Exploring Provisions

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Permanent Establishment - Insights

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PREFACE

One of the most important and widely debated concepts of Double Taxation Agreements is that of "Permanent Establishment". Time and again courts have given interpretations and clarifications on its multi aspects. This periodical deals with the changing nature of a controlled subsidiary company in India that turns into PE of its foreign principal and can be held liable to pay higher tax. The importance of Permanent Established was presented in our issue of May 2013; the same is also available on our website www.dailytaxreporter.com

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Purpose of this Document

This document aims to bring together the factors that change subsidiary into PE

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I. What is permanent Establishment

A **permanent establishment** (PE) is a fixed place of business which generally gives rise to income or value added tax liability in a particular jurisdiction. The term is defined in many income tax treaties and most European Union Value Added Tax systems. The tax systems in some civil law countries impose income and value added taxes only where an enterprise maintains a PE in the country. Definitions of PE under tax law or tax treaty may contain specific inclusions or exclusions

Fixed place of business

The starting point for determination if a permanent establishment exists is generally a fixed place of business. The definition of permanent establishment in the OECD Model Income Tax Treaty is followed in most income tax treaties.

The commentary indicates that a fixed place of business has three components:

- **Fixed** refers to a link between the place of business and a specific geographic point, as well as a degree of permanence with respect to the taxpayer. An "office hotel" may constitute a fixed place for a business for an enterprise that regularly uses different offices within the space. By contrast, where there is no commercial coherence, the fact that activities may be conducted within a limited geographic area should not result in that area being considered a fixed place of business.

- A **place** of business. This refers to some facilities used by an enterprise for carrying out its business. The premises must be at the disposal of the enterprise. The mere presence of the enterprise at that place does not necessarily mean that it is a place of business of the enterprise. The facilities need not be the exclusive location, and they need not be used exclusively by that enterprise or for that business. However, the facilities must be those of the taxpayer, not another unrelated person. Thus, regular use of a customer's premises does not generally constitute a place of business.

- **Business** of the enterprise must be carried on wholly or partly at the fixed place.

The requirements of what constitutes a 'permanent establishment'
within the scope of a particular treaty depend on what interpretation a particular country places on that term, in context of the text of that treaty. As per Article 3 of the Vienna Convention, no one is entitled to claim rights under a particular treaty unless otherwise authorized by the contracting state. Therefore if a particular contracting state places a different meaning on the term 'permanent establishment' than what the taxpayer seeks to place, the taxpayer would be left with virtually no remedy within that state, other than to seek a mutual agreement to that dispute with the other contracting state to that treaty.

Specifically included Places

The following are generally considered, *prima facie*, as constituting permanent establishments:

- A branch
- A warehouse (but see excluded places below)
- A factory
- A mine or place of extraction of natural resources
- A place of management

Specifically excluded Places

Many treaties explicitly exclude from the definition of PE places where certain activities are conducted. Generally, these exclusions do not apply if non-excluded activities are conducted at the fixed place of business. Among the excluded activities are:

- Ancillary or preparatory activities
- The use of a storage facility solely for delivery of goods to customers
- The maintenance of a stock of goods owned by the enterprise solely for purposes of processing by another enterprise (sometimes referred to as toll processing)
- Purchasing or information gathering activities

Other specific provisions

Many treaties provide specific rules with respect to construction sites. Under those treaties, a building site or construction or installation project constitutes a PE only if it lasts more than a specified length of time. The amount of time varies by treaty.

In addition, the activities of a dependent agent may give rise to a PE for the principal. Dependent agents may include employees or others under the control of the principal. A company is generally not considered an agent solely by reason of ownership of the agent company by the principal. However, activities of an independent agent generally are not attributed to the principal.

Some treaties deem a PE to exist for an enterprise of one country performing services in the other country for more than a specified length of time or for a related enterprise.

II. When does a controlled subsidiary company in India turn PE of its foreign principal and can be held liable to pay higher tax?

1. Domain of Permanent Establishment

The Supreme Court in DIT (International Taxation) v. Morgan Stanley and Co. Inc., [2007] 292 ITR 416 explained the significance of this principle in the following words (page 442):

"The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under article 7(2), not all profits of MSCO would be taxable in India but only those which have economic nexus with permanent establishment in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the permanent establishment in India. The quantum of taxable income is to be determined in accordance with the provisions of Income-tax Act. All provisions of Income-tax Act are applicable, including provisions relating to depreciation, investment losses, deductible expenses, carry-forward and set-off losses, etc. However, deviations are made by the DTAA in cases of royalty, interest etc. Such deviations are also made under the Income-tax Act (for example: sections 44BB, 44BBA, etc.). Under the impugned ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the permanent establishment (MSAS). In other words, the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken; there is no further need to attribute profits to a permanent establishment. The impugned ruling is correct in principle in so far as an associated enterprise, that also constitutes a permanent establishment, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the permanent establishment. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the permanent establishment for those functions/ risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporate on the basis of the concept of Economic Nexus is an important feature of attributable profits (profits attributable to the permanent establishment)." (emphasis supplied)

2. Subsidiary as a permanent establishment

Extracts from Bulletin for International Taxation, February 2011 titled 'The Subsidiary as a Permanent Establishment'

"A permanent establishment is, however, not always easy to identify. This is particularly true where a permanent establishment is hidden behind a dependent operating company, i.e., if an operating company in addition to its own business also carries on another company's business as a permanent establishment of the latter. In this regard, the 2010 OECD Model Tax Convention (the 'OECD Model') states in article 5(7) that:

'the fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other state (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other (emphasis added)

This follows from the principle that, for the purpose of taxation, such a subsidiary constitutes an independent legal entity. Accordingly; both companies are subject to unlimited tax liability in the state in which they are resident or where their place of management is located.

However, by using the wording 'not of itself', the provision clarifies
that a parent company (parent) can have an (agent) permanent establishment in its subsidiary's state of residence if the general requirements for a permanent establishment set out in article 5(1) to (5) of the OECD Model are met. Accordingly, any space or premises belonging to the subsidiary that is at the disposal of the parent (the 'right-to-use test') and that constitutes a fixed place of business (the 'location test' and the 'duration test') through which the parent carries on its own business (the 'business activity test'), gives rise to a permanent establishment of the parent under article 5(1), subject to article 5(3) and (4), of the OECD Model. In addition, under article 5(5) of the OECD Model, a subsidiary constitutes an agency permanent establishment of its parent if the subsidiary has the authority to conclude contracts in the name of its parent and habitually exercises this authority, unless these activities are limited to those referred to in article 5(4) or unless the subsidiary does not act in the ordinary course of its business as an independent agent within the meaning of article 5(6) . . ."

i) Right-to-use-test or disposal test

Reading through the commentary on paragraph 5 of UN Model the Delhi High Court in Director of Income-tax v. e-Funds IT Solution (2014) 364ITR256 held that to hold a place of business a permanent establishment, the enterprise using it must carry on its business wholly or partly "through" it, though the activity need not be productive in character and need not be permanent in the sense that there is no disruption, but the operations must be carried out on regular basis. Branch offices and factory mentioned in paragraph 2 are examples of fixed place of business. In paragraph 4.6 of the OECD Commentary, the words "through which" have been interpreted to have a wide meaning but postulate that the particular location should be at the disposal of the enterprise for that purpose and only then the business is carried through the location where the activity takes place. The word "through" has been interpreted and read in a manner that the foreign enterprise should have the right to use the location in the second State. The said right may or may not be formalized through legal documentation, but right to use should be established and shown. Then and then alone fixed place permanent establishment shall exist. Fixed location test may be in form of a legal right or can be inferred from the facts when the foreign establishment and its employees are allowed right to use the place of business belonging to a subsidiary, a third party. At the same time the Court also observed that overwhelming international commentaries, write ups and decisions support the position that for applying the location test, requirements of paragraph (1) of article 5 must be independently satisfied.

ii) The LG Case Scenario

In L.G. Electronics Inc. V. Asstt. DIT (2014) 368ITR401 the foreign holding company is called to pay tax in India on 25% of the total value of international transactions consisting of supply of raw materials, finished goods, commission and reimbursements for the following survey finds (19 in number) in the case of Indian subsidiary that revealed the assessee holding company having PE in India:

(i) The Indian company, LGIL, is a 100% subsidiary company of the petitioner and it does not function as an independent corporate entity and is totally dependent on the petitioner.

(ii) All the senior employees i.e. heads of all departments are Koreans. The hiring of these Korean expatriates is done by the petitioner.

(iii) While working in India, the expatriates have a lien over their employment over the petitioner company and work on deputation in India clearly establishing a continuous connection between the subsidiary company and the petitioner, which is nothing but a business connection.

(iv) The employees do not report only to the Indian management but also send reports to their principals in Korea.

(v) The Korean expatriates visit Korea and other countries very frequently for business purposes and implement decisions taken thereof.

(vi) The regional headquarters in Singapore monitors each and every function of the Indian company. It provides business consultancy and financial consultancy to the Indian company.

(vii) The regional director visits India regularly and monitors the progress of the Indian company. It also looks after the interest of the petitioner and other affiliates in the region including India.

(viii) The order of raw material and finished products is placed from India on a global portal provided by the petitioner which is accessed by the India company. This proves that there is a continuity of business and the office of LGIL is nothing but an extension of the petitioner company.

(ix) The petitioner company has a menu card of products manufactured and launched by it. The Indian company can only import and launch those products as an independent business enterprise and cannot import or sell brands of any other company.

(x) The Indian company does not own the brand. The brand promoted in India is LG brand which is owned by the petitioner. In India also the brand is registered by the petitioner.

(xi) The Indian company cannot hire expatriates from anywhere else other than Korea. Every requirement of heads of various divisions is processed by the petitioner.

(xii) Before the launch of a particular product, the employees of the petitioner company visit India and understand the market and do a comprehensive market survey which is a core business activity and not ancillary or auxiliary business activity.

(xiii) Once the decision is taken to launch a particular product in India is decided by the petitioner company, they provide the technology and details of parts to be used which are mainly supplied by the petitioner and its other affiliates.

(xiv) The petitioner through its employees in India takes a decision as to what part can be localized or procured locally.

(xv) Once the imported parts are decided by the petitioner, the quantity is decided by LGIL and order is placed through the portal without any price negotiation as price is strictly decided by the petitioner.

(xvi) The contract for sale is concluded in India once the orders are placed. No agreements are signed and no negotiation takes place. However, employees of the petitioner visit India to finalise the deal and in order to estimate the total sale to be made by them during a particular period.

(xvii) As per the petitioner the sale is on C & F basis and therefore, the sale is concluded in India.

(xviii) The MD of LGIL reports to the HQ at Singapore and Korea and is responsible to the petitioner.

(xix) For the imports made by the Indian company, it has not done any analysis of comparative pricing or the price at which it can get the product from any other company.

Further taking note of such findings the AO drew following ten conclusions, namely:

(i) There is a continuity of business between the Indian company and the non-resident.

(ii) The transaction of import is not an isolated transaction but a close business connection on a regular basis.

(iii) The non-resident is doing business in India through its employees who are heading various divisions in the Indian company and also through employees visiting India regularly.

(iv) There is a close business connection in terms of the dependence of the Indian company on the nonresidents for all imports as it does not have the authority or choice to make imports from any other concerns other than LG affiliates.

(v) The whole transaction is so intermixed that supply of equipment cannot be segregated from the supply of technology and marketing of product. Each transaction is dependent on the other and has a close nexus with India.

(vi) The products supplied including raw material and finished products are customized for India e.g. the sound system in television is customized for India as per the local needs. The Indian company is nothing but an extension of the Korean company. If we analyse the functioning of LG India it works as a branch of LG Korea.

(vii) LG India and LG Korea work as partners in business.

(viii) The transaction between both the parties are so inter linked that the Indian company cannot move an inch without the support and supplies of the nonresident.

(ix) The function of the Indian company is marketing for the non-resident companies to build their brand and also manufacturing which is primarily assembly of products already launched by the non-residents.

(x) The business arrangement between the two company is something like a partnership where roles are defined and divided but the ultimate decision is taken by the non-residents.

On the aforesaid basis, the Assessing Officer in LG case concluded that the assessee had business connection in India and was liable to be taxed under Section 9(1)(i) of the Act and income is taxable in India under Article 7 of the DTAA as the petitioner has a permanent establishment in India. The AO invoked provisions of section 147 and reopened the case of the assessee and called for a return of income from the holding company. The foreign company filed NIL return and further objected to reassessment on the ground that the transactions that it had with its subsidiary in India are already tested for their arm's length by the TPO having taken into consideration FAR analysis carried by the Indian subsidiary post which no further taxes could be determined as payable by it. The AO however rejected such study as well as the objections filed by the foreign company and held as under:

“The survey clearly indicated that the petitioner had a permanent establishment in India and, consequently, the profits were required to be attributed to the permanent establishment in India in terms of the functions performed, risks assumed and assets deployed by the permanent establishment.”

The foreign company then filed a writ petition before the Allahabad High Court. The High Court referred to both section 9 of the Income tax Act and Article 7 of the DTAA and commented the two as identical. Further sub-article (1) of article 7 of Indo Korea DTAA states that 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. The High Court from their reading of clause (1) held that the establishment of a permanent establishment presupposes that business operations are being carried out for profit. In other words if the AO is able to establish presence of PE in India as per Article 5 then there would perhaps be a statutory requirement upon the foreign entity to submit a return of income. And for this reason the High Court declined to admit the contention of the company of precluding AO to take reopening action after conclusion of TP proceedings. The Court held the following after drawing

reference to Supreme Court decision in ***DIT (International Taxation) Vs. Morgan Stanley and Co. Inc., 292 ITR 416***Morgan:

‘The contention that as per the provisions of Chapter X of the Act, the Indian subsidiary, in terms of the provisions of Section 92E of the Act had disclosed all the transactions with the petitioner relating to purchase of raw materials, finished goods, commission and reimbursements and further, in terms of Section 92CA of the Act, the TPO of the Indian subsidiary had already examined the said transaction and by its order dated 20th December, 2006 found the same to be meeting the arm's length principle, consequently, the Assessing Officer was precluded from drawing any inference that any further income of the petitioner from the same transactions was chargeable to tax had escaped assessment is erroneous and cannot be accepted.’

As in this case the survey had been conducted after conclusion of order of TPO the High Court held that the survey findings and documents impounded did reveal the existence of permanent establishment of the foreign company and its business operations in India without disclosing its taxable income for which reason the reopening cannot be adjudged as invalid under the law. Now to know whether TPO's acceptance of arm's length price would undermine any further action in this regard to separately determine profits/income of the foreign company viz a viz any permanent establishment that it has is something that the Allahabad High Court held it as independent and necessitating in certain situations as in the case of LG.

iii) Guidance for AO

The Allahabad High Court order further carried the following guidance for the Assessing Officer:

'Once the Assessing Officer is satisfied that a permanent establishment of the petitioner exists in India and business is being conducted from this permanent establishment, the attribution of profits is a necessary consequence. The order of TPO will not come in the way for the reason that the TPO's order is in relation to the transactions between a subsidiary company and the petitioner. The situation becomes different when the subsidiary company also works as a permanent establishment of the petitioner. Once a permanent establishment is established, the petitioner becomes liable to be taxed in India on so much of its business profits as is attributable to the permanent establishment in India. The order of the TPO is in relation with the subsidiary company and not in relation with the permanent establishment of the petitioner. The transfer pricing analysis is to be undertaken between the petitioner and its permanent establishment which has not taken place as yet. Once a transfer pricing analysis is done, the computation of income arising from international transaction has to be done keeping in mind the principle of arm's length price. Once this is done, there is no further need to attribute profits to a permanent establishment. However, where the transfer pricing analysis does not take into account all the risk taking functions of the enterprise and it does not adequately reflect the function performed and the risk assumed by the petitioner, the situation would be different and, in such a situation, there would be a need to attribute profits to the permanent establishment for those functions/risk that have not been considered. This is precisely what was considered in ***Morgan Stanley's case (supra)*** wherein the Supreme Court held:

"As regards attribution of further profits to the PE of MSCo where the transaction between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an

associated enterprise (that also constitutes a P.E.) is reimbursed on arm's length basis taking into account all the risk taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the P.E. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be need to attribute profits to the P.E. for those functions/risks that have not been considered. The entire exercise ultimately is to ascertain whether the service charges payable or paid to the service provided (MSAS in this case) fully represent the value of the profit attributable to his service."

iv) Hiring Policy and Agency PE

Ordinarily hiring of labour by the subsidiary from the associated enterprise does not constitute it a permanent establishment of the parent company vide Director of Income-tax v. e-Funds IT Solution (2014) 364ITR256. In the LG case however it was found that much of the hiring of senior heads is done by the holding company. This fact establishes the dependence of the subsidiary upon its holding company for day-to-day management of affairs of the business in India. On the subject of agency permanent establishment the Delhi High Court in E-Funds case further held as under:

'Agency permanent establishment under article 5(4) and (5) of DTAA Paragraphs (4) and (5) of article 5 relate to creation of agency permanent establishment in the second contracting country. Agency replaces fixed place with personal connection. Arvid K. Skaar in his work Permanent Establishment has opined that primacy of "location test" of the basic rule is consistent with the conceptual structure of the permanent establishment clause itself. An agency will constitute a permanent establishment only when a permanent establishment cannot be found according to those conditions in the basic rule which are altered or replaced by the agency clause. OECD and UN Model Treaties recognize agency permanent establishment. The principle being, that a foreign enterprise may choose to perform business activities itself or through a third person in the other States. An agent is a representative who acts on behalf of another with third persons. International taxation laws recognize and accept two distinct types of agency permanent establishment, dependent and independent. Every agent by very nature of principle of agency is to follow the principal's instructions. But this principle is not squarely applicable to the DTAAs, as third parties may not be strictly an agent under the domestic law. Further, the aforesaid dependency cannot be the distinguishing factor which determines whether the agency is dependent or an independent agency for the purpose of article 5 paragraphs (4) and (5) respectively. A dependent agency is one which is bound to follow instructions and is personally dependent on the enterprise he represents. Such dependency must not be isolated or once in a while transaction but should be of comprehensive nature.'

In the LG case the employment of expats was not an isolated instance but a recurring instance and they had a lien over their employment over the holding company and further they were to report to their principal in Korea apart from the Indian management thereby meeting the test of dependent agency.

v) Stewardship activities and PE

The Delhi High Court in DIT v. E-Funds IT Solution(2014) 364ITR256 held that every subsidiary which engages an employee on the non-resident, would always become a service permanent establishment of the controlling foreign company is a misconceived notion. In this case the employees of the non-resident holding company were hired to provide stewardship services only. Drawing their reference to Supreme Court ruling in DIT (International Taxation) v. Morgan Stanley and Co. Inc. (2007) 292ITR416 the High Court held that the stewardship activity would not fall under article 5(2)(l) of DTAA.

Extracts of SC ruling in Morgan Stanley - pg 427-428

'Article 5(2)(l) of the DTAA applies in cases where the MNE furnishes services within India and those services are furnished through its employees. In the present case, we are concerned with two activities namely stewardship activities and the work to be performed by deputationists in India as employees of MSAS. A customer like an MSCo who has worldwide operations is entitled to insist on quality control and confidentiality from the service provider. For example in the case of software permanent establishment a server stores the data which may require confidentiality. A service provider may also be required to act according to the quality control specifications imposed by its customer. It may be required to maintain confidentiality. Stewardship activities involve briefing of the MSAS staff to ensure that the output meets the requirements of the MSCo. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of the MSCo. These stewards are not involved in day to day management or in any specific services to be undertaken by MSAS. The stewardship activity is basically to protect the interest of the customer. In the present case as held

hereinabove the MSAS is a service permanent establishment. It is
in a sense a service provider. A customer is entitled to protect its interest both in terms of confidentiality and in terms of quality control. In such a case it cannot be said that MSCo has been rendering the services to MSAS. In our view MSCo is merely protecting its own interests in the competitive world by ensuring, the quality and confidentiality of MSAS services.

We do not agree with the ruling of the Authority for Advance Rulings that the stewardship activity would fall under article 5(2)(l).'

vi) Management Reporting and agency PE

The periodic reporting of the results of operations of the subsidiary to the management of the holding company highlight continuous business monitoring in which case the subsidiary would provide the face of dependent agency where it is bound to follow instructions of its holding entity.

vii) Engagement of Expats on deputation and Service PE

When the expats are hired directly by the holding company and deputed to subsidiary for a specified period they would sense service PE in India if they report to the parent company or associated enterprise. In LG case it was found that the expats reported to the parent company management too.

Extracts of SC ruling in Morgan Stanley- pg 428

'As regards the question of deputation, we are of the view that an employee of MSCo when deputed to MSAS does not become an employee of MSAS. A deputationist has a lien on his employment with MSCo. As long as the lien remains with MSCo the said company retains control over the deputationist's terms and employment. The concept of a service P.E. finds place in the U.N. Convention. It is constituted if the multinational enterprise renders services through its employees in India provided the services are rendered for a specified period. In this case, it extends to two years on the request of MSAS. It is important to note that where the activities of the multinational enterprise entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service P.E. can emerge. Applying the above tests to the facts of this case we find that on request/requisition from MSAS the applicant deputes its staff. The request comes from MSAS depending upon its requirement. Generally, occasions do arise when MSAS needs the expertise of the staff of MSCo. In such circumstances, generally, MSAS makes a request to MSCo. A deputationist under such circumstances is expected to be experienced in banking and finance. On completion of his tenure he is repatriated to his parent job. He retains his lien when he comes to India. He lends his experience to MSAS in India as an employee of MSCo as he retains his lien and in that sense there is a service P.E. (MSAS) under article 5(2)(l). We find no infirmity in the ruling of the ARR on this aspect. In the above situation, MSCo is rendering services through its employees to MSAS. Therefore, the Department is right in its contention that under the above situation there exists a service P.E. in India (MSAS).'

Secondment to subsidiary and service PE

in Centrica India Offshore Pvt. Ltd. v. Commissioner of Income-tax (2014) 364ITR336 the overseas group entities of Centrica PLC are stated to be in the business of supplying gas and electricity to consumers across the U. K and Canada. The overseas entities outsource their back office support functions-for instance, debt collections/consumers' billings/monthly jobs to third party vendors in India, etc. To ensure that the Indian vendors comply with quality guidelines, the assessee company (subsidiary company) was established in India. It was to act as service provider to these overseas entities. Thus the assessee company entered into service agreement with overseas entities to provide locally based interface between those overseas entities and Indian vendors. The scope and range of services so provided in terms of those agreements/ understanding are : (i) management assistance for outsourced supplies in India and facilitating efficient interface back to U. S. business of Centrica Plc ; (b) ensure that outsourced suppliers adhered to best practices and share them on e-2-e on optimal basis ; (c) expert advice on widening scope of potential services in India to target work force through greater control and such other services as may be requested by Centrica Plc from time to time. The assessee therefore entered into agreements for secondment of employees from the overseas entities for a fixed tenure. The employees so seconded continued to remain on the payroll of the overseas entities which paid and disbursed their salaries. The assessee thereafter reimbursed such salary costs to the overseas employers.

In this entire arrangement therefore more than anything else the presence of seconded employees in India is felt to serve the interest of the overseas entities. In other words their performance in India was only to yield to the interest of the parent company. The seconded employees held full responsibility upon them for final output of service. They were to oversee subsidiary's operations as per the requirements of overseas entities and to be overall responsible to the parent for subsidiary's activities and functions. Under this situation the seconded employee acted more under the direct control and supervision of the parent company so that what is actually remunerated by the assessee to the parent company is not salaries but consideration for provision of services of seconded personnel. And because they acted for parent company their presence constituted service permanent establishment in India.

3. Business Connection and PE- Advance Ruling P. No. 8 of 1995, In Re (2007) 223ITR416

The LG case somehow affirms the AAR 1996 ruling in which it is held that when a subsidiary performs services for its foreign parent, it constitutes a "service PE". The ruling further states that for ascertaining the position in this regard, <u>the exact working of the subsidiary, the correspondence between the subsidiary and the principal and the mode of their functioning and operations would have to be examined in toto</u>. As in LG case only survey could only reveal the exact working of the subsidiary and then it was found that the foreign parent was carrying on business operation in India through a permanent establishment.

In this case the applicant was a company incorporated in Switzerland, a trader in goods and commodities on an international basis and intending to trade with India. It proposed to set up a subsidiary company in India to provide consultancy services from India to the applicant-company for use outside India. The facts in this case further envisaged proposed agreements for: (a) secretarial and clerical assistance to complete documentation of tenders, contracts and subsequent documentation required to enable the Indian customers who had purchased commodities from the Swiss company overseas, to obtain delivery of the said commodity on its arrival in India; (b) assistance in responding to global tenders floated by Indian organisations, which entailed providing information and submitting tenders within the parameters laid down by the applicant; and (c) follow-up of tenders and signing of contracts. The foreign parent would retain the Indian subsidiary as consultant on a non-exclusive basis for a year, to be automatically renewed, and the Indian subsidiary was at all times to act on instructions from the applicant and would not have any authority to accept orders on behalf of or bind the foreign company.

The AAR in this case held that the expression "business connection" means something more than a business. It presupposes an element of continuity between the business of the non-resident and the activity in the taxable territory. A stray or isolated transaction would normally not be regarded as a business connection. Business connection may take several forms; it may include carrying on part of the main business or activity incidental to the non-resident through an agent or it might merely be a relation between the business of the non-resident and the activity in the taxable territory which facilitates or assists the carrying on of that business. A relation to be a "business connection" must be real and intimate and through or from which income must accrue or arise, whether directly or indirectly to the non-resident. Such a business connection could be spelt out on the terms of the agreements in question. Though the term of the agreements in question was initially for one year and liable to termination at short notice, it was envisaged also that, unless so terminated, it should continue indefinitely, automatically renewed at the end of each year. Though the subsidiary was not to render services exclusively to the applicant, it was bound to render all services for the applicant as stipulated in the agreement. There was a term of "confidentiality" included in the agreements, which also placed considerable restrictions on the capability of the subsidiary in rendering like service to other parties. The scope of work in the proposed agreements included not only clerical and secretarial assistance but supply of information in respect of global tenders, by the subsidiary to the applicant and vice versa; signing and submitting of tenders on behalf of the applicant, although stated to be within the parameters fixed by the applicant; negotiating the terms of the tender with the tendering authority, again within the parameters laid down by the applicant; and follow-up of the tenders and finally signing the agreements. The business activity or the business relationship between the applicant and the subsidiary would not be based on any stray transaction but would be a continuous process in respect of the series of purchase and sale transactions undertaken by the applicant in India and in all such transactions the subsidiary would do the work as stated in the four agreements. <u>Such an intimate and continuous relationship would constitute a "business connection" for purposes of section 9(1)(i).</u> The subsidiary would have to undertake such substantial and important commercial activities systematically and continuously for the applicant as to justify an inference that the applicant would be deriving income through or from a "business connection" in India.

(ii) That in terms of the definition of "permanent establishment" in
article 5.2(l) of the Agreement for the Avoidance of Double Taxation between India and the Swiss Confederation and in the background of the stated facts and the proposed four service agreements between the applicant and the subsidiary company, there would be a permanent establishment of the applicant in India.

(iii) That for ascertaining whether articles 5.4 and 5.6 of the Agreement of the Avoidance of Double Taxation between India and the Swiss Confederation applied, the exact working of the subsidiary, the correspondence between the subsidiary and the principal and the mode of their functioning and operations would have to be examined in toto. The quantum of work done, the services rendered, the contracts undertaken for outsiders, i.e., other than the principal and companies controlled by the principal would have to be examined to determine whether the subsidiary was an agent having independent status or not in terms of the paragraph. At this stage, however, since the total activities which would be carried on by the subsidiary company in India could not be ascertained, it might be difficult to come to a conclusion as to the extent of activities of the subsidiary company which would be in the nature of services rendered to the applicant or its other controlled companies. For these reasons, the subsidiary would have to be considered to be a permanent establishment of the applicant unless it had significant independent activities on its own or on behalf of persons other than the applicant and unconnected with it.

Food for thought

The survey findings in L G Case of 2014 and facts finding in AAR ruling No. 8 of 1996 both mark importance to intimate and continuous flow of transactions in every year since inception between the subsidiary and holding company as they establish a business connection between the two. Also parent company in either of the case contributed far greater role in the running of the day-to-day operations of the main business of the subsidiary through employment of expats and that the expats and other personnel deputed therefore not just rendered stewardship functions but participated in the running of business of the subsidiary and consistently reported to the parent company. Likewise the subsidiary which when rendered services to the parent company on regular basis did not limit itself to routine clerical and secretarial functions but also ventured into supply of information in respect of global tenders; signing and submitting of tenders on behalf of the applicant within the parameters fixed by the applicant; negotiating the terms of the tender with the tendering authority, again within the parameters laid down by the applicant; and follow-up of the tenders and finally signing the agreements all of which are undertaken not based on any stray transaction but as a continuous process in respect of the series of purchase and sale transactions undertaken by the applicant in India all of which point to the presence of PE in India.

III. Bibliography

1. http://en.wikipedia.org/wiki/Permanent_establishment
2. UN Tax Convention
3. Circulars and notifications on International Taxation
4. OECD Model Tax Convention
5. 2010 OECD REPORT
6. Commentary

Annexure 1

Text of Article 7 of the OECD Model Tax Convention

ARTICLE 7

BUSINESS PROFITS

1. 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 that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
3. 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 to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
4. 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.

Annexure 2

Relevant portions from the text of the Commentary on Article 7, as published in the 2010 OECD Model Tax Convention:

COMMENTARY ON ARTICLE 7
CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that 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 has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State.

2. Article 5, which includes the definition of the concept of permanent establishment, is therefore relevant to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. That Article, however, does not itself allocate taxing rights: when an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, it is necessary to determine what, if any, are the profits that the other State may tax. Article 7 provides the answer to that question by determining that the other State may tax the profits that are attributable to the permanent establishment.

3. The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm‘s length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.

9. The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it. The Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

II. Commentary on the provisions of the Article (Paragraph 1-4)

Paragraph 1

10. Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (*e.g.* those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (*e.g.* income derived by an enterprise in respect of personal activities of an entertainer or sportsman).

11. The first principle underlying paragraph 1, *i.e.* that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.

12. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent

establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general ―force of attraction‖ according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

13. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase ―profits that are attributable to the permanent establishment‖ found in paragraph 1. <u>Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State,</u>

subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

14. The purpose of paragraph 1 is to limit 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. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

Paragraph 2

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm‘s length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has

never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

18. Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23 A or 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

19. As indicated in paragraphs 8 and 9 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2010. The Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose of the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.

20. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the 1995 Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

21. Under the first step, a functional and factual analysis is undertaken which will lead to:

– the attribution to the permanent establishment, as appropriate, of
the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
– the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
– the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
– the identification of other functions of the permanent establishment;
– the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and
– the attribution of capital based on the assets and risks attributed to the permanent establishment.

22. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the 1995 Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:
– the determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and
– the application by analogy of one of the Guidelines' methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

23. Each of these operations is discussed in greater detail in the Report, in particular as regards the attribution of profits to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (see Part II of the Report, which deals with permanent establishments of banks; Part III, which deals with permanent establishments of enterprises carrying on global trading, and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

24. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (*e.g.* the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to the permanent establishment to reflect what a separate and independent enterprise would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between State R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty.

25. Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist.

26. It is generally not intended that more burdensome documentation requirements be imposed in connection with such dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation referred to in the Report —*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*‖, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances. Nevertheless, considering the uniqueness of the nature of a dealing, countries would wish to require taxpayers to demonstrate clearly that it would be

appropriate to recognise the dealing. Thus, for example, an
accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer's documentation does not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions.

27. The opening words of paragraph 2 and the phrase ―in each Contracting State‖ indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.

28. The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income

notwithstanding paragraph 1 of Article 7. Assume, for example, that
the circumstances of a particular case justify considering that the economic ownership of a building used by the permanent establishment should be attributed to the head office (see paragraph 75 of Part I of the Report). In such a case, paragraph 2 could require the deduction of a notional rent in determining the profits of the permanent establishment. That fiction, however, could not be interpreted as creating income from immovable property for the purposes of Article 6. Indeed, the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise; it merely applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7, 23 A and 23 B. Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise. Clearly, however, if interest paid by an enterprise to a different person is paid on indebtedness incurred in connection with a permanent establishment of the enterprise and is borne by that permanent establishment, this real interest payment may, under paragraph 2 of Article 11, be taxed by the State in which the permanent establishment is located. Also, where a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States from taxing profits or gains from such a dealing as long as such taxation is in accordance with Article 7 (see paragraphs 4, 8 and 10 of the Commentary on Article 13).

29. Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent

provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (*e.g.* a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.

30. Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 33 and 34 below).

31. Thus, for example, whilst domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2 or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2, rules that prevent the deduction of certain categories of expenses (*e.g.* entertainment expenses) or that provide when a particular expense should be deducted are not affected by paragraph 2. In making that distinction, however, some difficult questions may arise as in the case of domestic law restrictions based on when an expense or element of income is actually paid. Since, for instance, an internal dealing will not involve an actual transfer or payment between two different persons, the application of such domestic law restrictions should generally take into account the nature of the dealing and, therefore, treat the relevant transfer or payment as if it had been made between two different persons.

32. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of

certain expenses will normally result in a different amount of
taxable income in each State even though, for the purposes of the Convention, the amount of profits attributable to the permanent establishment will have been computed on the basis of paragraph 2 in both States (see also paragraphs 39-43 of the Commentary on Articles 23 A and 23 B). Thus, even though paragraph 2 applies equally to the Contracting State in which the permanent establishment is situated (for the purposes of paragraph 1) and to the other Contracting State (for the purposes of Articles 23 A or 23 B), it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given taxable period, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B. Also, to the extent that the difference results from domestic law variations concerning the types of expenses that are deductible, as opposed to timing differences in the recognition of these expenses, the difference will be permanent.

33. In taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether they are incurred for the purposes of a permanent establishment situated in a Contracting State or for the purposes of an enterprise of that State. As stated in paragraph 40 of the Commentary on Article 24:

Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

34. The requirement imposed by paragraph 3 of Article 24 is the same regardless of how expenses incurred by an enterprise for the benefit of a permanent establishment are taken into account for the purposes of paragraph 2 of Article 7. In some cases, it will not be appropriate to consider that a dealing has taken place between different parts of the enterprise. In such cases, expenses incurred by an enterprise for the purposes of the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment (*e.g.* the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment of a foreign enterprise). In other cases, expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment and an appropriate charge will be deducted in determining the profits attributable

to the permanent establishment (*e.g.* overhead expenses related to administrative functions performed by the head office for the benefit of the permanent establishment). In both cases, paragraph 3 of Article 24 will require that, as regards the permanent establishment, the expenses be deductible under the same conditions as those applicable to an enterprise of that State. Thus, any expense incurred by the enterprise directly or indirectly for the benefit of the permanent establishment must not, for tax purposes, be treated less favourably than a similar expense incurred by an enterprise of that State. That rule will apply regardless of whether or not, for the purposes of paragraph 2 of this Article 7, the expense is directly attributed to the permanent establishment (first example) or is attributed to another part of the enterprise but reflected in a notional charge to the permanent establishment (second example).

35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7.

36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to <u>the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment.</u>

37. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

38. Article 7, as it read before [2010], included the following paragraph 3:

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including

executive and general administrative expenses so incurred,
whether in the State in which the permanent establishment is situated or elsewhere.

Whilst that paragraph was originally intended to clarify that paragraph 2 required expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account in determining the profits of the permanent establishment even if these expenses had been incurred outside the State in which the permanent establishment was located, it had sometimes been read as limiting the deduction of expenses that indirectly benefited the permanent establishment to the actual amount of the expenses.

39. This was especially the case of general and administrative expenses, which were expressly mentioned in that paragraph. Under the previous version of paragraph 2, as interpreted in the Commentary, this was generally not a problem since a share of the general and administrative expenses of the enterprise could usually only be allocated to a permanent establishment on a cost-basis.

40. <u>As now worded, however, paragraph 2 requires the recognition and arm‘s length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (*e.g.* through the provision of assistance in day-to-day management).</u> The deduction of an arm‘s length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all relevant expenses of the enterprise, wherever incurred, be taken into account. Depending on the circumstances, this will be done through the deduction of all or part of the expenses or through the deduction of an arm‘s length charge in the case of a dealing between the permanent establishment and another part of the enterprise.

Paragraph 3

44. The combination of Articles 7 (which restricts the taxing rights of the State in which the permanent establishment is situated) and 23 A and 23 B (which oblige the other State to provide relief from double taxation) ensures that there is no unrelieved double taxation of the profits that are properly attributable to the permanent establishment. This result may require that the two States resolve differences based on different interpretations of paragraph 2 and it is important that mechanisms be available to resolve all such differences to the extent necessary to eliminate double taxation.

45. As already indicated, the need for the two Contracting States to
reach a common understanding as regards the application of paragraph 2 in order to eliminate risks of double taxation has led the Committee to develop detailed guidance on the interpretation of that paragraph. This guidance is reflected in the Report, which draws on the principles of the Committee‘s 1995 report ―Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations‖.

46. Risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, which will ensure the same result for the purposes of Articles 7 and 23 A or 23 B (see, however, paragraph 66). Insofar as each State agrees that the taxpayer has done so, it should refrain from adjusting the profits in order to reach a different result under paragraph 2. This is illustrated in the following example.

47. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, the Report provides that a dealing must be recognised and a notional arm‘s length price must be determined for that dealing. The enterprise‘s documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm‘s length price of 100 has been used to determine the profits attributable to the permanent establishment. Both States agree that the recognition of the dealing and the price used by the taxpayer are in conformity with the principles of the Report and of the Transfer Pricing Guidelines. In this case, both States should refrain from adjusting the profits on the basis that a different arm‘s length price should have been used; as long as there is agreement that the taxpayer has conformed with paragraph 2, the tax administrations of both States cannot substitute their judgment for that of the taxpayer as to what are the arm‘s length conditions. In this example, the fact that the same arm‘s length price has been used in both States and that both States will recognise that price for the purposes of the application of the Convention will ensure that any double taxation related to that dealing will be eliminated under Article 23 A or 23 B.

48. In the previous example, both States agreed that the recognition of the dealing and the price used by the taxpayer were in conformity with the principles of the Report and of the Transfer

Pricing Guidelines. The Contracting States, however, may not always reach such an agreement. In some cases, the Report and the Transfer Pricing Guidelines may allow different interpretations of paragraph 2 and, to the extent that double taxation would otherwise result from these different interpretations, it is essential to ensure that such double taxation is relieved. Paragraph 3 provides the mechanism that guarantees that outcome.

49. For example, as explained in paragraphs 105-171 of Part I of the Report, paragraph 2 permits different approaches for determining, on the basis of the attribution of ―freeǁ capital to a permanent establishment, the interest expense attributable to that permanent establishment. The Committee recognised that this could create problems, in particular for financial institutions. It concluded that in this and other cases where the two Contracting States have interpreted paragraph 2 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated.

50. Paragraph 3 will ensure that this result is achieved. It is important to note, however, that the cases where it will be necessary to have recourse to that paragraph are fairly limited.

51. First, as explained in paragraph 46 above, where the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and both States agree that the taxpayer has done so in accordance with paragraph 2 as interpreted by the Report, no adjustments should be made to the profits in order to reach a different result under paragraph 2.

52. Second, paragraph 3 is not intended to limit in any way the remedies already available to ensure that each Contracting State conforms with its obligations under Articles 7 and 23 A or 23 B. 232 For example, if the determination, by a Contracting State, of the profits attributable to a permanent establishment situated in that State is not in conformity with paragraph 2, the taxpayer will be able to use the available domestic legal remedies and the mutual agreement procedure provided for by Article 25 to address the fact that the taxpayer has not been taxed by that State in accordance with the Convention. Similarly, these remedies will also be available if the other State does not, for the purposes of Article 23 A or 23 B, determine the profits attributable to the permanent establishment in conformity with paragraph 2 and therefore does not comply with the provisions of this Article.

53. Where, however, the taxpayer has not determined the profits attributable to the permanent establishment in conformity with paragraph 2, each State is entitled to make an adjustment in order to ensure conformity with that paragraph. Where one State makes an adjustment in

conformity with paragraph 2, that paragraph certainly permits the
other State to make a reciprocal adjustment so as to avoid any double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State (*e.g.* the State where the permanent establishment is located) may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. It may also be that, as indicated above, the two Contracting States will adopt different interpretations of paragraph 2 and it is not possible to conclude that either interpretation is not in accordance with paragraph 2.

54. Such concerns are addressed by paragraph 3. The following example illustrates the application of that paragraph.

55. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm‘s length price must be determined for that dealing. The enterprise‘s documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional price of 90 has been used to determine the profits attributable to the permanent establishment. State S accepts the amount used by the taxpayer but State R considers that the amount is below what is required by its domestic law and the arm‘s length principle of paragraph 2. It considers that the appropriate arm‘s length price that should have been used is 110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of the exemption (Article 23 A) or the credit (Article 23 B) claimed by the taxpayer with respect to the profits attributable to the permanent establishment. In that situation, since the price of the same dealing will have been determined as 90 in State S and 110 in State R, profits of 20 may be subject to double taxation. Paragraph 3 will address that situation by requiring State S, to the extent that there is indeed double taxation and that the adjustment made by State R is in conformity with paragraph 2, to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States.

56. If State S, however, does not agree that the adjustment by State R was warranted by paragraph 2, it will not consider that it has to make the adjustment. In such a case, the issue of whether State S should make the adjustment under paragraph 3 (if the adjustment by State R is

justified under paragraph 2) or whether State R should refrain from
making the initial adjustment (if it is not justified under paragraph 2) will be solved under a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25 (since it involves the question of whether the actions of one or both of the Contracting States have resulted or will result for the taxpayer in taxation not in accordance with the Convention). Through that procedure, the two States will be able to agree on the same arm's length price, which may be one of the prices put forward by the taxpayer and the two States or a different one.

57. As shown by the example in paragraph 55, paragraph 3 addresses the concern that the Convention might not provide adequate protection against double taxation in some situations where the two Contracting States adopt different interpretations of paragraph 2 of Article 7 and each State could be considered to be taxing —in accordance withǁ the Convention. Paragraph 3 ensures that relief of double taxation will be provided in such a case, which is consistent with the overall objectives of the Convention.

58. Paragraph 3 shares the main features of paragraph 2 of Article 9. First, it applies to each State with respect to an adjustment made by the other State. It therefore applies reciprocally whether the initial adjustment has been made by the State where the permanent establishment is situated or by the other State. Also, it does not apply unless there is an adjustment by one of the States.

59. As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under paragraph 3 simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The corresponding adjustment is required only if the other State considers that the adjusted profits conform with paragraph 2. In other words, paragraph 3 may not be invoked and should not be applied where the profits attributable to the permanent establishment are adjusted to a level that is different from what they would have been if they had been correctly computed in accordance with the principles of paragraph 2. Regardless of which State makes the initial adjustment, the other State is obliged to make an appropriate corresponding adjustment only if it considers that the adjusted profits correctly reflect what the profits would have been if the permanent establishment's dealings had been transactions at arm's length. The other State is therefore committed to make such a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount.

60. Paragraph 3 does not specify the method by which a corresponding adjustment is to be made. Where the initial adjustment is made by the State in which the permanent establishment

is situated, the adjustment provided for by paragraph 3 could be granted in the other State through the adjustment of the amount of income that must be exempted under Article 23 A or of the credit that must be granted under Article 23 B. Where the initial adjustment is made by that other State, the adjustment provided for by paragraph 3 could be made by the State in which the permanent establishment is situated by re-opening the assessment of the enterprise of the other State in order to reduce the taxable income by an appropriate amount.

61. The issue of so-called ―secondary adjustments, which is discussed in paragraph 8 of the Commentary on Article 9, does not arise in the case of an adjustment under paragraph 3. As indicated in paragraph 28 above, the determination of the profits attributable to a permanent establishment is only relevant for the purposes of Articles 7 and 23 A and 23 B and does not affect the application of other Articles of the Convention.

62. Like paragraph 2 of Article 9, paragraph 3 leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text of either paragraph 2 of Article 9 or paragraph 3 but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25).

63. There may be cases where the initial adjustment made by one State will not immediately require a corresponding adjustment to the amount of tax charged on profits in the other State (*e.g.*, where the initial adjustment by one State of the profits attributable to the permanent establishment will affect the determination of the amount of a loss attributable to the rest of the enterprise in the other State). The competent authorities may, in accordance with the second sentence of paragraph 3, determine the future impact that the initial adjustment will have on the tax that will be payable in the other State before that tax is actually levied; in fact, in order to avoid the problem described in the preceding paragraph, competent authorities may wish to use the mutual agreement procedure at the earliest opportunity in order to determine to what extent a corresponding adjustment may be required in the other State at a later stage.

64. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the example in paragraph 55 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention (the arbitration provision of paragraph 5 of Article 25 will play a critical role in cases where the competent authorities would otherwise be unable to agree as it will ensure that the issues that prevent an agreement are resolved through arbitration).

65. Paragraph 3 only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment. Assume, for instance, that the State where the permanent establishment is situated adjusts the profits that the taxpayer attributed to the permanent establishment to reflect the fact that the price of a dealing between the permanent establishment and the rest of the enterprise did not conform with the arm‘s length principle. Assume that the other State also agrees that the price used by the taxpayer was not at arm‘s length. In that case, the combined application of paragraph 2 and of Article 23 A or 23 B will require that other State to attribute to the permanent establishment, for the purposes of providing relief of double taxation, adjusted profits that would reflect an arm‘s length price. In such a case, paragraph 3 will only be relevant to the extent that States adopt different interpretations of what the correct arm‘s length price should be.

66. Paragraph 3 only applies with respect to differences in the determination of the profits attributed to a permanent establishment that result in the same part of the profits being attributed to different parts of the enterprise in conformity with the Article. As already explained (see paragraphs 30 and 31 above), Article 7 does not deal with the computation of taxable income but, instead, with the attribution of profits for the purpose of the allocation of taxing rights between the two Contracting States. The Article therefore only serves to allocate revenues and expenses for the purposes of allocating taxing rights and does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law as long as there is conformity with paragraph 2. Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable

income on which tax will be levied in each State for a given taxable
period may be different given differences in domestic law rules, *e.g.* for the recognition of income and the deduction of expenses. Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3.

67. Also, paragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State‘s tax under the domestic law of that other State and in accordance with Article 23 A or 23 B.

68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State‘s preferred position as to the arm‘s length price or method. These States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm‘s length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:

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 Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

69. This alternative version is intended to ensure that the State being asked to give a corresponding adjustment would always be able to require that to be done through the mutual agreement procedure. This version differs significantly from paragraph 3 in that it does not create a legal obligation on that State to agree to give a corresponding adjustment, even where it considers the adjustment made by the other State to have been made in accordance with paragraph 2. The provision would always give the possibility for a State to negotiate with the

other State over what is the most appropriate arm's length price or
method. Where the State in question does not unilaterally agree to make the corresponding adjustment, this version of paragraph 3 would ensure that the taxpayer has the right to access the mutual agreement procedure to have the case resolved. Moreover, where the mutual agreement procedure is triggered in such a case, the provision imposes a reciprocal legal obligation on the Contracting States to eliminate the double taxation by mutual agreement even though it does not provide a substantive standard to govern which State has the obligation to compromise its position to achieve that mutual agreement. If the two Contracting States do not reach an agreement to eliminate the double taxation, they will both be in violation of their treaty obligation. The obligation to eliminate such cases of double taxation by mutual agreement is therefore stronger than the standard of paragraph 2 of Article 25, which merely requires the competent authorities to ―endeavour‖ to resolve a case by mutual agreement.

70. If Contracting States agree bilaterally to replace paragraph 3 by the alternative above, the comments made in paragraphs 66 and 67 as regards paragraph 3 will also apply with respect to that provision.

Paragraph 4

71. 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. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

72. Absent paragraph 4, this interpretation of the term ―profits could have given rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are dealt with separately in other Articles of the Convention, *e.g.* dividends, the question would have arisen as to which Article should apply to these categories of income, *e.g.* in the case of dividends, this Article or Article 10.

73. To the extent that the application of this Article and of the relevant other Article would result in the same tax treatment, there is little practical significance to this question. Also, other Articles of the Convention deal specifically with this question with respect to some types of income (*e.g.* paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 17 and paragraph 2 of Article 21).

74. The question, however, could arise with respect to other types of income and it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to

specific categories of income will have priority over Article 7. It
follows from this rule that Article 7 will be applicable to business profits which do not belong to categories of income covered by these other Articles, and, in addition, to income which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within Article 7. This rule does not, however, govern the manner in which the income will be classified for the purposes of domestic law; thus, if a Contracting State may tax an item of income pursuant to other Articles of this Convention, that State may, for its own domestic tax purposes, characterise such income as it wishes (*i.e.* as business profits or as a specific category of income) provided that the tax treatment of that item of income is in accordance with the provisions of the Convention. It should also be noted that where an enterprise of a Contracting State derives income from immovable property through a permanent establishment situated in the other State, that other State may not tax that income if it is derived from immovable property situated in the first-mentioned State or in a third State (see paragraph 4 of the Commentary on Article 21 and paragraphs 9 and 10 of the Commentary on Articles 23 A and 23 B).

75. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term —profits with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the Articles on dividends, interest and royalties.

Annexure 3

EXCERPTS FROM 2010 OECD REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

B-1. The "functionally separate entity approach —force of attraction principle

8. The authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. The phrase —profits of an enterprise in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that—the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment (*i.e.* there should be no —force of attraction principle). Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, Article 7 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

B-5. Summary of the two-step analysis

44. The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). This analysis involves the following two steps:

Step One

A functional and factual analysis, leading to:

o The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;

o The identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the PE;

o The identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the PE;

o The identification of other functions of the PE;

o The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test; and

o The attribution of capital based on the assets and risks attributed to the PE.

Step Two

The pricing on an arm‘s length basis of recognised dealings through:

o The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines‘ comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and

o Selecting and applying by analogy to the guidance in the Guidelines the most appropriate method to the circumstances of the case to arrive at an arm‘s length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

The pricing on an arm‘s length basis of any transactions with associated enterprises attributed to the PE should follow the guidance in the Guidelines and is not discussed in this Report. The order of the listing of items within each of the steps above is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a PE as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the PE and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

45. It can be seen that the functional and factual analysis is primarily needed to hypothesise the PE as a functionally separate entity, to identify the significant people functions relevant to determining which part of the enterprise assumes and/or subsequently manages particular risks and economically owns 22

particular assets, and to attribute to the PE as a hypothetically separate entity an appropriate amount of capital. This step of the analysis is likewise necessary to identify which part of the enterprise should be hypothesised to have undertaken the enterprise's rights and obligations arising from transactions with other enterprises and what dealings should be hypothesised to exist between the PE and other parts of the enterprise. Secondly, it is important to identify the respective functions performed by both the PE and other parts of the enterprise with which it is hypothesised to have dealings in order to price those dealings under the second step of the authorised OECD approach.

Annexure 4
Text of Article 7 of UN Tax Convention

Article 7
BUSINESS PROFITS

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 (*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.

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.

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. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or

for management, or, except in the case of a banking enterprise, by
way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far 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.

5. 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.

6. 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.

(NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

Annexure 5

CBDT Circular No. 5 dated 28.09.2004

Subject : Taxation of IT enabled business process outsourcing units in India.

To

All Chief Commissioners/Directors-General of Income-tax.

Subject : Taxation of IT enabled business process outsourcing units in India.

A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a permanent establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961.

2. However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the permanent establishment of the non-resident entity. The tax treatment of the permanent establishment in such a case is under consideration in this circular.

3. During the last decade or so, India has seen a steady growth of outsourcing of business processes by non-residents or foreign companies to IT enabled entities in India. Such entities are either branches or associated enterprises of the foreign enterprise or an independent Indian enterprise. Their activities range from mere procurement of orders for sale of goods or provision of services and answering sales related queries to the provision of services itself like software maintenance service, debt collection service, software development service, credit card/mobile telephone related service, etc. The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its permanent establishment. The extent to which the profits of the non-resident enterprise is to be attributed to the activities of such permanent establishment in India has been under consideration of the Board.

4. A non-resident or a foreign company is treated as having a permanent establishment in India under article 5 of the Double Taxation Avoidance Agreements entered into by India with different countries, if the said non-resident or foreign company carries on business in India through a branch, sales office, etc., or through an agent (other than an independent agent) who

habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the permanent establishment becomes taxable in India under article 7 of the Double Taxation Avoidance Agreement.

5. Paragraph 1 of article 7 of the Double Taxation Avoidance Agreement provides that if a foreign enterprise carries on business in another country through a permanent establishment situated therein, the profits of the enterprise may be taxed in the other country but only so much of them as is attributable to the permanent establishment. Paragraph 2 of the same article provides that subject to the provisions of Paragraph 3, 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. Paragraph 3 of the article provides that in determining the profits of a permanent establishment there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. What are the expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961.

6. Paragraph 2 contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle". Paragraph 3 only provides a rule applicable for the determination of the profits of the permanent establishment, while paragraph 2 requires that the profits so determined correspond to the profit that a separate and independent enterprise would have made. Hence, in determining the profits attributable to an IT enabled BPO unit constituting a permanent establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the head office or by the head office to the permanent establishment on the basis of "arm's length principle".

7. The "arm's length price" would have the same meaning as in the
definition in section 92F(ii) of the Income-tax Act. The arm's length price would have to be determined in accordance with the provisions of section 92 to 92F of the Act.

8. The Central Board of Direct Taxes Circular No. 1 of 2004, dated 2nd January, 2004*, is hereby withdrawn with immediate effect.

9. The contents of this circular may be brought to the notice of all officers in your region.

Yours faithfully,

(Sd.) Sandeep Goyal,

Under Secretary (FT & TR)-I,

Central Board of Direct Taxes.

[F. No. 500/67/2003-FTD]

*See [2004] 265 ITR (St.) 23.

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Our Values: