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Just how far does the AOA go?

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"When I use a word," Humpty Dumpty said in rather a scornful tone, " it means just what I choose it to mean, neither more nor less." (Lewis Carroll, Alice through the Looking Glass)

Prior to the OECD's 10 year project on attribution of profits to permanent establishments, there were very few reported cases on the operation of Article 7 of the OECD Model Treaty. However, since publication of the OECD report of PE profit attribution and the 2008 and 2010 OECD Models that endorse the tendentially named "Authorised OECD Approach", cases seem to be multiplying. Recent cases highlight the hazards of an extreme interpretation of Article 7.

Profit while making a loss

One such case is *Hyatt International Southwest Asia Ltd. v Additional Director of Income Tax* (ITA 216/2020) 2024 SCC OnLine Del 6546, a decision of the Indian High Court (Delhi). The facts are very simple. The taxpayer, a resident of the United Arab Emirates suffered a loss. The issue before the court was whether, notwithstanding the loss, the company's Indian permanent establishment had profits which Article 7 of the India – UAE Tax Treaty (1992) permitted India to tax. Article 7 followed the text of the OECD Model,as it read up to 2008.

The court ruled that the Indian permanent establishment was taxable in India under Article 7, even though the taxpayer company as a whole made a loss. This conclusion was reached almost entirely by reference to the OECD Commentary to Article 7 introduced in 2008, following the report on attribution of profits to PE.

In particular, paragraph 11 of the Commentary to Article 7 contends that "[w]hen referring to the part of the profits of an enterprise that is attributable to a permanent establishment" in Article 7(1), it "should not be interpreted in a way that could contradict [Article 7(2)] e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole." Paragraph 11 then says "In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits"

Paragraph 17 of the Commentary repeats that." [Article 7(2)] does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise."

In my view, the court's conclusion is erroneous and the OECD Commentary is flawed as a matter of principle and sound treaty interpretation.

Allocation or fabrication of profit?

The starting point in understanding Article 7(2) is Article 7(1) which applies to the "profits of an enterprise of a Contracting State": "enterprise of a Contracting State" generally means "an enterprise carried on by a resident of a Contracting State" (Article 3(1)(g). Thus the article is about the profits of, in this case, a company, resident in the UAE.

The second sentence of Article 7(1) then allocates taxing rights to the other state (the source state) as follows: " 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." It is clear from the ordinary meaning of the words of this sentence, in context, that the profits that are to be attributed to the source state are those of the same enterprise as mentioned in the first sentence (the UAE resident company). This was certainly the conclusion of the Delhi High Court previously in *Commissioner of Income Tax v Nokia Solutions and Networks Oy* [2022] DHC 5483 on the same language in the Finland- India Treaty.

The purpose of Article 7(1) is to provide limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State (Paragraph 10.1 of the 2005 OECD Commentary to Article 7; Paragraph 13 of the 2017 UN Commentary to Article 7).

Article 7(2) then provides the mechanism by which the attribution is to be undertaken. It specifies that "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."

The critical interpretative question is the meaning of the word "attributed". In my view the correct meaning in this context is "allocated to" or "assigned to". Attributed to does not mean deemed to exist. This is supported by the 2008 OECD Commentary itself which records that Article 7(2) "contains the central directive on which the allocation of profits to a permanent establishment is intended to be based."(paragraph 14). Paragraph 14 of the 2017 UN Commentary endorses this statement. The court itself referred to right to "allocate or attribute income" in its conclusion at [66].

Paragraph 11 of the OECD Commentary, cited by the court, is right in saying that Articles 7(1) and 7(2) should not contradict each other. However, they put the cart before the horse in order to engineer a result that is contrary to the purpose of the article and to the purposes of paragraphs 1 and 2. The references to "profits" in both paragraphs are to the profits of the enterprise referred to in 7(1). In this case it is the profits of the UAE resident company. There were none as the company made a loss.

Paragraph 11 of that OECD Commentary is wrong in suggesting that a fictional amount of profit can be allocated to the state of the permanent establishment in excess of the profit of the enterprise as a whole. In following this contention, the court further erroneously relied on fictions advanced in paragraph 16 of the Commentary:

"16. The basic approach incorporated in [Article 7(2)] for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises.

Even if these cumulative fictions are accepted, they do not support the conclusions that the OECD Commentary contends for. The purpose of the "distinct and separate enterprise" hypothesis in Article 7(2) is to provide a mechanism for allocation of profits of the enterprise to the permanent establishment. The deeming provision only applies for the purpose for which the fiction is to be resorted to, but not where it would produce effects clearly outside those purposes (*Fowler v HMRC* [2020] UKSC 22 at [27], a case on the meaning of business profits in the South Africa -UK Treaty).

The fallacy of the court's and the OECD reasoning is underlined by Article 7(3) which requires the source state to deduct expenses incurred for the purposes of the business of the permanent establishment, including executive and general administrative expenses so incurred regardless of whether they are incurred by the permanent establishment itself or not. This is entirely consistent with the purpose of the article in allocating the business profits of a resident of one state, with a permanent establishment in the other state, between the two states.

Supreme Court authority

The court also placed mistaken reliance on the Supreme Court of India decision in *DIT(International Taxation), Mumbai v Morgan Stanley & Co* (2007) 7 SCC 1 which concerned the India-United States Treaty.

There, the Supreme Court dealt with a different question, that is, in relation to a services permanent establishment, once the transfer pricing analysis of the transaction supplying the services is under taken, is there a further need to attribute profits to a PE if the pricing is arm's length? It held that, in such a case, nothing further would be left to attribute to the PE.

The Supreme Court's statement that "what is taxable under Article 7 is profits earned by the [non-resident enterprise]" and that "the quantum of income taxable is income attributable to PE of the said foreign company in India" and its conclusion, if anything, supports the opposite of the Delhi High Court's decision.

Principles of treaty interpretation

There is no sign of the court applying the principles of treaty interpretation. In particular it applied OECD Commentary without regarding its status as supplementary material or the cogency of the reasoning (See *Fowle*r at [18]). Suplementary material may be used to confirm the ordinary meaning or to provide a meaning if the ordinary meaning is manifestly absurd or unreasonable. Here it relied on such material to conclude that an enterprise can have more profit than it actually had.

The court further relied on OECD Commentary introduced some 35 years after the treaty was concluded, without examination of the merits of doing so. The strained interpretation introduced into the Commentary in 2008 may well go down as Humpty Dumpty interpretation.

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