



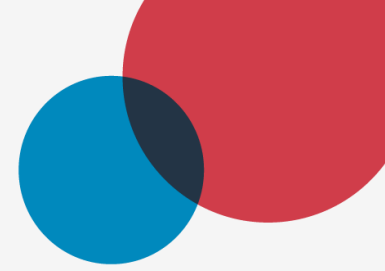
Business Profits

Taxand Asia Junior
School 2019

July 29-31, 2019

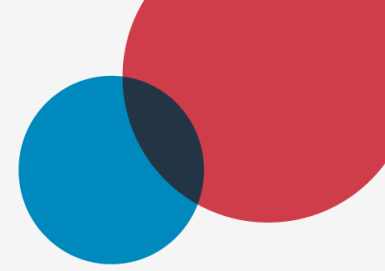
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Outline



- ❖ Relevance of “Business Profits” & Domestic Law
- ❖ Tax Treaty Law
 - Main Rule – exception
 - Arm’s Length Principle
 - Current OECD Commentary
 - UN Model
- ❖ Current and Future Developments
 - The authorised OECD approach (AOA)

Structure of Art. 7 OECD MC



PRIOR TO 2010

- (1) Main rule + Exception
- (2) Arm's Length Principle
- (3) Allocation of Expenses
- (4) Indirect Method (Fractional Apportionment)
- (5) Special Rule for Purchasing Offices
- (6) Consistency in Profit Attribution
- (7) Relationship with other Distributive Rules

2010/2017 OECD MC

- 1) Main rule + Exception

- (2) Arm's Length Principle

- (3) Elimination of Double Taxation

- (4) Relationship with other Distributive Rules

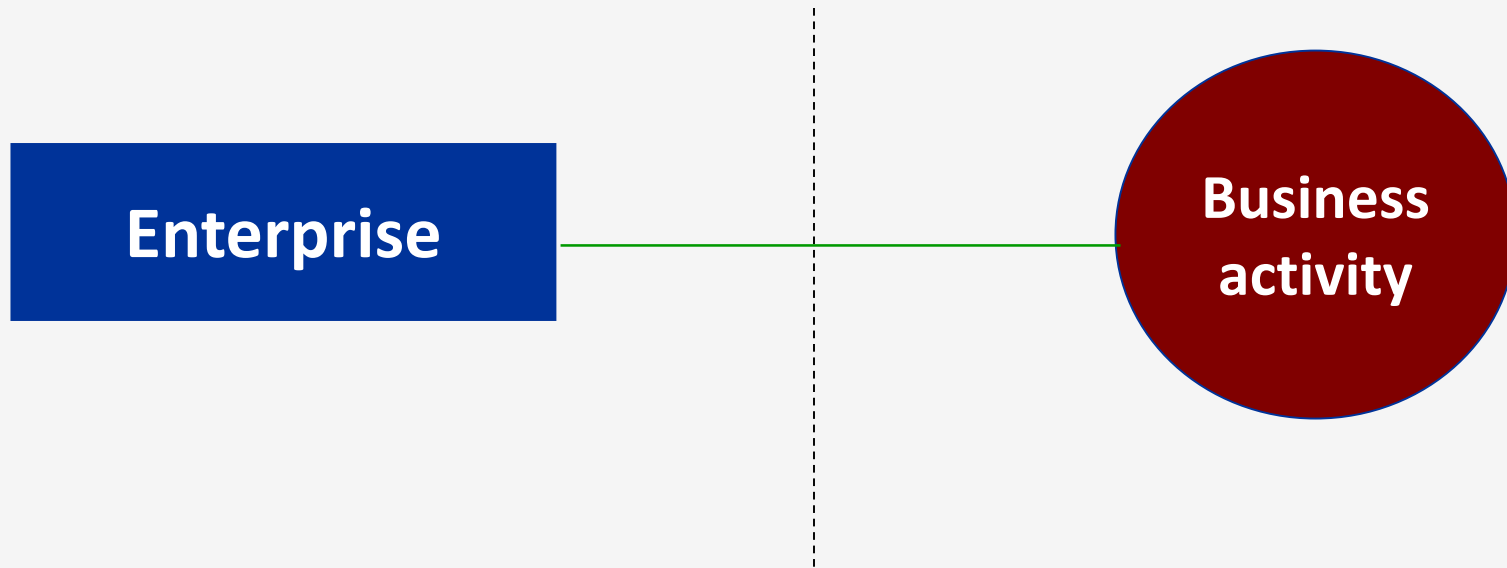
Note: UN Model adopted the pre-2010 version in developing the 2011 UN Model

OECD – Taxation of a PE



Residence State

Source State

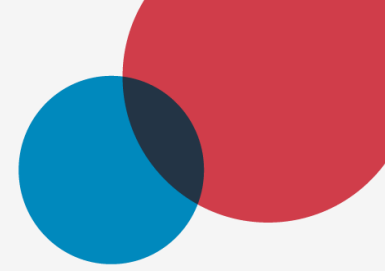


Where are the profits taxable?

Basic Principles

- ❖ Existence of a Permanent Establishment
- ❖ Allocation of Taxing Rights
- ❖ Profit Attribution

Art. 7(1): Allocation of Taxing Rights on Business Profits



❖ Para. 1, Article 7, Model Convention:

Profits of an enterprise only taxable in State of residence of enterprise

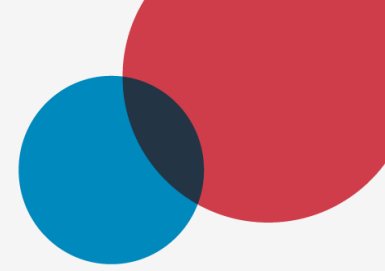
unless

enterprise carries on business in the other Contracting State through a PE situated there

consequence

the profits of the enterprise may be taxed in the other State but only so much as is attributable to that permanent establishment.

Art. 7(1) – Main Rule/Exception



- ❖ Business profits is the most important category of income for international (and generally for domestic) tax purposes
- ❖ 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”.
- ❖ Enterprise of a Contracting State: Art. 3(1)(d)
- ❖ Permanent Establishment: Art. 5
- ❖ Attributable: Art. 7(2)

Art. 7(1) – Main Rule/Exception



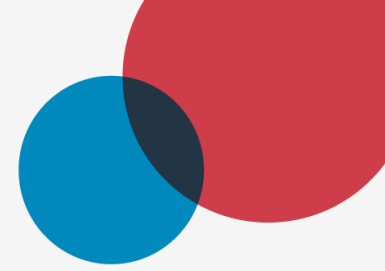
❖ Rationale

- Until an enterprise of one State has a PE 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

❖ Limitation

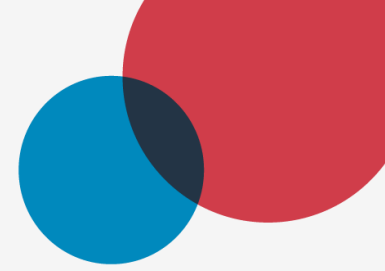
- The right to tax of the State where the PE is situated does not extend to the profits that the enterprise may derive from that State but that are not attributable to the PE

OECD Commentary



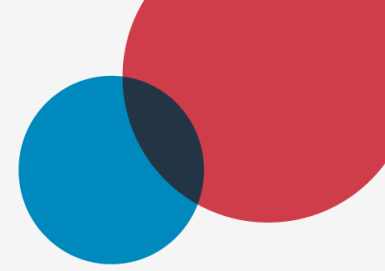
- ❖ The OECD rejected the “Force of Attraction Principle” (where income such as other business profits, dividends, interest and royalties arising from sources in their territory are fully taxable by them if the beneficiary had a PE therein even though such income was clearly NOT attributable to that PE.
- ❖ **UN Model (Para 7[1][b] & [c])** includes:
 - ❖ Sales in that other State of goods or merchandise of the same or similar kind as those sold through the PE
 - ❖ Other business activities carried on in that other State of the same or similar kind as those effected through the PE

Art. 7(2): Profit Attribution



- ❖ The profit attribution rules determine the Source State's taxing rights by reference to:
 - ❖ Nature of income
 - ❖ Quantity of income
- ❖ It determines amount/limit of Double Taxation relief in Residence State

Art. 7(2): 2005 version vs. 2010 version



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 PE 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.

2. For the purposes of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the PE 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 of 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.**

How are Profits Attributed?



- ❖ OECD - “but only so much of the profits as is attributable to that permanent establishment”
- ❖ How?

“... 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 taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through other parts of the enterprise . . .”



Look to relevant
business activity



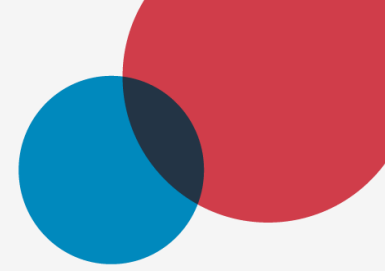
Functional separate
entity

Relevant Business Activity Method



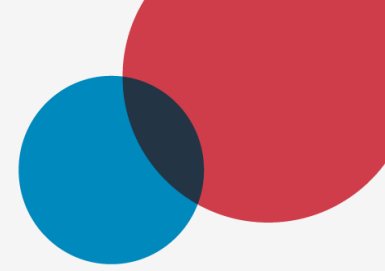
- ❖ Only so much of the profits of the business activity in which the PE has some participation
- ❖ Look at profits of a single enterprise (*i.e.*, of the PE and the enterprise of which it is a part of)
- ❖ Takes the view that no profit is earned between the PE and the enterprise of which is it a part of – only with 3rd parties
- ❖ Takes into account the following:
 - Functions performed
 - Assets used
 - Risks assumed

Functional Separate Entity Method



- ❖ Determination of the profits under the fiction that the PE is a separate enterprise
- ❖ Application of Arm's Length Principle, so also taxation of notional profits possible – even where the enterprise itself makes a loss
- ❖ Preferred by the OECD (adopted in 2010/2017 model)

2010/2017 – Functional and Factual Analysis (1st Step)



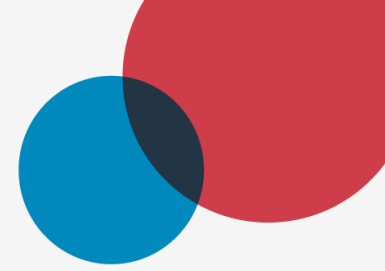
- ❖ Attribution to the PE of the rights and obligations arising out of the transactions
- ❖ Identification of significant people functions relevant to the attribution of economic ownership of assets
- ❖ Identification of significant people functions relevant to the assumption of risks
- ❖ Determination of nature of dealings between PE and other parts of the same enterprise
- ❖ Attribution of capital based on the assets and risks attributed to the PE

Arm's length pricing (2nd Step)



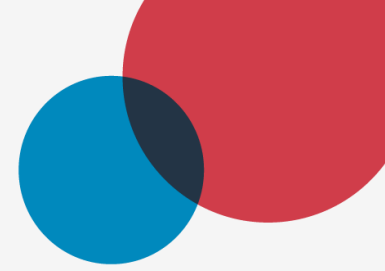
- ❖ Determination of comparability between dealings and uncontrolled transactions established by OECD Transfer Pricing Guidelines' comparability factors directly or by analogy
- ❖ Applying by analogy of one of the Guidelines' methods to arrive at an arm's length compensation for the dealings between the PE and other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE and the other parts of the enterprise

Consider...



- ❖ Thai Co. Ltd, a company based in Thailand has an office in India which acts as a sales office. The sales office is run by one employee who acts on behalf of the Thai company in India. The Thai company does not have a subsidiary company in India, nor has it registered a branch here.
- ❖ The employee in India enters into negotiations on behalf of the Thai company although most purchase orders are placed directly between the end-purchaser and the Thai Company. However, there is a warehouse in India from which such orders are fulfilled.
- ❖ ***Is the Thai company taxable India based on the model convention?***
- ❖ ***Is there a PE?***

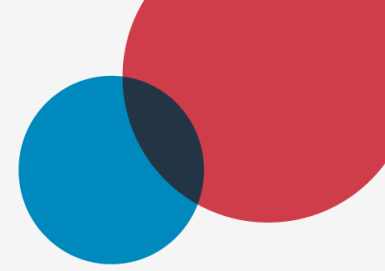
Implications of a PE



- ❖ What are the implications?
- ❖ If there is a PE ...?
- ❖ Business profits attributable to that PE will be taxed in India
- ❖ If the PE is essentially securing and making sales, the gross margins* associated with those sales would be the attributable income for the PE
- ❖ Expenses incurred at the sales office and some expenses incurred in Thailand would need to be charged to the sales office

(*“gross margin” – based on the arm’s length principle)

Example



STATE A



Co. A
(Manufactures cereals)

Transfer the cereals



STATE B



PE of Co. A

Sales
to Customers
in Country B



Example



- ❖ Cost of the cereal: 30 State A levies tax on 20
- ❖ FMV at time of transfer to State B: 50
- ❖ Sales price to customers: 90 State B levies tax on 40

In some States (accounts approach):

- ❖ State A levies tax upon transfer to PE on 20 (50 - 30)
- ❖ State B levies tax upon sale to customer on 40 (90-50) and State A taxes also 40 (90-50) but gives relief on 40 (exemption or credit)

In other States (allocation approach):

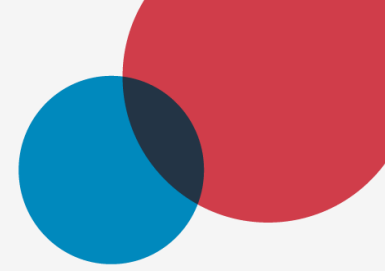
- ❖ State A does not levy tax upon transfer to PE
- ❖ State B levies tax upon sale to customer on 40 (90-50) and State A also levies tax at that time but on 60 (90-30) but gives relief on 40

Deductibility of Expenses



- ❖ Same rights as resident enterprise (Art. 24, para. 3)
 - Expenses incurred by an enterprise for purposes of the activities of the PE
 - Expenses attributed to the functions performed by other parts of the enterprise wholly or partly for the benefit of the PE (overhead)
- ❖ Arm's length principle: Requires the recognition and arm's length pricing of dealings between parts of an enterprise
- ❖ No Apportionment: Apportionment of profits of an enterprise to its various parts was deleted; to be applied only to the extent that its application is customary in a Contracting State

Art. 7(3): Expenses (prior to 2010 version)

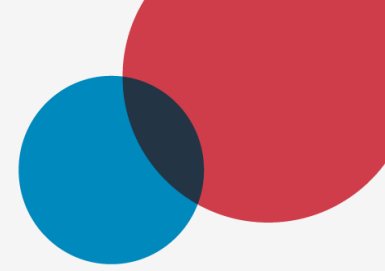


“In determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including executive and general administrative expenses so incurred, whether in the State in which the PE is situated or elsewhere”

Note:

- In the 2010 model, this was deleted as it was viewed to limit the expenses that indirectly benefited the PE to those actually incurred.*
- Deletion does not do away with expense deductions*

Art. 7(3): Expenses (prior to 2010 version)



❖ Previous Version of Article 7 -- The OECD Commentary contains several ‘**exceptions**’ to the arm’s length principle (though it says *there is no difference of principle between para. 2 and 3 of Art. 7*):

- Temporary transfer of assets (para. 33 Comm. on Art. 7)
- Intangibles (para. 34 Comm. on Art. 7)
- Services (para. 35-37 Comm. on Art. 7)
- Gen. management (para. 38 Comm. on Art. 7)

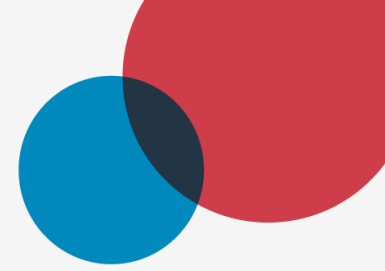
Art. 7(4): Expenses (prior to 2010 version)



“For the purposes of the preceding paragraphs, the profits to be attributed to the PE shall be determined by the same method year by year unless there is good and sufficient reason to the contrary”

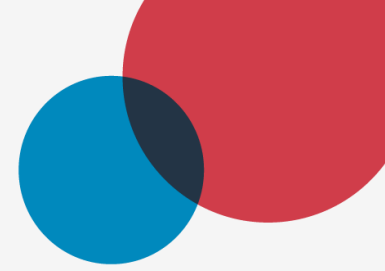
Note: Deleted in the 2010/2017 Revised Model Treaty; Intended to ensure consistent treatment, using direct and indirect methods or even on the basis of apportionment of the profits of an enterprise. However, the Commentary does not allow for application of fundamentally different methods and therefore no need of the provision.

Art. 7(3): Elimination of Double Taxation



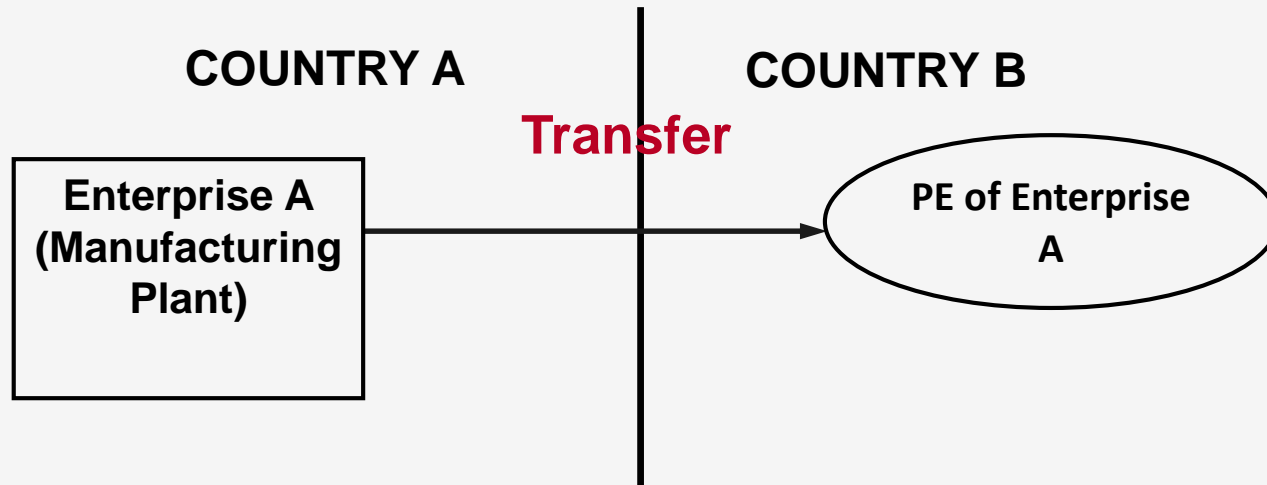
“Where in accordance with para. 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting State and taxes accordingly the profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits make the appropriate adjustment to the amount of the tax charged on those profits. ”

OECD Commentary



- ❖ Articles 7 & 23A and 23B (which obliges the other state to provide relief from double taxation) – ensure that there is no unrelieved double taxation.
- ❖ There is a need for two Contracting States to reach a common understanding to eliminate double taxation

Transfer of Assets

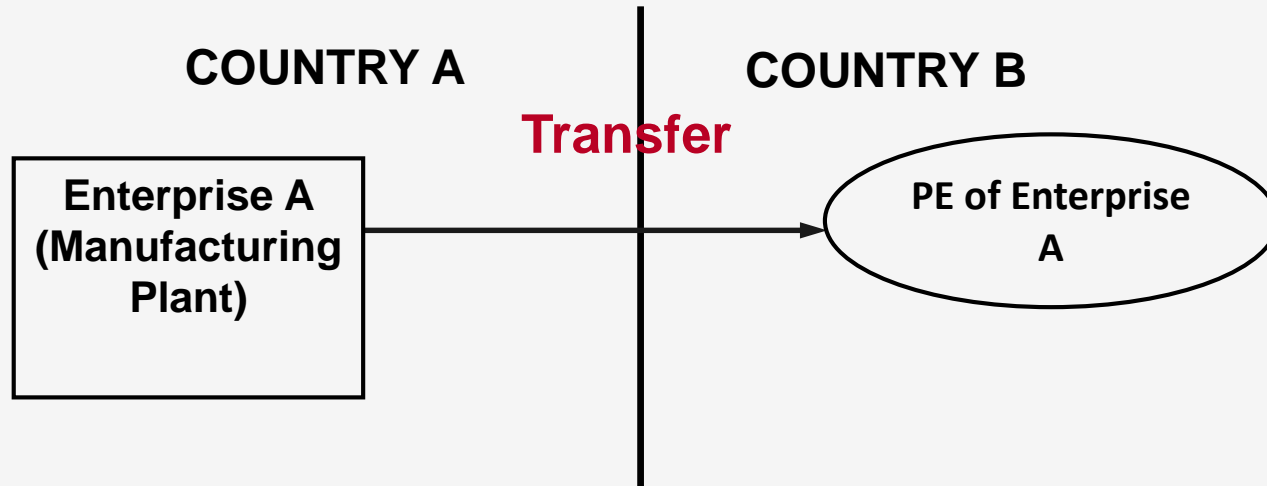


For purposes of determining profits: notional arm's length price

Example: 100

Both State should refrain from adjusting the profits and should not substitute their judgment for that of the taxpayer, provided para. 2 is complied with.

Transfer of Assets



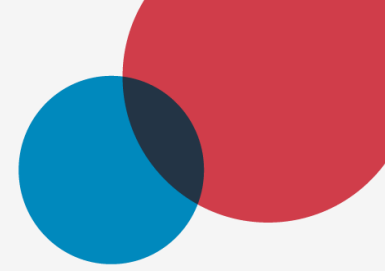
If para. 2 is not complied with, each State is entitled to make adjustment; where one State makes the adjustment, the other state should make reciprocal adjustment

OECD Commentary



- ❖ Issues:
- ❖ Para. 3 does not specify the method by which a corresponding adjustment is to be made
- ❖ Para. 3 leaves open the question whether there should be period of time after the expiration of which a State would not be obliged to make the adjustment.
- ❖ In case of dispute, the mutual agreement procedure under Article 25 should be implemented

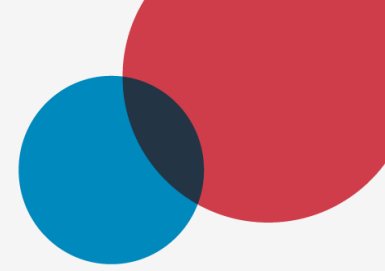
Art. 7(4): Relationship with other distributive rules



“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”

- **Priority is given to other Articles, Except Arts. 10(4) and 11(5) and 21(2) refer back to Art. 7**

UN Model (as of November 2017)



Contents

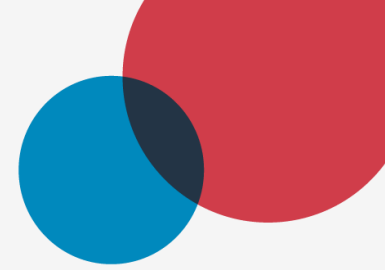
- 1) Main rule + Exception + Limited force of attraction rule
- 2) Attribution of profits following the Arm's Length Principle
- 3) Deduction for expenses of the PE + Allocation of Expenses
- 4) Method of profit attribution: apportionment of total profits of the enterprise to its various parts, as is customary
- 5) Consistency in Profit Attribution
- 6) Relationship with other Distributive Rules

Authorised OECD Approach (AOA) (2008 Report)



- ❖ Need for a preferred interpretation of Art. 7
 - Considerable variation in domestic law regarding the taxation of PE
 - No consensus on the correct interpretation of Art. 7
 - Lead to the formulation of the preferred approach for attributing profit to a PE under Art. 7 in terms of sound tax policy, simplicity, and administrability
- ❖ Two broad interpretations used by OECD member countries: (1) “functionally separate entity” approach; and (2) “relevant business activity” approach
 - FSE approach adopted as the AOA

Authorised OECD Approach (AOA) (2008 Report)



Two Steps:

❖ **Functional and factual analysis:**

- Think of PE as “distinct and separate enterprise” engaged in “same or similar activities” under “same or similar conditions” and “dealing wholly independently” with enterprise of which it is a part
- Identify the economically significant activities and responsibilities

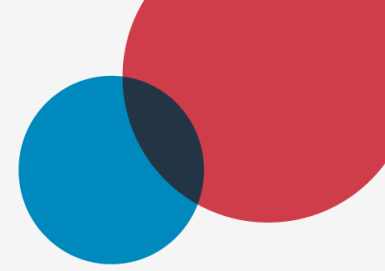
❖ **Arm’s length pricing analysis**

- Apply OECD’s Transfer Pricing Guidelines by analogy to “dealings” between PE and other parts of enterprise



Thank you.

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