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Article 7 and CFC Rules
M.A. (International Taxation), NALSAR

Divyasha Mathur

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Business Profits: Article 7
Session 1

Conceptual Approaches to Attribution of Profits

1

Relevant Business Activity Approach

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Functionally Separate Enterprise Approach

Attribution of profits of foreign enterprises – Governing Provisions in India

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Under Income Tax Act and Rules (Domestic Law)

- Section 9(1)(i) of the Act read with Rule 10

Under tax treaty

- Article 7 of tax treaties read with the provisions of the Act

Beneficial provisions of the Act or the Tax Treaty can be applied

Journey of Article 7

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OECD model

1963 | 2008 | 2010 | 2019

Functions, assets and risk (FAR) approach introduced in the Commentary on Article 7(2)

Receipts, expenses and working capital – recognized as the commonly used criteria for apportioning profits to the PE (Commentary on Article 7(4))

FAR approach - as the basis of the profit attribution (Article 7(2) and the Commentary thereon)

AND

Removal of erstwhile Article 7(4)

'distinct and separate' enterprise approach considered as corresponding to the 'arm's length principle'

UN model

1980 | 2019

- Similar to Pre-2010 OECD model convention.
- However, provides greater taxation rights to the source country in the form of FOA rules and restrictions on deduction of certain expenses
- Sales taken into account, both in the direct accounting method as well as in the indirect apportionment method
- 'Distinct and separate' enterprise approach considered as corresponding to the 'arm's length principle'

Indian tax treaties

1969 | 2019

- Most treaties similar to UN model convention and Pre-2010 OECD model convention

Evolution of Authorized OECD Approach – Article 7

1994

- Report on Attribution of Income to Permanent Establishments
- Lack of consensus on attribution approaches under Article 7

1998

- Report on the Taxation of Global Trading of Financial Instruments

2001

- Working Hypothesis - OECD's initial report on PE attribution.
- Testing of working hypothesis was completed by August 2004 – eventually became AOA.

2008

- Report on the Attribution of Profits to the PE
- Rejection of the relevant business activity approach
- Adoption of the functionally separate entity approach.

2010

- Report on the Attribution of Profits to PE
- Revised the text of Article 7 to incorporate AOA
- Amended the previous version of the Commentary to Article 7 to align it with the conclusions of the 2008 Report.

Authorized OECD Approach

Determining profits of a PE

Functional/Factual Analysis to determine activities of PE

Step 1:
Hypothesizing PE as a distinct and separate enterprise

- Functions performed
- Assets used
- Risks assumed
- Capital and funding
- Recognition of dealings

Step 2:
Determining the profits of a PE

- Comparability Analysis
- Applying transfer pricing methods to attribute profits

Background: OECD and UN Models

OECD Model Convention

- Favors capital exporting countries.
- Focuses more on Residence-based taxation rights - mitigates double taxation by requiring the source country to give up some or all of its taxing right on certain categories of income earned by residents of the other treaty country

UN Model Convention

- Favors capital importing countries.
- Provides source countries with greater taxing rights.
- OECD Model convention with modifications for developing states.

India follows mix of OECD and UN with some of its own modifications with inclination towards source-based taxation

Article 7 (Business Profits): OECD and UN Models

OECD Model Convention

- Not all streams of income of an enterprise is liable to be taxed in the other Contracting State on account of having a PE: But only so much which is attributable to the business carried on by the PE.

UN Model Convention

- Article 7(1) – Limited force of attraction rule
- All profits that the foreign enterprise derives from the Source State, whether through the PE or not can be taxed by the Source State.
- The profits are taxed in the source country if such profits are attributable to: (a) A PE (b) sales in the other state of goods or merchandise of the same similar kind as those sold through the PE or (c) other business activities carried in the other state of the same or similar kind as those effected through the PE.

- Treaties with Japan, Vietnam, Uzbekistan, Singapore, United Kingdom follow OECD Model
- Some Indian tax treaties (Canada, Belgium, Portugal, Slovak Republic, Spain, Denmark, Italy, USA, New Zealand) contain a limited force of attraction rule (either partially or fully) as contained in Art. 7(1) of the UN Model
- India has amended its treaty with Norway and Australia to remove force of attraction rule.

Article 7 (Profit Attribution): OECD and UN Models

OECD Model Convention

- (Pre- 2010 Version) - Similar to that of UN Model .

2010 version

- Introduced FAR analysis as the basis of profit attribution to a PE;
- Taxation of profits solely on the basis of contributions made by supply side factors ignoring the sales, and contributions made by maintenance of markets and demand side factors to the profitability of the non-resident enterprise;
- Omitted the option to determine attributable profits by way of 'apportionment', which is permissible under the pre-2010 OECD and UN model conventions.

UN Model Convention

Profits are to be attributed to a PE as if it were a 'distinct and separate entity':

(a) Direct accounting method based on the separate accounts of the PE; or

(a) Indirect apportionment method under the domestic laws in India [Rule 10 of the IT Rules], where detailed and accurate accounts are not available.

Friction between OECD and UN Approach

Limited Force of Attraction

Article 7(1) of UN

Restricted deduction of expenses

Article 7(3) of UN

(Retained)

Accepts domestic apportionment methods

Article 7(4) of UN

(Retained)

"profits of the enterprise may be taxed in the other State but only so much of them as is attributable to…(b) sales in that other State 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…"

"no such deduction shall be allowed in respect of amounts by the PE 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…"

"…it has been customary in a Contracting State to determine the profits to be attributed to a PE 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…"

Article 7 (Profit Attribution): OECD and UN Models

- Most of India's treaties follow UN Model/ Pre- 2008 OECD Model Approach
- Treaties with Singapore, Canada, Mauritius, Poland, etc. provides an additional clause that in case correct amount of profits attributable to PE is not determinable then the profits attributable to PE may be estimated on a reasonable basis.
- Reservation on inclusion of Authorized OECD approach (AOA) under Art. 7(2) of the OECD MC to attribute profits based on FAR analysis.
- Rule 10, ITR, 1962: In case profits attributable to business connection cannot be ascertained, tax authorities may resort to any of three methods: (i) Presumptive method - Percentage of turnover accruing or arising as Revenue may consider reasonable; (ii) Proportionate method - Proportionate profits based on world income attributed to PE; (iii) Residuary/Discretionary method.
- Indian tax treaties, domestic law and several court decisions have upheld the apportionment method as envisaged in treaties - ***E-Funds Corporation v. ADIT [(2017) 399 ITR 34 (SC)***

An objective method was not prescribed in the existing regime - wide discretion was accorded to the assessing officers - different methodologies seem to have been adopted in different cases, leading to litigation due to uncertainty.

India’s Treaty Position on Attribution

- India’s tilt towards **Article 7 of UN Model**:

Profits are to be attributed to a PE as if it were a ‘distinct and separate entity’:

(a) Direct accounting method based on the separate accounts of the PE; or

(b) Indirect apportionment method under the domestic laws in India [Rule 10 of the IT Rules], where detailed and accurate accounts are not available

- Treaties with Singapore, Canada, Mauritius, Poland provide an additional clause that in case correct quantum of profits attributable to PE is not determinable then the profits attributable to PE may be estimated on a reasonable basis.

Reservation on inclusion of Authorized OECD Approach (AOA) under Art. 7(2) of the OECD MC.

a) Approach favours capital exporting countries.

b) Approach does not address the issue of digital business models

a) Business profits are dependent on sale revenue and costs; sale revenue, in turn, depends on both demand and supply → hence it is not appropriate to attribute profits exclusively on the basis of FAR alone.

CBDT Committee Proposal for Public Consultation - 2019

- CBDT committee examined the existing scheme of profit attribution under Article 7 of the DTAAs and recommend changes to Rule 10 of the ITR.
- Released proposal on April 18, 2019
- Addressed concerns relating to excessive taxation due to its uncertainty and *ad hoc* basis for determining profits attributable to a PE

Concluded

- Both demand and supply of goods were integral contributors to business profits; and
- A mixed approach that accounts for both these factors should be used to attribute profits.

Rejected

Formulary apportionment as it would require country wise information of the MNEs to arrive at their global profit for apportionment.

Suggested

Fractional apportionment as it considers only those profits that have been derived from India

CFC Rules
Session 2

Back to basics

- Corporate law concept – separate and distinct legal entity

- Shareholder level – Tax law applies at the time of distribution of income

- Most prevalent form of tax avoidance –
- Deferral → delayed taxation

Evolution of CFC Rules

The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland…I therefore recommend that legislation be adopted which would, after a two-step transitional period, tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations…

What are CFC Rules?

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- In general, CFC is a foreign company that:
  - ✓ Is directly or indirectly controlled by a resident taxpayer;
  - ✓ Earns substantial passive income; and
  - ✓ Is subject to substantial lower taxation than in resident state
- Passive income arising in overseas jurisdictions is attributed to resident shareholders
  - ✓ Passive income – interest, rent, dividends, royalties and capital gains
- Nature of control
  - ✓ Generally, > 50% ownership (e.g., US, UK)
  - ✓ Voting power (e.g., US)

General - CFC

- CFC is defined as a foreign company that is either directly or indirectly controlled by a resident taxpayer.
- CFC is set up in a foreign jurisdiction where there is little or no tax.

- A CFC must ideally be controlled by one or more participants, who can make financial policy decisions.
- Tax avoidance via foreign entities is most likely to be effective if the income of these entities is taxed at a lower level in their country of residence than the income of their participants in the participants' country of residence.

- Definition of CFC varies from jurisdiction to jurisdiction in terms of control.

Approaches in Control

- Taxation test: if the foreign company does not pay tax in its jurisdiction of residence
- Voting rights held by resident taxpayers
- Shareholder value held by resident taxpayers
- If the company carries out its operations in a low-tax jurisdiction

Components of CFC

CFC legislation in most countries has a number of components:

- The first part sets out rules for determining the type of entity that is viewed as 'controlled'. Generally, the starting point is that the entity is not tax resident in the parent jurisdiction.

- Once the CFC has been identified, the rules then set out the consequences of taxing certain income of the CFC in the hands of the residents of the parent jurisdiction, as if it had been remitted to them or was their income, even though there is no actual remittance, and the income clearly remains within the legal ownership of the CFC itself.

Methods of Taxing CFC

CFC rules attempt to tax 'passive' income, the income which is taxed at a rate lower than that which applies in the parent jurisdiction, as also income from related parties.

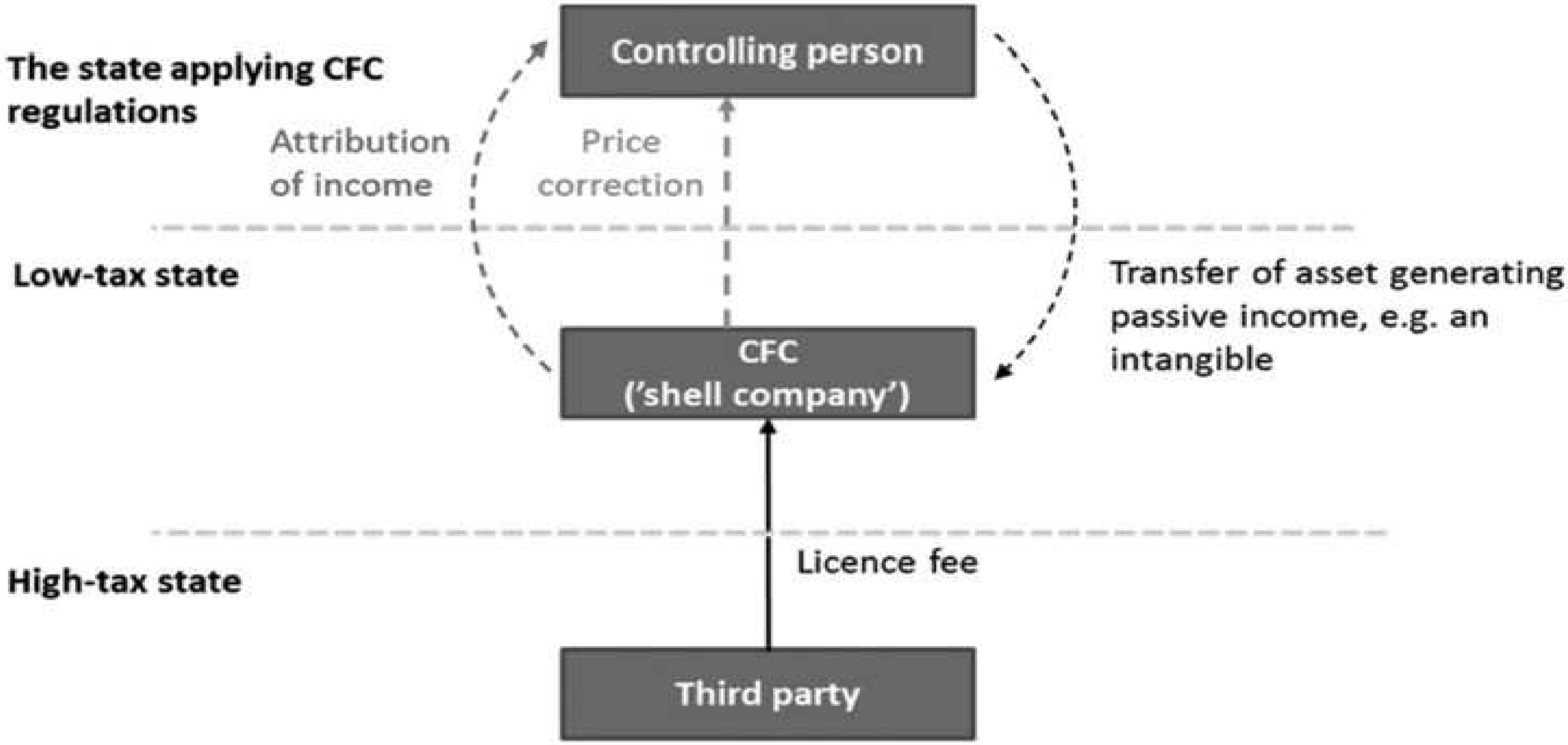
Passive income typically includes:

- Dividends and
- Certain types of interest and royalties

CFC regimes which target income taxed at a lower rate do so by :

- identifying or listing the countries with low tax rates or
- by setting a minimum tax rate threshold, or by a combination of both.

Example – CFC v. TP regulations



Revolutionary Changes to the Arm's Length Principle under the OECD BEPS Project
INTERTAX, Volume 46, Issue 3 (2018)

Policy Rationale to introduce CFC Rules

The CFC Rules can fulfill the following requirements:

- As a general “anti-deferral” measure
- As a defensive measure against the investment in tax havens and in jurisdictions with a preferential tax regime
- As a tax policy measure against the erosion of the domestic tax base and to reduce the outflow of capital towards low-tax countries
- As a supplementary legislation to transfer pricing rules
- As a supplementary legislation to the residence test

OECD/G20 BEPS Action Plan 3 Report
Designing effective CFC Rules

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The report sets out the following six building blocks for the design of effective CFC rules:

- Definition of a CFC
- CFC exemptions and threshold requirements (next)
- Definition of income
- Computation of income
- Attribution of income
- Prevention and elimination of double taxation

Co-ordination with AP-1, AP-2, AP-4, AP-5 and AP-8 to 10

CFC Exemptions and Threshold Requirements

Country	Approach
Canada	*Global approach* CFC rules are applied to all CFCs irrespective of where they are resident or the amount of foreign tax on their income
USA, Germany	*Low-taxed-income approach* countries adopt a global approach but provide an exemption for income that is subject to a minimum level of foreign tax
Others Most Common	*Designated-jurisdiction approach* CFC rules apply only to CFCs in defined or listed low-tax countries

Design and Compatibility with Tax Treaties

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❖ For including a CFC's income in the taxable base at the level of the parent company

Look-through Approach

- CFC is regarded as tax transparent;
- Its income is considered the own income of the parent company

Deemed dividend Approach

- Income is assumed to be paid by CFC to parent company as dividend;
- Regardless of actual dividend payment

❖ Relevant while deciding on compatibility of CFC rules with tax treaties

Controversy

CFC rules following look-through approach should not apply to business profits under A. 7 of the OECD Model

Controversy

CFC rules following deemed dividend should be considered a breach of Article 10 (5) of the OECD Model

Design and Compatibility with Tax Treaties

Position of OECD

- Commentary on Articles 1, 7 and 10 of the OECD Model
- The OECD does not consider CFC Rules to constitute a treaty override

Para 81 of Commentary on Article 1

India's Proposed CFC Rules: Direct Tax Code (1)

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- India planned to introduce CFC rules as part of its' Direct Tax Code Bill (DTC)
- The draft rules required every resident taxpayer to furnish details of investment and interest in any entity outside India in a manner as may be prescribed by the CBDT
- Residents having an interest in a CFC would be required to include income attributable to a CFC in their taxable income in the following manner:

$$\frac{A \times B}{100} \times \frac{C}{D}$$

where,
A = specified income of the CFC
B = percentage of (i) value of capital, or (ii) voting share of interest, whichever is higher, held by the taxpayer in the CFC
C = number of days out of D, the voting shares or capital or interest has been held by the taxpayer in the CFC
D = number of days the company remained as a CFC during the accounting period

India’s Proposed CFC Rules: Direct Tax Code (2)

Definition of a CFC: A CFC is defined as a foreign company which satisfies each of the following conditions

It is a tax resident of a territory with lower rate of taxation

The shares of such company are not traded on any recognized stock exchange

One or more persons, resident in India, individually or collectively exercise control over the company

It is not engaged in any active trade or business

Specified income of the company determined in the specified manner exceeds INR 2.5 mn

Brazil Case Study (I)

Petrobras
(Brazil)

Brazilian Oil and Gas state-owned enterprise

Brazil 'CFC' Legislation:

- Annual inclusion of the profits of PNBV in the taxable base of the parent company in Brazil, irrespective of its actual distribution.

Since Petrobras had not included profits of PNBV, it was charged for the corresponding income tax, social contributions and penalties that surpassed 75% of the debt.

Brazil

The Netherlands

Petrobras NL BV
(The Netherlands – 'PNBV')

- PNBV HQ – 600 m2
- Employs 26 people (incl 6 directors and 2 Dutch residents)
- Petrobras invested EUR 750 mn in assets for activities in NL

Dutch subsidiary carrying out its business in Europe

Brazil Case Study (II)

- Issues under consideration:

  - ✓ Whether the Brazilian CFC Rules are compliant with the Brazilian tax system?
  - ✓ Whether CFC rules have an anti-abuse character and what are the consequences for its interpretation and application?
  - ✓ Whether analysis of the substance and business purpose of the Ducth entity would be relevant for the purposes of interpretation of the CFC Rule?
  - ✓ Whether income taxed under CFC rule should be qualified as dividends or business profits under the Brazil-Netherlands tax treaty?

Brazil Case Study (III)

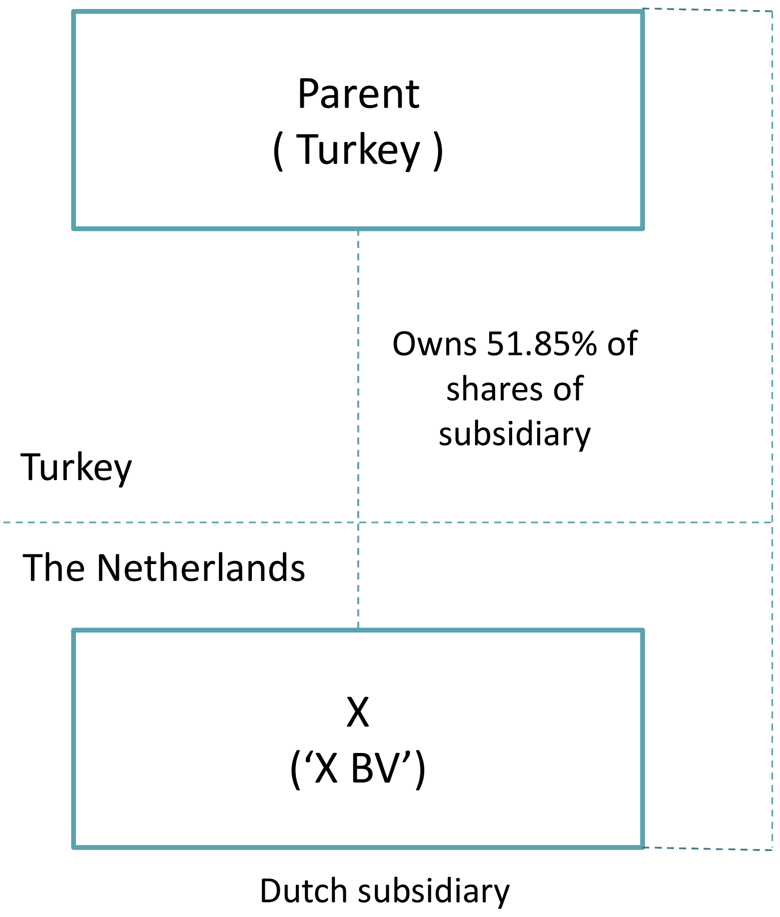
- Tax Authorities' Arguments:
  - ✓ Economic availability to the parent company (equity increase or deemed dividend) is sufficient for the purpose of levying income tax in Brazil under CFC Rule. Financial availability (actual profit distribution) is not necessary.
  - ✓ The CFC Rule has the nature of an anti-abuse rule.
  - ✓ Existence of a business purpose or substance of activities not relevant.
  - ✓ A. 7 of the Brazil-NL treaty do not conflict with the CFC rules and the latter are perfectly compliant with A. 7 principles.

- Taxpayers' Arguments:
  - ✓ Brazilian CFC rule violates the concept of income under the domestic tax system - against ability to pay principle.
  - ✓ Abusive behavior to be evidenced by tax authorities – to prove that PNBV was a 'paper company' w/o operational capacity, etc.
  - ✓ No GAAR in force in Brazil – tax authorities have no grounds to apply anti-abuse rule.
  - ✓ It was in breach of A. 7 (situation of treaty override)

Brazil Case Study (IV)

- Brazilian Court of Justice – dissenting views
- Issue: Whether for treaty purposes (Brazil-Netherlands Tax Treaty - 1990), taxation under former CFC rules should be regarded as business profits (article 7) or alternatively as dividend taxation (article 10)
- The Court held that since the profit would be "economically available", the rule would apply so that not the profits of the foreign company, but its dividends would be taxed
- Hence, profits under the domestic CFC legislation would be qualified as dividends for the purposes of Brazil's tax treaties

Turkey Case Study (I)



- 2006-07: Turkish Parent included undistributed CFC income in its tax return.
- 2008: Subsidiary distributed actual dividends to the Parent
- Parent applied for credit of paid CIT and refund for the year 2006-07.
- Tax authorities rejected Parent's application
- Parent Co. appealed based on CFC rule and A. 23 of NL-Turkey tax treaty.

Turkey's 'CFC' Legislation:

- A. 7 of the Corporate Income Tax Law – CFC earnings (w.e.f 01.01.2006)
- Profits of a CFC (corresponding to the participation ratio), whether distributed or not, may be taxable in Turkey

Turkey Case Study (II)

- Issues under consideration:

  - ✓ No discussion about application of CFC rules
  - ✓ Consequences of application of CFC Rules – their aim and position in Turkish Tax system; Tax security measures, to protect tax base from deferral
  - ✓ *“The income of the CFCs covered in the scope of the article, which shall be taxed in Turkey, will be the corporate income after the deductions, including the deduction of the losses, but before the exemptions”.*
  - ✓ Relationship between the CFC Rules and tax treaties
  - ✓ Violation of constitutional principles – clarifications through an administrative announcement

Turkey Case Study (III)

- The first degree tax Court and the Supreme Administrative Court – against the taxpayer
- The Courts held that the taxpayer’s undistributed CFC income during the years 2006 and 2007 was a taxable income that needed to be declared and taxed in Turkey.
- Thus, there was no reason to refund the taxes that had been paid.
- Revenue protective approach
- Possible case of treaty override – practice of applying domestic rules to international issues
- Participation exemption not considered by courts or arguing parties – if an income derived from foreign sources has already been exempted, there is no reason to apply CFC rules.

Learnings

- Tax policy choices - enacting coherent CFC regimes to counter tax deferral and income diversion - respecting tax treaties.
- Whether deferral and income diversion should be curtailed as a matter of principle **or** only if the deferred/diverted income is low taxed in the state of residence of the CFC?
- Is CFC opposed to the very theoretical basis of Article 7?
- Inter-relation between Pillar Two and CFC Rules?
- Limitations of CFC rules - CFC rules do not usually apply to active business income or to deductible payments received from related parties.
    - ✓ While CFC rules are reasonably effective in preventing resident taxpayers from diverting passive income and limited types of business income to CFCs, they do not prevent all types of base erosion.

Divyasha Mathur
divyasha.mathur@bmrlegal.in

Annexures

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Controlled foreign company provisions

81. A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign base companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign company legislation conflicted with these provisions. Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1; for the reasons explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10, the interpretation according to which these Articles would prevent the application of controlled foreign company provisions does not accord with the text of paragraph 1 of Article 7 and paragraph 5 of Article 10. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign company legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention.

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