Article 7: Business Profits

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1. *An overview:*

Article 7 aims at allocating the taxing rights with respect to the 'business profits' of an enterprise of a Contracting State to the extent these profits are not subject to different rules under other Articles of the Convention. It incorporates the basic principle that unless an enterprise of a Contracting State ("State R") has a permanent establishment ("PE") situated in the other State ("State S"), business profits of that enterprise may not be taxed in State S.

This Article connects the identification of a PE to substantive legal consequences (i.e. the qualitative decision on the assignment of taxing rights to source State as well as quantification of income). Pre-2010 OECD Model Convention ("OECD MC") Commentary on Article 7 correctly equates Article 7 as a continuation of, or a corollary to, Article 5 which deals with the concept of PE.

2. *Evolution of Article 7:*

The text of Article 7 of OECD MC remained almost unchanged between 1963 to 2010. In contrast to the long standing stability of the Article itself, the OECD MC Commentary has been amended and enriched several times, with its length more than doubled since 1963.

Despite of the considerable time and efforts spent by OECD Committee[1] trying to ensure a more consistent interpretation and application of the rules of the Article, OECD and non-OECD countries' interpretation of Article 7 continued to vary considerably. As a result, in 2008, the OECD issued a detailed report titled 'Attribution of Profits to Permanent Establishment' ("2008 OECD Report"). The report focused on formulating the most preferable approach for attributing profits to the PE under Article 7, given the modern-day multinational operations and trade.

The conclusion in 2008 OECD Report, were, in some areas, different from the historical interpretation of Article 7. In order to provide maximum certainty on how profits should be attributed to the PE, the Committee therefore decided that the 2008 Report's full conclusion should be reflected in a new version of Article 7, together with accompanying Commentary. The new version of the Article 7, which now appears in the OECD MC and the accompanying commentary was adopted in 2010 (precisely on July 22, 2010).

Interestingly, India has not adopted the new version of Article 7 and its position on the Article read as "*India reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update, subject to its positions on that previous version (see annex below). It does not agree with the approach to the attribution of profits to permanent establishments in general that is reflected in the revised Article, in its Commentary and in the consequential changes to the Commentary on other Articles*"

The UN has also refrained from adopting the 2010 OECD updates and greatly relies on the pre-2010 version of OECD MC and its commentary.

[1] OECD Committee on Fiscal Affairs

Hence, the OECD MC Commentary on Article 7 as it read before July 22, 2010 will be relevant from Indian tax treaties perspective.[2] Remarkably, the OECD Commentary also states that the previous version of the Article and its Commentary will continue to be relevant for the application and interpretation of bilateral tax conventions concluded before that date.

3. ***Structure of the Article:***

Article 7(1) contains two distributive rules. The first sentence assigns exclusive taxation of business profits to State R unless the enterprise has a PE in State S. The second sentence of OECD MC provides that State S may tax only so much of the enterprise's profits as is attributable to the PE.

The second sentence of UN MC amplifies the corresponding provision in OECD MC further by including the limited force of attraction rule. This entitles State S to not only tax profits attributable to the PE in State S, but moreover, to include,

a. profits from sales in State S of goods or merchandise, if these sales are the same or similar kind as those sold through the PE; and
b. profits from other business activities carried in State S, if these activities are of same or similar kind as those effected through the PE.

The UN MC is based on the idea that when an enterprise sets up a PE in another country, it brings itself within the fiscal jurisdiction of that other country to such a degree that such other country can properly tax all profits that the enterprise derived from that country – whether through the PE or not.

The quantification of the amounts of profits so attributable to the PE is stipulated in Article 7(2) to (6) of OECD MC and Article 7(2) to (5) of UN MC. It is only within the limits set out therein that the Contracting State concerned may determine the profits by applying its own domestic rules.

Article 7(7) of OECD MC and Article 7(6) of UN MC focuses on overlap of Article 7 with other distributive rules under the Convention.

4. ***Meaning of 'Business Profits':***

Noticeably, while the title of Article 7 refers to 'business profits', the language in Article 7 refers to only 'profits'. However, it is amply clear that Article 7 is meant to cover taxation of 'business profits'.

The expressions 'business profits' or 'profits' is not defined in OECD MC or UN MC. Also, while Article 3(1)(h) defines the term 'business' in an inclusive manner to include "*the performance of professional services and of other activities of an independent character*" it only infers that the term should be extended to independent personal service, but does not bring out the true scope of business.

In view of Article 3(2), in the Indian context, the meaning of these expressions would have to be ascertained in accordance with the provisions of the Income-tax Act, 1961 ("the Act"). The term 'business' has been defined under section 2(13) of the Act to include "*any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture*".

The term 'profits' however has not been defined in the Act, although there do exist elaborate provisions for the 'computation of business profits' under the Act. Lord Herschell in an English case

[2] Reference to OECD Commentary in this Article hereinafter means pre-2010 OECD MC Commentary on Article 7.

law in **Russel (Surveyor of Taxes) vs. Town & Country Bank Ltd. [1888] 13 A.C. 418 at 424 (HL)** observed that "*The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. That seems to me to be the meaning of the word 'profits' in relation to any trade or business. Unless and until you have ascertained that there is such a balance, nothing exists to which the name 'profits' can properly be applied.*" Referring to the above extract, the Supreme Court in **Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1**, held that "*the expression "profits and gains" has to be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom*".

Thus, it can be inferred that 'profits' are essentially surplus by which the receipts of any business exceed the expenditure necessary for the purpose of earning those receipts. In fact, Article 7(3) also supports this view by providing that in determining the profits of a PE, there shall be allowed as deduction, expenses which are incurred for the purposes of the PE.

Coming to the term 'business profits', in **Clifford Chance, UK vs. DCIT [2002] 82 ITD 106 (Mum Trib)**, it has been held that "*In India the definition of the terms 'business profits' is of wide import. It is something which occupies the attention and labour of a person for the purpose of profit. It has a more extensive meaning. An activity carried on continuously in an organised manner with a view to earn profit is business.*"

Noticeably, Indo-USA DTAA employs an elaborate definition of the term 'business profits' to mean "*income from any trade or business including income from furnishing of services other than included services as defined in Article 12(Royalties and fees for other services) and including income from the rentals of tangible personal property other than the property described in paragraph (3)(a) of Article 12*". The treaty also provides that profit shall include "*only the profits derived from the assets and activities of the PE*".

The OECD Commentary on Article 7 also observes that "*Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise.*"

Also, eminent international tax expert, Philip Baker in his Commentary on OECD Model Tax Convention on Income and on Capital of 1992 (2nd Edition) stated at 177 that "*The undefined term "profits" in appears to be wider than "industrial and commercial profits", and Article 7(7) clearly contemplates that it may embrace items of income dealt with separately in other Articles of the Convention, in which case the specific Articles override Article 7.*"

5. *Right to tax business profits:*

The first sentence of Article 7(1) provides that profits of an enterprise of State R 'shall be taxable' only in that State unless the enterprise carries on business in the other State (i.e. State S) through a PE situated therein. The second sentence reverses the order of priority by allowing (i.e. 'may be taxed') taxation by the State S.

A question arises as to whether in case of a PE in State S, State S gets an exclusive right to tax profits attributable to PE in that State and thereby precludes State R from taxing such profits or State R also has a right to tax such profits.

Though in the context of Controlled Foreign Companies, the OECD Commentary tends to suggest that State residence has an inherent right of taxation of business profits, although such profits may also be taxed in the source State. Para 13 of the Commentary read as "*The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise.*"

Philip Baker at page 174 of his Commentary states that "*Where an enterprise carries on business in the other Contracting State through a permanent establishment, then that other state may tax profits attributable to the permanent establishment. The right is not exclusive, however, the state of residence also has the right to tax such profits.*"

The learned author, Klause Vogel, in his book titled "Klause Vogel on Double Taxation Conventions", Third Edition while analyzing the main features of Article 7(1) at page 403 states that "*Profits of enterprise operated by a resident of a contracting state are, as a rule, taxed exclusively by the state of residence, and this applies even if profits result from activities exercised in the other contracting state.*" He emphasizes on the phrase "shall be taxable only" used in the first part of Article 7(1).

However, Indian judicial authorities have expressed divergent issues on this subject, the landmark ruling being **CIT vs. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654** which reached finality after almost 25 years of judicial hassle –

- In **P.V.A.L. Kulandagan Chettiar vs. ITO [1983] 3 ITD 426 (Mad ITAT)**, the Special Bench held that no portion of the income earned by a resident Indian from business and immovable property in Malaysia could be assessed to tax in India.

- The matter reached High Court and disposing a batch of matters together, Madras High Court affirmed the Tribunal's decision in **CIT vs. Vr. S.R.M. Firm [1994] 208 ITR 400**[3].

- Revenue again challenged the High Court's order and the same was dismissed by Supreme Court in **CIT vs. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654**. While the Court dismissed the batch of matters together, the facts in the case of Vr. S.R.M Firm were only adjudicated and without entering into the semantics of 'may be taxed', it was held that in case of dual residency, the right of taxation should be granted to the country which has a closer economic relationship to the income.

- In fact, the review petition filed against Supreme Court's order was also dismissed in **[2008] 300 ITR 5 (SC)**.

[3] Refer Tax Case No. 789 of 1984

Subsequent decisions have relied on P.V.A.L. Kulandagan Chettiar (SC) *(supra)* and held that 'may be taxed' should be construed to grant the source State an exclusive right to tax profits attributable to PE. [4]

However, the Delhi Tribunal in the case of **M/s Telecommunications Consultants India Ltd. [2012] 148 TTJ 311** stated that the Supreme Court *(supra)* upheld the basic principle that State of residence has right to tax global income of its resident and in the facts in that case Malaysia became the State of residence for assessee after applying tie breaking rules. It further submitted that ratio of the Supreme Court's decision has not been correctly applied in the subsequent decisions and militates against the basics of DTAA.

The Delhi Tribunal has elaborately explained the interpretation and scope of the phrase 'may be taxed' vis-à-viz the phrase 'shall be taxed' and observed that the phrase 'shall be taxed only' precludes other contracting state from taxing that income whereas the phrase 'may be taxed' which gives simultaneous taxing rights to State of residence as well as source. In the context of Article 7(1), it has been held that "*the first part of the Article gives exclusive right to the taxation of business income to the state of residency as the phrase used as 'shall be taxable only'. The second part of this article 7 of the relevant DTAA provides right to taxation of the state of residency as well as to the other contracting state wherein the permanent establishment situated. Thus, the Article 7 provides that in such a situation, the state of the residents does not have exclusive right to tax but it has inherent right to tax such income. The article also provides that the state of the source has also right to tax the business income. It is a non-exclusive right in case there exist a permanent establishment. The phrase used 'may be taxed'. Therefore, the combined reading of the sentences of Article 7 of relevant DTAA means that the state of source has non-exclusive right to tax business income attributable to permanent establishment. In view of this, such income may be taxed as per the domestic laws. This non-exclusive right of state of source does not extinguish the inherent right of state of residency to tax global income of its residents.*"

Another interesting observation was also made in **Bombay Burmah Trading Corpn. Ltd. vs. ACIT [2002] 76 TTJ 983 (Mum Trib)** in the context of Article 7(3). The Tribunal held that the expression '*.... there shall in each Contracting State be attributed to that permanent establishment the profits....*' makes it clear that the profits of the PE shall be taxed in both the States.

It is noteworthy that the CBDT vide **Notification no. 91/2008 dated August 28, 2008** assigned meaning to the phrase "may be taxed" and expressly provided that where the tax treaty provides that any income of a resident of India 'may be taxed' in other country, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Act, and relief shall be granted in accordance with the method of elimination or avoidance of double taxation provided in such agreement.

To give effect to the said notification, Explanation 3 was inserted in section 90 w.r.e.f October 1, 2009 providing that any meaning assigned through notification to a term used in DTAA but not defined in the Act or the DTAA, shall be effective from the date of coming into force of the agreement.

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[4] DCIT vs. Torqouise Investment & Finance Ltd [2008] 300 ITR 1 (SC); DCIT vs. Mideast India Ltd.[2009] 124 TTJ 924 (Delhi Trib); DCIT vs. Essar Oil [2011] 47 SOT 139 (Mum Trib)(URO);CIT vs. Bank of India [2015] 64 taxmann.com 215 (Bom HC)

Is the controversy put to rest? Not really. Appellate authorities still take a view that prior to the said notification, State S had an exclusive right to tax the underlying income. The present round of litigation is on the applicability of the notification with retrospective effect and penal consequences thereto[5].

6. ***Profits attribution to a PE even if the enterprise as a whole made no profits:***
Article 7(2) does not seek to allocate the overall profits of the whole enterprise to the PE, instead, requires that the profits attributable to a PE be determined as if it were a separate enterprise. This deemed independence of the PE implies that profits may be attributed to a PE even though the enterprise as a whole has never made profits. Conversely, no profits may be attributed to the PE, even though the enterprise as a whole has made profits.[6]

In **Wellinx Inc. vs. ADIT [2013] 158 TTJ 900 (Hyd Trib)**, the assessee contended that since the head office has suffered a loss, there cannot be any profits attributable to the branch. The Tribunal held that the same is not acceptable as profit of the branch office has to be computed as per the income earned by it.

7. ***Attribution of Profits to PE:***
Article 7(2) contains the central directives for determining what profits should be attributed to the PE. This paragraph incorporates the view that the profits to be attributed to the PE are those which that PE would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. The attribution of profits is based on the "arm's length principle".

'Economic Nexus' is an important aspect of principle of attribution of profits to PE, which forms the basis of the distributive rules in Article 7(1). Explaining the rationale of Article 7(1), the OECD Commentary at Para 9 states that this principle reflects the international consensus that "*until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as* <u>*participating in the economic life of that other State*</u> *to such an extent that it comes within the jurisdiction of that other State's taxing rights.*"

Importance of 'economic nexus' has also been enunciated by Klause Vogel which has the approval of the Apex Court in **Ishikawajma-Harima Heavy Industries Ltd. vs. DIT [2007] 288 ITR 408 (SC)**. The extract reads as under:

> "*In contrast, the second sentence of Art. 7(1) MC allows the State of the permanent establishment to tax only those profits which are economically attributable to the permanent establishment, i.e. those which result from the permanent establishment's activities, which arise economically from the business carried on by the permanent establishment (cf. also para 5 MC Comm. Art. 7, supra m. no. 10). As regards the profits made by the enterprise in the State of the permanent establishment, a distinction must always be made between those profits which result from the permanent establishment's activities and those made, without any interposition of the permanent establishment, by*

[5] Essar Oil Ltd. vs. ACIT [2014] 157 TTJ 785 (Mum Trib); Sumit Aggarwal vs. DCIT [2014] 167 TTJ 509 (Chandigarh Trib); N.V. Srinivas vs. ITO [2014] 173 TTJ 126 (Hyd. Trib); Daler Mehndi vs. DCIT [2018] 91 taxmann.com 178 (Delhi Trib); DCIT vs. Shahrukh Khan [2019] 103 taxmann.com 252 (Mum Trib)

[6] Para 11 of OECD Commentary;

the head office or any other part of the enterprise (also for mere assembly permanent establishment: BFH 37 RIW 258 (1991). It is only when there is a connection with the permanent establishment that the State of the permanent establishment is entitled to impose tax."

The Apex Court in **DIT (Intn Tax) vs. Morgan Stanley & Co. [2007] 292 ITR 416 (SC)** has also held that "*taxing corporates on the basis of the concept of Economic Nexus is an important feature of Attributable Profits (profits attributable to the PE)*".

The principle of apportionment or attribution is also recognised in our domestic tax law. Explanation 1(a) to section 9(1)(i) of the Act provides that "*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*"

Thus, for profits to be treated as being attributable to a PE, such profits must arise economically from the business carried out by the PE and have a 'direct and proximate' connection with the PE. As discussed earlier, UN MC, however, incorporates Force of Attraction rule, whereby profits which are not strictly attributable to the PE and thus do not have a 'direct and proximate' connection with the PE are also included.

8. *Approaches to determine business profits:*

Unfortunately, the Commentaries on Article 7 provides little guidance on how to interpret the term 'profits of an enterprise', beyond confirming that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.

2008 OECD Report on "Attribution of Profits to Permanent Establishments" acknowledged that in practice two broad interpretations of the terms are most common *viz.* the "relevant business activity" approach and the "functionally separate entity" approach. These approaches are discussed elaborately in the 2008 OECD report.

Briefly, under 'relevant business activity' approach, the profits of an enterprise arising from a business activity supported by the PE have to be considered for the purpose of allocation. This approach provides for determination of profits to be attributed to the PE on the basis of an apportionment of the total profits on an enterprise to its various business activities.

In contrast, under '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 performing the same or similar functions under the same or similar conditions. This approach echo's the language of Article 7(2).

From the perspective of administration, 2008 OECD Report suggest that "functionally separate entity" approach is more preferable. This approach is known as the 'Authorised OECD Approach' (AOA). In fact, in the new version of Article 7, the alternative of adopting "relevant business activity" approach has been deleted citing that "*as its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle*" [Para 41 of 2017 OECD Commentary on Article 7].

In India, the judicial precedents appear to have adopted the 'relevant business activity' approach rather than the 'functionally separate entity' approach[7].

In the context of business connection, Rule 10(ii) of the Indian Income-tax Rules, 1962 provides that in case the tax authorities are of the opinion that the actual amount of the income accruing to any non-resident, through or from any business connection in India, cannot be definitely ascertained, the taxable income may be computed as follows:

(a) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or
(b) $\frac{\text{Receipts accruing in India * Total profits and gains of the business of the enterprise}}{\text{Total receipts of the business of the enterprise}}$
(c) In such other manner as the Assessing Officer may deem suitable.

It should be borne in mind that treaties which incorporate the Force of Attraction Rule essentially rely on the 'relevant business entity' approach to determine the profits attributable to a PE. The OECD MC is not in consensus with this rule and hence its affinity lies with the 'functionally separate entity' approach.

A detailed discussion on attribution of profits to the PE and its approaches is found in another chapter of this compendium.

9. *Characterisation of income & Effectively connected to PE:*

Although the term 'business profits' covers all income from the operations of the enterprise, Article 7(7) of the OECD MC or Article 7(6) of UN MC gives a priority to the special distributive rules provided in other specific Article of the tax treaties such as dividend, interest, royalty, fees for technical services, etc. The said clause makes it clear that the provisions of other Articles of the MC shall not be affected by the provisions of Article 7.

The understanding of 'business profits' as a concept is based on income-generating unit while other distributive rules focus on the economic character of a single payment or transaction. These distributive rules generally carve out an exception to provide that Article 7 (and not the special distributive rule) shall apply where the taxpayer has a PE in the other contracting state and such income is 'effectively connected' with such PE.

The words 'effectively connected with the PE' are not words of redundance and should be given their due meaning. Thus, it becomes relevant to understand the concept of 'effectively connected' and its interplay with the term 'attributable to'.

The term 'effectively connected' is neither defined in the tax treaties nor the Act and thus, its meaning has to be construed under common parlance. 'Effective connection' denotes a real and intimate connection between the PE and the services, property, rights, contract, debt-claim, etc. which gives rise to the income. A real and perceptible connection should exist to be effectively connected. The term should not be understood to mean the opposite of legally connected but rather something in the sense

[7] CIT vs. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC); Wellinx Inc. vs. ADIT [2013] 158 TTJ 900 (Hyd Trib); DDIT vs. Nipro Asia Pte Ltd. [2017] 79 taxmann.com 154 (Delhi Trib); Caterpillar Global Mining Europe GmbH vs. ADIT [2017] 166 ITD 282 (Hyd Trib); Samsung Heavy Industries Co. Ltd. vs. DCIT [2018] 93 taxmann.com 224 (Delhi Trib)

of really connected. In the context of royalties, it is in the nature of something more than the mere possession by the PE of property or right but equal to or a little less than the legal ownership of such property or right.[8]

Indo-US DTAA, however, following US Model, uses the term 'attributable to' in place of 'effectively connected with'. The reason for this deviation have been exquisitely explained in **Bechtel International Inc. vs. ADIT [2012] 150 TTJ 792 (Mum Trib)** making reference to the Klaus Vogel's Commentary. The Tribunal observed that "*US Model convention deviates from OECD and UN Model Conventions (MCs) because the term "effectively connected" is a technical term of US domestic tax law and that it is defined in detail in I.R.C. section 864(c) whereas "attributable", though used in US domestic tax law as well, is not defined. If US MC were to refer to "effectively connected", the question would arise whether that term would be required by Article 3(2) MC to be interpreted on the US side in accordance with its definition under US tax law. Use of the term "attributable" avoids that problem and that is the reason the expression "attributable" is used in US Model Conventions. Therefore, the term appearing in US Model Conventions have the same meaning as the expression "Effectively Connected". The expression "attributable" as used in Article 11(5) of the India-USA DTAA has, to be construed as equivalent to "effectively connected".*"

A question arises as to whether the term 'effectively connected with' and 'attributable to' can be construed to be synonyms. The 2006 US Model Technical Explanation provides that the concept of "attributable to" provides an alternative to the analogous but is somewhat different from the concept of "effectively connected" used in US Code section 864(c). The Technical Explanation to the Indo-US Tax Treaty (1989) states that the concept of 'attributable to' is narrower than the concept of 'effectively connected'.

The Full Bench of the Federal Court of Australia had a chance to examine the interaction between 'effectively connected' and 'attributable to' while examining the Indo-Australia DTAA in the case of **Tech Mahindra Limited vs. CT [2016] FCAFC 130 (FCA)**. In this case, the taxpayer was a company resident of India which carried on business in Australia through a PE. It provided software products and IT services to customers in Australia through its PE. These services were partly performed by employees located in India ("Indian services"). The issue was whether Australia had any taxing rights in respect of the income from the Indian services. The Appellant contended that, the remittance was not in the nature of royalty as the service was effectively connected with the Australian PE and thereby Article 12(4) was engaged and gave priority to Article 7. The Appellant further contended that profits referable to Indian services were not attributable to the Australian PE and thereby Australia did not have taxing rights in respect of such profits. The Commissioner, in turn, argued that Article 12(4) and Article 7 are co-extensive and thus, the remittance should be either treated as royalty under Article 12 of the DTAA or alternatively, business profits liable to be taxed under Article 7.

The Full Bench of Australian Court while opining that Indian services constituted 'royalty' observed that –

- The essential competing difference in construction between the parties is whether Art 12(4) is simply a gateway to Art 7 so that whether the source State will have taxing rights under

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[8] Sumitomo Corpn vs. DCIT [2008] 110 TTJ 302 (Delhi Trib); Worley Parsons Services Pty. Ltd., In re [2009] 312 ITR 273 (AAR); [2011] 130 ITD 137 (Delhi)(SB); MSC Mediterranean Shipping Company; DCIT vs. JC Bamford Excavators Ltd. [2014] 150 ITD 553 (Delhi Trib); ACIT vs. Clough Engineering Ltd, S.A. vs. DDIT [2015] 154 ITD 478 (Mum Trib); International Management Group (UK) Ltd. vs. ACIT [2016] 162 ITD 219 (Delhi Trib)

Art 7 will depend on whether the royalties "assimilated" to business profits are, relevantly, attributable to the PE in the source State through which enterprise carries on business. On the construction argued by the Appellant, a royalty may fall outside of the scope of the source State's right to tax by virtue of Art 12(4), if Art 7 does not give taxing rights to the source State in respect of that royalty. The context and evident purpose of Art 12(4) does not give support for that construction.

- In construing Art 12(4), it is important to consider how Art 7 and Art 12 interact.

- There is circularity: the application of the business profits rule in Art 7(1) is subject to Art 7(7); where business profits include "royalties", Art 7(7) is subject to Art 12(4) which has the effect that Art 7, not Art 12, will be applicable.

- Article 12(4) is to be construed in the context that Art 7(7) gives priority to Art 12 over Art 7. Without Article 12(4), royalties forming part of the business profits of an enterprise attributable to a permanent establishment in the source State would be taxed by the source State but subject to a limit on the amount of tax that may be charged.

- The evident purpose of Art 12(4) is to relieve the source State from the limitation on taxing rights.

- The co-extensive operation of Art 12 and Art 7 gives content and meaning to the phrase "effectively connected with" in Art 12(4). Art 12(4) is engaged where the royalties in question are able to be taxed by the source State under Art 7 as part of business profits attributable to a permanent establishment in that state.

Indian judicial precedents, however, have interpreted the interaction between 'effectively connected' and 'attributable to' differently. The Supreme Court in the case of Ishikawajima *(supra)* held that the term 'effectively connected' and 'attributable to' are to be construed differently, even if the offshore services were connected. Following the Supreme Court's decision, in **IHI Corporation vs. ADIT [2013] 155 TTJ 4**, the Mumbai Tribunal held that offshore services even though effectively connected with the permanent establishment in India, would not be taxable in India as nothing was attributable. Various appellate authorities have held that that even though the services are effectively connected with the PE, only so much of the income as is attributable to the PE can be brought to tax under Article 7[9].

10. *Deduction of Expenses:*

Article 7(3) specifically recognises that in calculating the profits of a PE, allowance is to be made for the expenses incurred for the purposes of the PE. This rule explicitly includes executive and general administrative expenses. It is based on the principle of 'matching concept' which requires that the revenue has to be matched with cost.

[9] P. No. 13 of 1995, In re [1997] 228 ITR 487 (AAR); Worley Parsons Services Pty. Ltd., In re [2009] 312 ITR 273 (AAR); Nippon Kaiji Kyokoi vs. ITO [2011] 47 SOT 41 (Mum Trib)

Divergent views have been found in our judicial precedents on applicability of domestic laws for deduction of expenses. These views are based on interpretation of two sets of tax treaties based on OECD and UN Model.

a. Treaties based on OECD MC, which is silent on applicability of domestic law:

OECD Commentary is of the view that Para 3 only determines which expenses should be attributed to the PE for the purpose of determining the profits attributable to that PE. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the PE, since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the Article on Non-discrimination.[10]

The CBDT is also of the view that the expenses that are deductible by the PE in India would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Act.

However, certain appellate authorities have held that in the absence of the words "in accordance with the provisions of and subject to the limitation of the taxation laws of the Contracting State", the restrictions under the domestic law cannot be extended to the treaty provisions.[11]

Certain treaties which have adopted Para 3 of the OECD MC, also incorporate a provision in the Article dealing with Elimination of Double Taxation, which is not present in the OECD Model. For instance, Article 23(1) of the Indo-Mauritius DTAA provides that "*The laws in force in either of the Contracting States shall continue to govern the taxation of income in the respective Contracting States except where provisions to the contrary are made in this Convention.*"

Differing views are found in India on the interplay between Article 7(3) and Article in tax treaties which is similar to Article 23(1) above. Certain case laws have held that in view of the later provisions in the DTAA, Indian domestic laws are applicable to determine the deductibility of expense[12], while others have held that Article on Elimination of Double Taxation cannot be extended to Article 7(3)[13].

Though not relevant in the context of the existing bilateral treaties, it may also be noted that para 3 has been deleted from the new version of Article 7 (i.e. post-2010 OECD Model). The new Article 7(3) requires each Contracting State to follow the profit allocation of the other State. Like Article 9(2) of OECD MC, the new Article 7(3) provides that where a Contracting State adjusts the profits that are attributable to a PE and taxes profits of the enterprise that have been taxed in the other State, the other State shall make appropriate and necessary adjustment to the amount of its tax charged on those profits.

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[10] Para 30

[11] JCIT vs. State Bank of Mauritius Ltd. [2011] 11 taxmann.com 331 (Mum Trib); DDIT vs. Unocol Bharat Ltd. [2018] 99 taxmann.com 158 (Delhi Trib)

[12] DCIT vs. Mitsubishi Heavy Industries Ltd. [1998] 61 TTJ 656 (Delhi Trib); Mashreqbank PSC vs. DDIT (Intl Taxn.) [2007] 108 TTJ 554 (Mumbai). In fact, in Mashreqbank, it have been further held that even without such provision on Elimination of Double Taxation, the disallowances as per the Indian domestic law would apply.

[13] State Bank of Mauritius Ltd. vs. DDIT (Intl Taxn.) [2012] 149 TTJ 708 (Mum Trib); Abu Dhabi Commercial Bank Ltd. vs. ADIT (Intl Taxn) [2012] 176 TTJ 115 (Mumbai); ADIT (Intl Taxn.) v. Dalma Energy LLC [2012] 136 ITD 208 (Ahd. Trib

b. <u>Treaties based on UN Commentary, which expressly provide for deduction in accordance with domestic law:</u>

In contrast to the wording of OECD MC, the UN MC allows, in determination of a PE's profits, the deduction of those expenses which were incurred for the purpose of the 'business' of the PE[14]. Since, however, Article 7 deals with taxation of business profits, the former phrasing merely makes the rule more specific and does involve any change in substance when compared with OECD MC. The UN Commentary also acknowledges views expressed in the OECD Commentary on applicability of domestic laws for deductibility of expenses. The Commentary further notes that some countries may wish to point out in the treaty text that they allow only those deductions that are permitted by their domestic laws.

Certain bilateral treaties expressly restrict the deductibility of expenses by adding the words "*in accordance with the provisions of and subject to the limitation of the taxation laws of the contracting State*"[15]. Such treaties would attract the limitations and restriction envisaged under sections 44C, 43B, 37, 40(a)(i), etc.

The Supreme Court in Morgan Stanley *(supra)* has held that the quantum of taxable income is to be determined in accordance with the provisions of Act. All provisions of Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry forward and set-off losses, etc.

Moreover, the UN MC provides that no deduction shall be allowed in respect of amounts paid (otherwise than towards reimbursement of actual expenses) by the head office to the permanent establishment (or vice versa) by way of royalties, fees or 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 banking enterprises, by way of interest on money lent. The envisaged exceptions – reimbursements, and interest between partial units of financial institutions as well – reveal that Article 7(3) of UN MC generally pursues that same aim as the profit allocation rule laid down in Article 7(3) of OECD MC, *viz.* to ensure an appropriate apportionment of the actual profits.[16]

11. ***Mere purchase by PE of goods and merchandise:***

Article 7(5) of OECD MC should be viewed in close connection with the definition of the term 'PE'. According to Article 5(4)(d), a fixed place of business is not deemed to be PE if is maintained solely for the purpose of purchasing goods or merchandise for the enterprise. If so, Article 7 is inapplicable from the outset. Article 7(5) is concerned with a PE which, although carrying on other business, also carries on purchasing for its head office. In that event, the paragraph provides that the profits of the PE shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities will also be excluded in calculating the taxable profits of the permanent establishment.

UN MC does not have a paragraph corresponding to Article 7(5) of the OECD MC, but has left it to the discretion of the States negotiating the bilateral treaty.

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[14] Rather than 'for the purposes of the PE' as provided in OECD MC

[15] See Indian tax treaties with Belgium, Canada, Demark, France, Netherlands, New Zealand, Poland, USA

[16] See also Sumitomo Mitsui Banking Corpn. vs. DDIT (Intl Taxn.) [2012] 145 TTJ 649 (Mumbai) (SB); ABN Amro Bank N.V. v. CIT [2012] 343 ITR 81 (Cal HC); Standard Chartered Grindlays Pty Ltd. vs. DDIT [2017] 80 taxmann.com 99 (Delhi - Trib); Explanation (a) to Section 9(1)(v) of the Act

Under the domestic laws as well, Explanation 1(b) to section 9(1)(i) offers immunity from taxation in the hands of a non-resident, from operation which are confined to the purchase of goods in India for the purpose of export.

Though not relevant in the context of the existing bilateral treaties which contain a paragraph similar to Article 7(5) of the OECD MC, it may also be noted that this paragraph has been deleted from the new version of Article 7 considering administrative problems and inconsistency with the arm's length principle.

12. ***Applicability of Minimum Alternate Tax:***

Section 115JB provides for an alternate tax where the tax payable on the total income of a 'company' computed as per the normal provisions of the Act is lower than 18.5% of the book profits of the company. The term 'company' has been defined under the Act widely to not only cover domestic companies but also "*any body corporate incorporated by or under the laws of a country outside India*"[17].

In Advance Ruling **P. No. 14 of 1997, In re, [1998] 234 ITR 335,** the assessee, a Dutch company had a PE in India in the form of a project office for executing contract works. In the context of section 115JA (which is *pari materia* to section 115JB of the Act), the AAR held that the section "*does not make mention of foreign companies. It speaks only of 'every assessee, being a company'. There is no reason to presume that the legislature did not intend the provision of section 115JA to apply to an assessee which is a foreign company.*" It was further held that –

- In view of Article 7(1), a foreign company does not have to pay tax on its entire world income, but its liability is limited to so much as is attributable to that PE;
- The effect of Article 7 is to limit the quantum of the taxable income of a foreign company, but it does not absolve the non-resident from paying any tax which is payable by a resident company;
- There may be some practical difficulties for imposition of MAT on foreign companies, but once the charge is clearly established, the machinery sections should be constructed in a way to effectuate the charge and not to nullify the charge.
- There is hardly any practical difficulty in cases where a foreign company has a place of business in India as it is statutorily required to prepare Profit & Loss A/c under Companies Act.

However, in **Timken Co, In re [2010] 6 taxmann.com 54 (AAR)** and **Praxair Pacific Ltd., In re [2010] 326 ITR 276 (AAR)** it was held that section 115JB would not be applicable to a foreign company which has no presence or PE in India. The AAR in case of Timken Co *(supra)* went into the circumstances warranting the introduction of section 115JB by the Finance Bill, 2002. Clause 49 of the Notes on clauses declared that MAT was leviable on domestic companies. Even the CBDT in its Circular No.794 of August 9, 2000, made it appear that MAT applied only to domestic companies. The AAR also pointed out that since the assessee, a foreign company did not have a place of business in India, it was not required to prepare its accounts in accordance with the provisions of Part II and III of

[17] Section 2(17) of the Act

Schedule VI of the Companies Act,1956[18] and hence section 115JB is not designed to be applicable to a foreign company which has no presence or PE in India.

In Advance Ruling of **ZD, In re [2012] 348 ITR 351**, the issue before the AAR was applicability of section 115JB on sale of listed shares of Indian companies by a foreign company which enjoy exemption in section 10(38)[19]. Dissenting from Timken Co's *(supra)* ruling, the AAR followed P. No. 14 *(supra)* and held that MAT provisions are applicable to both resident and non-resident companies.[20]

Thus, the applicability of MAT to foreign companies has been a matter of intense debate in India.

Since 2015, section 115JB has witnessed various amendments with respect to applicability of the said section to foreign companies. Vide Finance Act, 2015, the provisions were amended w.e.f. AY 2016-17 to provide that the amount of income from (i) capital gains arising on transactions in securities; or (ii) interest, royalty or fees for technical services chargeable to tax at the rates specified in Chapter XII, accruing or arising to a foreign company shall not be liable to MAT. Similarly, expenditures, if any, debited to the profit loss account, corresponding to such income shall also be added back to the book profit for the purpose of computation of MAT.

This amendment resulted in tax authorities concluding tax assessments and issuing re-assessment notices to Foreign Institutional Investors ("FIIs) & Foreign Portfolio Investors ("FPIs" for prior periods) to bring the capital gains under the ambit of MAT provisions, which created an uproar in the foreign investor community.

To settle the controversy and provide certainty, a Committee on Direct Tax Matters chaired by Justice A.P. Shah, was constituted to examine the issue of applicability of MAT to FIIs/FPIs for the period prior to April 1, 2015. Accepting the recommendation of the Committee, the Government issued a press release on September 1, 2015 and an Instruction bearing no. 9/2015 on the next day confirming non-applicability of MAT provisions to FII/FPIs having no place of business or PE in India, for the periods prior to April 1, 2015.

However, the controversy was not settled yet. The broader issue of applicability of MAT provisions to foreign companies, other than FII/FPIs, not having place of business or PE in India remained unclear and uncertain.

The Finance Ministry in its press release dated September 24, 2015 indicated that w.e.f. April 1, 2001, MAT provisions will not apply to foreign companies, having no place of business or PE in India.[21]

Thereafter, in case of **Castleton Investment Ltd. vs. DIT (Intl. Taxn) [2015] 379 ITR 363**, the Learned Attorney General made a statement at the Bar that the Government would abide by the decision which has been taken in the Instruction dated 02.09.2015 and Press Release dated 24.09.2015.

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[18] Now, Schedule III of Companies Act, 2013

[19] First proviso to section 10(38) provides that the income by way of long-term capital gain of a company shall be taken into account in computing the book profit and income-tax payable under section 115JB

[20] Also refer Castleton Investment Ltd., In re [2012] 211 Taxman 282 (AAR); SmithKline Beecham Port Louis Ltd. [2012] 348 ITR 556 (AAR)

[21] An instruction to that effect was issued on December 23, 2015 by the Ministry.

Subsequently, vide Finance Act, 2016, section 115JB was amended to provide that w.r.e.f. AY 2001-02, the MAT provisions would not apply where foreign company has no place of business or PE in India. The amendment finally clears the air but, one may also draw an inference that for period prior to AY 2001-02, MAT provisions would be applicable irrespective of whether the foreign company has a place of business or PE in India or not.

The latest amendment is vide Finance Act, 2018 again w.r.e.f. AY 2001-02 to clarify that the provisions of section 115JB shall not be applicable to a foreign company, if its total income comprises solely of profits and gains from business referred to in sections 44B, 44BB, 44BBA or 44BBB of the Act and such income has been offered to tax at the rates specified in the said sections.

13. *Reliance upon Accounts of PE:*

Every foreign company is required to prepare financial statement of its Indian business operations in accordance with Schedule III or as near thereto as may be possible for each financial year[22].

Now, a question arises to whether these accounts can be relied upon to determine the profits attributable to the PE.

In the case of **CIT vs. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC)**, the Supreme Court observed that "*since there is no specific provision under the Act to compute profits accruing in India in the hands of the foreign entities, the profits attributable to the Indian PE of foreign enterprise are required to be computed under normal accounting principles and in terms of the general provisions of the Act. Therefore, ascertainment of a foreign enterprise's taxable business profits in India involves an artificial division between profits earned in India and profits earned outside India.*" OECD Commentary and 2008 OECD Report on "Attribution of Profits to Permanent Establishments" also consider such accounts to be the 'starting point' for determining the profits attributable to the PE. The OECD Commentary also states that the profit so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.

In case of intra-organisation transactions, **DDIT vs. Set Satellite (Singapore) (Pte.) Ltd. [2007] 108 TTJ 445,** the Mumbai Tribunal observed that there are several ways of accounting for the same, e.g. at cost, at transfer price, at arm's length price or simply at fair market price.

In the context of intra-organisation transaction, the OECD Commentary also concludes that accounting records and contemporaneous documentation, constitute a useful starting point for the purpose of attributing profits to the PE.

Published in Compendium on International Taxation – Chamber of Tax Consultants, 2019 Edition

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[22] Section 381 of Companies Act 2013 read with Rule 4 of Companies (Registration of Foreign Companies) Rules, 2014.