Article 7 – Business Profits

Definition

As per article 7, the term "business profits" means income derived from any trade or business including income from the furnishing of services and including income from the rental of specified tangible personal property. However income from Royalty/FTS services as under article 12 are not covered.

Existence of PE

- The profits of an enterprise of a Contracting State (say USA) shall be taxable only in that State (i.e., USA) unless the enterprise carries on business in the other Contracting State (say India) through a permanent establishment (PE) situated therein (i.e., India).

- If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State (i.e., India) but only so much of them as is attributable to that PE.

  For example; a company of USA is to be taxed in India only if business carried out through its PE in India. Once there is a PE, country of source has primary right to tax only such profits as are attributable to PE.

- Further distinction is to be made between profits resulting from PE's activities and profits made without any interposition of the PE, say directly by HO or any other part of enterprise.

  For example; A Ltd (Head Office–USA) sells/supplies equipment to B Ltd (India) directly without the intervention of a PE existing in India for A ltd. Hence income from such an activity cannot be taxed under this article as there is no attribution to PE.

Attribution of profits – Separate Entity

- Such profits are attributable to PE as
  - ✓It might be expected to make if it were;
  - ✓a distinct and separate enterprise engaged in;
  - ✓same or similar activities;
  - ✓under same or similar conditions;
  - ✓dealing wholly independently with the enterprise of which it is a PE

- And transaction should be at arm's length.

Deduction for expenses

- In determining profits of a PE, deduction shall be allowed for expenses (including executive & general administrative)
  a. Incurred for the PE
  b. Incurred in or outside the source country
  c. In accordance with and subject to limitations of domestic laws

- Further most DTAA's does not allow for deduction of amounts paid by PE to the Head Office (HO) such as payments made towards royalties, commission, fees for specific services etc.,
- However reimbursement of actual expense incurred shall allowed as a deduction.

Mere Purchases - Exempt

- No profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise. In line with Article 5 which excludes enterprises established in source state solely for purpose of purchasing activities.

- It is concerned with a PE which, although carrying on other business, also carries function of purchase for its HO. Therefore this benefit is not available if PE carries out some process on purchased goods before exporting them outside India to the HO.

- However some DTAA's (like Belgium, Egypt, Zambia etc.,) specifically provide that goods should be for the purpose of exports to the enterprises to qualify for the above referred exclusion. Even explanation 1(b) to section 9 (1) (i) excludes income of NR on similar lines.

Method of Apportionment

- The profits to be attributed shall include only the profits derived from the assets and activities of the PE.

- Further the same shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

- Three categories which may be a criterion commonly used for apportionment of profits are:
  a. On basis of Receipts (say turnover or commission) of the enterprises;
  b. On basis of expenses (say wages) of the enterprises;
  c. On basis of its Capital Structure (say working capital).

Some Advance Rulings:

✓ **Purchase of Software**

Indian company imported certain readymade off the shelf computer software packs under the agreement for the purpose of distributing the same to the ultimate users. Issue arose whether the payment to the NR supplier was taxable as royalty or whether the business income will be exempt as there was no PE of the NR supplier in India.

Held that the payment was not royalty as the transaction was mere trade of copyrighted product and not the copyright itself. As there was no PE in India, the payment was not liable to tax in India.
[Sonata Software Ltd. vs. ITO (International Taxation) 6SOT 700 (Bang)]

✓ **Purchase of Software**

MBL was engaged in business of development of computer software. MBL made payment for purchase of software to non residents without deduction of tds. AO held that the payment was in nature of royalty and thus MFL was liable to deduct TDS. MBL argued that a readymade off the shelf computer software was acquired, any right to utilize copyright of the computer software was not acquired. Transaction was a mere purchase of copyrighted article like book or a CD.

Accepting the argument ITAT held that payment for import of software was not by way of royalty and TDS was not required.
[Mphasis BFL Ltd. vs. ITO (Taxation) Ward 19(2) Bangalore, 9SOT 756 (Bangalore ITAT)]

- **Access to database on subscription basis**
  Whether Assessee was liable to deduct TDS for payments made to foreign co. for providing access to its database on subscription basis.

  Held that the foreign co. earned money by providing copyrighted information on subscription basis. The subscription was in the nature of access fee to database maintained outside India. Thus such receipts could not be treated as income accrued in India. Hence no TDS was required to be deducted.
  [Wipro Ltd. Vs. ITO (2005) 278 ITR (AT) 57 (Bangalore)]

- **Sale of BIRs (E-commerce transaction)**
  In the case of DBE it was held that payment of fees made for download of Business Information Report (BIRs), which is in the form of general information about all the companies in the world online is business income and not "Royalty".

  Also Bangalore Tribunal in the case of Wipro Ltd vs. ITO (92 TTJ 796) held that periodic subscription charges or fees paid for providing electronic access to information/journal or magazine maintained on database was not taxable as 'Royalty'.
  [Dun & Bradstreet Espana S.A. , In re AAR [2005] 272 ITR 99 (AAR)]

- **Reimbursement made to a foreign company for employees on secondment basis**

  Held that the salary reimbursement of seconded employees is taxable as Fees for Included Services (FIS) under Article 12 of India-USA DTAA and also as fees for technical services u/s 9(1)(vii) of the I.T. Act. Accordingly, tax is required to be deducted u/s 195 of the Act on such reimbursements.

  Further, the AAR held that while the seconded employees are providing services to the Indian Company, they will remain the employees of a foreign company. Accordingly, the services performed by the seconded employees are performed on behalf of such the foreign company and not as employees of the Indian Company.
  [Verizon Data Services India Private Limited v. CIT (AAR No 865/ 2010)]

  However for similar scenario there are views given by other tribunals where wht was not applicable.

- **ILD-NLD/Bandwidth Services**

  Indian Company is engaged in the business of providing international long distance and domestic long distance telecommunication services in India. It enters into an agreement with another group company incorporated outside India with a view to providing end to end international long distance telecommunication services to its Indian customers.

  Under the proposed agreement the Indian Co. would provide the Indian leg of the service by using its own network and equipments and network of other domestic operators, and the international leg of the service would be provided by foreign Co., using its international infrastructure and equipments. In other words, whereas the Indian Co. will carry the calls and data within the country, foreign Co., will further carry those calls and data to the recipients outside India. The network and equipments of foreign Co. will not be used in India and the Indian Co.'s network and equipments will not be used outside India.

Held that payments made by Indian Co. to the foreign Co. in respect of the aforesaid services rendered by later are in the nature of business profits. In the absence of there being any PE for the foreign company In India, this income is not at all taxable here. Therefore there is no need for any tds u/s 195. *[M/s Cable & Wireless [315 ITR 072]*

However recently in case of Verizon Communications Singapore Pte. Ltd the Chennai Tribunal has held that consideration for provision of of International Private Leased Circuit(IPLC)/dedicated bandwidth are towards use of 'equipment' or 'process' and therefore would qualify as royalty under the Act as well as DTAA.