

BUSINESS PROFITS **[ARTICLE 7]**

The taxation of Business Profits under the Double Taxation Avoidance Agreement (DTAA) in Article 7 is directly linked to the concept and the creation of Permanent Establishment in accordance with Article 5 of the DTAA. The basic rule of Taxation of Business Profits of the Enterprise in the Country of Residence under goes a shift where the Enterprise carries on business in the other Contracting State through a PE. Therefore, the PE criterion is the litmus test to determine whether the Income is to be taxed in the Country of Source. While Article 5 seeks to set the various tests determining the establishment of a PE it does not provide the ways and means to determine the quantum of Profits to be taxed at the hands of the PE. This is provided in Article 7 – Business Profits.

Business Profits are not defined in most of the DTAA which Qatar has entered into. Therefore, the meaning of ‘Business Profits’ is to be given a meaning as found in the local Tax Laws in the ‘Country of Source’. Where, the source of profit income is say, Qatar, the profits would have to be arrived at in accordance with the Qatar Tax Laws 2009 read with the tax Regulation’s 2010. Articles 7 to 10 of Tax laws 2009 would be the relevant provisions for determining the said Business Profits. Generally speaking, Business Profits would mean Profits arising out of carrying on an activity by an enterprise.

Qatar – UK treaty is a very recent treaty and importantly has been executed subsequent to the enactment of Qatar Tax Law 2009. This treaty is considered by the author while analyzing Article 7 Pertaining to ‘Business Profits’.

Article 7 of Qatar – UK double Taxation Avoidance Treaty

Business profits

(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 Contracting State through a permanent establishment situated therein. If the taxed in the other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3) of this Article, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment 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 conditions dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative permanent establishment is situated or elsewhere which are allowed under provisions relating to indirect expenses in the domestic law of the Contracting State in which the permanent establishment is situated.

(4) insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph (2) of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary. The method of apportionment shall, however, be such that the result shall be in accordance with the principles contained in this Article.

(5) No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(6) For the purpose of the preceding paragraphs of this Article, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is a good and sufficient reason to contrary.

(7) Where profits include items of income or capital gains which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 7 (1) is almost a standard clause in all DTAA. It provides a basis for taxation of Income in the Country of source and in the Country of Residence. It states that the profits of an enterprise of a Contracting State shall be taxable in that State unless the enterprise carries on business in the other Contracting State through a PE. Where the enterprise has a PE in the other Contracting State the enterprise would be liable for taxation in the other Contracting State on the income which is attributable to the business carried on by the PE. Therefore not all of the income of the 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. Therefore, once it is determined that the Enterprise has a PE in the other Contracting State. The next step would be to determine the profits which are attributable to the PE.

Certain Tax treaties contain a force of attraction (FOA) principle thereby widening the ambit of taxation in the Source Country. In such cases, the enterprise having a PE in the other Contracting State is not only liable for the profits arising out of the business carried on by the PE but also for profits which arise in the other Contracting State on account of similar kind of business activities conducted directly. These provisions effectively create a situation where an enterprise having a PE and do as same or similar business directly in the other Contracting State are liable to pay tax on the intent behind the profits accruing on such direct dealings or business. The FOA clause is to prevent treaty abuse in cases where the taxpayer undertakes minimal profitable activities through the PE while carrying on large scale operations directly in the other Contracting State or the Source State. The FOA principle therefore implies that where a foreign enterprise sets up a PE in the Source State, it brings itself within the fiscal jurisdiction of the Source State to such a degree that all profits that the enterprise derives from the Source State, whether through the PE or not can be taxed by the Source State. Typical clauses (generally in US treaties) provide that the profits in one state are taxed in the other State or the Country of Source 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.

However, it may be noted that there are FOA provisions in the Qatar – UK treaty.

The term “attributable to a PE” is not defined in the DTAA and the meaning may therefore be determined from the local laws where the Source of Profits takes place. The tax law of Qatar also does not define the term ‘attributable’. Instead, it uses the word “derived” & “derived from”. In our opinion the word “derived” is similar to the word ‘attribute’ in the context of arising at the profits of the PE in Qatar. Further, the word ‘attributable’ in the OECD Model Convention provides a guide. The MC has interrupted the word to convey profits which arise economically from the business carried out by the PE.

Article 7 (2) to 7 (7) of the Qatar – UK DTAA are machinery provision and while they do not create any Tax liability they help compute the Quantum of profits attributable to PE.

Article 7 (2) specifies that to arrive at the profits attributable to the PE, the Enterprise shall adopt the “Functionally separate Approach”

Article 7(2)

Subject to the provisions of paragraph(3) of this Article, where an enterprise of a contracting State carries on business in the other contracting State through a permanent establishment situated therein, there shall be each contracting State be attributed to that PE the profits which be expected to make if it were a distinct and separate enterprise engaged in the same or similar conditions and dealing wholly independently with the enterprise of it is a PE”.

Article 7 provides that the attribution of profit should be done treating the PE as an wholly independent entity. Every transaction conducted or done by the PE should be done at arm’s length and at commercial prices. This is also called the ‘functionally separate approach’. This approach would most probably help determine the ‘profits’ of the Enterprise. However, this approach also brings in complexities. One of the issues would be the determination of ALP for several intangibles that the Enterprise may provide to the PE. Listing the intangible, the extent of usage and the valuation are complex issues. Secondly, this could also lead to a situation where the profits of the PE would exceed the overall loss to the Enterprise. However, all DTAA’s following the OECD model rely more or give more weightage to this method of determining the profits of the PE.

Article 7(4) suggests the second method of apportionment mainly the “Relevant Business Activity” approach. It is an allocatory method of apportionment of profits. It provides for determination of profits to be attributed to the PE on the basis of an apportionment of the total profits of an Enterprise to its various parts. The approach is subject to the following conditions;

- (i) If it is customary in a Contracting State to determine profits in such a manner; and
- (ii) the result of such determination is in consonance with the principles articulated in Article 7.

This method deviates from the first mentioned and seeks to distribute global profits. Hereto, there could be complications in allocating the profit to the PE considering the functions performed by the PE.