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Article 5 – Permanent Establishment
Article 7 – Business Profits

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Contents

- The Concept of Permanent Establishment
- Variations of Article 5
- Attribution of Profits to Permanent Establishment
- Variations of Article 7

Introduction to DTAA's

Introduction to DTAAs

- Purpose of DTAAs
 - Avoidance of double taxation & prevention of fiscal evasion
 - Relief for taxes paid in other country
 - Exchange of information
 - Others
- Distribution of taxing rights between the countries

Introduction to DTAAs

Art. 1 Persons Covered

Art. 2 Taxes covered

Art. 3 General definitions

Art. 4 Resident

Art. 5 Permanent establishment

Art. 6 Income from immovable property

Art. 7 Business profits

Art. 8 Shipping, inland waterways transport and air transport

Art. 9 Associated enterprises

Art. 10 Dividends

Art. 11 Interest

Art. 12 Royalties

Art. 13 Capital gains

Art. 14 [Deleted]

Art. 15 Income from employment

Art. 16 Directors' fees

Art. 17 Artistes and sportsmen

Art. 18 Pensions

Art. 19 Government Service

Art. 20 Students

Art. 21 Other income

Art. 22 Capital

Art. 23 A Exemption method

Art. 23 B Credit method

Art. 24 Non-discrimination

Art. 25 Mutual agreement procedure

Art. 26 Exchange of information

Art. 27 Assistance in the collection of taxes

Art. 28 Members of diplomatic missions and consular posts

Art. 29 Territorial extension

Art. 30 Entry into force

Art. 31 Termination

Significance of Permanent Establishment

Significance

- Decisive condition for the taxation of income from **business activities**
- This rule is designed to ensure that business activities will not be taxed by the state unless and until they have created significant **economic bonds** between the enterprise and that state
- Narrower definition of PE is generally adopted when imports exports between the countries are balanced.
- DTAA between industrialized and developing countries have broader definition of PE (UN MC)

Definition of Permanent Establishment – Article 5

Article 5 of the OECD Model Convention

- Para - 1 General Definition
- Para - 2 Illustrative list of PE
- Para - 3 PE in relation to project
- Para - 4 List of exceptions
- Para - 5 Dependent Agent
- Para - 6 Independent Agent
- Para - 7 Associated Enterprises

Basic rule PE

Basic Rule PE

As per Article 5(1) of the OECD MC-

“For the purpose 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” (Basic Rule)

What is fixed place of business?

- Distinct place with a certain degree of permanence and continuity
- There has to be a link between the place of business and a specific geographical point
 - Ships permanently moored to the bank
 - Oil rigs firmly anchored to the sea bed
 - Connection to geographical area as against geographical point

Degree of permanency

- A place of business of a temporary nature would not amount to PE
- Depending on the nature of business even a short period may amount to PE
- Generally no PE unless the period exceeds 6 months
- Activity of recurrent nature
- Temporary interruptions (seasonal business, holidays) to be ignored while determining permanency

Coherent whole commercially and geographically

- Movement of activities between neighboring locations
 - A very large mine
 - Office hotel
 - Pedestrian street
 - Outdoor market or fair

Coherent whole commercially and geographically

- No commercial coherence

Painter working for different clients in a building

- No geographical coherence

Consultant working at different branches for the same company on a project

Ownership legal rights

- The place need not be owned or hired by the enterprise
- The place should be at the **disposal of** the enterprise
- The enterprise need not have a legal enforceable right to use the place of business
- Even illegal use of certain location by the enterprise can amount to PE
- A place can be at the disposal of more than one person
- A fixed place owned by A placed at the disposal of B would not become PE of A
- If the place is at the disposal of more than one person then it would be PE for all of them

Letting and leasing of facilities or resources

- If equipment, building, intangible property etc. are let out from or through a fixed place of business then such place becomes a PE
- The building let out does not become a place of business for the lessor

Basic rule and other PEs

- **If basic rule PE is formed then other tests need not be satisfied**

Article 5(2) of the OECD MC

What is especially included in PE?

Includes especially:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop; and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources

Requirements of 5(1) to be fulfilled

- 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
 - Exceptions

Article 5(3) of the OECD MC

Construction / Installation

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

Service PE

Article 5(3)....Service PE

The term 'permanent establishment' encompasses:

(a)....

(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 continues (for the same or a connected project) within the country for a ***period or periods*** aggregating more than six months within any twelve month period.

Article 5(4) – Activities not resulting in PE

Activities not resulting in PE

- Exceptions in Para 4 - Activities not considered as resulting in PE
- Activities of general, preparatory and auxiliary character
- Rationale of exceptions

Activities not resulting in PE

- 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**;

Activities not resulting in PE

- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- 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;

Activities not resulting in PE

- *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.

Agency PE

Dependent agent

- **Notwithstanding** the provisions of paragraph 1 and 2, where **a person - other than as 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, **the 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.

Dependent agent

- A person....
- Need not be a resident nor have place of business in the state in which they act for the enterprise
- Employee as an agent

Authority to conclude contracts

- **If the contract negotiated upto finalisation and ready for signature - signing at the enterprise HO outside the State will not help - substance over form - authority granted**
- **Lack of active involvement of enterprise in transactions may be indicative of grant of authority**
- **If agent solicits & receives orders (but not formally finalises) which are sent directly to warehouse for delivery where enterprise approves routinely**

Agency PE - Miscellanea

- Agency contracts to constitute PE must be **related to business proper** and not internal management or administration
- Authority to negotiate & conclude purchase contracts - No PE - due to exclusion

Extension of agency PE

- Maintenance of stock of goods without authority and habitual delivery
- Securing orders

Independent Agent

No PE - Independent Agent

- Para 5(6) is a clarificatory para clarifying that an enterprise shall not be deemed to have a PE if it carries on business in the other state through:
 - brokers, general commission agents and other agents of **Independent nature**
- AND
- the independent agent is acting in his **ordinary course of business**

Article 5(7) of the OECD MC

Subsidiary / Associated Enterprise

- Controlling by capital or management by itself do not constitute PE of either / each other

Specific features of Double Taxation Avoidance Agreements (DTAAs) signed by India - Article 5

Actual DTAAAs

- Model Conventions v Actual DTAAAs
- Significance of deviations

Article 5(1)

- “Fixed place of business *through/ in* which the business of the enterprise is wholly or partly carried on”
- PE “in relation to an enterprise”

Article 5(2)

- The term “permanent establishment” **includes**
.....
- Specific inclusion in the list
 - Warehouse
 - Farm or plantation
 - Sales outlet

Article 5(2)/ 5(3)

- Construction / installation project
 - 6 months, 9 months ,12 months,120 days, 183 days
- Supervisory activity resulting in PE
- Equipment resulting in a PE
- RIG resulting in a PE

Article 5(2)/ 5(5) ... service PE

- Service PE
 - 90 days, 3months, 6 months, 183 days
 - 1 day!!
 - Related party
- “Same or connected” projects
- “through employees or other personnel”
- Exclusion of technical fees
- Reference to services in a country

Article 5(3)/ 5(4) - Exclusions

- Use of facility for 'delivery' of goods
 - UN Type
 - OECD Type
 - Occasional delivery
- Combination of auxiliary activities
- Processing by others

Article 5(4)/ 5(5) – Dependent Agent

- Delivery of goods / Fills orders
- Securing contracts
- No exclusion of auxiliary activities other than purchases
- No exclusion of any auxiliary activity
- Para non-obstante

Article 5(5)/ 5(6)/ 5(7) – Independent agent

- Exclusive services affecting independence
- Imposition of conditions affecting independence
 - Arm's length

Business Profits – Article 7

Issue of Attribution

	Locality A	Locality B
	Function A [@10 per KG]	Function B [@15 per KG]
Profits 500	Profits ??	Profits ??

Indian position on attribution

- Requirement of maintenance of books of accounts under the tax laws
- Requirement of maintenance of books of accounts under the corporate law
- Requirements of audits

Methods under the Act and Rules

- Under the Act
 - Computation Method
 - Presumptive Method
 - Gross taxation
- Rule 10
 - Percentage of turn over
 - Proportionate Method
 - Discretionary Method

Indian position on attribution

- No specific provisions dealing with attribution
“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 of profits - a guesswork ?

- Court observations (Bom)-

“We are not impressed by the said submission of Mr. Mehta. 25%, no doubt, is some guesswork done by the Income-tax officer, but substituting it by 10% again would be nothing more than indulging in further guesswork”

- Court observations(SC)-

“In the absence of some statutory or other fixed formula, any finding on the question of proportion involves some element of guesswork. The endeavor can only be to be approximate and there cannot in the very nature of things be great precision and exactness in the matter.”

Approach of courts on attribution

- Lower authorities [AO, CIT(A), ITAT] in a better position to decide the issue
- AARs reject questions on attribution of profits
- The courts prefer to not to interfere unless attribution found to be unreasonable or arbitrary

Operations in India	Profits determined by the tax authorities	Profits approved by the courts
Negotiation of the deal, procurements of orders, arrangements for opening letter of credit by agent 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%
Procurements 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%

Arm's length consideration to agent

- Does arm's length consideration to an agent extinguish the tax liability of a foreign company?
- CBDT Circular no. 23 (withdrawn)
- Recent rulings
 - Morgan Stanley - BPO activities
 - Set Satellite (Singapore) Pte Ltd. -TV Channels
 - LG Korea (All HC)

Attribution of profits

- Attribution of profits to various activities of the business
- Attribution in case of transactions between branch and head office

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)

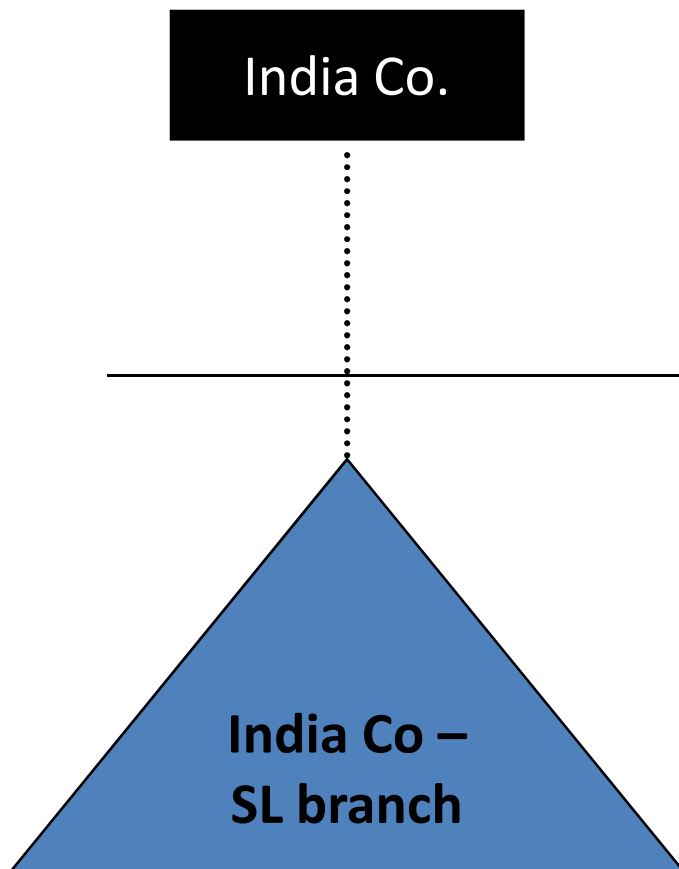
- Profits of an “enterprise”
- Source country gets right to tax only if PE exists
- Restriction on amount of profits to be taxed in the source country

Article 7(1)

- Right of the resident country to tax the profits earned from the source country

Rights of the country of residence

CIT v. S.R.M. Form 208 ITR 400



- **Article 7** of Tax treaty reserves the taxing rights in India, while granting restricted rights of taxation to SL /Malaysia with regard to business profits
- **Article 24/23** of Tax treaty provides for grant of tax credit to avoid double taxation – Credit Method.

Held that profit of PE in SL/Malaysia are exempt in India

Whether decision is in accordance with interpretation principles?

Rights of the country of residence

- **C.I.T v. P.V.A.L. Kulandagan Chettiar (267 ITR 254)(SC)**
- Notification u/s 90(3) – “May be taxed”
“.....provides that any income of a resident of India “may be taxed” in the other country, such income shall be included in his total income chargeable to tax in India”
in accordance with the Act and relief for double taxation may be provided

Notification no. S.O. 2123 (E) dated 28-8-2008

Article 7(1) – Force of Attraction

- 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.

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.

Transactions with self

- Transactions between head office and PE

Transactions with self

- Conversion of capital asset into stock in trade – “transfer”
- Domestic TP – Section 80-IA(8)
- Judicial Precedents-
 - Industrial Development Bank of India v. DCIT [2004] 91 ITD 34 (Mum Trib.)
 - ABN Amro Bank [2005] 98 TTJ 295 (Cal. Trib.)
 - Sumitomo Banking Corporation
 - Mafatlal Gagalbhai & Co. (P.) Ltd. v. CIT 193 ITR 188 (HC Bom.)
 - Castrol India Limited v. State of Tamil Nadu 114 STC 468
 - CIT v. Bai Shrinbai K.Kooka [1962] 46 ITR 86 (SC)
 - Sir Kikabhai Premchand v. CIT [1953] 24 ITR 506 (SC)
 - Mitsui Bank Ltd. v. IAC [1989] 35 TTJ 426 (Bombay ITAT)
 - Ram Lal Bechairam v. CIT [1946] 14 ITR 1 (HC All.)
 - Betts Hartley Huett And Company Ltd. v. CIT [1979] 116 ITR 425 (HC Cal.)

Article 7(3)

- 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.

Article 7(3) ... UN Model

- 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.

Article 7(3) ... UN Model

- 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

- Rationale
- Transactions to be recognised only to the extent of reimbursements
- Are all the payments covered?
- Banking enterprises

Article 7(3) - OECD -UN Model

- Do both the provisions lead to same result?
- Nature of expenses for which deductions allowed / restricted

Article 7(4)/ (5)/ (6)

- 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.
- 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.
- 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.

Specific features of Double Taxation
Avoidance Agreements (DTAAs) signed
by India - Article 7

Article 7(1)

- Force of Attraction Rule
- Profits “directly or indirectly” attributable

Article 7(3)

- Provisions based on OECD Model
- Provisions based on UN Model
- Limitations of domestic law

Thank You

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