



BMR & Associates LLP

Article 7 and 9 of the model conventions including International and Domestic TP

Beginners Study Course on International Taxation

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Article 7 of the Model Convention-

Business Profits and PE attribution

Why Attribution?...

- Residence Country – generally taxation of global profits
- Right of source country to tax profits of foreign enterprise operating in its jurisdiction – when PE exists i.e. Source Based Taxation
- Only those profits which are attributable to PE in the source country
- Concept of PE – Article 5 – litmus test whether particular income is taxable in country of source
- Article 7 – determination of quantum of profits are taxable

Attribution of profits –
the biggest controversy

Basic theory of profit attribution to PE

- Attribution of profits to PEs currently one of the most intriguing topics of TP
- OECD paper on PEs
- Several rulings issued
- OECD → two approaches – “relevant business activity” & “functionally separate entity”
- OECD prefers “functionally separate entity” (hypothesis) approach
- Profits attributable to significant people functions performed by PE for assumption/ management of risks & economic ownership of assets
- TP guidelines apply not directly but by analogy to dealings between HO & PEs

OECD recommends the
Separate Entity Approach

Positions under tax treaties

Mechanics of Article 7

Residence State

Enterprise

Source State

**Article 5: Constitution
of Permanent
Establishment**

Overview of Article 7 of OECD Model

- Article 7(1) – Scope of Taxation of PE – taxing rights – charging provision
- Article 7(2) – Basis of Attribution of Profits to PE
- Article 7(3) – Elimination of double taxation
- Article 7(4) – non applicability of article 7 on income dealt separately in other articles

**Article 7:
Taxation of PE**

Article 7(1) - OECD Model Convention

*“The profits of an enterprise shall be taxable only in that State unless the enterprise carries on business in the other State through a PE. If the enterprise carries on business in the other state through a PE, the profits that are attributable to the PE **may be taxed** in that other state.”*

Key aspects:

- PE test for each source of income
- No guidance on how to interpret the term ‘profits of an enterprise’
- Existence of PE must for attribution
- Only profits attributable to such PE is taxable in the source country
- Applicability of Minimum Alternate Tax

Article 7(1) - UN Model Convention

“The profits of an enterprise shall be taxable only in that State unless the enterprise carries on the business in the other state through a PE 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 PE;

- *Sales in that other state of goods of similar kind as those sold through that PE; or*
- *Other business activities carried on in that other State of similar kind as those effected through that PE.”*

Force of attraction rules

Article 7(2)

- *“The profits that are attributable to the PE referred to paragraph 1 are the **profits it might be expected to make** in its dealings with other parts of the enterprise, **if it were a separate and independent enterprise engaged in similar activities under similar conditions** and taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through other parts of the enterprise”*
- OECD 2010 commentary provides a detailed approach on conducting FAR for PE and determining attribution after adjustments. India has stated that it does not agree with the commentary in general.

Approaches to determine business profits

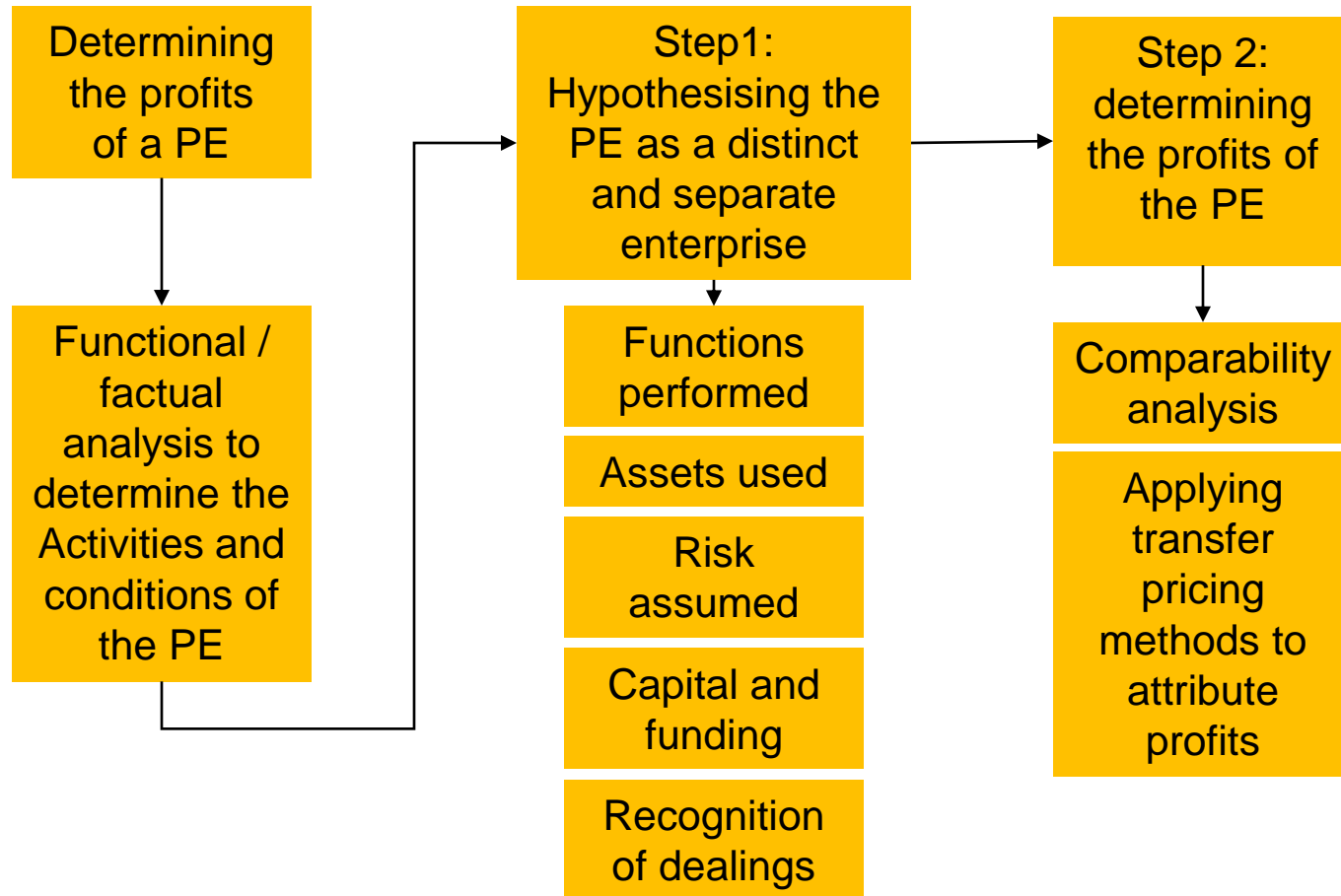
➤ Functionally Separate Approach

- Also known as Authorised OECD Approach ('AOA')
- PE is an independent and separate enterprise
- Two step approach
- Based on FAR
- Corresponds to arm's length principle
- CBDT Circular No. 23, dated July 23, 1969 – now withdrawn
- No further attribution once PE is remunerated at ALP
 - *DIT vs Morgan Stanley and Co. Inc*

➤ Relevant Business Activity Approach

- Allocatory Method
- Basis of an apportionment of the total profits of an enterprise to its various parts

Authorized OECD Approach: An outline



Article 7(3) - Provisions

*“Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, **the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment, the competent authorities of the Contracting states shall if necessary consult each other**”*

Article 7(4) - Provisions

“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”

Other Articles to prevail

Position under the Act

Attribution of profits under the Act

➤ Section 9(1)(i) of the Act:

“The following incomes shall be deemed to accrue or arise in India:-

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(a) to section 9(1)(i) of the Act:

“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 under the Act (...contd.)

- Rule 10 of the Income-tax Rules:

In any case in which the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax may be calculated:

- Rule 10(i) - Presumptive Method
- Rule 10(ii) - Proportionate Method
- Rule 10(iii) - Discretionary Method

Rulings on PE Attribution

Morgan Stanley – Supreme Court ruling

- Revenue's stand → Indian captive BPO of foreign MNC providing IT services, create PE of MNC in India
- Revenue's attempt to tax percentage of global profits of foreign MNC in India [in hands of PE] over & above arm's length remuneration received by Indian captive BPO at cost plus
- Supreme Court → Indian captive BPO neither fixed place of business PE (as carrying out back office functions in nature of preparatory/ auxiliary services) nor dependent agent PE (as not concluding contracts/ securing orders) of foreign MNC in India
- Foreign MNC deputed technicians to assist Indian captive BPO on long-term basis → salary costs of technicians recharged
- Supreme Court → technicians resulted in service PE of foreign MNC in India, however, since salary costs recharged already marked up in hands of Indian captive BPO, no further profit attribution in hands of service PE of foreign MNC

Rolls Royce – Delhi Tribunal ruling

- F Co set up Indian Sub Co for providing marketing support services → Sub Co remunerated on reimbursement of full costs + mark up
- Tribunal found that Sub Co actually secured orders for F Co & thus created agency PE for F Co [under Indian treaties, securing orders → agency PE]
- Tribunal also held that Sub Co created fixed place of business PE for F Co since F Co reimbursed all costs (including rental) of Sub Co
- Tribunal went ahead with attributing 35% of profits arising out of sales made to Indian customers, to PE of F Co in India
- Ruling disturbing :
Cost plus model by itself does not mean Sub Co's premises at disposal of F Co, for constituting fixed place of business PE (presence of F Co's employees in Sub Co's premises could) → captive IT/ BPO companies on cost plus model at risk ?
- Proper profit attribution methods not followed by ITAT → would we see more of this high-handed approach of Revenue post withdrawal of CBDT Circular no 23 of 1969 ?

Some other judicial precedents

- Galileo International Inc (Delhi High Court)
- BBC Worldwide Ltd. (Delhi High Court)
- MTV Asia (ITAT Mumbai)
- B4U International Holdings Ltd. (ITAT Mumbai)
- Hyundai Rotem Company (ITAT Delhi)
- SET Satellite (Singapore) Pte Ltd (ITAT Mumbai and Bombay HC)

Key Takeaways

- PE – a dynamic concept
 - Especially with emergence of economic and technological advancements
- Attribution – very contentious in practice
- Documenting functional analysis – key defense
- Attribution vis-à-vis arm's length payments

Article 9 of the Model Convention – Associated Enterprises

Article 9(1) – OECD and United Nations (‘UN’) Model

“Where

a) an enterprise of a Contracting State **participates** directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) The same persons participate direct or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either **case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises**, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Enterprise

- Article 3(1)(c) of the OECD Model defines the term ‘enterprise’ as under:
“the term ‘enterprise’ applies to the carrying on of any business”
Article 3(1)(h) of the OECD Model defines business to expressly include the
“performance of professional services and of other activities of an independent character.
- Section 92F(iii) of the Act also defines enterprise
 - Very wide and practically covers all kinds of activities
 - Includes a PE
 - ‘Engaged’ – National Projects Construction Corporation Ltd. vs. CWT – Certain level of continuity

Article 9(2) – OECD and UN Model

*“Where a Contracting State includes in the profits of an enterprise of that state – and taxes accordingly – profits on which an enterprise of the other contracting state has been charged to tax in that other state and the profits so included are profits which would have accrued to the enterprise of the first mentioned state if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that **other state shall make an appropriate adjustment to the amount of the tax charged therein on those profits.** In determining such adjustment, due regards shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.”*

Types of Adjustments

- **Primary Adjustments** – Made in accordance with Article 9(1)
- **Correlative Adjustments [Article 9(2)]** – Consequent downward adjustment to the income of an enterprise of other contracting state
- **Secondary Adjustments** – Adjustments bringing the situation of the transaction to the exact level as it would have been, had the transactions taken place at ALP

Article 9(2) – Correlative Adjustments

- Relief mechanism to avoid economic double taxation
- ‘and’ – Actual double taxation is a precondition for applicability of article 9(2)
- Mandatory only if the primary adjustment made by Contracting State is considered to be in accordance with Article 9(1) and not arbitrary by the other Contracting State

Article 9(3) of the UN Model Convention

“The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or willful default.”

Enterprises whose profits are adjusted under article 9(1)



Liable to penalty in the first state on account of fraud, gross negligence or willful default



Article 9(2) is not applicable

Position under the Act

Section 92 of the Act and other allied sections

Section 92(1)

“Any income arising from an international transaction shall be computed having regard to the arm's length price.

Explanation.—For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.”

Key Aspects:

- Applicable only to ITs
- Applicable not only to the credit side (income) but also the debit side (expenses) of the Profit and loss account

Section 92(2)

- Applicable to ITs and Specified Domestic Transactions ('SDT')
- Covers Cost Sharing Agreements
- A mutual agreement or arrangement for allocation of expenses would also be considered as an IT / SDT

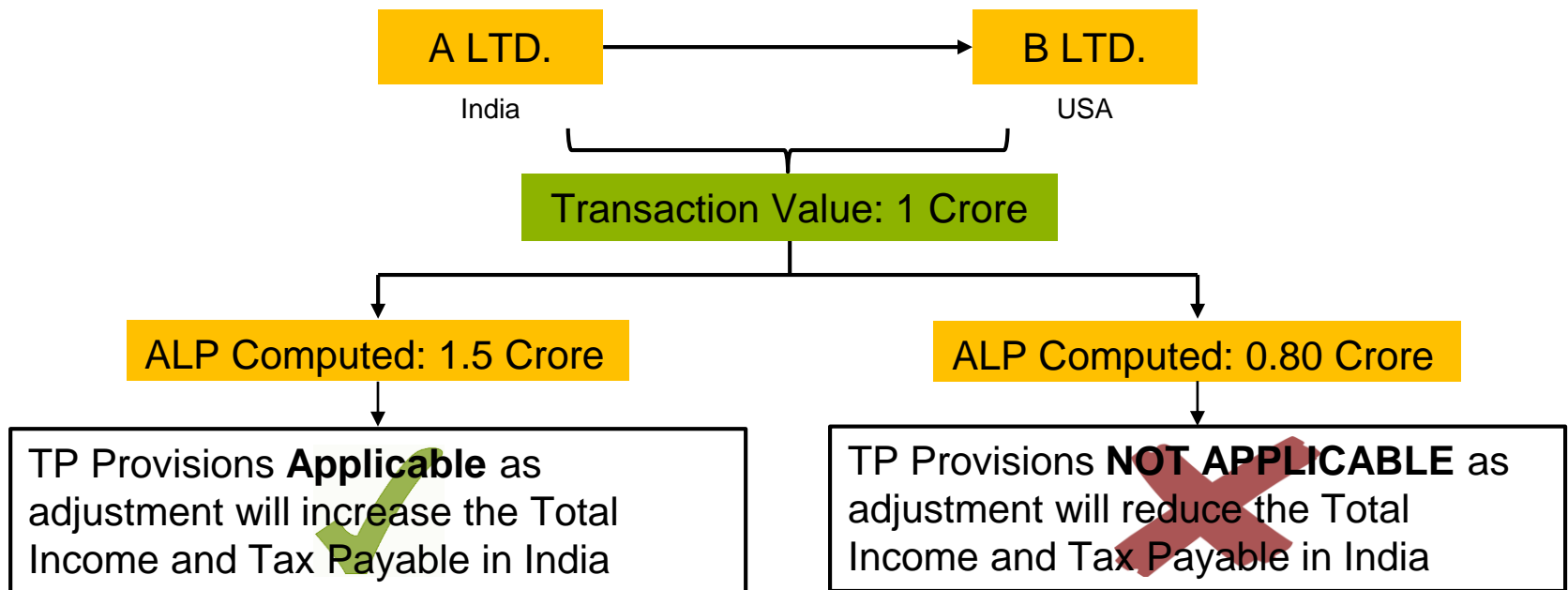
Section 92(2A)

- Section 92(2A) was inserted by Finance Act, 2012, w.e.f. A.Y. 2013-14 to ensure reasonableness of transactions between domestic related parties and make TP provisions applicable to SDTs as well.
- Section 92(2A) states that
 - Any expenses or
 - Any interest or
 - Allocation of any cost or expense or
 - Any incomein relation to a **SDT** should be computed at an Arm's Length Price ('ALP')

Section 92(3)

- TP Provisions shall not apply where application of Arm's Length Methodology has the effect of reducing the income or increasing the loss incurred in relation to an IT or SDT

ILLUSTRATION

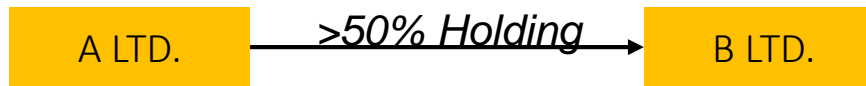


Associated Enterprises

Direct or Indirectly [Section 92A(1)]

- Participation in the management or control or capital directly, indirectly or through one or more intermediaries
- Common persons participating directly or indirectly in the management or control or capital

ILLUSTRATION



DIRECT HOLDING: A & B are AEs



INDIRECT HOLDING: A & C are AEs

Associated Enterprises (...contd.)

Management, Control or Capital [Section 92A(1)]

- Neither defined in Model Conventions nor in the commentaries
- Article 3(2) of the OECD Model Conventions – Any term not defined in the Convention should be interpreted as per the domestic law
- Section 92A(2) of the Act – Instances of deemed participation of management, control or capital
- Satisfaction of any of the situation / circumstances stated in section 92A(2) of the Act would render two enterprises as AEs even for the purpose of all Indian tax treaties

Section 92A and Article 9

Section 92A(2): Deemed AEs

Capital	Management	Activities	Control
26% direct or indirect holding by an enterprise	Appointment of more than half of the directors / One or more executive directors in an enterprise	Supply of $\geq 90\%$ of the raw materials	Common control by individual or relative, individually or jointly
By the same person in both enterprises		Complete dependence on the intangibles provided	Control by HUF and / or other member of HUF / relative of member
Loan $\geq 51\%$ of book value of total assets	Appointed by the same person(s) in both enterprises	Sale of manufactured / processed goods under influenced prices and conditions	$\geq 10\%$ inter firm / AOP / BOI holding
Guarantees $\geq 10\%$ of borrowings			Relationship of mutual interest

Section 94A

Notified Jurisdictional Areas ('NJA')

- Introduced by Finance Act 2011 w.e.f June 01, 2011
- Entities to a transaction shall be considered as AEs if a transaction is entered into with a person located in a NJA
- The transactions will be considered as ITs
- As of now, Cyprus has been notified as a NJA

Section 92B

Section 92B(1): Meaning of IT

- Transaction between two or more AEs
- At least one of the AE must be a non-resident
- Transactions between two non-residents also covered
- Scope of transactions covered
 - Purchase, sale, lease of tangibles or intangibles
 - Provision of services
 - Financing
 - Cost apportionments, allocations, contributions
 - Any other transactions having a bearing on profits, income, losses or assets of an enterprise (mutual agreements / arrangements, etc)
- Detailed explanation on types of transactions covered under the definition of IT introduced w.r.e.f. April 01, 2002
- Detailed explanation of intangible property introduced w.r.e.f. April 01, 2002



Section 92B (...contd.)

Section 92B(2): Deemed IT

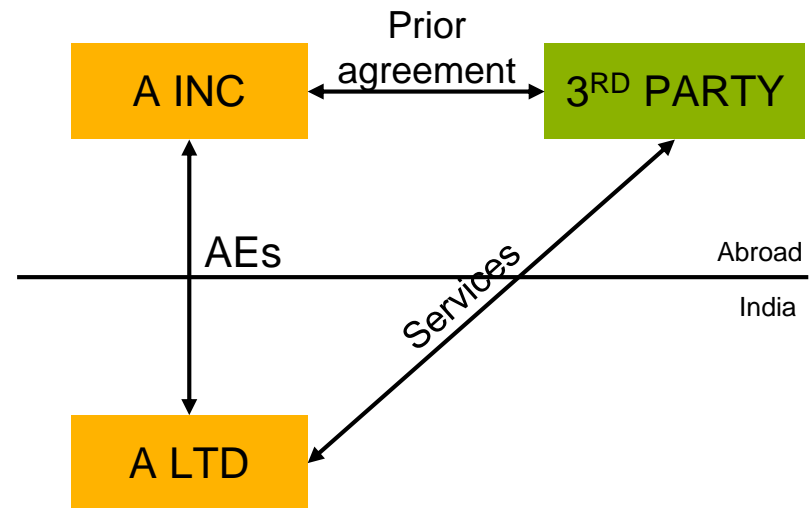
Provisions and Interpretation **upto AY 2014-15**

- Transaction with a person other than an AE shall be deemed to be a **transaction** entered into between two AEs if:

a prior agreement exists between the AE and 3rd party;

Or

terms of transaction are determined in substance by the AE and 3rd party



Section 92B (...contd.)

Section 92B(2): Deemed IT

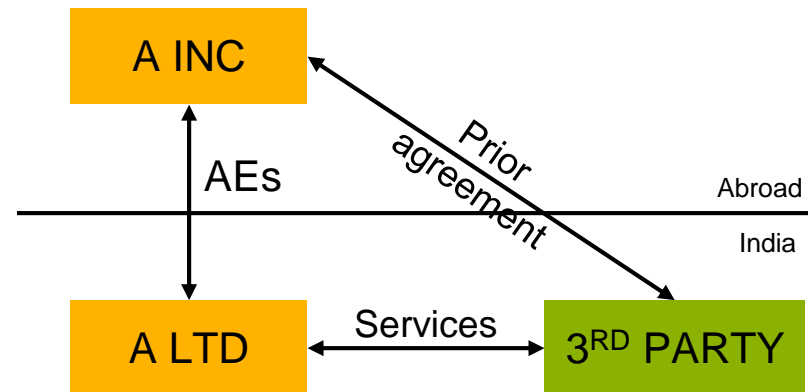
Provisions after **Amendment** by Finance Act, 2014 w.e.f. **AY 2015-16 onwards**

- Transaction with a person other than an AE shall be deemed to be **an IT** entered into between two AEs if:

a prior agreement exists between AE and 3rd party;

Or

terms of transaction are determined in substance by AE and 3rd party

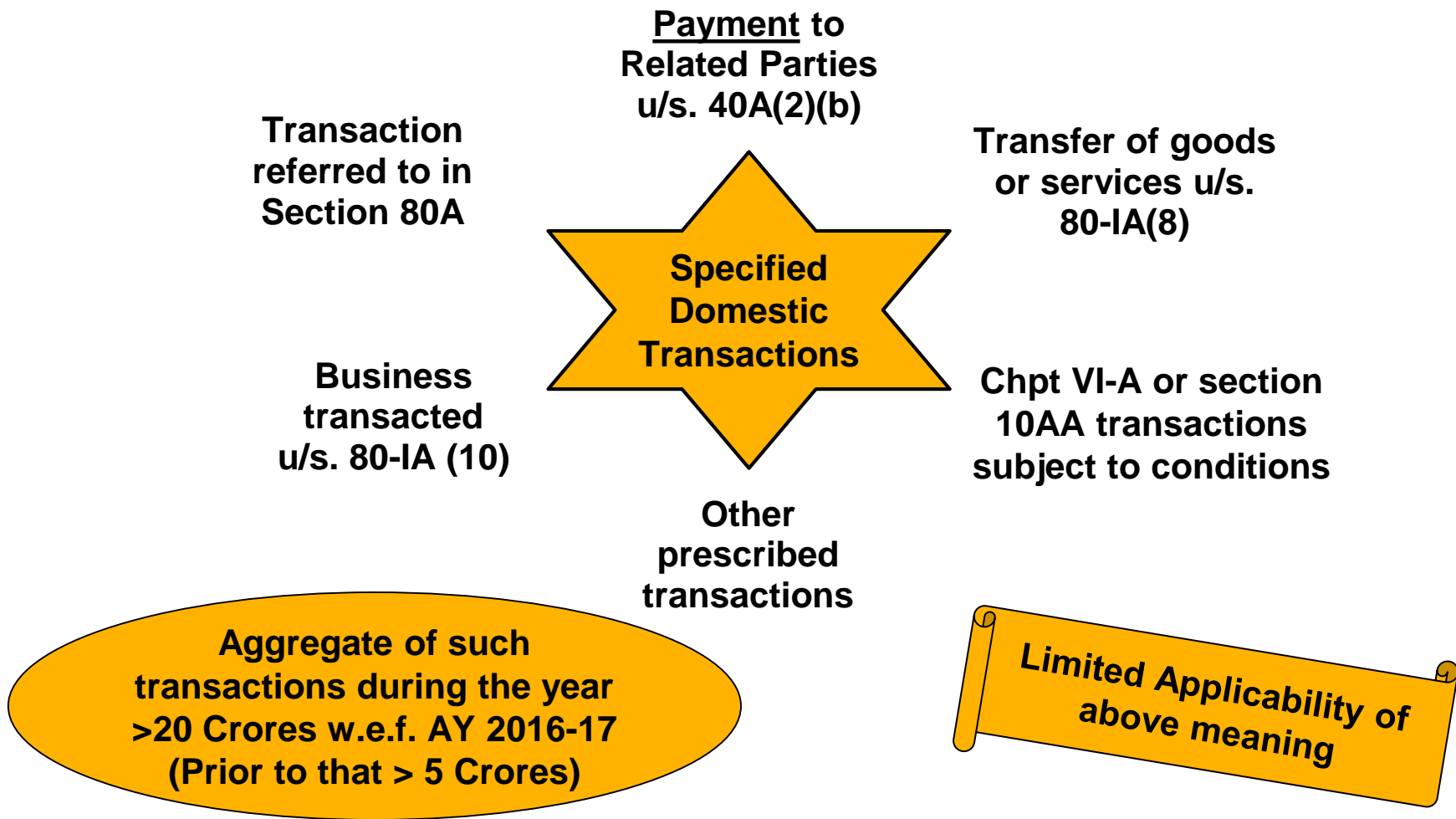


where the A Ltd or A INC or both of them are non-residents irrespective of whether the 3rd party is a non-resident or not.....

Tax Residency of the 3rd Party becomes immaterial

Section 92BA

Meaning of Specified Domestic Transactions



Section 92C

COMPUTATION OF ALP

MOST APPROPRIATE METHOD

6 METHODS EXPLAINED IN RULE 10B

- **Comparable Uncontrolled Price ('CUP') Method - Compares prices.**
- **Resale Price Method ('RPM') - Compares gross margins.**
- **Cost Plus Method ('CPM') - Compares profit mark-ups on costs.**
- **Profit Split Method ('PSM') - Profits from transactions are split amongst the entities based on the level of contribution.**
- **Transactional Net Margin Method ('TNMM') - Compares net margin in relation to an appropriate base, such as costs, sales or assets.**
- **Other Method (detailed definition in Rule 10AB)**

Application of Methods

Methods (Rule 10B)	Comparability requirements	Approach	Remarks
CUP	Very high	Prices are benchmarked	Difficult to apply as very high degree of comparability required
RPM	High	Gross Profit margins are benchmarked	Difficult to apply as high degree of comparability required and lack of adequate data
CPM	High	Gross Profit margins are benchmarked	Difficult to apply as high degree of comparability required and lack of adequate data
PSM	Medium	Net Operating Profit margins are benchmarked	Complex Method, sparingly used
TNMM	Medium	Net Operating Profit margins are benchmarked	Most commonly used method

Selection of ‘Most appropriate method’

Section 92C(2) r.w. Rule 10C

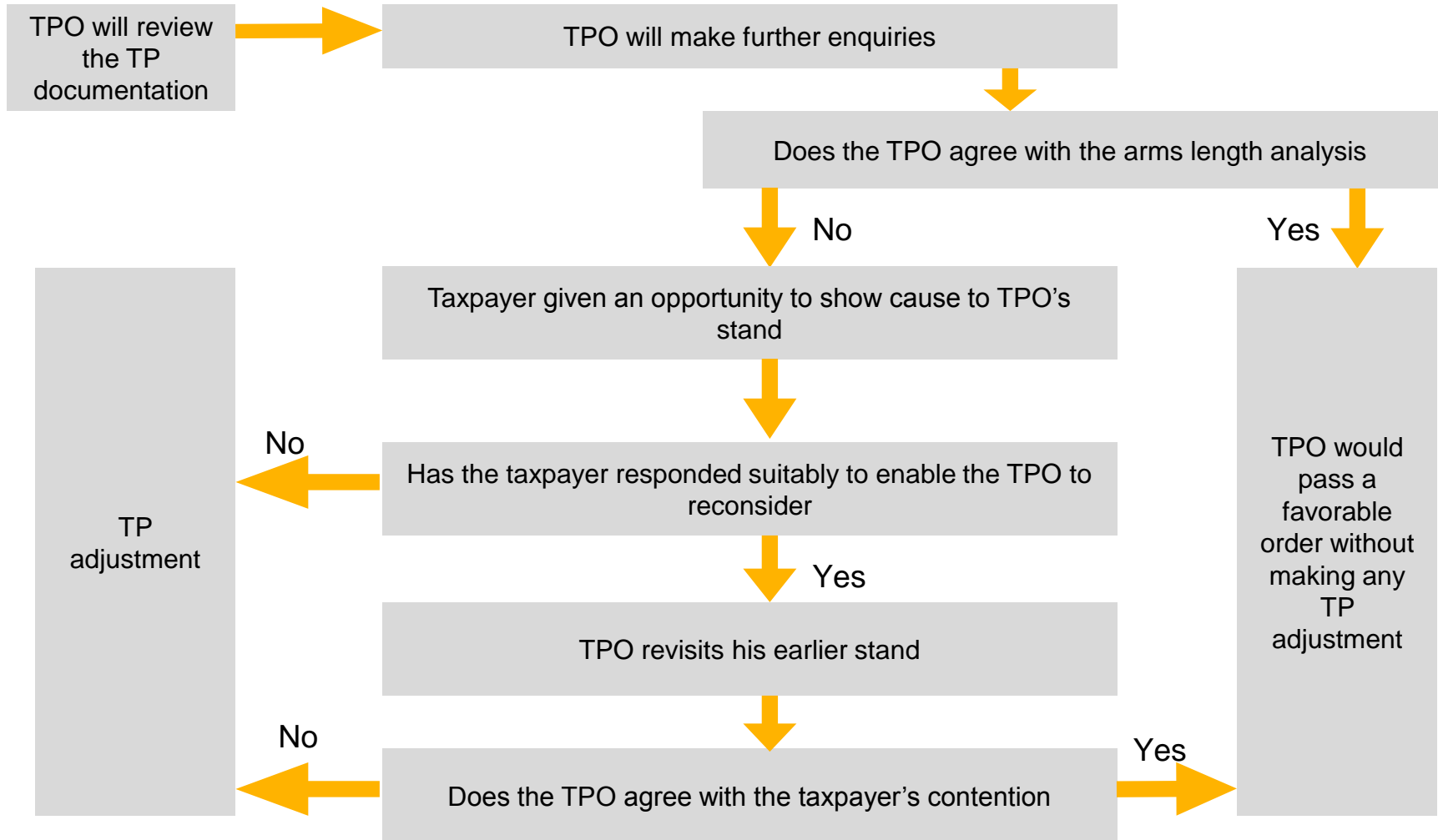
Rule 10C(1)

- Method best suited to the *facts and circumstances* of each particular IT or SDT &
- Provides the *most reliable measure* of an ALP in relation to the IT or SDT

Rule 10C(2)

- Factors to be considered for selection of the most appropriate method:
 - Nature and class of IT or SDT
 - Class of AE and functions performed
 - Availability, coverage and reliability of data
 - Degree of comparability between the IT or SDT and uncontrolled transaction
 - Extent to which reliable and accurate adjustments can be made
 - The nature, extent and reliability of assumptions for application of the method

TP assessment process – At operational level



Documentation requirements

Section 92D of the Act r.w. Rule 10D of the Rules prescribes a list of documents to be maintained

➤ *Rule 10D(1)*

Detailed documentation requirements have been laid down
(Discussed in detail in subsequent slides)

➤ *Rule 10D(2)*

If the aggregate value of ITs as recorded in the books of account does not exceed **one crore rupees**, then, Rule 10D(1) would not apply provided that the income arising from international transactions has been computed in accordance with section 92

➤ *Rule 10D(3)*

The information specified in sub-rule (1) should be supported by authentic documents

Documentation requirements (...contd.)

Section 92D of the Act r.w. Rule 10D of the Rules prescribes a list of documents to be maintained

➤ *Rule 10D(4)*

The information and documents should be contemporaneous and should exist latest by the specified date i.e. due date of filing the return of income

➤ *Rule 10D(5)*

The documentation should be maintained for a period of **eight years** from the end of the relevant assessment year

TP Report

Section 92E and Rule 10E

- Every person **who has entered into an IT or SDT** during the previous year shall obtain a report from an accountant and furnish such report by the specified date (November 30th of the subsequent financial year) in **Form no. 3CEB**
- **Typical particulars:**
 - The certificate requires furnishing of factual information relating to the IT / SDT entered into, the ALP determined by the taxpayer and the method applied in such determination. It also requires an opinion as to whether the prescribed documentation has been maintained.
 - Names/addresses of AEs
 - Nature of IT / SDT
 - Value of IT / SDT
 - As per books of account
 - ALP as computed by the taxpayer

Aspects of the TP Documentation – Rule 10D

- Corporate Background
- Functional, Assets and Risk ('FAR') Analysis
- Economic Analysis
 - Choice of Most Appropriate Method
 - Identification of tested party
 - Selection of the profit level indicator
 - *Search for comparables*
 - Internal comparables
 - External comparables
- Economic analysis
 - Identified comparable companies
 - Tested party
- Periodic review and appropriate adjustments for significant changes (if necessary)
- Conclusion

Other TP Provisions under the Act and Rules

Other Allied Sections of the Act

Section Number	Particulars
92CB	<u>Power of Board to make safe harbor rules</u>
	- Circumstances under which Transfer Price determined by the taxpayer shall be accepted by the Income Tax Authorities
	- Nature of presumptive taxation
	- Final Rules issued on September 18, 2013
	- Not popular amongst the taxpayers
92CC	<u>Advance pricing agreement</u>
	- Allows taxpayer to enter into an agreement for the pricing of the IT
	- Can be entered into for a period of 5 years
	- Rollback Rules recently issued
	..contd.)

Other Allied Sections of the Act

Section Number	Particulars
	- Rollback can be applied for a period of 4 years subject to conditions specified
92CD	Effect to advance pricing agreement
92F	<u>Definitions of certain terms relevant to computation of ALP</u>
	- Accountant
	- Arm's Length Price
	- Enterprise
	- PE
	- Specified Date
	- Transaction

Other Allied Sections of the Rules

Rule Number	Particulars
10A	<u>Meaning of expressions used in computation of arm's length price</u>
	- AE
	- Enterprise
	- Uncontrolled transaction
	- Property
	- Services
	- Transaction
10F to 10T	Advance Pricing Agreement Scheme (Including rollback provisions)
10TA to 10TG	Safe Harbour Rules

Questions?

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