Article 7 – Force of Attraction

NALSAR University of Law

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This PPT shall be used only for reference purpose

Profit attribution under domestic law

- **Rule 10 –**
  - ✓ Determine actual profit if it can be ascertained
  - ✓ If actual profit determination fails in opinion of Assessing Officer, the Assessing Officer can ascertain profits:
    - o By adopting reasonable % of turnover
    - o By adopting global profit formulary approach in the ratio of Indian receipts to total receipts
    - o Such other manner as Assessing Officer deems suitable

- Explanation 1(a) to Section 9, Provision to Expl 2A/Expl 3 of 9(1)(i) – refers Attribution of income

- **CBDT Circular No 23 of 23 July 1969 (withdrawn now) reads as follows:**
  "Section 9 does not seek to bring into the tax net the profits of a non-resident which cannot reasonably be attributed to operations carried out in India......... It is only that portion of the profit which can reasonably be attributed to the operations of the business carried out in India, which is liable to income-tax.'

- **Circular No 5 of 28 September 2004 – Taxation of IT Enable BPO units in India**
  - ✓ Focus is on attribution as per treaty
  - ✓ Confirms and reiterates that Non-resident is taxable in respect of income attributable to activities of PE in India
  - ✓ CBDT equates such income with Arm's length principle'

- Presumptive taxation recognized for certain sectors

Article 7 – Framework - MC

Para	UN Model	OECD MC
7(1)	Income Attributable to PE Force of Attraction Rule (if any) or Indirect attribution	Income Attributable to PE
7(2)	As if PE is • a distinct and independent enterprise • engaged in same or similar activities • under same or similar conditions	In addition, UN model provisions, OECD also include an aspect of **<u>taking into account of FAR</u>**
7(3)	Actual Expense incurred, incl. reasonable allocation of General & Admin Overheads • Whether in source state or in HO state • Subject to domestic law • No deduction for HO payment (except reimbursement of actual expenses)	Provisions concerning avoidance of double taxation
7(4)	Applying Apportionment method in case of difficulty (reasonable)	Provisions of those Articles overrides Article 7
7(5)	Methodology applied consistently Y-on-Y	
7(6)	Provisions of those Articles overrides Article 7	

Article 7 - India's Treaty Structure

Para	Contents
7(1)	• Income Attributable to PE • Force of Attraction Rule (if any) ('FoA') or Indirect attribution
7(2)	• a distinct and independent enterprise • engaged in same or similar activities • under same or similar conditions

7(3)	• Actual Expense incurred, incl. reasonable allocation of General & Admin Overheads
	  • Whether in source state or in HO state
	  • Subject to domestic law
	  • No deduction for HO payment (except reimbursement of actual expenses)

Others	Applying Apportionment method in case of difficulty (reasonable) • Methodology applied consistently year on year • Exception for Purchase activity

Article of Non discrimination is also relevant subject to wordings of Tax Treaty

Concept of FoA

"Principle under which a country may tax a foreign enterprise in respect of income it derives in the other country if the enterprise maintains a permanent establishment in the other country irrespective of whether that income is derived through or otherwise economically connection with the permanent establishment…"

- IBFD International Tax Glossary

UN Model Convention, 2021

"….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".

Rationale for FoA

- Prevent tax evasion/avoidance through artificial contracts/business arrangements
- Identification of business transactions - Source based taxation

FoA in Model Conventions

Aspects	OECD	UN	US
Type	No FoA	Limited FoA	Does not include FoA in DTAA; but there are certain DTAA contain FoA. Code Section 864(c)(3) contains limited FoA under the domest law
Method	DSE and taking into FAR Analysis	DSE with Restricted FoA and FAR Analysis	DSE and FAR analysis
Attribution	Attributable to PE	Attributable to (i) PE (ii) Direct sale of same goods/similar goods as those sold through PE (iii) Other same/similar business activities as those carried on through PE	Refer India-US DTAA - Similar to UN Mode

Types of FoA

- **Full FoA** - All profits derived in source State taxable as profits of the PE whether or not they are of similar or same kind as transactions carried on by PE; and whether or not attributable to such PE (i.e. 100% attribution) – **(Not used internationally)**

- **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

FoA Rule

Arguments favoring FoA

- When an enterprise has set-up a PE in a state, it has brought itself within the jurisdiction of the state to such degree that they can properly tax all profits derived by the enterprise from the state.
- FoA would reduce tax avoidance
- Members of developing countries point out that FoA approach avoids administrative problems

- Undesirability of taxing income from an activity that was totally unrelated to the establishment.
- The fiscal authority of the PE state should look at the separate source of profit that the enterprise derives from their country and should apply to each source the PE test.
- Legitimate commercial reasons drive enterprises to conduct business in the source state

Arguments against FoA

India’s Treaty with other countries

- India DTAA’s with other countries are mostly in line with UN MC
- Many DTAA adopts language of UN MC i.e. limited FoA – Around 25+ DTAAs contain FoA - *Canada, Belgium, Denmark, Italy, USA, France etc.*
- 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*
- 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.*
- 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*.
    - As per *India-Vietnam* – PE should have an active role in negotiation of the contract
- *Switzerland (Protocol)* – Contracts for survey, supply, installation or construction of ICS – Profits not to be determined on total value of contract – Such portion of contract effectively carried out by PE
- Force of attraction rule has been omitted subsequently - *Norway, Australia, China etc*

Extracts from DTAAs

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** :

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

ii. the permanent establishment in **any way was involved in this transaction**.

Extracts from DTAAs

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 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 **directly or indirectly attributable** to that permanent establishment.

3. Where a permanent establishment **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 permanent establishment 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 permanent establishment.

Broad FoA rule was used for the first time in Article III of the 1945 US - UK DTAA :

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

(2) A US 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 its is 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 the PE, but extends to all profits earned by the foreign enterprise from ‚within' the PE state

Same or Similar

- The expression “***same or similar”*** is not defined in the tax treaty. Neither there is a definition under domestic law.

- Ordinary meaning can be adopted

- **“Same”** – resembling in every aspect / identical

- **“Similar”**
  - ✓ **Oxford Dictionary** – of the same kind in appearance, character, or quantity, without being identical
  - ✓ **Law Lexicon** – Partial resemblances and may also denote same in all essential particulars
  - ✓ **Customs law** – The phrase ‘similar’ or ’identical’ are used for valuation purposes - “Although not like in all aspects, have like characteristics…”

Item	Criteria satisfied
Computer and Printer	No
Copy Machine and Scanner	Yes

Same or Similar

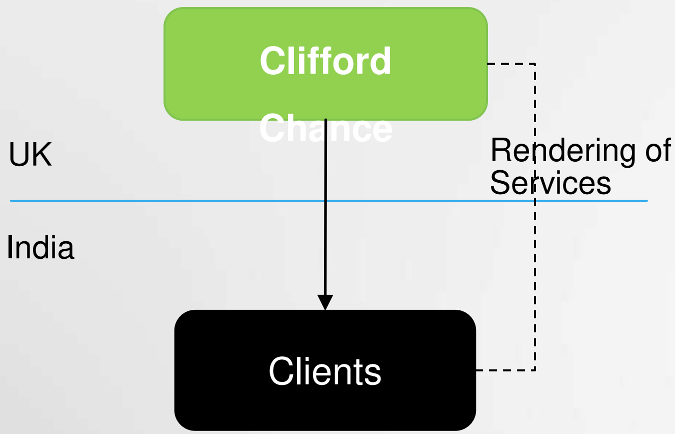
Same or similar goods or merchandise

- Following factors may be considered to evaluate same or similarity of goods or merchandise:
  - ✓ Nature of goods
  - ✓ Characteristics of goods
  - ✓ Purpose or utility of goods

Same or similar activities

- Same or similar activities have not been defined or discussed
- Court has analysed the term "similar business" in many cases. Following factors may be relevant to determine whether two businesses are similar or not:
  - ✓ Proximity of time when the two businesses are carried out
  - ✓ Proximity of place where the two businesses are carried out
  - ✓ Commonality of purpose and continuity of action / connectivity of the two businesses and unity of command/ common management
  - ✓ Whether a business can be continued after closure of the other
  - ✓ Whether both the businesses are carried out through common employees
  - ✓ Whether the expenses incurred for such businesses are common

Clifford Chance (SB) – 143 ITD 1



<u>Facts in brief</u>

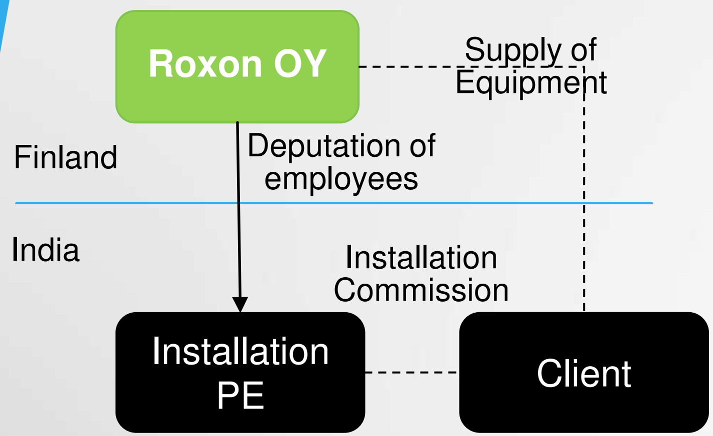
- UK LLP firm rendered consultancy services to clients in India.
- UK Firm did not have any branch or any fixed place of business.
- The services were rendered in UK and India.
- Personnel of firm visited India to render services to client in India

<u>Issue</u> – Whether income earned in respect of services rendered in UK is taxable in India

Special Bench ruling

- Directly attributable to PE –explained in Article 7(2) - PE be treated as separate and distinct enterprise
- Profits indirectly attributable to PE" –Defined in Article 7(3)
  - ✓ Active part in negotiating, concluding or fulfilling contracts
  - ✓ Article 7(3) is unambiguous
- Meaning given in UN convention is materially different from provisions of Article 7(1) of Indo-UK treaty -no need to rely on meaning given under UN Convention
- Profits apportioned to activities of other parts of enterprise cannot be treated as profits indirectly attributable to the PE.
- Overruled the interpretation ‘directly or indirectly’ of Mumbai ITAT ruling in the case Linklaters LLP.
- Explanation to Sec.9(2) – impact explained

Roxon OY – 106 ITD 489 (2007)



Facts in brief

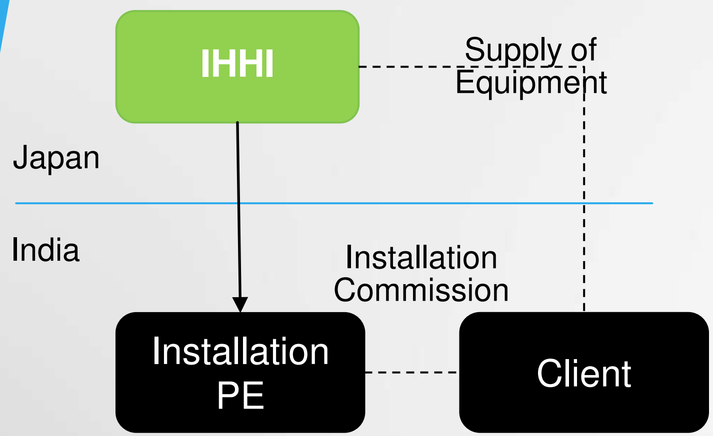
- F Co was assigned turnkey contract for sale of equipment including I&C and training
- F CO directly supplied the equipment to Client
- Employees were sent to India to carry out I&C and training – This has resulted in installation PE

Issue – Whether income earned in respect of sale of equipment is taxable in India?

Tribunal 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 – *abinitio*
- 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
- Question of taxing such profit does not arise unless PE was set-up
- Even otherwise, no part of equipment supply profit can be attributed to PE if supply is at arm's length
- Profit on sale of equipments not taxable in India, since FoA is not applicable

Ishkiwajima Harima Heavy Industries – 288 ITR 408



Facts in brief:

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: Whether income of sale of equipment is taxable in India in light of Protocol to India-Japan DTAA

Supreme Court Ruling

- Tax Treaty between India and Japan is essentially based on OECD model which does not have a FOA rule.
- Article 7(1) of the OECD MC allows the PE State to tax only those profits which are economically attributable to the PE, i.e. those which result from the PE's activities, which arise economically from the business carried on by the PE.
- The Revenue's contention for invoking the provisions of article 7(1) of the Treaty read with para 6 of the protocol for considering the offshore supply within the meaning of the phrase directly or indirectly attributable to that permanent establishment, was held to be incorrect.
- SC noted that PE's non-involvement in the offshore transactions excludes it from being part of income.
- The 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.

Thank You

Q & A