Taxation of Cross-Border Royalties, Interest, and Dividends: Understanding the Force of Attraction Rule and Permanent Establishments

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NALSAR

Force of Attraction

Purpose of FOA

Prevents foreign enterprises from evading taxes by artificially segregating profits between PE and HO.

Force of Attraction

IBFD International Tax Glossary

- "Principle under which a country may tax a foreign enterprise in respect of income it derives in that country if the enterprise maintains a PE there, irrespective of whether that income is derived through or otherwise economically connected with the PE"

First FOA rule

- A broad FOA rule was used for the first time in Article III of the 1945 US-UK DTAA

Types of Force of Attraction

- **Full force of attraction**: All profits derived in source State taxable as profits of the PE whether or not through such PE (i.e., 100% attribution)

- **Limited force of attraction**: Profits derived through PE as well as profits from sale of goods / activities of same or similar to that of PE directly carried out by the HO in the source country taxable as profits of PE

- **No force of attraction**: Only profits derived through PE taxable

Full Force of Attraction

1945 US-UK DTAA

- *"(1) A United Kingdom enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a PE situated therein.* ***If it is so engaged****, United States tax may be imposed* ***upon the entire income of such enterprise from sources within the United States****.*

  (2) A united States enterprise shall not be subject to UK tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the UK through a PE situated therein. ***If it is so engaged, UK tax may be imposed upon the entire income of such enterprise from sources within the UK****:…."*

Accordingly, once a PE is constituted, the taxability of profits in the PE state is not restricted only to profits attributable to PE, but extends to all profits earned by the foreign enterprise from "within" the PE State

Limited Force of Attraction [1/2]

UN Model Convention

- *(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 effected through 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 Para 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a PE situated therein, there shall in each Contracting State be attributed to that PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activity under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE*

Limited Force of Attraction [2/2]

The expression ‘same or similar’ has not been defined in any tax treaties. As per the Dictionary meaning:

- ‘Same’ - resembling in every aspect / identical
- ‘Similar’
  - of the same kind in appearance, character, or quantity, without being identical (Oxford)
  - Partial resemblances and may also denote same in all essential particulars (Law Lexicon)
  - “Although not like in all aspects, have like characteristics (Customs law)

- **Items of comparison for ‘Same or Similar’**
  - Computer and Copying machine ?
  - Copying machine and Scanners?

No Force of Attraction

- *“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 PE situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State* ***but only so much of them as is attributable to that PE****.”*

Force of Attraction - Comparison

OECD Model	UN Model	Rejected Model
• No force of attraction • Taxed to the extent profits are attributable to the PE • Eg. India-Netherlands DTAA	• Limited force of attraction • Tax only direct transactions effected by the non-resident • Eg. India-US DTAA, India-Canada DTAA	• Full force of attraction • Tax profits from all transactions • Eg. 1945 US-UK DTAA

Force of Attraction - India Tax Treaties

#	Description	Countries
1	Many DTAA adopts language of UN MC i.e., limited FoA	Canada, Belgium, Denmark, Italy, USA, France etc.
2	Some DTAAs adopt only part of the Article 7(1) of the UN Model (sale of similar goods) - does not contain other business activities	Indonesia and New Zealand
3	Some DTAAs adopt the provisions of UN Model with a “Right to Prove Otherwise” - Enterprise can prove that profit from sale of same or similar goods / activities are not attributable to PE -	Germany, Indonesia etc.
4	Some DTAAs adopt OECD Model with a variation - Phrase “directly or indirectly” attributable to that PE	Japan, Singapore, United Kingdom, Malta, Oman, Switzerland, Vietnam etc. The term ’directly or indirectly’ defined in Singapore, Malta, UK etc.
5	Force of attraction rule has been omitted subsequently	Norway, Australia, China etc
6	No Force of attraction adopted	Netherlands

Force of Attraction - India Tax Treaties

Article 7(1) of India - USA DTAA

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

Article 7(1) of India - Germany DTAA

(c) In respect of paragraph 1 of Article 7, profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment, may be considered attributable to that permanent establishment **if it is proved that:**

- this transaction **has been resorted to in order to avoid taxation** in the Contracting State where the permanent establishment is situated, and
- the permanent establishment in **any way involved in this transaction**.

Article 7(1) of India - UK DTAA

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 PE situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is **directly or indirectly attributable** to that PE.

3. Where a PE **takes an active part in negotiating, concluding or fulfilling contracts** entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of profits of the enterprise arising out of those contracts which the contribution of the PE to those transactions bears to that of the enterprise as a whole shall be treated for the purpose of paragraph 1 of this Article as being the profits indirectly attributable to that PE.

Directly and Indirectly attributable - Meaning

- The phrase ‘directly or indirectly’ attributable to PE’ is used in some of the tax treaties such as Malta, UK, Vietnam, Oman, Switzerland etc.
- For example, Article 7(1) India – Uzbekistan treaty has clarified the phrase as follows:

  “The words "directly or indirectly" mean, for the purposes of this Article, that where a ***PE takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise****, then notwithstanding that other parts of the enterprise have also participated in those transactions, there shall be attributed to the PE that proportion of profits of the enterprise arising out of those contracts as the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole.”*

- Protocol to Article 7(1) India – Japan treaty has clarified as follows:

  6. With reference to paragraph 1 of article 7 of the Convention, it is understood that by using the term ***'directly or indirectly attributable to the permanent establishment'****, profits arising from transactions in which the* ***permanent establishment has been involved*** *shall be regarded as attributable to the permanent establishment* ***to the extent appropriate to the part played by the permanent establishment in those transactions****. It is also understood that profits shall be regarded as attributable to the permanent establishment to the above-mentioned extent, even when the contract or order relating to the sale or provision of goods or services in question is made or placed directly with the overseas head office of the enterprise rather than with the permanent establishment.*

Ishikawajima Harima Heavy Industries Ltd. (288 ITR 408) (SC)

Background

- IHHI Ltd, a company incorporated in Japan, along with five other enterprises formed a consortium which was awarded a turnkey project for setting up a liquefied natural gas (LNG) facility in India. The contract involved various components including: (i) offshore supply; and (ii) Onshore Supply.

Issue

- All activities in connection with offshore supply were carried out outside India, can the income from the same be taxed in India ?

Ruling

- SC referred to paragraph 6 of the Protocol to the India - Japan DTAA and reiterated that only income arising from activities where the PE has been involved can be said to be attributable to the PE.
- SC noted PE’s non-involvement in the offshore transactions.
- SC concluded that Paragraph 6 of the Protocol is not applicable, because, for the profits to be attributable directly or indirectly‘, the PE must be involved in the activity giving rise to the profits

Roxon OY - (2007) (291 ITR 275) (Mumbai Tribunal)

Background:

- F Co. entered into contract to design, manufacture, deliver, erect, test and commission certain bulk handling facility at I Co. and to impart training to I Co..
- F Co. supplied equipment directly to I Co.
- F. Co. sent employees for erection, commissioning, installation and training which constituted installation PE in India (no dispute here)
- Tax officer held that F Co. was required to supply the equipment (offshore equipment supply) and install it in India as part of a turnkey contract, thus the supply was linked to the installation and chargeable to tax under the 'Force of Attraction' principle

Ruling:

- Article 7 of India-Finland DTAA based on UN Model Convention which envisages
  - Direct sales by an enterprise covered by "force of attraction rule‟ only when enterprise has a PE for selling goods and direct sales by enterprise is same or similar kind of goods
  - Installation PE thus to be excluded ab initio
- Profits earned on supply of equipment cannot be said be said to be attributable to PE as installation PE comes into existence after supply of equipment

SNC-Lavalin vs. ACIT (110 TTJ 13) (Delhi Tribunal)

Background:

- Assessee entered into contract with NHPC for Chamera project.
- Assesse claimed it had performed work relating to project even prior to setting up of PE but bills were raised after PE was established; claimed that profit not attributable to PE had to be excluded

Ruling:

- Tribunal held limited FoA under India-Canada DTAA applies and FoA holds good even for rendering of services
- It was held that as there was a composite contract for rendering services in connection with setting up of the Hydroelectric project, the work carried out outside India was deemed to have arisen in India as it was the same as the services rendered by the PE in India
- The fact that the invoices for the said off-shore work was raised through the PE in India and accounted for in the books of project office set up in India sealed the fate of the assessee.

Illustration 1

- A Co., resident of Country X, has Branch in Country Y
- Branch sells garments to customers in Country Y
- A Co. also sells garments directly to customers in Country Y
- Possible that business is being passed from branch to head office, thereby reducing profits of the branch.
- Force of attraction rule seeks to tax such profits derived by A Co.

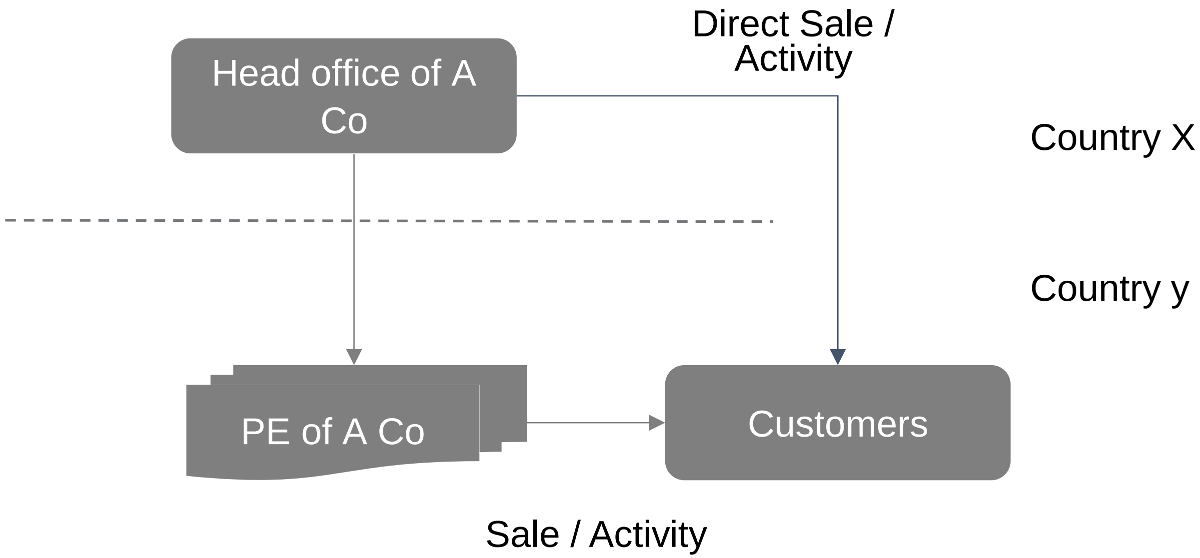
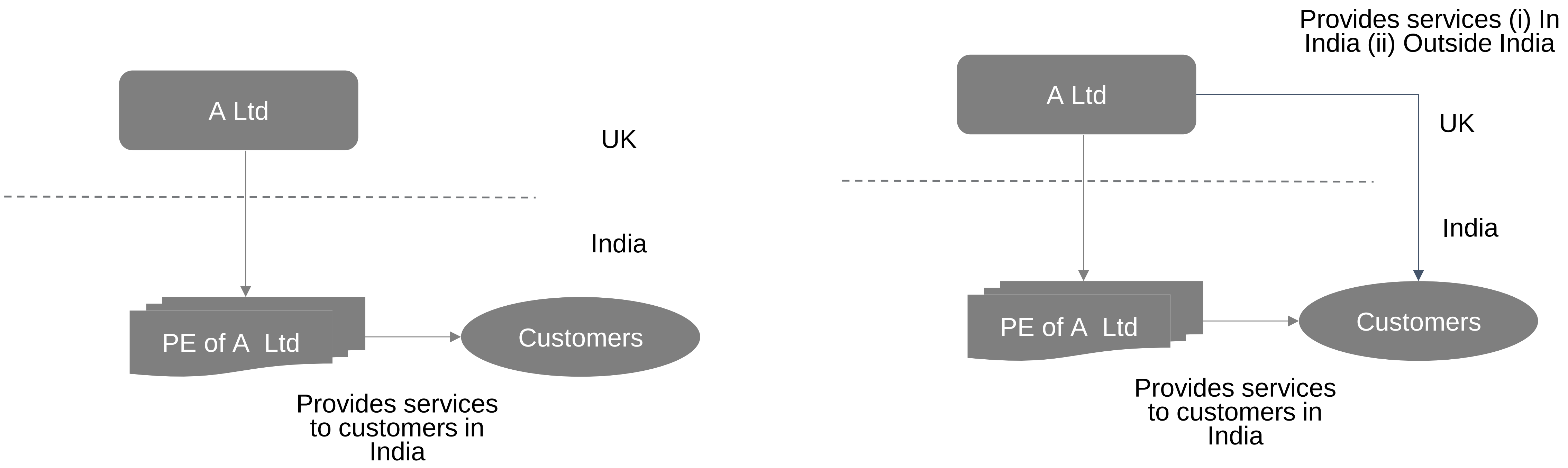


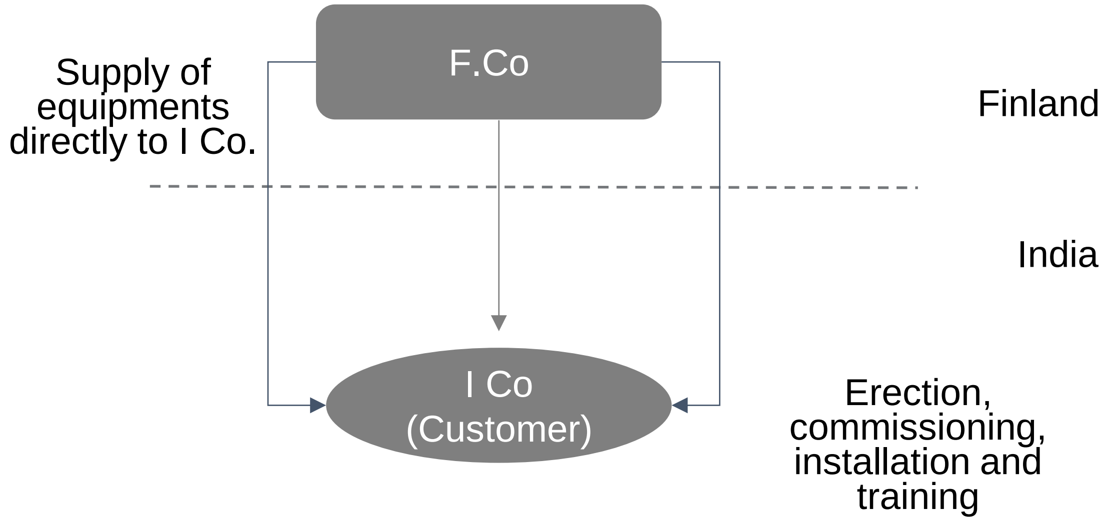
Illustration 2



Can the services provided by A Ltd. outside India be taxed in India ?

Illustration 3

- F Co. was assigned turnkey contract for sale of equipments and erection, commissioning, installation and training by I Co.
- F Co. supplied equipment directly to I Co.
- F. Co. sent employees for erection, commissioning, installation and training which constituted installation PE in India



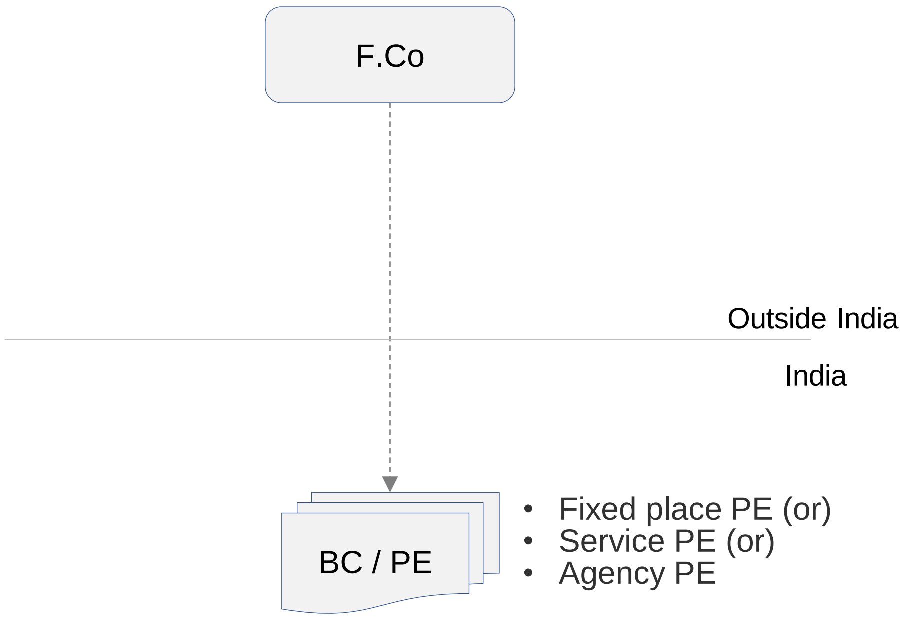
Can the profits from supply of equipment be taxed using the Force of Attraction principle?

Q&A?

Principles of Attribution

Attribution of profits

- **Residence principle** - Country of residence of taxpayer has right to tax on world-wide basis i.e., Residence Based Taxation
- **Source principle** - Country of source of income has right to tax based on source of income i.e., Source Based Taxation
- Only those profits which are attributable to PE in the source country are taxable



Taxation of Business profits of a foreign enterprise in India:

- Business connection (BC) under Income Tax Act, 1961 - Section 9(1)(i)
- Permanent Establishment (PE) under treaty - Article 7 read with Article 5

Principles of Attribution - Domestic law [1/2]

Section 9(1)(i)

- **Direct and Indirect incomes:** Section 9(1)(i) "all income accruing or arising, whether directly or indirectly through or from any business connection in India, or through……"

Explanation 1(a) and 3

- **Restricted to activities carried in India:**

  Explanation 1(a): "In the case of a business, other than the business having business connection in India on account of significant economic presence, of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India"

  Explanation 3: "Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India."

Rule 10

- **Attribution Methods**: Where income of Business Connection cannot be ascertained, Rule 10 applies, which provides for the following methods:
  - % of turnover as considered reasonable by AO (Presumptive Method)
  - Total PGBP X Receipts arising business connection / Total receipts of the business (Proportionate Method)
  - Such other manner which AO may deem suitable (Discretionary Method)

Principles of Attribution - Domestic law [2/2]

Concept of SEP

- Earlier, section 9 of the Income-tax Act provides for physical presence based nexus rule for taxation of business income of NR in India
- In line with BEPS Action Plan 1, the definition of “business connection” is amended to include “Significant Economic Presence” to counter business models capable of being conducted without physical presence or agent
- SEP defined in **Explanation 2A** to mean:
  - ❑ Any transaction in respect of any goods, services or property carried out by an NR with any person in India, including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the year exceeds INR 2 Crores (*Revenue-linked condition*) OR
  - ❑ Systematic and continuous soliciting of its business activities or engaging in interaction with 3 lakhs or more number of users in India. (*User-linked condition*)

ABB FZ-LLC vs. DCIT (International Taxation), 83 taxmann.com 86 (Bang. Trib.)

Facts:

- Assessee a company incorporated in UAE, was engaged in the business of providing regional service activities for the benefit of ABB legal entities in India, Middle East and Africa. During the year under consideration, assessee had rendered regional services to the Indian entity and for rendering some part of these services, 3 employees of the taxpayer visited India for total of 25 days.
- **Company's view** - The amount received was not taxable as Fees for technical service as per India-UAE tax treaty as it does not have a FTS clause. Accordingly, the taxability would fall under Article 22 - "Other income", which provides that income would be taxable in India only if the taxpayer has a PE in India. As per Article 5(2)(i) of the Treaty, a foreign company is deemed to have its PE in India, if the foreign company renders services through its employees or any other person for period of 9 months or more in any 12 months period.
- **Assessing Officer's View** - In the absence of FTS article in India-UAE tax treaty, definition of FTS provided in the Income Tax Act should be applied. Accordingly, the AO taxed the receipts as FTS as well as Royalty. Further, the AO also held that taxpayer had not proved that it did not have a PE in India.

Ruling:

- Taxpayer constituted a Service PE in India as it has rendered services for more than 9 months. **The fact that employees had visited India only for 25 days is not relevant as in the present age of technology, services can be rendered without physical presence of the employees**. Services can be provided through various virtual modes like email, internet, video conference, remote access, etc.
- Further, ITAT also observed that Service PE clause is an independent clause and it does not require to fulfill the requirement of Fixed Place.
- However, the Tribunal held that services rendered by the taxpayer resulted in making available commercial and industrial information which was secret in nature having IPR rights and confidential information. Accordingly, the same was taxed as Royalty as per India-UAE Tax Treaty and Act.

Principles of Attribution - Model conventions

Para	OECD MC	UN Model
7(1)	• Profits to be taxed to the extent attributable to PE	• Profits to be taxed to the extent attributable to PE. • In addition, there is an indirect attribution through <u>Force of Attraction (FOA) Rule</u>
7(2)	• Profits of PE taxable as if PE is a distinct and independent enterprise, <u>taking into account the FAR</u>. Also, referred to as Authorized OECD Approach (AOA) ❑ Step 1 - FAR analysis ❑ Step 2 - Comparability analysis to determine profit attribution based on FAR analysis (TP principles)	• Profits of PE taxable as if PE is a distinct and independent enterprise (engaged in same or similar activities under same or similar conditions)
7(3)	• Provisions concerning avoidance of double taxation i.e., making an appropriate adjustment	• Actual expense incurred including reasonable allocation of General & admin overheads allowable • No deduction for payments to HO viz., royalty, FTS or similar payments
7(4)	• Provisions of those Articles overrides Article 7	• Attribution based on customary apportionment approach of the contracting state (subject to the principles contained in this article)
7(5)		• Methodology applied consistently year on year
7(6)		• Provisions of those Articles overrides Article 7

Principles of Attribution - Domestic law vs OECD (Summary)

	Attribute actual profits based on separate books of account. If profits cannot be ascertained ⬇ Domestic law (Rule 10)	Authorized OECD Approach (AOA) ⬇ OECD Model (AOA)
Attribution of Profits to PE	• Rule 10(i): Presumptive Method: Percentage of turnover as the Assessing Officer may consider reasonable (or) • Rule 10(ii): Proportionate Method: Applying global profitability per cent to Indian receipts (or) • Rule 10(iii): Discretionary Method: Any other method deemed fit by Assessing Officer	• Step I - Undertake Functions, Assets and Risk (FAR) Analysis of the PE; **and** • Step II - Undertake comparability analysis to determine arm's length return for the FAR

CBDT Draft Rules - Proposed approach:

On 18 April 2019, CBDT issued a press release inviting stakeholder comments on report pertaining to Profit Attribution to PE in India. Key aspects:

- The report highlights India's reservation against the Authorized OECD Approach
- Proposed **fractional apportionment approach** under the following circumstances: (i) where there are no India centric financial statements or (ii) where the books of accounts have been rejected by the tax officer, or (iii) where the tax officer records the reason that the accounts do not adequately reflect the profits (attributable to PE)

The rules are yet to be finalized.

Judicial precedents [1/2]

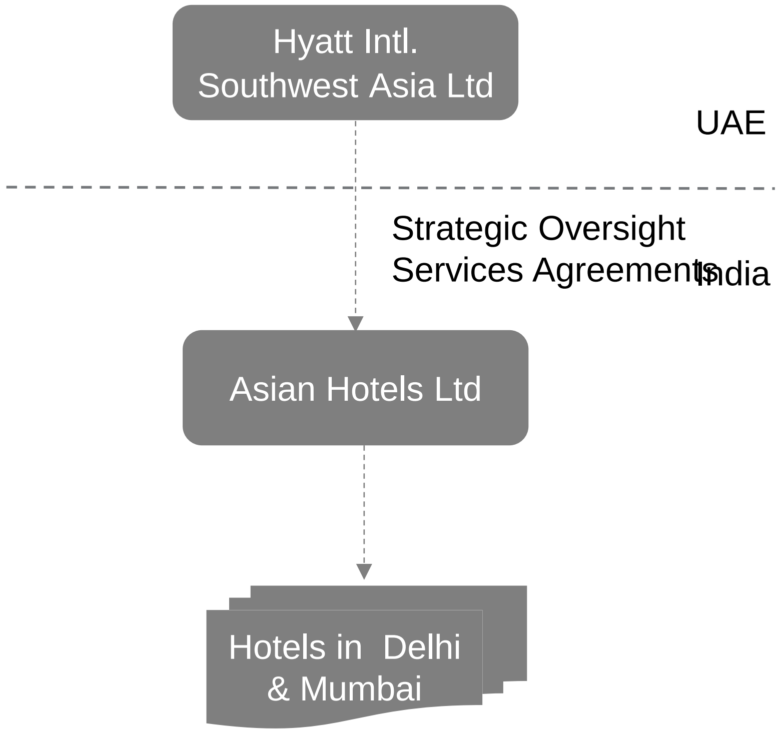
#	Name of the Ruling		Attribution %
1	Rolls Royce (Delhi Tribunal)	• The project office of Rolls Royce carried out marking activities (securing orders and solicit request for quotation/purchase orders for Rolls Royce Plc's products etc.). • Since no specific P&L provided, Rule 10 applied for income attribution. [Manufacturing - 50%, R&D - 15%; Marketing and others - 35%]. • Since only marketing done in India, 35% of profits attributed.	35% for Marketing activity
2	Galileo International Inc (Delhi High Court)	• Galileo US developed a global computerised reservation system (CRS). It maintained master computer system in US, which was connected to servers of participant hotels and airlines. • Galileo US engaged an Indian company as 'distribution agent' in India. Indian agent entered in 'subscriber's agreement' with travel agents to provide them computer, connectivity, access code and support service. Galileo US paid all expenses for installation of computer at premises of travel agents. • Assessee got 3 Euro for each bookings from Airlines and paid 1 Euro for each bookings to the distribution agent. • It was held that Galileo carried on business of partly operating the CRS system in India through the computers installed in the premises of subscribers in India and thus had a PE under article 5(1). • Tribunal held that only 15% of revenue accruing to assessee in respect of bookings made in India should be treated as income i.e., 0.45 Euro. Since commission of 1 Euro is the expense, no further income attributable	15% for Distribution activity

Judicial precedents [2/2]

#	Name of the Ruling		Attribution %
3	Morgan Stanley (Supreme Court)	• Apex Court held that employees carrying out stewardship activities would not create a Service PE. • In relation to other services, where the employees are creating a Service PE, no further profits to be attributed where the PE is remunerated on arm's length basis considering all the risk-taking functions of the enterprise	0% if the PE is remunerated at ALP

Case study [1/3]

- Hyatt Intl. Southwest Asia Ltd. entered into a Strategic Oversight Service Agreement (SOSA) with Asian Hotels Limited to provide strategic planning services and Know-how to ensure the Hotels are developed and operated as an efficient and a high quality international full-service hotel
- Assessee's claim:
  - Service income is not taxable in the absence of FTS article; and
  - No PE since the presence of assessee's employees in India during the PY did not exceed 9 months (6 employees stayed for 158 days)
- Assessing Officer's claim:
  - Assessee provided its proprietary, written knowledge, skill, experience, operational and management information and associated technologies etc. and therefore receipts shall be taxable as 'royalties' u/s 9(1)(vi) of the Act and Article 12 of the DTAA.
  - Assessee had a fixed place at its disposal, hence constitutes fixed place PE in India. Assessee also provided Central Reservation System (CRS) which also constituted PE
  - In the absence of information, 25% of the receipts were considered as net profits



Hyatt Intl. Southwest Asia Ltd vs ACIT (IT) [No ITA 216/2020 & CM Nos. 32643/2020 & 56179/2022 dated 22 December 2023]

Case study [2/3]

- Ruling of the HC:

<u>**Royalty or Business Income**</u>:

- HC did not accept with the Revenue's contention that the fee received by the Assessee in terms of SOSA could be termed as consideration for use or for right to use any design, model, process and also for information concerning commercial and scientific experience since such <u>access is only incidental to the services</u> agreed to be provided by the Assessee.
- Merely because the extensive services rendered by the Assessee in terms of the SOSA also included access to written knowledge, processes, and commercial information in furtherance of the services, cannot lead to the conclusion that the fee received by the Assessee was in the nature of royalty as defined under Article 12 of the DTAA since the access to the same are <u>in furtherance of the service provided</u>.
- Therefore, concluded the income to be Business Income

<u>**Existence of PE**</u>:

- HC noted the observations of the Tribunal. The Tribunal held that the SOSA not only <u>provided the Assessee with unrestricted right to access</u> the Hotel premises but also complete control over such premises. The Tribunal accepted that in view of the length and duration of the use by the Assessee and the noninvasive activities being carried out from the Hotel, the Assessee had certain amount of <u>physical space at its disposal</u> in the form of the Hotel premises.
- The Assessee may be correct in its submission that it was **not required to carry on day-to-day management of the Hotel**. However, **it would be erroneous to accept that the agreements entered into by the Assessee did not provide a pervasive control**.
- SOSA was entered with assessee; simultaneously an agreement with Hyatt India (an affiliate of the assessee) was also entered for managing the day-to-day operations of the Hotel. There is no dispute that the day-to-day management of the Hotel was required to be conducted in the manner and in terms of the policy and guidelines laid down by the Assessee.

Case study [3/3]

- Ruling of the HC:

  Attribution of Profits to PE:

  - One of the principal contentions advanced by the Assessee is that even if it is assumed that the Assessee has a PE in India, there is no question of attributing any amount as income chargeable to tax under the Act to its PE, as it has incurred a loss on an entity level (global basis). According to the Assessee, income chargeable to tax under the Act could be attributed to its PE in India only if the Assessee had made profit on an entity level. Concededly, the said issue is covered in favour of the Assessee by a decision of the Coordinate Bench of this Court in Commissioner of Income Tax (International Taxation)-2 v. M/s Nokia Solutions and Networks OY . However, we have some reservations regarding the said view.
  - The profits attributable to the Assessee's PE in India are required to be determined on the footing that the PE is an independent taxable entity. It is, thus, possible that an Assessee makes a net loss at an entity level on account of losses suffered in other jurisdictions, which is partly offset by profits arising from India. In these circumstances, if it is held that the Assessee has a PE in India, prima facie the Assessee would be liable to pay tax on the income attributable to its PE in India notwithstanding the losses suffered in other jurisdictions.
  - This Court was of the view that the fourth question as raised by the Assessee ought to be referred to a larger Bench.

Q&A?

Thank You

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