict applicability of FOA?
- Co. A is a car manufacturer in USA
- It does business of selling Car X through its Dependent Agent PE in India
- It also does business of selling Car X through an Independent Agent in India.



Issue:

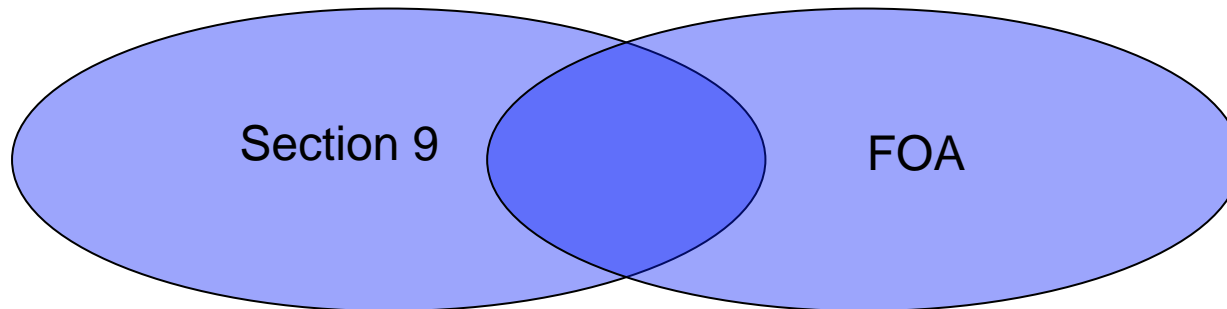
What is the profit attributable to tax in India?

Section 9 v. FOA

- Article 7(1) of India-US DTAA
 - The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.
 - If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to
 - (a) that permanent establishment;
 - (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or
 - c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

Section 9 v. FOA

- FOA – expands scope of attribution under DTAA for a PE
- Limited by scope of taxable income under Section 5 r.w. Section 9



Other provisions

- Second Sentence of Article 7(1) should not be read in a way to contradict Article 7 (2)
- Article 7(1) does not limit the right of a Contracting State to tax its own residents under CFC rules
- Domestic Tax Law – MAT, Presumptive tax

Thank You

Arvind M Darji | Rutvik R Sanghvi