

Diploma in International Taxation

Paper – 2

International Tax - Practice (Part-II)



(Set up by an Act of Parliament)

The Institute of Chartered Accountants of India
New Delhi

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Foreword to the Seventh Edition

The Committee on International Taxation is one of the important non-standing Committees of the Institute of Chartered Accountants of India (ICAI). As a partner in nation building, ICAI through this Committee submits Pre and Post-budget Memoranda pertaining to International Taxation. Apart from the same, the Committee at regular intervals examines the tax laws, rules, circulars, notifications etc. relating to international taxation issued by the CBDT and sends suitable suggestions for improvements. The Committee also submits inputs/submissions to OECD from time to time. Besides conducting various activities ICAI through this Committee regularly organises Workshops/Seminars/ Conferences/ Refresher Courses/ Residential course, prepares e-learning modules, revises its existing publication, releases new publication and many more.

One of the core activities of the Committee is to organise *Post Qualification Diploma in International Taxation*. I am happy to mention that the Committee has prepared the seventh edition of Background Material for Diploma in International Taxation in which all the amendments made upto Finance Act, 2022, have been incorporated. It has been written and reviewed by eminent experts in the area of taxation. This course, if completed, would provide an aspiring practitioner the desired confidence to practice in this complex and upcoming field.

For this course, an open book, case study-based assessment pattern for international taxation Assessment Test (INTT-AT) has been adopted recently to initiate practical understanding of the subject. As there are only few chartered accountants who are practicing in this area, there are plentiful of professional opportunities available for the person who masters in this area.

I appreciate the efforts of CA. Sanjay Kumar Agarwal, Chairman, CA. Cotha S. Srinivas, Vice-Chairman and other members of the Committee on International Taxation for updating this publication and for conducting the course in a professional manner.

I am sure that this seventh revised edition of the Background Material for Diploma in International Taxation will be very useful to the members.

Date: 25.01.2023

Place: New Delhi

CA. (Dr.) Debashis Mitra

President, ICAI

Preface to the Seventh Edition

Long distance trade has been taking place since pre-historic times. Evidences suggest that sea-route trade was prevalent during Indus Valley Civilisation, apart from those other civilisations. However, during those days the concept of “nation/country” did not exist. The concept of “nation-state” came into existence after the French Revolution (1789-99). However, there is another view that this concept was established in 1649 through English Commonwealth. Whatever, the genesis of this concept may be, it gave rise to competition among nations to increase cross-country trade on the one hand, and to protect their revenue by building fiscal and non-fiscal structures on the other. These gave rise to the concept of “international taxation” which is a subset of domestic income tax law which covers the transactions between persons of two countries. Since the law of one country cannot be extended to apply on the person or jurisdiction of another country; the same is governed by the agreement entered by the two countries. The agreement entered by both the country is called Double Tax Avoidance Agreement (DTAA) which defines the methods of sharing jurisdiction to tax, reducing evasion of taxes as well as ways to reducing/eliminating double taxation and avoiding litigation and supporting one another on administrative measures. Although the DTAA may help in deciding the taxing rights of the jurisdictions, the computational aspect is governed by domestic tax laws of the respective country. Unlike Indian income tax which characterise income under five heads of income, DTAA specifies separate article for the nature of transactions. In the changing business environment, many recent issues have evolved which made difficult for the identification of permanent establishment and attribution of business profit. Such transactions become even more complex when passive incomes are connected to such permanent establishment. In those conditions interplay of transfer pricing provisions may arise.

To protect the revenue base, India has developed Transfer pricing regulations more than two decades ago. The international transactions may be examined as per the TP regulation in accordance with the arm’s length principles. Finding the appropriate comparable, benchmarking of those transactions and reporting thereof involve a lot of intricacies. It has many issues like cases of restructuring, cost sharing arrangements, expenditure on marketing and promotions and expenditure on research & developments of intangibles etc., the transfer pricing adjustments of which may not be an easy exercise. In the present situation almost all the major countries have developed their own transfer pricing regulations.

In the changing business environment, the members are expected to have robust understanding of international taxation and transfer pricing. Since the members are expected to have practical understanding of the subjects, the Committee has adopted a case study-based assessment pattern for international taxation Assessment Test (INTT-AT).

I am grateful to CA. (Dr.) Debashis Mitra, President, ICAI and CA. Aniket Sunil Talati, Vice-President, ICAI for being the guiding force behind initiatives being taken by the Committee.

I whole heartedly acknowledge the contribution of CA. Ganesh Rajgopalan, Sree Lakshmi Valli, CA. Sachin Kumar in revision of the background material pertaining to “*International*

Taxation” which further reviewed by Past CCM. CA. Dhinal Ashwin Shah with the assistance of CA. Karan Sukhramani.

We also thank CA. Arun Saripalli and his team members CA. Anand Kankani, CA Aman Agrawal, CA. Disha Kevin Vora, CA. Keyur Shah, CA. Mayur Chudasama, CA. Sumit Rathod, Tarun Mirchandani, CA. Vashishth Dave, CA. Nilesh Bangera and CA. Vipra Shetty who contributed towards the revision of the background material for the subject ‘*Transfer Pricing*’.

I, admire the guidance of Mr. S.P. Singh, Ex-IRS in reviewing the background material. Being an Ex-Deputy Secretary, Foreign Tax and Tax Research Division, CBDT his long experience can be perceived in this revised edition. As Director of International Taxation, Mumbai he was involved in implementation of the tax laws and his knowledge and experience in the area has added value to the publication.

I would also like to thank CA. Cotha S Srinivas, Vice-Chairman, Committee on International Taxation of ICAI for his support in all activities of the Committee. I gratefully acknowledge the support provided by the members of the Committee (including co-opted members) and special invitees; *Committee members*: CA. Chandrashekhar Vasant Chitale, CA. Vishal Doshi, CA. Purushottamlal Khandelwal, CA. Mangesh Pandurang Kinare, CA. Priti Savla, CA. Umesh Sharma, CA. Sridhar Muppala, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Rohit Ruwatia, CA. Anuj Goyal, CA. Gyan Chandra Misra, CA.(Dr.) Raj Chawla, CA. Pramod Jain, CA. Charanjot Singh Nanda, CA.(Dr.) Sanjeev Kumar Singhal, CA. Chhajer Piyush Sohanraji, Shri Ritvik Ranjanam Pandey, *Co-opted members*: CA. Avinash Gupta, CA. Rajat Sharma, CA. Mithilesh Sai Sannareddy, CA. Anup Kumar Sanghai, CA. Kaushik Mukerjee, CA. Nandkishore Chidambar Hegde, CA. Sanjay Bhattacharya, *Special invitees*: CA. Aseem Chawla , CA. Kriti Chawla Khanna, CA. Gaurav Singhal, CA. Sachin Sinha, CA. Manoj Kumar Mittal, CA. Smita Patni, CA. Ajay Rotti, CA. Akshay Kenkre, CA. Akshat Maheshwari, CA. Dilip Gupta, CA. Naman Shrimal, CA. Hari Om Jindal, CA. Deepender Kumar Agarwal, CA. Raju Kumar, CA. Parthasarathi Dasgupta, CA. Tejveer Singh, CA. Raj Kumar Nahata, CA. Parul Jolly, CA. Gaurav Geol, CA. Harpreet Singh, CA. Vikas Gupta, CA. Neha Gupta, CA. Surinder Kumar Kalra and CA. Geetika Gupta.

I also acknowledge the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation, and her team members CA. Dhiraj Shrivastav, Project Associate and CA. Harshita Sagar Jaiswal, Project Associate for co-ordinating the project and for rendering technical and secretarial assistance.

I am sure that this revised edition will help participants of the course to gain practical understanding of the subject.

Place: New Delhi

Date: 25.01.2023

CA. Sanjay K. Agarwal

Chairman,

Committee on International Taxation, ICAI

Foreword to the Sixth Edition

The world has been gradually moving towards digitalisation of business activities. COVID-19 has brought human tragedy and economic devastation which has been never seen before in our lifetime. Humanity is fighting tenaciously to defeat the pandemic resulting into paradigm shift in almost all walks of lives. Teleconferencing, which used to be novelty has become the regular way of doing business and communication. Technological advancements are being adopted at a speed not experienced in the recent times. All these changes are also the root cause for new challenges for tax advisors and tax administrations across the globe. Digitalisation of economies is altering the fundamental concepts of taxation. In order to make taxation more effective and efficient, India is taking several steps to simplify source based taxation which in turn makes the domestic law more transparent and certain. Recently, the law relating to taxation of payments for computer software, which had been a subject matter of litigation, has been settled by the Supreme Court of India; Similarly, the provision of dividend distribution tax was not free from litigation. The Finance Act, 2020 has abolished the dividend distribution tax as a result of which the incidence of taxation now lies in the hands of shareholder. Of late, sending positive message to foreign investors, the Taxation Laws Amendment Bill 2021, proposes to retract the retrospective amendment pertaining to Indirect transfers.

The transfer pricing law is becoming increasingly challenging due to unprecedented impact of COVID-19. Finding the comparable data, the most appropriate method and the arm's length price are significant challenges for all stakeholders. In these exceptional circumstances, OECD Guidance on the transfer pricing implications of the COVID-19 pandemic might be helpful. However, this guidance has not been yet adopted by many countries including India.

Since a lot has happened in the field of international taxation and transfer pricing during the recent years, members should have a comprehensive understanding of the concepts and changes in these areas. Understanding of domestic law appears to be incomplete without appreciating its interplay between treaties and Transfer Pricing Guidelines. This Background material on International Taxation and Transfer pricing is a comprehensive material which has been written and reviewed by eminent experts of the profession. For many years, Committee on International Taxation of ICAI has been effectively disseminated practical knowledge to members through this publication, which is revised annually.

I would like to appreciate Chairman, Vice-Chairman and all other members of Committee on International Taxation of ICAI under whose guidance the Committee on International Taxation has been taking various initiatives including series of refresher course, various panel discussions on important topics, revising publications and coming out with new ones so on and so forth. My best wishes for the members of ICAI!

Place: New Delhi

Date : 31.08.2021

CA. Nihar N. Jambusaria

President, ICAI

Preface to the Sixth Edition

Amid the pandemic, the cross border digital payments in India have accelerated. The pandemic has further reinforced the businesses to go digital which is the need of business and economy. Now, the traditional brick-and-mortar businesses have also adopted the internet based digitalised business models to increase revenue through the customers located across the globe without paying any or negligible taxes in those countries. This had raised concerns for revenue authorities of various countries. Each country is trying to establish consensus to tax the Digital Economy. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Where pillar-one focuses on tax certainty while pillar-two allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The latest development is conceptual adoption of Minimum Global Tax by many countries. The final picture will emerge after the details of this concept are drawn.

Considering the recommendation, the Government of India has taken measures to tax the digital transactions by way of introduction of equalization levy on sale of goods & AMP; services by e-commerce operator, redefining the scope of business connection to curb the issue of digital PE. Along with these, like in many jurisdictions, measures are being adopted through amendments in domestic law as well as in tax treaties with the help of Multilateral Instruments to avoid manipulation of clauses on permanent establishment and other clauses. Concepts like Principal Purpose Test, Limitation of Benefits, and measures against unjustified splitting of activities etc. are being adopted. Apart from this, the Government has also taken various other measures to provide tax certainty to the taxpayers. Earlier the Government had introduced the faceless assessment scheme, Vivad se Vishwas (VSVD) scheme to end up the long pending litigations. In addition to this, in order to provide pace in the decisions of AAR, the Authority for Advance Rulings has also been reconstituted. Recently, the Taxation Laws (Amendment) Bill 2021 has been introduced to provide exemption from indirect transfer of Indian assets made before certain period. The Government has also come out with the new e-filing portal with the features of less documentation leading to fast processing time.

Considering the rapidly evolving subject; understanding the impact of domestic law and treaties has become a necessity for the members of ICAI. In order to update the knowledge of its members and to provide learning knowledge the Committee on International Taxation, ICAI has come out with various publications on many important subject of international taxation. However, to have a comprehensive understanding of the subject; this Background Material of Diploma in International Taxation has proved to be a one stop shop, written and reviewed by veterans in the profession.

I am sincerely thankful to President, ICAI and Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhramani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by

CA. Abhishek Gupta and Ronak Jain in the revision of the background material pertaining to the subject of Transfer Pricing.

I, highly, appreciate the efforts put in by Mr. S.P. Singh, Ex-IRS in reviewing the background material. While working as Deputy Secretary, Foreign Tax and Tax Research Division in the CBDT Mr. Singh, participated in framing laws for non-residents and participated in negotiation of approximately 30 tax treaties. He was also, the first Director of Income Tax (International Taxation), Mumbai. He was one of the members of the Expert Group set up by the government for drafting Transfer Pricing regulations. His long experience in the areas of International Taxation and Transfer Pricing has rewarding impact on the material. We also thank CA Sharad Goyal and CA. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. N.C. Hegde and other members (including co-opted members) and special invitees of the Committee on International Taxation;

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and her team for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi
Date: 31.08.2021

Chairman,
Committee on International Taxation, ICAI

Foreword to the Fifth Edition

The globalized economy has fostered the growth of multinational and transnational enterprises, leading to a massive increase in the volume and nature of cross border trade and transactions. While international trade and commerce has grown manifold, the international tax framework, designed more than a century ago is proving to be inadequate in dealing with such transactions, thereby creating opportunities for Base Erosion and Profit Shifting (BEPS) between Countries. The introduction of Multilateral Instrument (MLI) has enabled countries to revise tax treaties bypassing the regular time taking process of revising tax treaties. It will go a long way in preventing Base Erosion and Profit Shifting. International organisations like United Nations and Organisation for Economic Cooperation and Development are endeavouring to develop internationally acceptable approach to tax Digital Economy.

Appreciating that a good tax system not only discourages revenue leakages, but is effective, efficient, equitable and economical, India has proactively taken measures like developing smoother tax filing mechanism, establishing computer generated documents identification system, introducing e-Assessment system, and granting relaxation from filing of returns in certain specific cases etc. These steps and initiatives help build an atmosphere of trust between taxpayers and tax authorities.

As the importance of international taxation is growing it is the need of the hour for the members of ICAI to develop expertise to take up the professional opportunities in this area. The ICAI through its dedicated Committee on International Taxation has been imparting knowledge to the members of ICAI to enhance their knowledge to enable them to provide high quality professional services.

I would like to express my gratitude to CA. Nandkishore Chidamber Hegde, Chairman and CA. G. Sekar, Vice-Chairman and all other members of Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders. Timely annual up-dation of the Background material of the Diploma course is one of the commendable accomplishments of the Committee.

I am sure that this Background Material would be of immense use for the participants of the Diploma in International Taxation.

Best Wishes,

Place: New Delhi

Date : 31.08.2020

CA. Atul Kumar Gupta

President, ICAI

Preface to the Fifth Edition

With recent rise in the digital transactions, the old brick-and-mortar business is now outdated. The business models are evolving rapidly along with the technology and it becomes important to understand the impact of technology on business model from taxation perspective. In digital transactions, the global economy is swiftly intertwined with the traditional economy by digital means, thus making it harder to create a clear delineation of the true meaning of a digital economy. Both developed and developing countries are struggling to develop an effective and efficient system of taxation of Digital Economy, which would be internationally acceptable and would address the possibilities of double taxation and double non-taxation. As international consensus is awaited, many countries have, unilaterally, imposed taxes on such economic transactions. In line with this approach, India has introduced Equalisation Levy for the taxation of digital economy.

An important consequence of the growth of Digital Economy is that it is now possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. This makes the present taxation system in almost all countries inadequate in bringing such transactions within tax net.

Considering the rapidly changing laws pertaining to international Taxation and the complexities involved, ICAI through its Committee on International Taxation organises Diploma in International Taxation so as to ensure that the members of ICAI are able to enhance their knowledge in this area. Considering the present situation due to pandemic, the course is now being organised online. The course takes care of International Taxation as well as Transfer Pricing.

Every year changes which are announced by the Finance Act as also changes in International tax laws are incorporated in the Background material of the course. This year also, the Committee has revised and updated the material to include all the recent amendments made by the Finance Act, 2020 like: deemed residency, equalisation levy, dividend distribution tax etc. The objective of this course is to provide our members update information about all the happening in the world of international taxation and to enable them to provide best professional services in the industry.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhramani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by CA. Tarun Bindlish and CA. Anurag Agrawal in the revision of the background material pertaining to the subject of Transfer Pricing. I, highly, appreciate the efforts put in by Mr. S.P. Singh, Ex-IRS in reviewing the background material. His long experience in the area of International Taxation and Transfer Pricing has rewarding impact on the material. We also thank Mr. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. G. Sekar and other members (including co-opted members) and special invitees of the Committee on International Taxation; CA. Tarun Jamnadas Ghia, CA. Chandrashekhar Vasant Chitale, CA. Dayaniwas Sharma, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Anuj Goyal, CA. Kemisha Soni, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Charanjot Singh Nanda, Shri Manoj Pandey, Shri Chandra Wadhwa, Dr. Ravi Gupta, CA. Sachin Sastakar, CA. T.P. Ostwal, CA. Ujwal Nagnath Landge, CA. B. M. Agrawal, CA. Nidhi Goyal, CA. Kirti Chawla and CA. Amar Deep Singhal.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and CA. Dhiraj Shrivastav, Project Associate for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi

Date: 31.08.2020

CA. Nandkishore Chidamber Hegde
Chairman,
Committee on International Taxation, ICAI

Foreword to the Fourth Edition

Developments in the area of International taxation have considerably impacted the multinationals as well as the tax authorities. The multinationals are gearing up for a tax regime driven by an agenda to curb the Base Erosion and Profit Shifting (BEPS) while the tax authorities in India are taking the lead in implementing tax measures that are now being looked at by more developed countries.

Since the developments in International taxation have opened up a plethora of opportunities for professionals, our members need to update the requisite skill sets professionally to help the stakeholders in investing both domestically and internationally. The Institute of Chartered Accountants of India (ICAI) through its Committee on International Taxation has been taking various steps so as to enable our members to keep a tab with the emerging developments in the area of international taxation for effective discharge of their responsibilities towards the stakeholders.

I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Pramod Jain, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders at large. I appreciate timely and regular updation of this background material which is an integral part of Diploma in International Taxation being organised by the Committee.

I am sure that this revised publication would be of immense use to the participants of Diploma Course. I wish the participants of the course a very delightful learning experience.

Best Wishes,

Place : New Delhi

Date : November 15, 2019

(CA. Prafulla P. Chhajed)

President

Preface to the Fourth Edition

In this dynamic world where there is constant free flow of cross border investments, knowledge and human capital, international tax assumes an important role. Significant changes in the law keep the regulators as well the assesseees on their toes. Our members, being tax professionals, too are required to keep themselves updated in the area. Thus, training is imparted to them, on regular basis, through the Diploma in International taxation organised by the Committee on International Taxation of ICAI.

In tandem with the updated knowledge being imparted through this Diploma course, the Committee every year updates its background material. Once again efforts have been made this year to revise the background material in a timely manner. Apart from the same the Committee is also working on various new publications which will be released over the period of time.

I am sincerely thankful to CA. Prafulla Premasukh Chhajed, President and CA. Atul Kumar Gupta, Vice-President of the Institute of Chartered Accountants of India for being a guiding force behind the activities being undertaken by the Committee.

I am appreciative of the efforts put in by CA. Pramod Jain, Vice-Chairman of the Committee and also other Committee Council members, CA. Tarun Jamnadas Ghia, CA. Nandkishore Chidamber Hegde, CA. Chandrashekhar Vasant Chitale, CA. Aniket Sunil Talati, CA. Dayaniwas Sharma, CA. G Sekar, CA. Pramod Kumar Boob, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, Shri Sunil Kanoria, Shri Chandra Wadhwa, Dr. Ravi Gupta, co-opted members CA. T.P. Ostwal, CA. Padam Khincha, CA. Ameya Kunte and CA. Yogesh Thar who have contributed towards revision of this Background material.

I also appreciate the efforts of CA. Dhinal Shah supported by CA. Twinkle Shah and CA. Karan Sukhramani who undertook the task of revising the background material pertaining to International taxation. I am also thankful to CA. Arun Saripalli supported by CA. Sunny Kishore Bilaney and CA. Leena Chhabria for their contribution towards the revision of background material pertaining to Transfer Pricing. This joint effort has enabled the Committee to come out with the revised version of the background material in a timely manner.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and her team for co-ordinating the project and for rendering secretarial assistance.

I believe that this background material would be helpful to the members not only for their examination but also in discharging their professional responsibilities.

Place: New Delhi
Date: November 14, 2019

CA. Nihar N. Jambusaria
Chairman,
Committee on International Taxation, ICAI

Foreword to the Second Edition

Globalisation has greatly impacted the economies of various Countries and their tax policies. There is a huge flow of funds across the nations, which needs to be monitored from various perspectives. Tax evasion is one of the important perspectives which required OECD on request of G20 countries to work on implementation of Base Erosion and Profit Shifting (BEPS) action plans.

Since there is difference in the tax rates across the countries BEPS was adopted by many multinationals. India too witnessed huge inflow and outflow of funds through tax haven countries like Mauritius. Sincere efforts are being made by the Government to plug all the loopholes which lead to loss of revenue to the Indian exchequer. Negotiations to amend DTAA's, implementation of GAAR and POEM, Cbc reporting are examples of some of the steps being taken in this direction. Further, in order to tackle treaty abuse, India has recently signed the multilateral Instrument (MLI). The MLI will be applicable alongside the existing tax treaty with the required changes, without any further bilateral negotiation between the countries concerned.

The ocean namely "International taxation" is much deeper than "domestic taxation". Sailing safely through it requires, will, knowledge, experience, and the ability to learn and keep oneself updated. The Committee on International Taxation of ICAI under the able chairmanship of CA. Sanjiv Kumar Chaudhary has been taking all efforts to educate the members in the area of International taxation. Infact considering the need and importance of International taxation in today's time, the subject has also been included in the new curriculum of Chartered Accountancy course.

I would like to express my whole hearted gratitude to CA. Sanjiv Kumar Chaudhary, Chairman and CA. Nand Kishore Hegde, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives through the Committee to keep the members updated in the field of International taxation. Revision of this publication is one of the important tasks accomplished by the Committee.

I am sure that this revised publication would be of immense use to the registrants of Diploma Course. I wish the registrants of the course all the very best for their future.

Best Wishes,

Place: New Delhi

Date : 20.07.2017

CA. Nilesh Shivji Vikamsey

President, ICAI

Preface to the Second Edition

Opening up of vast consumer base, economic potential and financial reforms has led to increase in investment in almost every sector of the Indian economy. Today, India is preferred over other developing countries for cross border investments. Increase in cross border trade and rendering of services, has further lead to various taxation issues which are interesting and also complex. Enormous increase in the digital transactions has further added to the complexities involved in taxation thereof. For the Government to have its fair share of taxes has become a challenge in itself. Successful implementation of BEPS Action plan is the only probable solution to the issue.

For broad and consistent implementation of BEPS the Inclusive Framework was established in June 2016. Nearly 100 countries and jurisdictions have become members since then. To cater to issues of tax avoidance, various countries including India have commenced implementation of some of the BEPS action plans. Further, to strengthen tax treaties the concept of multilateral Instrument has been brought in. India too is committed to address the issues of tax evasion and thus has signed this multilateral Instrument recently in June, 2017.

Since International Taxation has been assuming importance rapidly, gaining knowledge in this area has become a necessity. This area of practice has great prospects in the today's time and also in the years to come. It has always been the endeavour of ICAI to provide necessary support to its members to update themselves in such upcoming areas. Efforts are made through various means like sending updates to members on regular basis, organising of webcasts on recent issues in International Taxation, bringing out e-newsletter on quarterly basis, bringing out new publications and revising the existing ones and so on.

One such effort in this direction is organisation of Post Qualification Diploma in International Taxation on regular basis in all parts of the country by the Committee on International Taxation. The Committee launched this course in the year 2016 and has received overwhelming response from the members. With this course the Committee endeavours to strengthen the knowledge base of the members who practice in the area of International taxation as well as members who aspire to do so.

I am thankful to CA. Nilesh Shivji Vikamsey, President and CA. Naveen N D Gupta, Vice-President for being the motivational force behind the efforts being taken by the Committee.

The Study material for the course, developed by over 40 experts, has also been appreciated. Since taxation is a dynamic area, every year up-dation of the study material becomes a necessity. Thus, the Committee has come out with the revised second edition of the study material. The recent developments in the area have been taken care of.

I place on record my sincere thanks to the Vice Chairman, CA. N.C.Hegde who not only undertook revision of the publication but has actively supported all endeavors of the Committee. I am also thankful to all the Committee members for sharing their experience and knowledge for creating awareness about the subject of International Taxation.

It is indeed a pleasure to convey my gratitude to CA. N. C. Hegde supported by CA. Mallika Apte, CA. Paras Modi, CA. Richa Gandhi, CA. Jhankana Thakkar and CA. Miloni Mehta; CA. Nihar N. Jambusaria supported by CA. Kushal Shah and CA. Shyam Ambani; CA. Dhinal Shah supported by CA. Ashwin Vishwanathan and CA. Ankit Bansal; CA. Rahul Garg supported by CA. Saurav Bhattacharya; who took untiring efforts to revise this study material in a timely manner. I also appreciate the efforts of CA. Parul Mehta; CA. Mrugen Trivedi; CA. Madhavi Mandovra ; CA. Hetal Mehta; CA. Nidhi Khanna; CA. Vinaya Phanse; CA. Shruti Agarwal; CA. Radhika Mangla; CA. Surbhi Mahendru; CA. Alpesh Shete; CA. Shailendra Dhole; CA. Anuradha Rathod; CA. Karnik Kansara and Bhavesh Hodar who supported me in revising the portion assigned to me by the Committee.

Special thanks to CA.P.V.SS Prasad; CA. T.S.Ajai and CA. Arun Saripalli who took the enormous task of reviewing the revised material in a short span of time.

I would also like to extend my appreciation to CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and her team for providing technical and administrative support in revising this study material. I am sure that this study material would be able to bring conceptual clarity to the members, which, is indeed the need of the hour.

Place: New Delhi

Date: 20.07.2017

CA. Sanjiv Kumar Chaudhary

Chairman

Committee on International Taxation of ICAI

Foreword to the First Edition

The globalization of Indian economy and the progressive development that has taken place in recent years have offered strong incentive to multinational corporations to enter into Indian business space on their own or by engaging through domestic partners. This has led to various developments in the field of taxation and has generated interest in the Indian tax system by multinational corporations and their professional consultants. In fact, globalization, capital mobility and the increased trade and services has made international taxation a key concern area both for business enterprises engaged in the cross-border transactions and the tax administrations of the concerned states.

These developments have paved way for an additional area of expertise in practice for our Chartered Accountants. The Institute has always supported its members by updating their knowledge and professional skills so as to enable them to face such new challenges. ICAI introduced the Certificate Course on International Taxation in the year 2008 to provide focus attention in the evolving area of International Taxation. I am sure that the members who have pursued that course would vouch for the splendid work done by the Committee on International Taxation in all these years.

In order to give more value to the members, committed efforts have been made all these years to convert the Certificate course into Diploma. I am glad to mention that due to its unstinted efforts to provide the best to its members, ICAI had in the year 2015 received approval from the Ministry of Corporate Affairs for conducting Diploma in International Taxation. The Committee on International Taxation has been taking all possible efforts to launch this course in the most efficient manner. This study material is one such effort in this direction. I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Sanjiv Chaudhary, Vice-Chairman and all other members of Committee on International Taxation for bringing out this Study material for the participants of the course. In fact an important milestone shall be successfully achieved with its release.

I am sure that this comprehensive background material, which is specifically designed for the Diploma Course, will certainly provide an insight into the complex aspects of International Taxation in a very lucid manner.

Date: 1st May, 2016

Place: New Delhi

CA. M. Devaraja Reddy

President, ICAI

Preface to the First Edition

Since the opening up of the Indian economy in 1991, India has seen a huge inflow of capital in the form of foreign investments. With each passing year, the Government has taken further steps to ensure that India integrates with the global economy. The advent of economic reforms in the form of globalization and liberalization in our country has resulted in the rapid growth of the Indian economy in general and cross border transactions in particular. The process of globalization is set to gain further impetus with the good performance of the economy in recent past. There has been manifold increase in the cross border activities of multinational corporations and other non-residents in the manufacturing and service sectors of the economy.

All the above developments have a great impact on taxation of the transactions arising out of such activities. Thus, international taxation has steadily become a major area of professional interest. However, the concepts and issues concerning international taxation are of a complex nature. Realizing the importance of the subject, the Committee on International Taxation of ICAI had taken an initiative earlier in the year 2009 by introducing Certificate Course on International Taxation. Till date 44 batches have been conducted all over India.

Since ICAI has received approval from Ministry of Corporate affairs for conducting Diploma in International Taxation, the Committee on International Taxation is now making its unstinted efforts to launch the same. In this effort, CA. Manoj Fadnis, President, ICAI and CA. M. Devaraja Reddy, Vice- President, ICAI were the guiding force for the Committee. I place on record my sincere thanks to them on behalf of all the members of the Committee. I am also thankful to Vice Chairman, CA. Sanjiv Chaudhary and all Committee members for supporting me in such an important initiative of the Committee. The Committee also took the inspiration, encouragement and guidance of CA. T.P.Ostwal ji for which I am grateful to him.

The first and the most important step in the launch of this Diploma was preparation of the study material. The Committee had various meetings to finalise the syllabus, structure and the contributors to the Background material. It is heartening to mention that about forty senior International tax professionals have generously contributed to this material. Thereafter, the material was vetted by the stalwarts in the profession. From the bottom of my heart, I thank all authors; CA. Vijay Iyer, CA. Pallavi Dinodia, Mr. S P Singh, Mr. Gaurav Bhutani, CA. Mukech Buttani, Mr. Sunchit Majumdar, CA. Sandeep Puri, CA. Rajan Sachdev, CA. Hardev Singh, CA. Nidhi Khanna, CA. Madhavi Mandovra, CA. Dhishat B. Mehta, CA. Yashodhan Pradhan, CA. Mayur Nayak, CA. Tarun Chaturvedi, CA. Tarun Singhal, CA. Anil Doshi, CA. K.R. Girish, CA. Rajesh Simhan, CA. Nilesh Kapadia, CA. Prashant Maheshwari, CA. Neetu Vinayek, CA. Kedar Karve, CA. Paresh P. Shah, CA. Amrishi Shah, CA. Sonu Iyer, CA. Preeti Sharma, CA. Mayur Desai, CA. Dhigesh Rambhia, CA. Hariram Gilda, CA. K.R. Sekar, CA. Manju Bhardwaj, CA. Ashesh Safi, CA. Sunil Kapadia, CA. NatwarThakrar, CA. Paresh Parekh, CA. Dhinal Shah, CA. Nisha Shah, CA. Parul Mittal, CA. C A Gupta, CA. Romesh Sankhe, and reviewers CA. N.C. Hegde, CA. Pinakin Desai, CA. Mayur Desai, CA. Vishal Shah, CA. Rajan

Vora, CA. T.P. Ostwal, CA. Arun Saripalli, CA. Sudhir Nayak, CA. Rajan Vora for their untiring efforts, contributions and valuable inputs by authoring the material. I also place on record the efforts of CA. Basant Porwal and CA. Vinay Baloda who undertook the tasks of overall review of this material.

I also appreciate the efforts of CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and Mr. Ashish Bhansali, Assistant Secretary for providing technical and administrative support in giving final shape to this study material. I am confident that this comprehensive study would be of immense use to the members and would provide conceptual clarity regarding the basics of International taxation.

Date: 1st May, 2016

Place: New Delhi

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation of ICAI

SYLLABUS

Broad Objective

- (a) To gain working knowledge of the provisions of International taxation laws.
- (b) To acquire an analytical approach to apply the working knowledge to specific problem areas in a variety of practical situations.

Paper 1 - International Tax –Practice

- (a) Provisions of Income-tax Act, 1961 and Income tax Rules, 1962, relevant to International Tax in India, Principles of International Taxation, Double Taxation Avoidance Agreements, Tax Information Exchange Agreements, Anti-Avoidance Measures etc
- (b) Model Tax Conventions (UN, US and OECD), Basics of International tax Structures, International Financial Centre, other issues in International Taxation which may arise from time to time like digital economy & e-commerce, financial Instruments and Trusts etc.
- (c) Any new legislation having impact on International Taxation, introduced from time to time

Note:

1. The participant will have to undergo will have to undergo 126 hours International taxation Professional Training (INTT PT) through physical sessions OR 84 hours through online mode which would cover the above-mentioned syllabus. Considering the dynamic nature of International taxation, the Committee on International Taxation be authorized to make changes in the said curriculum within the broad framework of above-mentioned syllabus as approved by the Council.
2. If new legislations are enacted in place of the existing legislations the syllabus will accordingly include the corresponding provisions of such new legislations in the place of the existing legislations with effect from the date of its notification or effectiveness.

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Module D

Impact of Domestic Tax Systems

1. Source Rule

1.1 Introduction

Scope of taxable income is linked to the residential status of a person in India i.e., resident or non-resident.

Resident: In the case of a resident, it is immaterial where the income accrues or arises or whether or not it is received in India since the global income is taxable in India.

Non-resident: In the case of a person who is a non-resident in India, the total income taxable in India for a particular previous year shall include all incomes from whatever source derived during that year which:

- (a) is received in India; or
- (b) is deemed to be received in India; or
- (c) accrues or arises in India; or
- (d) is deemed to accrue or arise in India.

Note:

To summarise in the case of a non-resident, only those incomes which are received or accrued or deemed to accrue or be received in India are taxable in India. Consequently, the income accruing or arising outside and received outside India by a non-resident is not taxable in India.

The above concepts have been explained in detail below:

1.2 Income received in India

Any income received by a non-resident in India shall be taxable in India even if it has accrued or arisen outside India.

However, if the money had already been received abroad by a non-resident as income and the non-resident later remitted the same into India, it will not be taxable in India on receipt of the same in India.

Illustration

Mr X, a resident of USA, received rental income outside India from a property situated in USA. Mr X was assessed to tax in USA on the income received from the property situated in USA. Mr X remitted rental income received in USA, to his family in India for their livelihood. The rental income transferred by Mr X is already taxed in the country in which the property is

situated. Moreover, the income does not accrue or arise in India to Mr X. Accordingly, in the current scenario it is a mere remittance of money to India. Hence, the same cannot be taxed in India on the basis of receipt in India.

1.3 Taxability of Dividend income - Section 8 of the Income-tax Act

Dividend (other than interim dividend) from an Indian company is taxable in all cases as income of the previous year in which it is so declared and not in the year in respect of which it is declared.

In the case of interim dividend, it shall be taxable in the previous year in which the amount of such dividend is unconditionally made available by the company to the member who is entitled to it.

Income accruing or arising in India

The terms 'accrue' or 'arise' are not defined in the Income-tax Act.

The dictionary meanings of the terms 'accrue' or 'arise' are given below:

The term 'accrue' means 'to arise or spring as a natural growth or result^[1], 'to come by way of increase'^[2].

The term 'arising' means 'coming into existence or notice or presenting itself.

The Authority for Advance Ruling in the case of Cushman & Wakefield (S) Pte. Ltd.^[3] held "*An income is said to accrue or arise at the location where the services or activities for earning the income or the contract which gives rise to such income has been entered into.*"

The Income-tax Act does not set out how the place of accrual of income is to be determined. Section 5 proceeds on the assumption that income, profits and gains have a situs, though there is no indication as to how the situs is to be determined. Hence, the situs has to be determined according to the general principles of law and in the light of particular facts.

Illustration: In a money-lending transaction the decisive factor would be the place where the money is actually lent irrespective of where it came from, since, without actual advance, no interest can accrue or arise; the actual place of user of the money may not have a bearing in deciding the situs in such a case.

Income deemed to accrue or arise in India

Section 9 provides types of income which are deemed to accrue or arise in India.

Ordinarily, in the case of a non-resident, unless the place of accrual or arousal of income is in India, the said income cannot be taxed in India. However, income which accrues or arises outside India but is fictionally deemed to accrue or arise in India under the deeming provisions of section 9 will be subject to tax in India.

^[1] Murry's Oxford Dictionary

^[2] Webster's Dictionary

^[3] In Re (AAR no. 757 of 2007) and 172 TAXMAN 179 – Para 22

The word 'deemed to accrue' means 'deemed by the statute' to accrue or arise in India. In other words, section 9 enlarges the ambit of taxation by deeming certain income to accrue or arise in India in certain circumstances.

Following incomes shall be deemed to accrue or arise in India:

- 1.3.1 Any income accruing or arising to a non-resident:
 - (a) Out of a business connection in India
 - (b) Through or from any property in India
 - (c) Through or from any asset or source of income in India, or
 - (d) Through the transfer of a capital asset situated in India;
- 1.3.2 Any salary income earned by the non-resident in India;
- 1.3.3 Any salary payable by the Government to a citizen of India for services rendered outside India;
- 1.3.4 Dividend paid by an Indian company outside India;
- 1.3.5 Interest income;
- 1.3.6 Royalty income;
- 1.3.7 Income by way of fees for technical services.
- 1.3.8 Receipt of sum of money referred to in section 2(24)(xviii)¹ paid on or after the 5th day of July, 2019 by a person resident in India to a non-resident, not being a company, or to a foreign company

Under the source rule of taxation, income is taxed in the country where it is earned i.e., the country where the actual economic nexus of income is situated has a right to tax the income irrespective of the place of residence of the non-resident who derives the income.

In the context of the Income-tax Act, any sum in the nature of interest, royalty or fees for technical services paid by a resident to a non-resident shall be deemed to accrue or arise in India, except where such interest, royalty or fees for technical services are incurred by the resident in relation to a business or profession carried on by the resident payer outside India or for the purpose of making or earning any income from any source outside India.

Thus, a legal fiction was created whereby interest, royalty and fees for technical services utilised for a business or profession carried out in India were brought to tax in India on the basis of the source rule of taxation.

Hence, irrespective of the situs of the services, the tax jurisdiction will be determined by situs of the payer and situs of utilisation of services.

¹Inserted by Finance (No.2) Act, 2019 with effect from 1 April 2020

1.3.1 Section 9(1)(i)

(a) Any income out of a Business connection in India:

Any income earned by a non-resident from a business connection in India is taxable in India.

The term 'business connection' has not been expressly defined in the Income-tax Act.

However, the expression 'business connection' has been the subject matter of judicial interpretation. Based on well-established principles, the following prerequisites must exist for a non-resident to have a 'business connection' in India:

- there must be a business activity carried on outside India;
- there must be some business activity carried on within India;
- the relation between the two activities should contribute to the earning of income by the non-resident;
- there must be an element of continuity between the business of the non-resident undertaken outside India and the activity carried out in India;
- a stray or isolated transaction is normally not regarded as a business connection.

The Income-tax Act provides an inclusive definition of 'business connection' which solely deals with the case of a business connection arising on account of an agent of a non-resident in India [Explanation 2 to section 9(1)(i)].

As per the Act, the expression 'business connection' shall include any business activity carried out by a non-resident in India through a person who acting on behalf of the non-resident:

- (a) has an authority to conclude contracts on behalf of the non-resident and habitually exercises such authority in India; or has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—
 - (i) in the name of the non-resident; or
 - (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
 - (iii) for the provision of services by the non-resident; or²
- (b) has no authority to conclude contracts, but habitually maintains in India, a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
- (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-

² Inserted by Finance Act, 2018 w.e.f. 1st April 2019. It appears that the said amendments are effected to align the provisions to those in the tax treaties, which will now be subject to modification due to Multi-Lateral Instrument ('MLI').

resident and:

- (i) other non-residents who control the above-mentioned non-resident,
- (ii) other non-residents controlled by that non-resident,
- (iii) all other non-residents who are subjected to the same common control as that non-resident.

Where a business is carried on in India by a non-resident through a person as referred to in clause (a), (b), (c) above, only so much of the income of the non-resident as is attributable to the operations carried out in India shall be taxable in India.

Exclusions from “Business connection”:

It may be noted that a broker, general commission agent or any other agent shall not be deemed to have an independent status where such person works mainly or wholly on behalf of the non-resident or for that non-resident and:

- (i) other non-residents who control the above-mentioned non-resident,
- (ii) other non-residents controlled by that non-resident,
- (iii) all other non-residents subjected to the same common control, as that non-resident.

Explanation 2A to section 9(1)(i) of the Income-tax Act has been omitted w.e.f. FY 2020-21 and replaced with new Explanation 2A by the Finance Act, 2020 w.e.f. 1.4.2022 (i.e. assessment year 2022-23) that the significant economic presence of a non-resident in India shall constitute “business connection” in India and “significant economic presence” for this purpose, shall mean-

- (a) transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

Provided that the transactions or activities shall constitute significant economic presence in India, whether or not-

- (i) the agreement for such transactions or activities is entered in India; or
- (ii) the non-resident has a residence or place of business in India; or
- (iii) the non-resident renders services in India:

Provided further that only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b) shall be deemed to accrue or arise in India.

4.6 International Tax — Practice

The rules for “Significant Economic Presence” were notified by the CBDT vide Notification No. 41/2021 dated 3rd May 2021 which would come into effect from 1st April 2022 (i.e. Assessment Year 2022-23 relevant to the Financial Year 2021-22 and onwards).

The CBDT notified Rule 11UD in order to provide for the threshold limits for applicability of SEP as follows:

S. No.	Criteria	Conditions
1.	Revenue Threshold	Any non-resident deriving a revenue exceeding the threshold limit of Rs. 2 crores in a particular financial year in respect of any transaction of goods, services or property carried out by such non-resident with any person in India. Such transaction would also include transactions of download of data or software in India.
2.	User Threshold	Any non-resident entity which is engaged in systematic and continuous soliciting of business activities or engaging in interaction with 3 lakh or more users in India.

In case of a non-resident entity fulfilling either of the above mentioned conditions with their respective threshold, SEP would be triggered. Their business profits may be charged to tax in India subject to the tax treaty provisions, if any.

Explanation 3 restricts the scope of taxability in case of business carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2 to only so much income as is attributable to the operations carried out in India.

Further, Explanation 3A has widened the concept of income attributable to the operation carried out in India by including the following income w.e.f. 1.4.2021 (assessment year 2021-22):

- (i) such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;
- (ii) sale of data collected from a person who resides in India or from a person who uses internet protocol address located in India; and
- (iii) sale of goods or services using data collected from a person who resides in India or from a person who uses internet protocol address located in India

Provided that the provisions contained in this Explanation shall also apply to the income attributable to the transactions or activities referred to in Explanation 2A [*this has been inserted w.e.f. 1.4.2022 (Assessment year 2022-23)*].

Interpretation of the expression ‘business connection’ as per judicial precedents:

R.D. Agarwal and Co [(1965) 56 ITR 20 (SC)]

The landmark decision in the context of business connection is the decision of Supreme Court in the case of R.D. Agarwal and Co.

In R. D. Aggarwal case, the Supreme Court held that business connection involves:

- (a) a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains.
- (b) There has to be element of continuity between the business of the non-resident and the activity in the taxable territories,
- (c) A stray or isolated transaction not being normally regarded as a business connection.

Thus, business connection may take several forms:

- (a) It may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent, or
- (b) It may merely be a relation between the business of the non-resident and the activity in the taxable territories, which facilitates or assists the carrying on of that business.

Thus, for constituting “business connection” there should be a real and close relation between the trading activity carried on outside the taxable territories and the trading activity within the territories, the relation between the two contributing to the earning of income by the non-resident in his trading activity.

Anglo French Textile Co Ltd v CIT [1953] 23 ITR 101 (SC)

A Ltd, a company incorporated in the UK, owned a spinning and weaving mill at Pondicherry. A Ltd had appointed another company in Madras as its agent for the purpose of its business in India. In a particular assessment year, A Ltd had not made any sales of yarn or cotton manufactured by it in India, but all purchases of cotton required for the factory at Pondicherry were made by the agents in Madras and no purchases were made through any other agency. The question put forth for consideration was whether A Ltd could be said to have a business connection in India.

In this case, the Supreme Court held that: The activity performed by the Madras entity for A Ltd was not in the nature of an isolated transaction of purchase of raw materials. In this case, a regular agency was established in Madras for the purchase of the entire raw materials required for the manufacture abroad and the agent was chosen by reason of his skill, reputation and experience in the line of trade. The terms of the agency fully establish that the entity in Madras was carrying on an activity almost akin to the business of a managing agency in India of the foreign company and the latter certainly had a connection with the agency. When there is a continuity of business relationship between the person in Madras who helps

to make the profits and the person outside Madras who receives or realizes the profits, such relationship does constitute a business connection in India.

G V K Industries Ltd v ITO [1997] 228 ITR 564 (AP)

There are various factors, which need to be kept under consideration while determining whether a business connection exists in a particular situation, or not. The landmark judgment of the Andhra Pradesh High Court compiles the ratios of various other judgments and lays down the following principles of business connection:

- (i) Whether there is a business connection between an Indian person and a non-resident is a mixed question of fact and law which has to be determined on the facts and circumstances of each case;
- (ii) The expression business connection is too wide to admit of any precise definition; however, it has some well-known attributes;
- (iii) The essence of business connection is the existence of close, real, intimate relationship and commonness of interest between the non-resident and the Indian person;
- (iv) Where there is control or management or finances or substantial holding of equity shares or sharing of profits by the non-resident of the Indian person, the requirement of principle (iii) is fulfilled;
- (v) To constitute business connection there must be continuity of activity or operation of the non-resident with the Indian party and a stray or isolated transaction is not enough to establish a business connection.

This decision of the Andhra Pradesh High Court has subsequently been affirmed by the Supreme Court in the same case [2015] 54 taxmann.com 347 (SC).

Illustrations of existence of Business Connection:

Illustrations – Business connection exists

Illustration 1:

A liaison office is set-up in India by ABC Co, a Company resident in Dubai, to receive trade inquiries from customers in India. If the work of the liaison office is restricted only to forwarding the trade inquiries to ABC Co, no business connection exists. However, if the liaison office negotiates and enters into contracts on behalf of ABC Co with customers then it may be construed that a business connection exists in India. In such a scenario, the profits attributable to the operations conducted in India will be taxable in India in the hands of ABC Co.

Illustration 2:

XYZ Inc, a resident of USA has set up a branch in India for the purpose of purchase of raw materials for manufacturing its products. The branch office is also engaged in selling the products manufactured by XYZ Inc in India and in providing sales related services to customers in India on behalf of XYZ Inc. The branch of XYZ Inc will constitute a business connection in India since there is an element of continuity in the business transactions with

XYZ Inc owing to the business activities carried out by the branch in India.

Branch is generally considered to be an extended arm of an entity/company. In law, there cannot be a valid transaction of sale between the branch office of the assessee in India and its head office in a foreign country. It is an elementary proposition that a person cannot enter into contract with itself. Hence, if a non-resident maintains a branch office in India which carries out transactions in India, then business connection can be said to exist.

Illustration 3:

Raw material required by a foreign company was purchased by its agents in British India continuously for several years. The sale proceeds of the manufactured goods were collected by them in British India and were credited in their books to the account of the company as they acted also as bankers. They met all the expenditure out of the collections in their hands, paid for the purchase, and also made other payments referred to in the managing agents' accounts. They were given absolute discretion with reference to the purchases as to when to buy, where to buy and at what rate. The purchase of goods continuously to meet the requirements of manufacture in the mills required skill and judgment and that is exclusively vested in the managing agents. Practically, the entire management of the business was left to the agents and though it is said that they had an office also at Bangalore it is clear that most of the activities connected with the management of the business at Bangalore were carried out in British India. In view of the above, it was held that the foreign company had a Business Connection in India. [*Bangalore Woollen, Cotton & Silk Mills Co Ltd v CIT [1950] 18 ITR 423, 433 (Mad)*].

Illustration – Business connection does not exist.

Illustration 1:

Mr X, a resident in India is appointed as an agent by PQR Inc, a company incorporated in USA for tracking the Indian markets. Mr X only canvassed orders and communicated them to PQR Inc. Mr X had no authority to accept them. The orders were directly received and accepted, the price received and delivery of goods was given by PQR Inc outside India. No purchase of raw material or manufacture of finished goods took place in India. Mr X was only entitled to commission on the sales so concluded. Since Mr X does not have any authority to accept or conclude any contracts on behalf of PQR Inc or procure any raw material, it can be said that business connection does not exist in India in the case of PQR Inc.

Illustration 2:

X Ltd imported machinery from Y Inc of USA on a principal-to-principal basis. The purchase of machinery was the sole transaction between X Ltd and Y Inc. No business connection of Y Inc can be said to exist in India since the purchase of machinery by X Ltd from Y Inc was a solitary transaction and there is no continuity of business relationship between Y Ltd and X Ltd.

Difference between Business connection and Permanent Establishment:

Concept of PE

Under the Double Taxation Avoidance Agreements^[2] (DTAA), business income of a non-resident is not taxable in India unless the non-resident taxpayer has a Permanent Establishment^[3] (PE) in India and the business income is effectively connected to such PE.

PE is defined in section 92F(iii) to include a fixed place of business through which the business of a non-resident is wholly or partly carried on (For example, if a non-resident set up a branch office in India). The fixed place should be available at the disposal of the non-resident in India for carrying out such business. It is irrelevant whether the fixed place is owned or rented by the non-resident.

It may be noted that the Income tax Act restricts the definition of PE in India to a fixed place from which business operations of the non-resident are wholly or partly carried out. However, the concept of PE as defined in the DTAA entered into by India with other countries is wide and contemplates different kinds of PE. For instance, service PE, construction PE, etc.

Accordingly, where a non-resident carries on business through a PE in India, income attributable to such PE shall be taxable in India.

Business connection vs PE

Income derived by a non-resident from a business connection in India is taxable in India under the Act. In contrast, under most DTAAs, business income of a non-resident is taxable in India only if the income is derived by the non-resident from a PE in India.

“Business connection” under the Income-tax Act is wider than the term “Permanent Establishment”.

Existence of a PE in India will always give rise to a business connection in India. However, a business connection may exist independent of PE. Accordingly, there may be a situation where there is business connection in India under the Income-tax Act but there may not be a PE under the DTAA.

Hence, where the non-resident is eligible for treaty benefit there will be no liability to pay tax in India in a scenario where the non-resident has a business connection in India but does not have a PE in India as per the DTAA.

Illustration:

XYZ Inc, is a company incorporated in USA and also a tax resident of USA for income tax purposes. The income earned by XYZ Inc is liable to tax in USA. XYZ Inc conducts business operations in India as well. Accordingly, where the operations conducted in India constitute a business connection for XYZ in India, such profits attributable to such business operations conducted in India will be taxable in India as per section 9(1)(i) of the Income tax Act.

^[2] The concept of Double Taxation Avoidance Agreements has been discussed in detail in Module B.

^[3] The concept of Permanent Establishment as defined in Article 5 of the Double Taxation Avoidance Agreements has been discussed in detail in Module A and Module C.

However, under the India-USA DTAA, XYZ Inc shall be liable to tax in India only where a PE of XYZ Inc is constituted in India as per Article 5 of India-USA DTAA. Accordingly, even though XYZ Inc constitutes a business connection in India, owing to beneficial provisions contained in India-USA DTAA, XYZ Inc shall be liable to tax in India only if it conducts its business through a PE in India. In case the non-resident has a PE in India, the profits attributable to such PE shall be taxable in India.

Section 9A Certain activities not to constitute business connection in India

(1) Notwithstanding anything contained in sub-section (1) of section 9 and subject to the provisions of this section, in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund.

(2) Notwithstanding anything contained in section 6, an eligible investment fund shall not be said to be resident in India for the purpose of that section merely because the eligible fund manager, undertaking fund management activities on its behalf, is situated in India.

(3) The eligible investment fund referred to in sub-section (1), means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfils the following conditions, namely:—

- (a) The fund is not a person resident in India;
- (b) The fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A has been entered into or is established or incorporated or registered in a country or a specified territory notified by the Central Government in this behalf;
- (c) The aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five per cent of the corpus of the fund;
Provided that for the purposes of calculation of the said aggregate participation or investment in the fund, any contribution made by the eligible fund manager during the first three years of operation of the fund, not exceeding twenty-five crore rupees, shall not be taken into account; (w.e.f. 01-04-2020)
- (d) The fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;
- (e) The fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons;
- (f) Any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten per cent;
- (g) The aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent;
- (h) The fund shall not invest more than twenty per cent of its corpus in any entity;

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- (i) The fund shall not make any investment in its associate entity;
 - (j) The monthly average of the corpus of the fund shall not be less than one hundred crore rupees:
Provided that if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than one hundred crore rupees at the end of such previous year: [twelve months from the last day of the month of its establishment or incorporation] (w.e.f. 01-04-2020)
Provided further that nothing contained in this clause shall apply to a fund which has been wound up in the previous year;
 - (k) The fund shall not carry on or control and manage, directly or indirectly, any business in India
 - (l) The fund is neither engaged in any activity which constitutes a business connection in India nor has any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf;
 - (m) The remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the arm's length price of the said activity:
Provided that the conditions specified in clauses (e), (f) and (g) shall not apply in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund, or such other fund as the Central Government may subject to conditions, if any, by notification in the Official Gazette, specify in this behalf.
- (4) The eligible fund manager, in respect of an eligible investment fund, means any person who is engaged in the activity of fund management and fulfils the following conditions, namely:—
- (a) The person is not an employee of the eligible investment fund or a connected person of the fund;
 - (b) The person is registered as a fund manager or an investment advisor in accordance with the specified regulations;
 - (c) The person is acting in the ordinary course of his business as a fund manager;
 - (d) The person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager.
- (5) Every eligible investment fund shall, in respect of its activities in a financial year, furnish within ninety days from the end of the financial year, a statement in the prescribed form, to the prescribed income-tax authority containing information relating to the fulfilment of the conditions specified in this section and also provide such other relevant information or documents as may be prescribed.

(6) Nothing contained in this section shall apply to exclude any income from the total income of the eligible investment fund, which would have been so included irrespective of whether the activity of the eligible fund manager constituted the business connection in India of such fund or not.

(7) Nothing contained in this section shall have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

(8) The provisions of this section shall be applied in accordance with such guidelines and in such manner as the Board may prescribe in this behalf.

(8A) The Central Government may, by notification in the Official Gazette, specify that any one or more of the conditions specified in clauses (a) to (m) of sub-section (3) or clauses (a) to (d) of sub-section (4) shall not apply or shall apply with such modifications, as may be specified in such notification, in case of an eligible investment fund and its eligible fund manager, if such fund manager is located in an International Financial Services Centre, as defined in clause (a) of the Explanation to section 80LA, and has commenced its operations on or before the 31st day of March, 2024.

(9) For the purposes of this section,—

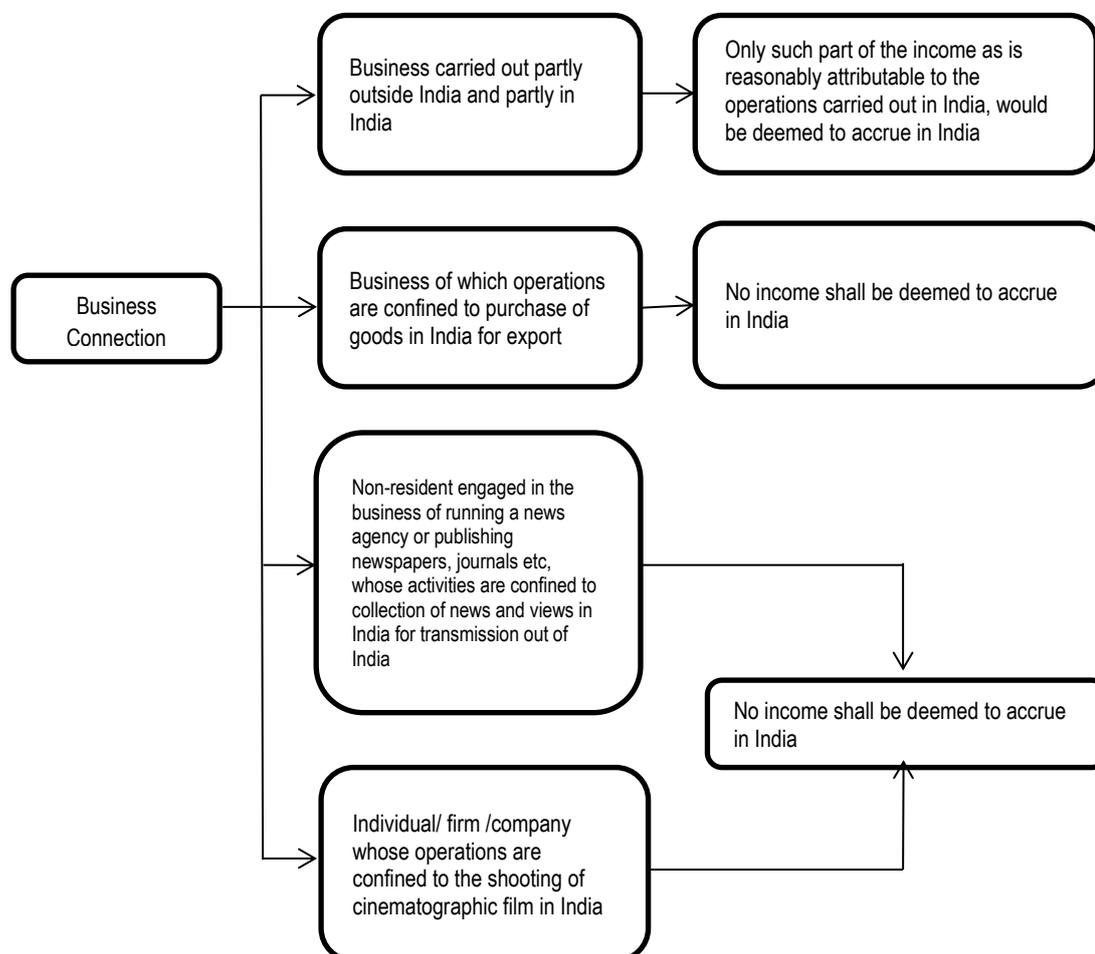
- (a) "associate" means an entity in which a director or a trustee or a partner or a member or a fund manager of the investment fund or a director or a trustee or a partner or a member of the fund manager of such fund, holds, either individually or collectively, share or interest, being more than fifteen per cent of its share capital or interest, as the case may be;
- (b) "Connected person" shall have the meaning assigned to it in clause (4) of section 102;
- (c) "Corpus" means the total amount of funds raised for the purpose of investment by the eligible investment fund as on a particular date;
- (d) "Entity" means any entity in which an eligible investment fund makes an investment;
- (e) "Specified regulations" means the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or the Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, or such other regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992), which may be notified by the Central Government under this clause.

Certain income streams not taxable in India

Explanation 1 to section 9(1)(i) carves out certain exceptions from income deemed to accrue or arise in India under section 9(1)(i) which are given below:

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The above exceptions are pictorially represented below:



(b) Through or from any property or asset or source of income in India:

Any income that accrues or arises to the non-resident through or from any property or asset or source of income in India, shall be taxable in India in the hands of the non-resident.

(c) Through the transfer of a capital asset situated in India:

Where a non-resident derives income through the transfer of a capital asset situated in India, the capital gains derived by the non-resident on such transfer shall be subject to tax in India.

The term 'transfer' has been defined in section 2(47) of the Income-tax Act and the term 'capital asset' is defined in section 2(14) of the Income-tax Act.

Illustratively, transfer of all rights in relation to a patent to manufacture a product in India, transfer of residential property situated in India, etc.

The Vodafone Controversy:

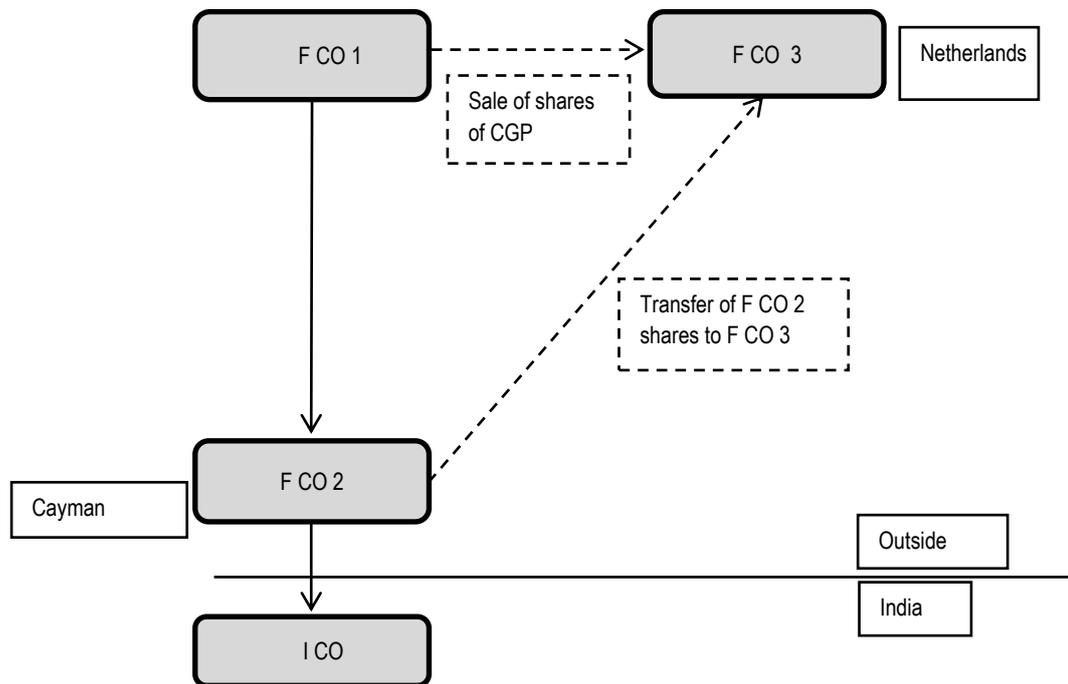
Shares/ interest in an Indian company is a capital asset situated in India and hence, gains derived from such transfer is taxable in India. However, shares of a foreign company, not being an asset situated in India, gains derived by a non-resident from transfer thereof is not

taxable in India.

However, in the case of Vodafone International BV (247 CTR 1) SC, the Indian Tax Authorities sought to tax the gains arising to a non-resident company on account of transfer of shares of a foreign company to another non-resident company on the basis that such transfer involves an indirect transfer of the underlying Indian assets (shares held in an Indian company).

The facts of the case are as under:

A diagrammatic presentation of facts is given below:



The issue before the Supreme Court was whether the Tax Authority had jurisdiction under the Indian Tax Laws to tax the gains arising to the foreign company (F CO1) from transfer of shares of a foreign holding company (F CO2), which indirectly held underlying Indian assets (shares of I CO).

The Supreme Court in a landmark judgment, held that the indirect transfer, would not be taxable in India. The Supreme Court held that the subject matter of the transaction was the transfer of F CO2 (a company incorporated in Cayman Islands and accordingly asset situated outside India). Consequently, the Indian Tax Authority had no territorial tax jurisdiction to tax the said Offshore transaction.

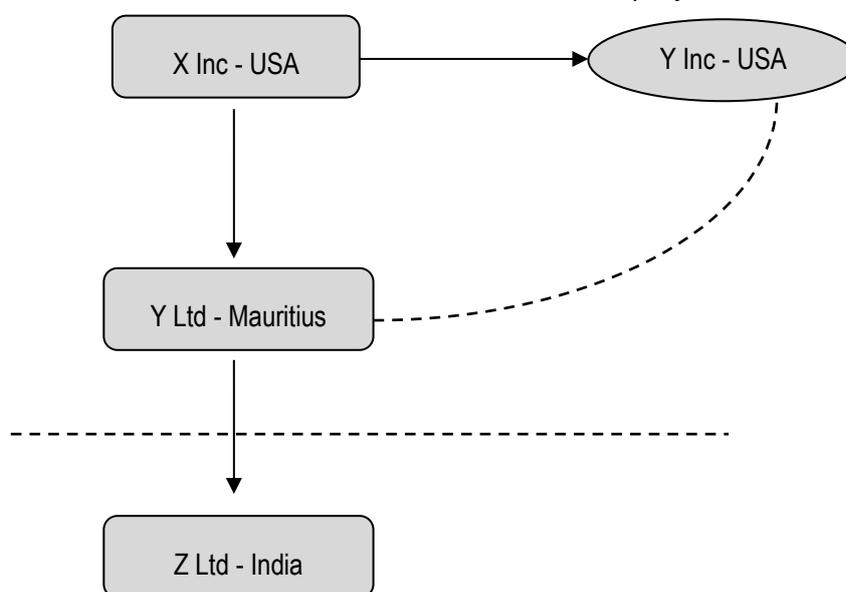
Accordingly in the absence of specific provision in the Indian tax law to tax income which arises indirectly from the assets situated in India, the Supreme Court held that the gains arising to F CO1 on transfer of the shares of a foreign company (F CO2) which indirectly held interest in an Indian company (I CO) would not be taxable in India.

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Thus, considering the impact and the controversy that arose due to the Supreme Court ruling in the Vodafone case, the Finance Act, 2012 inserted explanation 5 to section 9(1)(i) to bring to tax in India gains arising on transfer of shares/ interest in a foreign company which results in an indirect transfer of underlying Indian assets.

Explanation 5 provides that a share or interest in a company or entity registered or incorporated outside India would be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

Illustration – Indirect transfer of shares/ interest in an Indian Company



X Inc, USA holds 100% shares of Y Ltd, Mauritius which in turn holds 100% shares in Z Ltd a company incorporated in India.

X Inc, USA has entered into a transaction to transfer 100% of its shareholding in Y Ltd, Mauritius to Y Inc, USA. The shares are transferred by X Inc, a non-resident to Y Inc, another non-resident outside India.

The taxpayers generally adopted a position that the above transaction is not taxable in India since the asset transferred i.e., the shares of Y Ltd are not situated in India.

In view of Explanation 5 to section 9(1)(i) inserted by the Finance Act 2012, the transfer of shares of Y Ltd, Mauritius by X Inc to Y Inc will be taxable in India if the shares of Y, Ltd derive its value substantially from the India assets i.e., investment held in shares of Z Ltd (an Indian Company)].

Following amendments were made retrospectively by the Finance Act 2012:

The meaning of the terms “capital asset”, “capital asset situated in India” and “through” and “transfer” have been separately defined / explained under the Income-tax Act.

Retrospective amendments have also been made to definition of ‘capital asset’ in section 2(14) of the Income-tax Act and of ‘transfer’ in section 2(47) of the Income-tax Act.

The provisions as amended by Finance Act 2012 have been summarized below:

Meaning of the term “capital asset”

The term capital asset is defined in Section 2(14) of the Income-tax Act and reads as follows:

*“Capital asset means **property** of any kind held by an assessee, whether or not connected with his business or profession ...*

*Explanation 2 – For the removal of doubts, it is hereby clarified that “property” includes and shall be deemed to have always included any rights in or in relation to an Indian company, including **rights of management or control** or any other rights whatsoever.”*

Meaning of the term “capital asset situated in India”

Explanation 5 to Section 9(1)(i) of the Income-tax Act clarifies the scope of the term “capital asset situated in India” and reads as follows:

*“Explanation 5 - For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India **shall be deemed to be and shall always be deemed** to have been **situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.**”*

Meaning of the term “through”

The meaning of the expression “through” in Section 9(1)(i) of the Income-tax Act:

“Explanation 4 – For the removal of doubts, it is hereby clarified that the expression “through” shall mean and include and shall be deemed to have always meant and included “by means of”, “in consequence of” or “by reason of”.”

Meaning of the term “transfer”

The term “transfer” has been defined in Section 2(47) of the Income-tax Act and reads as follows:

“Transfer, in relation to a capital asset, includes, -

(i) The sale, exchange or relinquishment of the asset; or

...

...

*Explanation 2 – For the removal of doubts, it is hereby clarified that “transfer” includes and shall be deemed to have always **included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever**, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, **notwithstanding** that such transfer of rights has been characterized **as being effected or dependent upon** or flowing from **the transfer of a share or shares of a company registered or incorporated outside India.**”*

Amendments made by the Finance Act, 2015

By virtue of Explanation 5 to section 9(1)(i), gains arising from transfer of share or interest in a Foreign Company shall be taxable in India only if the share or interest derives, directly or indirectly its value substantially from assets located in India.

The term 'substantially' was not defined by the Finance Act, 2012. Considering the hardships faced by taxpayers in determining what constitutes substantial value, the meaning of the term substantially has been recently defined by the Finance Act, 2015 by way of Explanation 6 and Explanation 7 to section 9(1)(i).

Explanation 6 clarifies that shares or interest of the foreign entity will be deemed to derive its value substantially from assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian asset:

- (i) exceeds the amount of ten crore rupees; and
- (ii) represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;

(b) the value of an asset shall be the fair market value as on the specified date, of such asset without reduction of liabilities, if any, in respect of the asset, determined in such manner as may be prescribed;

(c) "Accounting period" means each period of twelve months ending with the 31st day of March:

Provided that where a company or an entity, referred to in Explanation 5, regularly adopts a period of twelve months ending on a day other than the 31st day of March for the purpose of—

- (i) complying with the provisions of the tax laws of the territory, of which it is a resident, for tax purposes; or
- (ii) reporting to persons holding the share or interest,

then, the period of twelve months ending with the other day shall be the accounting period of the company or, as the case may be, the entity:

Provided further that the first accounting period of the company or, as the case may be, the entity shall begin from the date of its registration or incorporation and end with the 31st day of March or such other day, as the case may be, following the date of such registration or incorporation, and the later accounting period shall be the successive periods of twelve months:

Provided also that if the company or the entity ceases to exist before the end of accounting period, as aforesaid, then, the accounting period shall end immediately before the company or, as the case may be, the entity, ceases to exist;

(d) "specified date" means the—

- (i) date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or
- (ii) date of transfer, if the book value of the assets of the company or, as the case may be,

the entity on the date of transfer exceeds the book value of the assets as on the date referred to in sub-clause (i), by fifteen per cent.

The above amendments made by the Finance Act, 2015 have been explained by way of illustrations in below paragraphs:

Illustration: Substantial value derived from assets situated in India

Consider a hypothetical standalone balance sheet (at FMV) of Y Ltd and Z Ltd as given below:

(Rs. in Crore)

Liabilities	Y Ltd	Z Ltd	Assets	Y Ltd	Z Ltd
Capital	6000	1000	Other Assets	5000	5000
Liabilities		4000	Investment in Z Ltd.(includes nominee investment)	1000	
Total	6000	5000	Total	6000	5000

In order to fall under the provisions of Explanation 5, the shares of Y Ltd should substantially derive their value from the shares of Z Ltd i.e.as on the specified date the value of Indian asset (i.e., shares of Z Ltd in this case):

In the above case, the value of assets held by Y Ltd is determined at Rs 6,000 crore and the value of Indian assets (shares of Z Ltd) in gross terms (ignoring liabilities) is Rs 5,000 crores. Hence the value derived by Y Ltd from shares of Z Ltd is to the extent of Rs 5,000 crores.

The value derived from the shares of Z Ltd by shares of Y Ltd satisfies the above conditions i.e., its value exceeds Rs. 10 crore and represents 50% or more of the value total of assets of Y ltd. Hence it can be said that the shares of Y Ltd substantially derive their value from asset situated in India i.e. shares of Z Ltd, an Indian Company.

Illustration: Determining the specified date

Assuming that the date of transfer of shares of Y Ltd is 31 August 2015, the specified date in various scenarios is given in the table below:

Particulars	Situation 1	Situation 2	Situation 3
Book Value of Y Ltd as of 31.3.2015	1000	1000	1000
Book Value of Y Ltd as of 31.8.2015	3000	1100	300
Specified Date for FMV determination	31.8.2015	31.3.2015	31.3.2015

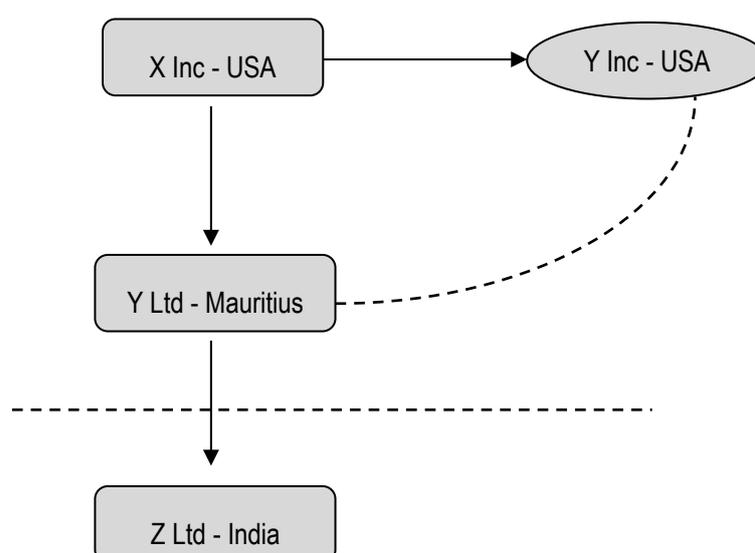
Besides, a few exceptions have been carved out so that shareholders having minority stake as mentioned in Explanation 5 to section 9(1)(i) are exempted from tax implications arising in India on account of transfer of their stake. The exceptions have been given below:

Exceptions – Clause (a) of Explanation 7 to section 9(1)(i):

No income shall be deemed to accrue or arise to a non-resident from transfer outside India, of any share of or interest in a company or an entity registered or incorporated outside India, as referred to in explanation 5 in the following cases:

- (i) if such company or entity directly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of such company or entity; or
- (ii) if such company or entity indirectly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds any right in, or in relation to, such company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India, nor holds such percentage of voting power or share capital or interest in such company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India

Illustration:



Continuing the above example, if X Inc, USA holds 4% shares (each share is entitled to one vote) of Y Ltd, Mauritius which in turn holds 100% shares in Z Ltd a company incorporated in

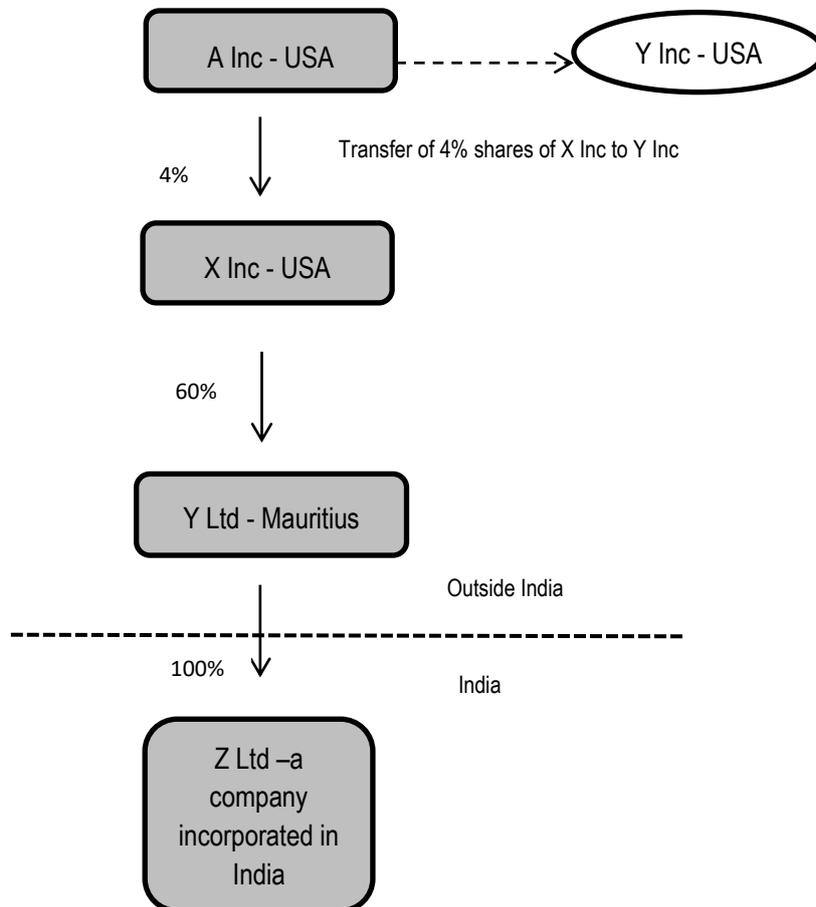
India.

X Inc, USA has entered into a transaction to transfer its shareholding in Y Ltd, Mauritius (i.e., 4% shares held by it in Y Ltd) to Y Inc, USA. The transfer of shares takes place outside India.

X Inc does not hold any right of control or management of the transferred foreign company i.e., Y Ltd.

In view of clause (a) of Explanation 7 to section 9(1)(i) of the Income-tax Act, the gains arising to X Inc on transfer of shares of Y Ltd to Y Inc will not be taxable in India since X Inc does not hold any right in Y Ltd entitling it to voting power or share capital exceeding 5% of the total voting power or share capital of foreign company ie Y Ltd.

Illustration



A Inc, USA holds 4% shares of X Inc, USA (each share is entitled to one vote). X Inc holds 60% stake in Y Ltd, Mauritius which in turn holds 100% shares in Z Ltd a

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company incorporated in India.

A Inc has entered into a transaction to transfer its shareholding in X Inc, USA to Y Inc, USA. The shares are transferred by A Inc, a non-resident to Y Inc, another non-resident.

A Inc neither holds any right of control or management of the transferred foreign company/ entity i.e., X Inc nor does A Inc hold any rights in, or in relation to X Inc which would entitle it to the right of management or control in Y Ltd which *directly* owns the assets situated in India (shares of Z Ltd);

In view of clause (a) of explanation 7 to section 9(1)(i) of the Income-tax Act, the gains arising to A Inc on transfer of shares of X Inc to Y Inc will not be taxable in India since A Inc does not hold any right in X Inc which will entitle it to voting power or share capital exceeding 5% of the total voting power or share capital of foreign company i.e., Y Ltd which directly owns the assets situated in India (shares of Z Ltd).

Clause (b) of Explanation 7 to section 9(1)(i): In a case where all the assets owned, directly or indirectly, by a company or, as the case may be, an entity referred to in the Explanation 5, are not located in India, the income of the non-resident transferor, from transfer outside India of a share of, or interest in, such company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in such manner as may be prescribed;

Certain transactions not regarded as transfer: The following transactions are exempt from tax in India subject to satisfaction of conditions stipulated:

Transfer of capital asset being shares held in an Indian company in a scheme of amalgamation by an amalgamating foreign company to the amalgamated foreign company shall not be taxable in India if the following conditions are satisfied [Section 47(via)]:

- The amalgamation should qualify as amalgamation as defined under section 2(1B) of the Act;
- At least 25% shareholders of the amalgamating foreign company continue to remain shareholders of amalgamated foreign company;
- Such transfer does not attract capital gains tax in the country in which the amalgamating foreign company is incorporated.

Finance Act, 2015 has inserted section 47(viab) for exempting capital gains tax arising on account of transfer of shares of a foreign company (which derives its value substantially from assets located in India) pursuant to a scheme of amalgamation between foreign companies on fulfilment of similar conditions as specified above.

Similarly, section 47(vic) grants capital gains exemption to demerged foreign company on the transfer of shares held in an Indian company which are transferred to a resulting foreign company under a scheme of demerger, subject to satisfaction of following conditions:

- The demerger should qualify as a demerger as defined under Section 2(19AA) of the Act;
- At least 75% shareholders of demerged foreign company continue to remain

shareholders of resulting foreign company;

- Such transfer does not attract capital gains tax in the country in which the demerged company is incorporated.

Finance Act, 2015 has extended similar exemption to gains arising on transfer of shares of a foreign company (which derives its value substantially from assets located in India) pursuant to a scheme of demerger between foreign companies on fulfilment of similar conditions as specified above [section 47(vicc)].

Reporting obligation:

An Indian company/ entity shall be obligated to furnish information relating to the off-shore transactions having the effect of directly or indirectly modifying the ownership, structure or control of the Indian company or entity. In case of any failure on the part of Indian concern, penalty as per section 271GA shall be leviable. The penalty shall be-

- (a) a sum equal to two percent of the value of the transaction in respect of which such failure has taken place in case where such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern;
- (b) a sum of five hundred thousand rupees in any other case.

1.3.3 Section 9(1)(ii):

Salary for services rendered by a non-resident in India is deemed to accrue in India and hence taxable in India irrespective of the place of payment.

Salary shall include the income payable to a non-resident for the leave period which is preceded and succeeded by services rendered in India and which forms part of the employment contract. Accordingly, such income shall also be deemed to have been earned for services rendered in India and is taxable in India.

Illustration:

A technician resident of USA, non-resident in India rendered employment services in India. The salary to the non-resident was paid in USA. As per section 9(1)(ii) of the Income-tax Act such salary income for services rendered in India is deemed to accrue in India and hence taxable in India.

1.3.4 Section 9(1)(iii):

Salary paid by the Indian Government to a citizen of India for services rendered outside India shall be deemed to accrue or arise in India and shall be taxable in India.

The above clause intends to cover salaries of Government employees irrespective of whether they are paid in India or outside India and whether the services are rendered in India or outside India.

1.3.5 Section 9(1)(iv):

Dividend paid by an Indian Company outside India.

Dividend paid by an Indian Company to a non-resident shareholder outside India is includible in the total income of the non-resident and is taxable in India.

It may be noted that dividends paid by an Indian company prior to 31 March 2020 were tax exempt in the hands of the shareholders in view of provisions of section 115-O of the Income-tax Act as Indian Company paying dividend, was liable to pay the dividend distribution tax ('DDT') at the prescribed rate. However, pursuant to amendment made by Finance Act, 2020, any dividend declared, distributed or paid by Indian Company on or after 1 April 2020 shall be taxable in the hands of recipient / shareholders only.

Illustration:

ABC Ltd a company incorporated in India has distributed dividend during FY 2019-20. Z Co, a company incorporated in UK holds 25% of the share capital of ABC Ltd and accordingly is entitled to dividend distributed by ABC Ltd on such shares. ABC Ltd pays the DDT as per section 115-O and distributes the dividend to its shareholders.

The dividend income so received by Z Co will be deemed to accrue or arise in India and thus taxable in India. However, by virtue of section 10(34) of the Income-tax Act, such dividend received shall be tax exempt in the hands of Z Co. However, if the dividend is declared / paid by ABC Ltd after 1st April, 2020, the same will be taxable in the hands of Z Co and no DDT will apply.

Source Related Income - Interest, Royalty and Fees for Technical services:

Unlike business income, for taxability of which there has to be a business connection in India as explained in para 1 above, income in the nature of interest, royalty, fees for technical services are taxable in India even if there is no business connection in India.

It is specifically stated in Explanation to section 9(2) that the income of the non-resident in the nature of royalty, interest or fees for technical services shall be deemed to accrue or arise in India and shall be included in his total income, whether or not:

- (i) the non-resident has a residence or place of business or business connection in India;
or
- (ii) the non-resident has rendered services in India.

It is thus no longer necessary that, in order to attract taxability in India, the services must also be rendered in India. As the law stands now, utilization of these services in India is enough to attract its taxability in India. The explanation has thus virtually negated the judicial precedents supporting the proposition that rendition of services in India is a sine qua non for its taxability in India. This is called the source rule of taxation.

The source rule would mean that irrespective of the situs of services, the situs of taxpayer and the situs of utilization of services will determine the tax jurisdiction.

1.3.6 Section 9(1)(v)

Interest income earned by any person shall be deemed to accrue or arise in India if it is

payable by-

- (a) the Government; or
- (b) a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
- (c) a person who is a non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India.

Illustration:

X Inc, a multinational company and tax resident in USA carries on business both outside India and in India.

X Inc borrows money from 'Y', another non-resident and invests the same in a business in India. Interest paid by X Inc to Y will be deemed to accrue or arise in India by virtue of section 9(1)(v)(c).

Amendment made by Finance Act, 2015:

The Special Bench of the ITAT in the case of Sumitomo Mitsui Banking Corporation [136 ITD-66 TBOM], Bank of Tokyo Mitsubishi OFJ Ltd v ADIT (ITA No 5364/Del/2010, ITA No 5104/Del/2011), Deutsche Bank AG vs ADIT, ADIT vs Mizuho Corporate Bank Ltd (54 SOT 117) ABN Amro Bank NV v. CIT [2011] 343 ITR 81 held that where interest is payable by an Indian Branch of a foreign bank to the overseas head office, the interest so paid is deductible while computing income of India Branch. Moreover, in the hands of the recipient head office, the same is not taxable in India as the payer and recipient are the same since branch is considered as an extension of the parent company for all legal purposes.

To supersede the aforesaid rulings, the Finance Act, 2015 inserted an Explanation to clause (c). The said explanation provides as under:

Explanation.—For the purposes of this clause,—

- (a) *it is hereby declared that in the case of a non-resident, being a person engaged in the business of banking, any interest payable by the permanent establishment in India of such non-resident to the head office or any permanent establishment or any other part of such non-resident outside India shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the permanent establishment in India and the permanent establishment in India shall be deemed to be a person separate and independent of the non-resident person of which it is a permanent establishment and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly;*
- (b) *"permanent establishment" shall have the meaning assigned to it in clause (iiia)*

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of section 92F;

If the above conditions are fulfilled then such PE in India shall be deemed to be a person separate and independent of the non-resident of which it is a PE. In such a case the interest will be deemed to accrue or arise in India and will be chargeable to tax in addition to any income attributable to the PE of the non-resident in India.

1.3.7 Section 9(1)(vi):

Royalty will be deemed to accrue or arise in India when it is payable by-

- (a) the Government; or
- (b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
- (c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India:

Provided that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, if such income is payable in pursuance of an agreement made before the 1st day of April, 1976, and the agreement is approved by the Central Government :

Provided further that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum payment made by a person, who is a resident, for the transfer of all or any rights (including the granting of a licence) in respect of computer software supplied by a non-resident manufacturer along with a computer or computer-based equipment under any scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India.

Illustration:

Y Inc, a company incorporated in US is the owner of "ONE UP" technology used in mobile phones which is patented in US. X Ltd, is a company incorporated in India and engaged in the business of manufacturing mobile phones. X Ltd has obtained from Y Inc right to use the ONE UP technology for the purpose of manufacturing mobile phones at the plant of X Ltd based in US. The mobile phones manufactured in the plant based in US are sold only in the US markets. X Ltd makes an annual payment of USD 1 Million for use of ONE UP technology owned by Y Inc. The amount paid by X Ltd, a resident, to Y Inc, a non-resident for right to use the ONE UP technology falls under the definition of royalty as per the Indian Income-tax Act; however, the same is not taxable in India as it is utilised for a business carried on by X Ltd, a resident, outside India.

An Indian company (I Co) makes payment to Foreign Company (F Co) for use of its trademark

for products manufactured and distributed by I Co in India. Since the payment in nature of royalty is made by a I Co towards earning of income from business carried on in India, such income shall be deemed to accrue or arise in India.

Exception to taxability as royalty income:

Meaning of the term royalty

Explanation 2 to section 9(1)(vi) defines the term 'royalty'. Royalty means consideration (including any lumpsum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains') for:

- (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trademark or similar property;
- (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ;
- (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;
- (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films ; or
- (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Important Points:

“Computer software” has been defined in Explanation 3 to mean any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.

Explanation 4 to section 9(1)(vi) further clarifies that the definition of royalty under the Income tax Act includes within its ambit the transfer of all or any right for use or right to use a **computer software** (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5 to section 9(1)(vi) also clarifies that royalty includes and has always included consideration in respect of any right, property or information, whether or not—

- (a) the possession or control of such right, property or information is with the payer;

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- (b) such right, property or information is used directly by the payer;
- (c) the location of such right, property or information is in India.

As per Explanation 6 the expression “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fiber or by any other similar technology, whether or not such process is secret.

The definition of the term royalty begins with the expression “means”, indicating an exhaustive coverage. The use of the phrase “or similar property” at the end of some of the limbs of the definition indicates an expansive coverage having wide application.

Typically, the expression, “royalty” indicates existence of an Intellectual Property that is “let out” or allowed to be “used” for a consideration. It is not important that the Intellectual Property should be compulsorily registered under any of the relevant Intellectual Property laws. It is sufficient if the payment made is for the use of the Intellectual Property as against a case of its complete transfer.

The royalty definition of the Income-tax Act also excludes any consideration which is chargeable as capital gains in the hands of the recipient. Hence, the use of the expression “transfer of ‘all’ rights” in clause (i) relating to patent, invention, etc. and clause (v) relating to copyright of Explanation 2 to section 9(1)(vi) does cause concerns. This is because income from transfer of “all rights” is generally taxed as capital gains and capital gains is specifically excluded in the beginning of the royalty definition. Accordingly, the nature of transfer shall need to be analyzed to determine the classification of income as royalty or as capital gains, for determination of taxability of the same.

Illustration:

Where there is an outright transfer of designs and drawing, and the transferor does not retain any rights in the asset, the transfer would result in capital gains income to the transferor and it would fall outside the ambit of royalty

The definition of “royalty” also includes services in the last limb of the definition. Services that are rendered “in connection with” the activities mentioned in the earlier limbs of the definition are also sought to be taxed as royalties under the Income-tax Act. The inclusion of services in the royalty definition is likely to result in classification issues and overlaps between royalty and fees for technical service (section 9(1)(vii) discussed in point 7 below) income streams.

1.3.8 Section 9(1)(vii)

Any Fees for technical services (‘FTS’) will be deemed to accrue or arise in India if they are payable by-

- (a) the Government; or
- (b) a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
- (c) a person who is a non-resident, where the fees are payable in respect of services

utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India:

Provided that nothing contained in this clause shall apply in relation to any income by way of FTS payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government.

The term 'FTS' has been defined in Explanation 2 to section 9(1)(vii) to mean any consideration (including any lumpsum consideration) received for rendering of any technical, managerial or consultancy services (including the provision of services of technical or other personnel) but does not include income which would be chargeable under the head 'salaries' or consideration for any construction, assembly, mining projects.

The term technical, managerial or consultancy services are not defined in the Income-tax Act. However, based on general understanding and various judicial precedents, the same would generally be interpreted as under:

Managerial services

The ordinary meaning of the term 'managerial' would suggest that the services rendered ought to be in the nature of management services. It may involve controlling, directing and administering the business. The term 'managerial services' may also be construed to be involving functions related to how a business is run as opposed to functions involved in carrying on that business. For example, function of hiring and training commercial agents would be 'managerial services', whereas the actual selling function performed by these hired commercial agents would not be so.

Consultancy

The provision of advice by a professionally qualified person would be 'consultancy services'. It can also mean the act of offering expert or professional advice in a field.

Technical

The term technical services may be meant to be services relating to, or involving the practical, mechanical, or industrial arts or the applied sciences.

Explanation to section 9(2)

Explanation to section 9(2) clarifies that for the purposes of section 9, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or (vi) or (vii) of subsection (1) of section 9 (i.e., interest or royalty or fees for technical services respectively) and shall be included in the total income of the non-resident, whether or not:

- (i) the non-resident has a residence or place of business or business connection in India;
or
- (ii) the non-resident has rendered services in India.

1.3.9 Section 9(1)(viii)

Finance (No. 2) Act, 2019 has inserted a clause (viii) in section 9(1) that deals with income deemed to accrue or arise in India for a person resident outside India.

On or after 5th day of July 2019, income arising outside India, being any sum of money which is of the nature referred to in section 2(24)(xviii), paid by a person resident in India to a non-resident (not being a company) or foreign company, shall be deemed to accrue or arise in India.

Pre-condition of new provision is that the income should be of a nature referred to in section 2(24)(xviii) i.e., any sum of money referred to in section 56(2)(x).

Determination of income taxable in India of a Non-resident:

Sections 5 to section 9 as discussed above define the scope of total income of a non-resident taxable in India under the Income tax Act. However, considering that the non-resident may be subject to tax on the same income in country of residence, India has entered into Double Tax Avoidance Agreements [DTAAs] with various countries with a view to avoid double taxation and for granting relief in respect of income on which tax has been paid both in India and country of residence.

Accordingly, where DTAA exists between India and the specified country, the non-resident who is eligible for such treaty has an option to apply either the provisions of the Act or the treaty, whichever is more beneficial. Hence, it is very important to do a comparative analysis of DTAA provisions vis-à-vis domestic tax provisions where a non-resident is entitled to benefits of DTAA as the DTAA may afford a non-resident to be rather not taxable at all due to restricted meaning/ coverage of relevant income or subject to lower rate of taxes where the DTAA so provides.

2. Basis of Tax Computation

2.1 Introduction – Business Connection/ Permanent Establishment

The Indian Income-tax Act, 1961 ('the Act') provides for levy of income-tax on the income of foreign companies and non-residents, but only to the extent of their income sourced from India. Under section 5 of the Act, a foreign company or any other non-resident person is liable to tax on income which is received or is deemed to be received in India by or on behalf of such person, or income which accrues or arises or is deemed to accrue or arise to it in India.

Section 9 thereafter specifies certain types of income that are deemed to accrue or arise in India in certain circumstances. These two sections (viz., section 5 and section 9) that embody the source rule of income taxation in the domestic law. Income of a non-resident can only be taxed in India if it falls within the four corners of section 5 read with section 9 of the Act.

2.2 Business connection under the Act

Section 9(1) of the Act specifies the income to be taxed in India, including income arising from 'business connection' in India. The term 'business connection' is the Indian equivalent of PE in the international double taxation conventions and creates a charge for all income arising directly or indirectly, through or from any business connection/ activity in India.

Though the term 'business connection' has not been expressly defined in the Act, Explanation 1 and Explanation 2 to section 9(1)(i) of the Act deal with the situation which may lead to business connection and provides for certain cases of inclusions and exclusions therefrom.

Specific Cases when Income shall not be deemed to Accrue or Arise under Clause (i)

1) Clause (a) to explanation 1 restricts the scope of taxability in the case of business (other than the business having business connection in India on account of significant economic presence) of which all the operations are not carried out in India, to only such part of income as is reasonably attributable to the operations carried out in India.

Therefore, in case of business of which some operations are carried outside India (other than those having business connection on account of significant economic presence), the income attributable to operations carried outside India shall not be taxed in India

2) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export;

3) in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India;

4) in the case of a non-resident, being—

a) an individual who is not a citizen of India ; or

b) a firm which does not have any partner who is a citizen of India or who is resident in India ; or

c) a company which does not have any shareholder who is a citizen of India or who is resident in India,

no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India

5) In the case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India through or from the activities which are confined to the display of uncut and unassorted diamond (without any sorting or sale) in the special zone notified by the Central Government in the Official Gazette in this behalf.

Business Connection

Explanation 2 has been inserted to section 9(1)(i) of the Income tax Act, 1961 with effect from assessment year 2004-05, to define the term business connection. Clause (a) to the said Explanation has been amended by the Finance Act 2018 w.e.f 1.4.2019. Now, therefore, the term 'business connection' shall include any business activity carried out through a person if

(i) the person is acting on behalf of the non-resident; and

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(ii) the person:

- (a) has and habitually exercises in India an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are-
 - in the name of the non-resident or
 - for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
 - for the provision of services by the non-resident; or
- (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
- (c) habitually secures orders in India, mainly or wholly for the non-resident and other non-residents controlling, controlled by or subject to the same common control, as that non-resident

The 'business connection', however, shall not be held to be established in cases:

- (i) Where the non-resident carries on business through a broker, general commission agent or any other agent of an independent status; and
- (ii) if such broker, general commission agent or any other agent of an independent status is acting in the ordinary course of his business

For this purpose, it is further provided that where such broker, commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of that non-resident and other non-resident which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status

Further, Explanation 2A to section 9(1)(i) of the Income tax Act, 1961 has been omitted w.e.f. FY 2020-21 and replaced with new Explanation 2A by the Finance Act 2020 w.e.f 1.4.2022 (i.e. assessment year 2022-23) that the significant economic presence of a non-resident in India shall constitute "business connection" in India and "significant economic presence" for this purpose, shall mean

- (a) transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

Provided that the transactions or activities shall constitute significant economic presence in India, whether or not -

- (i) the agreement for such transactions or activities is entered in India; or
- (ii) the non-resident has a residence or place of business in India; or

- (iii) the non-resident renders services in India:

Provided further that only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b) shall be deemed to accrue or arise in India.

2.3 Business Connection – Mode of computation of income

2.3.1 Under the Act

Section 9 of the ITA does not seek to bring into tax net the profits of a non-resident, which cannot reasonably be attributed to operations carried out in India. Business income of a foreign company or other non-resident person is chargeable to tax to the extent it accrues or arises through a business connection in India or from any asset or source of income located in India, and to the extent such income is attributable to the operations carried out in India.

Further, there is a specific provision, i.e., *Explanation 3 to section 9(1)(i)*, which provides that, where a business is carried on in India by a non-resident through a person referred to in clause (a), (b), (c) of Explanation 2 to section 9(1)(i) as stated above, only so much of income as is attributable to operations carried out in India shall be deemed to accrue or arise in India.

Finance Act, 2020 has inserted Explanation 3A to Section 9(1)(i), applicable with effect from 1 April 2022, to provide that the income attributable to the operations carried out in India, as referred to in Explanation 1, shall include income from following:

- (i) such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;
- (ii) sale of data collected from a person who resides in India or from a person who uses internet protocol address located in India; and
- (iii) sale of goods or services using data collected from a person who resides in India or from a person who uses internet protocol address located in India.

Rule 10 of the Income Tax Rules, 1962 ('the Rules') lays down the procedure to be followed for determination of income in the case of non-residents. The Rule provides that where the actual amount of income accruing or arising to a non-resident cannot be specifically determined, the income accruing to the business connection may be determined:

- (i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or
- (ii) on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or
- (iii) in such other manner as the Assessing Officer may deem suitable.

2.3.2 Computation of Income under the Act

For computation of total income of a taxpayer, the Act has classified income under five heads, viz. Salaries; Income from house property; Profits and gains of business or profession; Capital gains; and. Income from other sources. Different rules govern computation of income falling under each of the specific head.

Computation of income of a non-resident arising from business connection in India is covered under the head "Profits and gains of business or profession" under sections 28 to 44DB. These sections provide for certain expenses, allowances, disallowances, etc. which are to be factored while determining taxable profits.

2.4 Typical method of computation of income under the head “Profits and Gains from Business or Profession” under various scenarios

A non-resident carrying out business operations in India can choose to operate through either of the following ways:

A non-resident operating directly or through its branch office or a project office in India, has an option to offer income to tax either on net basis or gross basis (i.e., presumptive tax regime) depending on the nature of business activities.

Once the income is classified under the ambit of section 28, effect has to be given to expenses allowable/ disallowable as stated above, so that the net taxable income can be computed appropriately.

2.4.1 Treatment of Head office expenditure

Non-residents carrying on business activities in India generally have their head office ('HO') situated outside and their branch/branches situated in India. In computing the taxable income of the BO/ PE in India, apart from the deduction of allowable expenses, the BO would normally claim deduction in respect of certain portion of the general administrative expenses incurred by the foreign HOs, which are attributable to the branch operations in India.

Section 44C of the Act lays down certain ceiling limits for the deduction of HO expenses in computing the taxable profits in the case of non-resident taxpayers. This section applies to all non-resident taxpayers and not only to foreign companies.

A non-resident can claim expenditure in the nature of executive and general administration incurred by HO outside India against the taxable profits of BO situated in India, which shall be lower of:

- (a) an amount equal to five per cent of the adjusted total income; or
- (b) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India.

Where the adjusted total income of the taxpayer is a loss, the amount shall be computed at the rate of 5 percent of the average adjusted total income of the taxpayer.

The term average adjusted total income ('ATI') in relation to different circumstances is

summarized in the following table.

Where the total income of BO/ PO is assessable for	Average ATI
3 assessment years (AYs) immediately preceding the relevant AY	1/3rd of the aggregate amount of ATI in respect of such AYs
2 AYs immediately preceding the relevant AY	1/2 of the aggregate amount of the ATI
1 AY immediately preceding the relevant AY	ATI of the preceding AY

The term 'executive and general administration expenditure' includes expenditure incurred in respect of:

- (a) Rent, rates, taxes, repairs or insurance of any premises outside India used for the purposes of the business or profession;
- (b) Salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profits in lieu of or in addition to salary, whether paid or allowed to any employee or other person employed in, or managing the affairs of, any office outside India;
- (c) Travelling by any employee or other person employed in, or managing the affairs of, any office outside India; and
- (d) Such other matters connected with executive and general administration as may be prescribed.

2.4.2 Gross/ presumptive basis of taxation

As per the provisions of the Act, a person engaged in business is required to maintain regular books of account as per the provisions of section 44AA and further get his accounts audited under section 44AB.

To give relief to specified taxpayers from the tedious work of preparing and maintaining books of account, the Act has framed the presumptive taxation schemes under sections, 44AE, 44B, 44BB, 44BBA and 44BBB. Under the presumptive taxation scheme, certain percentage of the gross receipts/ turnover is deemed to be profits of a taxpayer. However, a person adopting the presumptive taxation scheme has an option to maintain books of account and get his books of account audited u/s 44AB and offer lower profits and gains to tax in India as compared to the profits and gains estimated under the presumptive basis of taxation.

Illustrative Gross/ presumptive basis of taxation under the Act

(a) Sections 44B: Shipping Business

Section 44B is a special provision for computing profits and gains of shipping business of a non-resident taxpayer. In the case of non-residents, such profits and gains will be taken at an amount equal to 7.5 percent of the amount paid or payable to the non-resident or to any other person on his behalf on account of the carriage of passengers, livestock, mail or goods

shipped at any Indian port as also of the amount received or deemed to be received in India on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

(b) Section 172: Shipping business

Section 172 is a complete code in itself and is a special provision for taxation of occasional shipping business of non-residents. In the case of non-resident, any income derived from carrying passengers, livestock, mail or goods shipped at a port in India, is taxed in the year of its earnings. Such profits and gains will be taken at an amount equal to 7.5 percent of the amount paid or payable on account of such carriage. The ship is allowed to leave the port if the tax on such income has been paid or alternative arrangements to pay tax are made. However, the taxpayer has an option to be assessed in accordance with the other provisions of the Act.

(c) Section 44BB: Business of Providing Services and Facilities in Connection with Exploration etc. of Mineral Oils

Section 44BB is a special provision for computation of taxable income of a non-resident taxpayer engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire, used or to be used, in the prospecting for, or extraction or production of, mineral oils.

As per section 44BB, 10 percent of the amount paid or payable to, or the amount received or receivable by, the taxpayer for provision of such services or facilities or supply of plant and machinery shall be deemed to be the taxable income of such non-resident taxpayer.

(d) Section 44BBA: Special provision for computing profits and gains of the business of operation of aircraft in the case of non-residents

Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of aircraft, a sum equal to five per cent of the aggregate of the amounts specified in sub-section (2) shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(2) The amounts referred to in sub-section (1) shall be the following, namely :—

- (a) the amount paid or payable (whether in or out of India) to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and
- (b) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

(e) Section 44BBB: Profits and Gains of Foreign Companies engaged in the Business of Civil Construction, etc. in certain turnkey power projects.

Section 44BBB applies to income of a foreign company engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning

thereof, in connection with turnkey power projects.

It provides for determination of the income of non-resident taxpayers on presumptive basis at a flat rate of 10 percent of the amount paid or payable to such taxpayer or to any person on his behalf, whether in or out of India. For this purpose, the turnkey power project should be approved by the Central Government.

(f) Special provision for computing income by way of Royalties, etc., in case of non-residents (Section 44DA and section 115A)

Where income is effectively connected to a PE in India (Section 44DA)

Income by way of royalty or fees for technical services received from Government or an Indian concern in pursuance of an agreement made by a non-resident (including a foreign company) with Government or the Indian concern would be computed under the head "Profit and gains of business or profession" in accordance with the provisions of the Act on net basis where such non-resident carries on business in India through a PE in India, or performs professional services from a fixed place of profession situated in India, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such PE or fixed place of profession, as the case may be. While computing income under section 44DA, deduction would be allowed in respect of any expenditure or allowance which is wholly and exclusively incurred for the business of the PE or fixed place of profession in India. Taxability under section 44DA of the Act would be at an effective rate of 40 percent (plus applicable surcharge and cess) on net income basis.

(g) Where income is not effectively connected to a PE in India or in absence of PE (Section 115A)

On the other hand, in absence of PE, royalty or fees for technical services received from Government or an Indian concern in pursuance of an agreement made by a non-resident with Government or the Indian concern is taxable at the rate of 10 percent³ (plus applicable surcharge and education cess) as provided under section 115A of the Act (subject to certain conditions).

As stated earlier, where a business is carried on in India by a non-resident through person referred as agent as per Explanation 2 to section 9(1)(i) above, only so much of the income of the non-resident as is attributable to the operations carried out in India shall be taxable in India.

Circular No. 23 dated 23rd July 1969 stated that only that portion of profit which can reasonably be attributed to the operations of the business carried out in India, is liable to income-tax. The said Circular No. 23 provided clarifications envisaged to be useful in deciding the application of provisions of section 9 in certain specific situations including sale of goods

³Amended by the Finance Act, 2015, with effect from Assessment Year 2016-17

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by a non-resident through an Indian agent.

Thereafter Circular No. 163 was issued on 29 May 1975 which clarified that tax liability will not be triggered for a non-resident in India where the activity is restricted to purchase of goods through an agent for export out of India.

The above circulars have been withdrawn by Central Board of Direct Taxes ('CBDT') with effect from 22 October 2009. The said circular has been relied upon in several judgements to determine attribution in the case of DAPE.

Where the tax officer is of the opinion that income arising to a non-resident cannot be properly ascertained, he may also resort to adopt Rule 10 of the Income Tax Rules for attribution of income.

As can be seen, there is no much guidance on the attribution of the profits to DAPE and accordingly, the taxability would need to be evaluated, having regard to the provisions of the Act and the judicial precedents available on the subject.

2.4.3 Disallowance due to default in deduction of tax at source ('TDS')

Entities making payments to non-residents that are taxable in India are required to withhold tax on the payments, which are set off against the recipient's actual tax liability. On the other hand, withholding tax on payments to residents have been made applicable only in case of specified payments under the Act, such as salary payments, payments to contractors and payments towards rent, commission and fees for professional and technical services.

As a step toward enforcing compliance of TDS provisions, the legislature has provided for disallowance of certain expenses where taxes have not been deducted or after deduction have not been deposited with the Government, while computing the taxable profits under 'net' basis of taxation.

A brief summary of such disallowances are as under:

Section	Description
40(a)(i)	<p>Any sum (other than salary) payable outside India or to a non-resident, which is chargeable to tax in India in the hands of the recipient, shall not be allowed to be deducted if it was paid without deduction of tax at source or if tax was deducted but not deposited with the Central Government till the due date of filing of return.</p> <p>However, if tax is deducted or deposited in subsequent year, as the case may be, the expenditure shall be allowed as deduction in that year.</p>
40(a)(ia)	<p>Any sum payable to a resident, which is subject to deduction of tax at source, would attract 30 percent disallowance if it was paid without deduction of tax at source or if tax was deducted but not deposited with the Central Government till the due date of filing of return.</p> <p>However, where in respect of any such sum, tax is deducted or deposited in subsequent year, as the case may be, the expenditure so disallowed shall</p>

Section	Description
	be allowed as deduction in that year.
40(a)(iii)	Salaries payable outside India, or in India to a non-resident, on which tax has not been paid/deducted at source is not deductible.
40(a)(iv)	Payments to provident fund or other funds for employees' benefit shall not be deductible if no effective arrangements have been made to ensure deduction of tax at source from payments made from such funds to employees which shall be chargeable to tax as 'salaries'.

Non-deduction/ non-payment of TDS may result in treating the person responsible for deducting the tax as "assessee in default" and accordingly, consequences for being an "assessee in default" will follow.

2.5 Applicability of Minimum Alternate Tax ('MAT') provisions

If the income tax payable by a taxpayer on its total income as computed under the Act in respect of any previous year, is less than 18.5 percent of such book profit (computed as per the manner laid down in the Act) plus surcharge plus education cess then such book profit shall be treated as total income of the company and the tax payable for the relevant previous year shall be deemed to be 18.5 percent of such book profit under section 115JB (plus surcharge plus education cess). This non obstante provision will override any other provision of the Income Tax Act. Thus, where the income-tax payable is less than 18.5 percent of book profit, such book profit will be deemed to be total Income and MAT will be payable @ 18.5 percent on such book profit plus surcharge and education cess.

Credit for excess taxes paid as MAT as per section 115JB in earlier years (in which MAT liability was more than tax liability as per normal provisions of the Act) is available in the assessment year in which tax payable on the total income computed under the normal provisions of this Act is more than tax payable under section 115JB for that assessment year.

Circular- not to levy MAT on foreign companies

As per recent *Instruction No. 111/2015 F. No.153 /12/2015-TPL dated 23rd December, 2015*, with effect from 1-4-2001, the provisions of section 115JB shall not be applicable to a foreign company (including an FII/FPI) if—

- (i) the foreign company is resident of a country with which India has a DTAA and such foreign company does not have a PE in accordance with the provisions of the relevant DTAA or
- (ii) the foreign company is a resident of a country with which India does not have a DTAA and such foreign company is not required to seek registration under section 592 of the Companies Act, 1956 or section 380 of the Companies Act, 2013.

3. Treatment of Tax Losses – How Domestic Tax System Impact Non-resident

3.1 Introduction

Diagrammatic depiction of inter-head set-off of losses in the year in which such loss is incurred is given below:

Head/Source of Income	Below losses can be adjusted as follows in the year in which they are incurred:							
	House property loss of the current year set off	Business Loss (other than speculation or specified business loss) of the current year set off	Loss from specified business	Loss from speculation business	Long term capital loss	Short term capital loss	Other sources loss (other than loss from race horses) of the current year set off	Loss from owning and maintaining race horses
Salary	✓	X	X	X	X	X	✓	X
House property	Can be adjusted against income from any other property under the head income from house property*	✓	X	X	X	X	✓	X
Non Speculation Business income	✓	Can be adjusted against income from any other non-speculation business	X	X	X	X	✓	X
Speculation Business income	✓	✓	X	✓	X	X	✓	X
Specified business income (Section 35AD)	✓	✓	✓	X	X	X	✓	X
Short-term capital gain	✓	✓	X	X	X	✓	✓	X
Long term capital gain	✓	✓	X	X	✓	✓	✓	X
Other sources (excluding profit from owning and maintaining race	✓	✓	X	X	X	X	Can be adjusted against income from any source under the head	X

Head/ Source of Income	Below losses can be adjusted as follows in the year in which they are incurred:							
	House property loss of the current year set off	Business Loss (other than speculation or specified business loss) of the current year set off	Loss from specified business	Loss from speculation in business	Long term capital loss	Short term capital loss	Other sources loss (other than loss from race horses) of the current year set off	Loss from owning and maintainin g race horses
horses)							income from other sources	
Profit from owning and maintaining race horses	✓	✓	X	X	X	X	✓	✓

*The maximum loss under the head "Income from House Property" that can be claimed in a particular year is Rs. 2 lakh and the loss remaining, if any, shall be carried forward to the subsequent years.

Note:

'✓' denotes eligible for set off

'X' denotes not eligible for set off

Step 1: Intra-head adjustment – Section 70		
Short term Capital Loss	(3,00,000)	
Long term Capital Gain	2,00,000	
Total income/ (loss) under the head capital gains after intra-head adjustment as per section 70		(1,00,000)
Step 2 : Inter-head adjustment – Section 71		
Loss under the head house property	(8,000)	
Loss under the head profits or gains from business or profession (refer Note 1)	(1,00,000)	
Income under the head salaries	2,00,000	
Loss under the head capital gains (refer Note 2)	(1,00,000)	
Total income of Mr R, after inter-head adjustment under section 71		1,92,000
Note 1:		
Loss under the head profits or gains from business or profession can be set off against income under		

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any other head of income except income under the head salaries. Note 2: Short term capital loss can be set off only against short term capital gains and long term capital gains		
Total taxable income of Mr R for AY 2016-17		1,92,000

3.2 Carry forward and set off of Losses

During a particular financial year, it may so happen that even after making intra-head and inter-head adjustments, still the loss remains unadjusted (i.e., there is no sufficient income to absorb the loss). Such unabsorbed loss can be carried forward and set off against income of the taxpayer in future years as enumerated below:

Section	Nature of loss to be carried forward	Maximum permissible period for carry forward of losses	To be set off against	Para Reference
71B	Loss from house property	8 years	Income from house property	-
72	Unabsorbed business loss	8 years	Income under the head Profits or gains from business or profession	C
32(2)	Unabsorbed depreciation	Indefinite period	Any head of income except income under the head salaries	C
73	Speculation business loss	4 years	Income from Speculation business only	D
73A	Loss from Specified business under section 35AD	Indefinite period	Income from Specified business under section 35AD only	E
74	Short term Capital Loss	8 years	Short term Capital gain Long term Capital gain	F
	Long term Capital Loss	8 years	Long term Capital gain only	
74A	Loss from certain specified sources falling under the head 'Income from	4 years	Income from owning and maintaining race horses only	G

Section	Nature of loss to be carried forward	Maximum permissible period for carry forward of losses	To be set off against	Para Reference
	other sources' i.e. Loss from owning and maintaining race horses *			

* Loss from any source other than owning and maintaining race horses under the head income from other sources cannot be carried forward to subsequent year for set off.

Carry forward of losses (other than loss from house property and unabsorbed depreciation) is permissible only if the return of income for the year in which the loss is incurred is filed within the due date of filing of return of income (Section 80). However unabsorbed depreciation can be carried forward to the subsequent previous year even if the return is not filed within the due date.

If in any particular assessment year, even after intra-head and inter-head adjustment, the net-result under the head profits or gains from business or profession is a loss, the same can be carried forward for a maximum period of 8 years immediately succeeding the year in which the loss was incurred. Such losses so carried forward can be set off only against income under the head 'Profit and gains of business and profession' in the subsequent assessment year.

The above provisions are not applicable in case of unabsorbed depreciation.

In a particular year, if there is no income under the head profits and gains from business or profession or the income under the head profits and gains from business or profession is less than the depreciation allowed to the taxpayer as per section 32 then the amount of depreciation which remains to be absorbed against the said income is called unabsorbed depreciation.

Unabsorbed depreciation can be carried forward for indefinite period and can be set off against income under any head of income. Unabsorbed depreciation can be carried forward and set off even if the business owing to which depreciation was allowed ceases to exist.

Section 72(2) prescribes the order in which the business losses shall be set off. In a case where the business profits are insufficient to absorb the current depreciation allowance, brought forward business losses and unabsorbed depreciation, the same should be set off in the order as explained in the illustration below:

Illustration: Following are the details of income/ loss earned by Permanent Establishment (PE) in India of X Inc, a company incorporated in USA.

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For AY 2021-22

Particulars	Amount (In Rs)
Profits or gains / (loss) from business or profession	
Business Loss	(2,00,000)
Unabsorbed depreciation	(1,00,000)

Note: The return of income of the PE was filed on 15 December 2021 however the due date of filing of return of income was 30 November 2021.

For AY 2022-23

Particulars	Amount (In Rs)
Profits or gains / (loss) from business or profession	
Business Income	2,00,000

Computation of income of PE of X Inc for AY 2022-23:

Particulars	Amount (In Rs)	Amount (In Rs)
Profits or gains / (loss) from business or profession		
Business Income	2,00,000	
Less: Brought forward business loss of AY 2021-22 (refer Note1)	Nil	
Less: Unabsorbed depreciation	(1,00,000)	1,00,000
Total taxable income of PE of X Inc for AY 2022-23		1,00,000
Note 1: Business loss of AY 2021-22 cannot be carried forward and set off in AY 2022-23 since the return of income for AY 2021-22 was not filed within the due date (Section 80).		

4. Foreign Tax Relief

4.1 Introduction

What is Foreign Tax Relief or Foreign Tax Credit?

In simple words, when a credit is given by a country for taxes paid in another country, it is called as Foreign Tax Credit. One of the fundamental principles of international taxation is that no income should be taxed twice in the hands of the same person. Thus, the objective of the foreign tax credit is to avoid the double-taxation burden in accordance with the DTAA that have been entered into between various countries. Article 23 of the DTAAs generally provide for the bilateral relief from double taxation and Section 91 of the Act provides for a unilateral relief under the Indian domestic law.

Why Foreign Tax Credit?

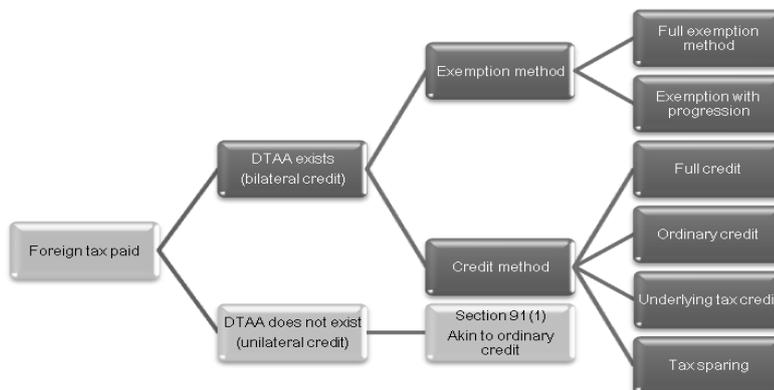
The DTAA's are entered into to avoid double taxation of the same income in the hands of one person in more than one jurisdiction. Thus, the basic aim of the DTAA is achieved by assigning an exclusive right of taxation to either of the countries for different categories of income.

However, when such exclusivity is not possible and conflicting claims to levy tax are not reconciled and both the countries insist upon exercising their right, it leads to double taxation. This arises due to difference in the approaches adopted by the countries in treaty negotiation.

Given the above, Article 23 of the DTAA's provides a mechanism to eliminate double taxation where the same income is taxable in the hands of one person in both the Contracting States/countries. Typically, as per Article 23, it is the Country of Residence ('COR') which is obliged to give credit for taxes paid in the Country of Source. The method by which the COR provides relief from double taxation depends primarily on its general tax policy and the structure of its tax systems and DTAA's.

4.2 Methods of granting Foreign Tax Relief

A pictorial representation about the methods which are generally applied for granting foreign tax relief is depicted below:



As can be seen, there are two primary methods for eliminating double taxation – (i) Unilateral credit, which is given under the domestic laws of a particular country and (ii) Bilateral credit, which is given under the provisions of the DTAA.

4.2.1 Unilateral credit

A unilateral credit/ relief is provided by a country in its domestic tax laws to provide relief to its residents for the foreign sourced income which is doubly taxed. Many countries including India have provisions in their local domestic laws offering unilateral credit in respect of such doubly taxed income in order to mitigate the adverse impact of double taxation.

Section 91(1) of the Act contains provisions dealing with Foreign Tax Credit ('FTC') for countries with which India does not have a DTAA. The text of the section is reproduced below:

'If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and which is not deemed to accrue or arise in India), he has paid in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation, income-tax, by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal.'

Conditions to be satisfied to avail FTC under section 91 of the Act

Accordingly, in case of income arising to the assessee in countries with which India does not have a DTAA, foreign tax relief would be granted under section 91 of the Act provided all the conditions mentioned therein are fulfilled.

Method of computation of relief as per section 91 of the Act

Thus, FTC = Lower of "Indian rate of Income tax" or the "foreign rate of tax" on the doubly taxed income

Illustrations:

Tax in country X	100,000*35% = 35,000
Tax in India	100,000*30% = 30,000
Doubly taxed income	100,000
FTC available [lower of (a) and (b)]	30,000
Actual tax payable in India	Nil

- Income of Mr Y, an Indian resident, is tabulated below:

Foreign business income	250,000
Business loss in India	(100,000)
Other income in India	50,000
Total income	200,000
Tax rate in foreign country	20%
Tax rate in India	30%

In the above example, foreign tax relief would be granted on 'doubly taxed income' which is 200,000 in this case. Thus, the tax liability in India would be as follows:

Net taxable income	200,000
Tax @ 30%	60,000
Less: Foreign Tax Credit (200,000*20%) (as the tax rate in foreign country is lower than the Indian tax rate)	(40,000)
Tax liability in India	20,000

4.2.2 Bilateral credit

Under section 90 read with treaties signed by Government with other countries tax credit is available depending on the language of DTAA. Under this method, the Governments of two countries enter into an agreement to provide relief against double taxation by mutually working out the basis on which the relief is to be granted. India has entered into DTAA's with more than 98 countries as on date.

4.3 Foreign tax Credit Rules

Rule 128 has been inserted by the Income-tax (Eighteenth Amendment) Rules, 2016, w.e.f. 1-4-2017 pertaining to Foreign Tax Credit. It provides as under:

(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule:

Provided that in a case where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.

(2) The foreign tax referred to in sub-rule (1) shall mean—

- (a) in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A, the tax covered under the said agreement;
- (b) in respect of any other country or specified territory outside India, the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in clause (iv) of the Explanation to section 91.

(3) The credit under sub-rule (1) shall be available against the amount of tax, surcharge and cess payable under the Act but not in respect of any sum payable by way of interest, fee or penalty.

(4) No credit under sub-rule (1) shall be available in respect of any amount of foreign tax or part thereof which is disputed in any manner by the assessee:

Provided that the credit of such disputed tax shall be allowed for the year in which such income is offered to tax or assessed to tax in India if the assessee within six months from the end of the month in which the dispute is finally settled, furnishes evidence of settlement of dispute and an evidence to the effect that the liability for payment of such foreign tax has been discharged by him and furnishes an undertaking that no refund in respect of such amount has directly or indirectly been claimed or shall be claimed.

(5) The credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:—

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- (i) the credit shall be the lower of the tax payable under the Act on such income and the foreign tax paid on such income :

Provided that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess shall be ignored for the purposes of this clause;

- (ii) the credit shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.

(6) In a case where any tax is payable under the provisions of section 115JB or section 115JC, the credit of foreign tax shall be allowed against such tax in the same manner as is allowable against any tax payable under the provisions of the Act other than the provisions of the said sections (hereafter referred to as the "normal provisions").

(7) Where the amount of foreign tax credit available against the tax payable under the provisions of section 115JB or section 115JC exceeds the amount of tax credit available against the normal provisions, then while computing the amount of credit under section 115JAA or section 115JD in respect of the taxes paid under section 115JB or section 115JC, as the case may be, such excess shall be ignored.

(8) Credit of any foreign tax shall be allowed on furnishing the following documents by the assessee, namely:—

- (i) a statement of income from the country or specified territory outside India offered for tax for the previous year and of foreign tax deducted or paid on such income in Form No.67 and verified in the manner specified therein;
- (ii) certificate or statement specifying the nature of income and the amount of tax deducted therefrom or paid by the assessee,—
- (a) from the tax authority of the country or the specified territory outside India; or
- (b) from the person responsible for deduction of such tax; or
- (c) signed by the assessee:

Provided that the statement furnished by the assessee in clause (c) shall be valid if it is accompanied by,—

- (A) an acknowledgement of online payment or bank counter foil or challan for payment of tax where the payment has been made by the assessee;
- (B) proof of deduction where the tax has been deducted.

(9) The statement in Form No.67 referred to in clause (i) of sub-rule (8) and the certificate or the statement referred to in clause (ii) of sub-rule (8) shall be furnished on or before the due date specified for furnishing the return of income under sub-section (1) of section 139, in the manner specified for furnishing such return of income.

(10) Form No.67 shall also be furnished in a case where the carry backward of loss of the current year results in refund of foreign tax for which credit has been claimed in any earlier previous year or years.

Explanation — For the purposes of this rule 'telegraphic transfer buying rate' shall have the same meaning as assigned to it in Explanation to rule 26.

4.4 Relief from taxation of income from retirement benefit account maintained in a notified country

In case of a non-resident who has become resident in India, the amount of income in his foreign retirement benefits account is chargeable to tax in India on accrual basis. However, some countries tax such amount at the time of receipt. Due to mismatch in the year of taxability of such income in retirement funds, the taxpayer (generally NRI who permanently returned to India) faces practical difficulties in availing the foreign tax credit in respect of tax paid outside India on such income.

To remove the aforesaid difficulty, section 89A has been inserted with effect from assessment year 2022-23 to provide that the income of a specified person from specified account shall be taxed in such manner and for such year as may be provided by rules.

For this purpose, the expressions "specified person", "specified account" and "notified country" have been defined as follows:

- '(a) "specified person" means a person resident in India who opened a specified account in a notified country while being non-resident in India and resident in that country;
- (b) "specified account" means an account maintained in a notified country by the specified person in respect of his retirement benefits and the income from such account is not taxable on accrual basis but is taxed by such country at the time of withdrawal or redemption;
- (c) "notified country" means a country as may be notified by the Central Government in the Official Gazette for the purposes of this section.

'Rule 21AAA - Taxation of income from retirement benefit account maintained in a notified country

- (1) Where a specified person has income accrued in a specified account or accounts, during a previous year relevant to any assessment year beginning on or after the 1st day of April, 2022, such income shall, at the option of the specified person, be included in his total income of the previous year relevant to the assessment year in which income from the said specified account or accounts is taxed at the time of withdrawal or redemption, as the case may be, in the notified country.
- (2) Where the option has been exercised by a specified person under sub-rule (1), the total income of the specified person for the previous year in which income is taxable under sub-rule (1) shall not include the income which,—
- (a) has already been included in the total income of such specified person in any of the earlier previous years during which such income accrued and tax thereon has been paid in accordance with the provisions of the Act; or
 - (b) was not taxable in India, in the previous year during which such income accrued,

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on account of,—

- (i) such specified person being a non-resident, or not ordinarily resident referred to in clause (6) of section 6, during that previous year; or
- (ii) application of the Double Taxation Avoidance Agreement, if any,

and the foreign tax paid on such income, if any, shall be ignored for the purposes of computation of the foreign tax credit under rule 128.

- (3) The option under sub-rule (1) shall be exercised by the specified person in respect of all the specified accounts maintained by the specified person.
- (4) In a case where the specified person becomes a non-resident during any relevant previous year, then-
 - (i) the option exercised under sub-rule (1) shall be deemed to have never been exercised with effect from the relevant previous year; and
 - (ii) the income which has accrued in the specified account or accounts during the period, beginning with the previous year in respect of which the option under sub-rule (1) was exercised and ending with the previous year immediately preceding the relevant previous year, shall be taxable during the previous year immediately preceding the relevant previous year and tax shall be paid on or before the due date for furnishing the return of income for the relevant previous year.
- (5) The option to be exercised under sub-rule (1) by the specified person, for any previous year relevant to the assessment year beginning on or after the 1st day of April, 2022, shall be in Form No. 10-EE and it shall be furnished electronically under digital signature or electronic verification code on or before the due date specified under subsection (1) of section 139 of the Act, for furnishing the return of income.
- (6) Subject to the provisions of sub-rule (4), the option once exercised for a specified account or accounts in respect of a previous year under sub-rule (1) in Form No. 10-EE shall apply to all subsequent previous years and cannot be subsequently withdrawn for the previous year for which the option was exercised or any previous year subsequent to that previous year.
- (7) The Principal Director-General of Income-tax (Systems) or Director-General of Income-tax (Systems), as the case may be, shall specify the procedures, formats and standards for ensuring secure capture and transmission of data and shall be responsible for evolving and implementing appropriate security, archival and retrieval policies in respect of Form No. 10-EE

Explanation — For the purposes of this rule,-

- (i) “*due date*” shall have the meaning assigned to it in Explanation 2 to sub-section (1) of section 139 of the Act;
- (ii) “*notified country*,” “*specified account*” and “*specified person*” shall have the meaning assigned to them in the Explanation to section 89A of the Act;
- (iii) “*relevant previous year*” shall mean the previous year during which the specified person becomes nonresident subsequent to the previous year in respect of which

option under sub-rule (1) has been exercised.

The countries notified for the purpose of Section 89A are Canada, United Kingdom of Great Britain and Northern Ireland and United States of America. [Notification No. 25/2022]

5. Advance Ruling

5.1 Introduction and background

Since the adoption of the new economic policy of liberalization, privatization and globalization in 1991, the foreign direct investments ('FDI') and joint ventures involving Indian Companies have increased.

To facilitate foreign investment into the country a number of steps have been taken by the Government of India in the past. Setting up an Authority for Advance Rulings ('AAR') to give binding rulings, in advance, on Income Tax matters pertaining to an investment venture in India is one such measure.

The scheme of advance rulings (Chapter XIX-B) was introduced from 1st June, 1993 in the Act for the benefit of non-residents ('NR'), to enable them to obtain a ruling in advance from the AAR. This measure ensured that they are not saddled with problems of uncertainty with regard to the taxability of income arising out of activities or transactions undertaken or proposed to be undertaken in India. This scheme sought to expedite the resolution of disputes between the Income-tax authorities and the taxpayers to achieve finality of a particular transaction in a simple and inexpensive manner.

The provisions of law pertaining to AAR are covered under sections 245N to 245V of the Act (Chapter XIX – B) and the procedure is spelt out in Income-tax Rules, 1962 – Rules 44E and 44F and also the Authority for Advance Ruling (Procedure) Rules, 1996 ['Rules'].

5.2 Importance and advantages of Advance Rulings

Advance Rulings are an indispensable tool in the modern world of tax administration and compliance. Very useful material on the advantages to be achieved by such a system is found in the reports of official commissions or working parties established in many countries to investigate and advise on tax reforms generally, or the need for establishing a system of formal rulings specifically.

5.3 Importance of Advance Rulings

- (a) To foster and encourage self-assessment;
- (b) To contribute to good relations between income tax administrators and the general public;
- (c) To give certainty to transactions;
- (d) To give more consistency in the application of the law;
- (e) To minimize controversy and litigation; and
- (f) To achieve a more coordinated system.

Another event that has led to an increase in uncertainty and, therefore, to a greater demand for advance rulings is the introduction of General Anti-Avoidance Regulations ('GAAR') in many countries. Such provisions contain potential overkill and could reach transactions that have a perfectly legitimate business purpose. The GAAR, therefore, could become real obstacle for genuine and desirable transactions, and an advance ruling mechanism could provide the answer to break the potential deadlock.

W.e.f from 1 April 2015, an applicant, being resident or Non-resident, can approach AAR to determine whether the transaction proposed to be undertaken is an impermissible avoidance arrangement as referred to in Chapter X-A [special provision relating to GAAR]. GAAR provisions are effective from 1 April 2017.

5.4 Advantages of seeking Advance Ruling

Some of the advantages of seeking an advance ruling are:

- (a) It enables the non-residents to ascertain the liability of income tax even before making investments or entering into the transactions in India. Hence, the non-resident can change its investment plans accordingly to avoid long-drawn litigation;
- (b) The authority is to pronounce its ruling within a statutory time limit of six months of the receipt of the application. This enables the investor speedy resolution and draw up the details of his transaction without undue delay on this account and ensure full certainty regarding its tax implications;
- (c) Complex issues of Income-tax including those concerning double taxation avoidance agreements (DTAA) which arise as a result of difference in opinion between the tax collectors and the tax-payers can be resolved;
- (d) The rulings of the Authority are binding on the applicant as well as the Commissioner, and the income-tax authorities subordinate to him. Further, having obtained the ruling on a given set of facts the taxpayer may be sure about his liability not only for one year but for all the years covered under the transaction unless there is a change in the facts or law;

5.5 Composition of the Erstwhile AAR

The AAR comprises of three members:

- (a) Chairman, who is a retired judge of the Supreme Court;
- (b) Member from the Indian Revenue Service, who is qualified to be a member of the Central Board of Direct Taxes; and
- (c) Member from the Indian Legal Service who is, or is qualified to be, an Additional Secretary to the Government of India.

Currently, the bench of the Authority is located at Delhi. Further, the Union Cabinet has approved formation of two additional benches of AAR - one in New Delhi and other in

Mumbai⁴.

The salaries and allowances payable to, and the terms and conditions of service of the Members have been prescribed by the Government of India.

The constitution of the Authority is such that it functions as an independent quasi-judicial body deemed to be a Civil Court for the purposes of section 195 of the Code of Criminal Procedure, 1973.

Application to the AAR

5.5.1 Who can make an application?

(a) Applicability to Non – residents⁵

The AAR provisions were originally introduced to address resolution of tax disputes arising in case of non-residents. NRs were the first set of taxpayers who came to be included within the scope of AAR. Further an amendment was also brought which enable residents to approach AAR for determining the tax liability of a non-resident arising out of transaction undertaken by such resident. There is no threshold limit for approaching AAR when an application is made by a NR

(b) Applicability to residents

The Finance (No.2) Act, 2014, introduced a new provision S.245N(a)(iia) which enables a resident taxpayer to approach the AAR for determining his own tax liability in advance.

Accordingly, a resident applicant can approach AAR for determining tax liability on transactions entered by him either with Resident or Non-Resident. This provision is for determining the resident's own liability and not in relation to tax liability of another person, with whom he may be transacting and the threshold limit qualifying for approaching AAR under this provision is transactions valuing INR 100 Crores or more. The Form and the Rules in this regard have been notified by the CBDT.

(c) Applicability to Public Sector Undertakings (PSU)

In order to rationalise the provisions in respect of a resident taxpayer, with effect from 1 October 1998, the Act covered PSUs as 'applicant' eligible to file application before AAR. PSUs can approach AAR even in cases where the matter is pending before the tax authority or the appellate authority.

(d) GAAR transactions covered within the ambit of meaning of “advance ruling”

An applicant, being resident or Non-resident, may approach AAR for the transaction to

⁴Source : Press Information Bureau[pib.nic.in]

⁵Broadly divided into individual, Hindu Undivided Family, Company, Firm, Association of persons, any other person.

be undertaken to determine whether the same is an impermissible avoidance arrangement as referred in S.98(1) of the Chapter X-A [special provision relating to avoidance of tax]. The aforementioned provision was introduced w.e.f 1 April 2015. GAAR provisions are effective from 1 April 2017.

5.5.2 Questions on which Advance ruling can be sought

- (a) Though the word "question" is unqualified, it is only proper to read it as a reference to questions, of law or fact, pertaining to the income-tax liability (ie considering the provisions of the Act and/or the relevant DTAA) of the applicant qua the transaction undertaken or proposed to be undertaken.
- (b) The questions may be on points of law as well as on fact; therefore, mixed questions of law and fact can also be included in the application. The questions should be so drafted that each question is capable of a brief answer. This may need breaking-up of complex questions into two or more simple questions.
- (c) The questions should arise out of the statement of facts given with the application. No ruling will be given on a purely hypothetical or academic question. Questions not specified in the application cannot be urged. Normally, a question is not allowed to be amended but in deserving cases the Authority may allow amendment of one or more questions.
- (d) Even though the word used in the definition is 'question', it is clear that the applicant can raise more than one question in one application. This has been made amply clear by the columns of the form of application for obtaining an advance ruling.

As discussed above, an AAR can be sought on any question of law or fact specified in the application in relation to a transaction which has been undertaken, or is proposed to be undertaken, by the non- resident applicant. However, **an advance ruling cannot be sought where the question:**

(a) **Is pending before other authorities**

The Authority cannot allow any application where the question raised in it is already pending before any income-tax authority, Tribunal or any Court. For eg: even a general notice, say, notice for initiation of assessment proceedings may be regarded as pendency of proceedings and may create an embargo on maintainability of application before AAR.

(b) **Involves determination of Fair Market value of any property**

The second prohibition is on questions relating to the determination of fair market value of any property, movable or immovable.

(c) **Is designed prima facie for tax avoidance**

Thirdly, the Authority would not allow any application if it relates to a transaction which is designed prima facie for the avoidance of income-tax.

What can be said to be prima facie avoidance of income-tax? To determine how a particular transaction is designed, it is not necessary to go into greater factual details. Clause (c) of the proviso to section 245R(2) refers only to the prima facie impression

created in the mind of the Authority on the facts stated before it. For eg, in the case of X Ltd [220 ITR 377] (AAR), where the British Bank holding shares in Indian Bank indirectly through companies incorporated in Mauritius thereby indirectly gaining benefits of DTAA between India and Mauritius, it was held that the transaction is prima facie to avoid income-tax and cannot be adjudicated by AAR.

(d) Other points

Questions cannot be put before AAR with respect to quantification of income of a taxpayer (e.g. quantum of taxable income/ profits of a PE of a taxpayer in a contracting state) and for determination of arm's length price under Indian Transfer Pricing regulations.

The following table provides a summary of discussion above on various applicants who can approach AAR for an advance ruling

Applicant	Relevant Sections of the Act	Issue that can be put up before AAR	Applicable limitations
NR for his own tax liability	245N(a)(i), 245N(b)(i)	Transaction undertaken or proposed to be undertaken by NR	<ul style="list-style-type: none"> • No pendency before tax authority / Tribunal/ Court • Non determination of FMV • Not relating to an issue designed prima facie for tax avoidance
Resident for determining tax liability of a NR	245N(a)(ii) 245N(b)(ii)	Transaction undertaken or proposed to be undertaken by resident with NR	<ul style="list-style-type: none"> • No pendency before tax authority /Tribunal/ Court • Non determination of FMV • Not relating to an issue designed prima facie for tax avoidance
Resident for his own tax liability	245N(a)(iia) 245N(b)(iia)	Transaction undertaken or proposed to be undertaken by resident the value of which is INR 100 crores or more	<ul style="list-style-type: none"> • No pendency before tax authority / Tribunal/ Court • Non determination of FMV • Not relating to an issue designed prima facie for tax avoidance
PSUs	245N(b)(iii)	Transaction undertaken or proposed to be undertaken	<ul style="list-style-type: none"> • Non determination of FMV • Can file an application even if the issue is pending before the tax authority or the Tribunal

Applicant	Relevant Sections of the Act	Issue that can be put up before AAR	Applicable limitations
Resident or NR himself	245N(a)(iv) 245N(b)(iiiia)	Determination of whether an arrangement which is proposed to be undertaken is an impermissible avoidance arrangement under Chapter XA	<ul style="list-style-type: none"> No pendency before tax authority / Tribunal/Court Non determination of FMV

Examples of matters dealt by erstwhile AAR (now BAR)

- **Taxability of direct, Indirect transfer of shares of an Indian Company by a NR Company** Dana Corporation [321 ITR 178], Z [249 CTR 225], - it was held that the expression 'income' in section 92 is not used in a sense wider than or different from its scope and connotation elsewhere in the Act
- **Taxability of capital gains on transfer of shares:** (Symphony Technology Group LLC, In re) [2021] 123 taxmann.com 189 (AAR - Mumbai) - Where Indian assets of foreign company were less than 31 per cent of its world assets, capital gain arising on transfer of shares of said company would not be taxable in India under section 9(1)(i).
- **The AAR in the case of Elsevier BV, In re [432 ITR 251]** has held that where the applicant, a Netherlands-based company, is engaged in business of providing electronic and print versions of books, journals, and online database solutions, receipt by applicant from Indian subscribers for access to database containing books/journals/articles with a limited right of printing, making e-copies, and storing information is not 'Royalty' but business income, as there is no transfer of any know-how or previous or new experience to subscriber
- **Taxability of payments received from use or sale of/access to software** - eg Dassault Systems K.K. [322 ITR 125], Acclerys KK, [68 DTR 206], etc

Amendments by Finance Act, 2021

Constitution of the Board for Advance Ruling

Vide amendments made by the Finance Act, 2021, AAR is substituted by the Board for Advance Ruling ('BAR'). The BAR will consist of two members, each being officer not below the rank of Chief Commissioner of Income Tax, which will ensure continued functioning⁶. The said changes are stated to impart greater efficiency, transparency and accountability.

These amendments are to take effect from 1st April, 2021.

⁶ First Bench of the BAR as well the rules for functioning of the BAR or application by taxpayers are yet to be notified.

Constitution of the Board for Advance Ruling

AAR consists of a Chairman and various Vice-Chairman, revenue members and law members. There are three benches of the Authority. A bench cannot function if the post of Chairman or Vice Chairman is vacant. As per past experience, the posts of Chairman and Vice-Chairman have remained vacant for a long time due to non-availability of eligible persons. This has seriously hampered the working of AAR and a large number of applications are pending since last many years. Hence, Finance Act, 2021 has introduced certain amendments to constitute a Board of Advance Ruling as under:

- The Authority for Advance Rulings shall cease to operate with effect from such date, as may be notified by the Central Government in the Official Gazette.
- Central Government shall constitute one or more Board for Advance Rulings for giving advance rulings under the said Chapter on and after the notified date. Every such Board shall consist of two members, each being an officer not below the rank of Chief Commissioner.
- Section 245N is amended to incorporate the definitions of the Board of Advance Rulings, notified date, Member of the Board of Advance Rulings and change in the definition of Authority to include the Board.
- Section 245-O is amended to provide that the Authority constituted under the said section shall cease to operate on or after the notified date
- Section 245-OB is inserted to provide for the constitution of the Board of Advance Rulings.
- Section 245P, 245R and 245T are amended to provide provisions of the said section shall have effect as if for the words “Authority”, the words “Board for Advance Rulings” had been substituted and provisions of Section 245R shall apply mutatis mutandi to the Board for Advance Rulings as they apply to the Authority
- Section 245Q (which deals with filing of application) is amended to provide that the pending application with the Authority shall be transferred to the Board for Advance Rulings along with all records, documents or material, by whatever name called and shall be deemed to be records before the Board for all purposes.
- Section 245U is amended to provide that on or from the notified date, the powers of the “Authority” under the said section shall be exercised by the “Board for Advance Rulings” and the provisions of the said section shall apply mutatis mutandi to the Board for Advance Rulings as they apply to the Authority.
- Section 245V and 245S is amended to provide that nothing contained in the said section shall apply on and after the notified date

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- A new section 245W is inserted to provide for appeal to High Court against the order passed or ruling pronounced by the Board for Advance Ruling. This appeal can be filed by the applicant as well as by the Department. The form and manner of filing appeal to the High Court shall be same as provided in the applicable procedure laid down by the jurisdictional High Court for filing appeal to the High Court. [Notification No. 57/2022]
- References to Customs Act, 1962, Central Excise Act, 1944 and Finance Act, 1994 in the definition of applicant in section 245N and in section 245Q relating to application for advance ruling is omitted.

Existing AAR vs. Proposed BAR

Particulars	Existing AAR	Proposed BAR
Constitution	3 Benches of AAR, constituted by the Chairman of AAE	One or more BARs, constituted by the CG by notification
Composition of members and qualification	<ul style="list-style-type: none"> • Chairman – Judge of SC or HC • Vide Chairman – Judge of HC • Revenue member from Indian Revenue service • Law Member from Indian Legal Service 	Two Members each being an officer not below the rank of Chief Commissioner as may be nominated by BAR
Scope of Application	For direct tax and indirect tax disputed	For direct tax only
Who can apply	NR taxpayer and resident tax payer as specified	Some, for direct tax application only
Applicability of the ruling	Binding on the applicant as well as department	Not Binding
Procedure on receipt of application	Regulated by Section 245R	Remains same. In addition, CG empowered to make a scheme, to be notified for advance ruling to be given by BAR – akin to faceless assessment and appeals procedure
Void Application	AAR can declare any advance ruling void ab initio if obtained by fraud or misrepresentations of facts	Same power to BAR

Particulars	Existing AAR	Proposed BAR
Appeal against advance ruling	Not specifically provided. However, aggrieved party could have filed a writ petition in a High Court	Appeal may be filed before High Court within 60 days CG empowered to make a scheme for filing appeal before High Court in respect of department's appeal
Regulation for procedure	AAR have the power to regulate its own procedure	No Specific provision, procedure likely to be governed by the scheme.

6. Chapter-XX Tax Deduction at Source / Withholding taxes

6.1 Introduction

The tax deduction at source ('TDS') is an important tool of revenue collection and therefore more and more items of income are being added to the already substantial list of items liable to TDS. The objective behind application of TDS provision to non-residents is to save the country from hassles of subsequent recoveries which may at times become difficult due to geographical distances and different legal jurisdictions. Therefore, the burden is cast on the "Person responsible for paying" to non-residents to deduct tax on the sum which is chargeable to tax at the rates, either prescribed under the Act or under the DTAA, whichever is lower. This method has proved to be a very effective tool in collection of taxes from the non-residents.

The withholding tax rate applicable for Non-resident being a company and/or other than company: A.Y. 2022-23:

Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
192	Employer	Employee	At the time of Payment	Basic exemption limit	Average rate of income-tax computed on the basis of

⁷In order to provide more funds at the disposal of taxpayers due to COVID-19, rates of TDS, in respect of non-salaried specified payments to residents has been reduced by 25% for the period 14 May 2020 to 31 March 2021, vide press release dated 13 May 2020.

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Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
					the rates in force
192A	Trustees of the EPF Scheme or any authorised person under the Scheme	Individual (Employee)	At the time of Payment	50,000	10% (30% if No PAN)
193	Any person responsible for paying any income by way of interest on securities	Any resident	Earlier Of: Credit or; Payment	> 10,000, in case of 8% Savings (Taxable) Bonds, 2003 > 5,000, in case of interest on debentures issued by a company in which the public are substantially interested, paid or credited to a resident individual or HUF No threshold specified in any other case.	10%
194	Domestic Company	Resident Shareholder	Earlier Of: Declared/Distributed or; Paid	5,000,(w.e.f . 01-04-2020 in case of an individual shareholder , where	10%

Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
				payment is made by A/c payee cheque	
194A]	Any Person (Except Ind/HUF; not liable to audit u/s 44AB in the immediately preceding FY)	Resident payee	Earlier Of: Credited or; Paid	5000/ 40000** (for Senior citizen 50,000)	10% **Bank/Post Office
194B	Any Person	Any person	At the time of Payment	10,000	30%
194BB	Any Person	Any Person	At the time of Payment	10,000	30%
194C	Any Person (Except Ind/HUF; not liable to audit u/s 44AB in the immediately preceding FY)	Any Resident contractor for carrying out any work (including supply of labour)	Earlier Of: Credit or; Payment	30,000 (single Payment) or more than 1,00,000 during FY	1% (if paid to Ind/ HUF) otherwise; 2%
194D	Any Person	Any Resident payee	Earlier Of: Credit or; Payment	15,000	5%
194DA	Any Person	Any Resident payee	At the time of Payment	100,000	5%
194E	Any Person	Non-Resident Sportsman/ Entertainer (not Indian Citizen)/ non-resident sports association	Earlier Of: Credit or; Payment	Income u/s 115BBA	20%
194EE	Payer; paying any amount as	Any Payee	At the time of Payment	2,500	10%

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Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
	referred u/s 80CCA(2)(a)				
194F	Payer; paying any amount as referred u/s 80CCB	Any Payee	At the time of Payment		20%
194G	Any Person	Any Payee	Earlier Of: Credit or; Payment	15,000	5%
194H	Any Person (Except Ind/HUF; not liable to audit u/s 44AB in the immediately preceding FY)	Any Resident payee	Earlier Of: Credit or; Payment	15,000	5%
194I	Any Person (Except Ind/HUF; not liable to audit u/s 44AB in the immediately preceding FY)	Any Resident payee	Earlier Of: Credit or; Payment	2,40,000	10% (land or Building or Furniture) 2% (plant and machinery or Equipment)
194IA	Any Person (i.e. Transferee)	Any Resident Transferor	Earlier Of: Credit or; Payment	>50 Lakh	1% of such sum or stamp duty value of that property, whichever is higher

Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
194IB	Individual /HUF	Any Resident payee	At the time of credit of rent, for the last month of the previous year or the last month of tenancy, if the property is vacated during the	50,000 p.m.	5%
194J	Any person, other than an individual or HUF; However, in case of fees for professional or technical services paid or credited, individual/HUF whose total sales, gross receipts or turnover from business or profession carried on by him exceed the limits specified u/s 44AB in the immediately preceding financial year is liable to deduct tax at source u/s 194J, except where such sum is credited or	Any resident payee	At the time of credit of such sum to the account of the payee or at the time of payment, whichever is earlier.	30,000 in a financial year, for each category of income. (However, this limit does not apply in case of payment or director's fee or remuneration).	- Payee engaged only in the business of operation of call centre 2% [w.e.f. 1st June, 2017] - 2% in case of FTS and royalty (where such royalty is in the nature of consideration for sale, distributi

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Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
	paid exclusively for his personal purposes.				on or exhibition of cinematographic films) - Others 10%
194LA	Any Person	Any resident Payee	At the time of Payment	2,50,000	10%
194LB	Any person	Non-Resident (Other than Company) or; Foreign company	Earlier Of: Credit or; Payment	NA	5%
194LC	Indian Company or business trust	Non-Resident (Other than Company) or; Foreign company	Earlier Of: Credit or; Payment	N. A.	5%
194LD	Any person	Foreign Institutional Investor or Qualified Foreign Investor	Earlier Of: Credit or; Payment	N. A.	5%
194M	Individual / HUF	Any resident	Earlier Of: Credit or; Payment	50,00,000	5%
194N	Bank, Cooperative Society or Post Office	Any Person		1,00,00,000	2%
195					Refer to paragraphs below
196B	The person	Offshore Fund	Earlier Of:		10

Sec.	Applicability		Time of Deduction	Limit	Rate ⁷
	Deductor	Deductee			
	responsible for paying		Credit or; Payment		
196C	The person responsible for paying	Non-Resident	Earlier Of: Credit or; Payment		10
196D	The person responsible for paying	Foreign Institutional Investor	Earlier Of: Credit or; Payment		20

Snapshot of key provisions- Section(s). 195, S. 197, S. 206AA, Rules & Circulars:

Section (S.)/Rules (R.) / Circular (C.)	Description
S. 195	195(1): Scope and conditions for applicability
	195(2): Application by <i>payer</i> to A.O. to determine the appropriate portion of the sum chargeable to tax
	195(3): Application by <i>payee</i> to A.O. for grant of a certificate for NIL / Lower deduction of tax
	195(4): Validity of certificate issued by the AO u/s 195(3)
	195(5): CBDT power to make Rules in respect of Section 195(3)
	195(6): Furnishing of prescribed information - CBDT empowered to prescribe rules/ forms
	Sec. 195(7): CBDT empowered to specify class of persons or cases who shall make mandatorily application to AO for determination of sum chargeable
S. 197	Certificate for deduction at lower rates
S. 206AA	Tax rates applicable in absence of Permanent Account Number
R. 21AB	Certificate for claiming relief under an agreement referred to in sections 90 and 90A
R. 29B	Payee to comply with conditions prescribed under Rule 29B before making any application for nil withholding certificate

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Section (S.)/Rules (R.) / Circular (C.)	Description
R. 37BB	Furnishing of information by payer for making payment to non-resident [Form 15 CA & CB]
C.152/1974	Deduction of tax at source under section 195 of the Income-tax Act, 1961, from payments to non-residents
C.333/1982	Conflict between the provisions of the Income-tax Act, 1961, and the provisions of the Double Taxation Avoidance Agreement
C.370/1983	Deduction of tax at source under section 195 of the Income-tax Act, 1961, from payments to non-residents where tax is to be borne by the payer
C.726/1995	Payments to persons resident in India by Foreign Companies or foreign law firms that have no presence in India
C. 728/1995	Deduction of tax at source under section 195 of the Income-tax Act, 1961--Correct rates of tax applicable
C.785/1999	Issue of certificate for tax deducted at source in respect of payment made "net of tax" in terms of section 195A of the Income-tax Act, 1961
C.7/2007	Procedure for refund of tax deducted at source under section 195 to the person deducting the tax – section 239 of the Income Tax Act, 1961
Press Release dated 20-01-2010	Transactions which are liable to TDS at the higher rate under new TDS provision applicable with effect from 1-4-2010 [S. 206AA]

6.2 Sec. 195(1) – ‘any person responsible for paying’ & ‘any sum chargeable’

Unlike other provisions in Chapter XVII (TDS provisions), S.195 uses a special phrase “**any sum chargeable under the provisions of this Act**” and casts a burden on any person responsible for paying to a non-resident to deduct tax at source on any interest (not being interest referred to in s.194LB, pr s.194LC or s. 194LD) or any other sum chargeable under provisions of the Act. Section excludes income chargeable under the head “Salaries”. Salary is governed by s. 192 and not by s. 195.

6.2.1 Amount on which tax has to be deducted:

Person making payment to a non-resident is liable to TDS irrespective of legal or residential status of the payer or liability to withhold TDS under other provisions of the Act. For example, individuals and HUFs who are not liable to TDS under general provisions of the Act are under an obligation to TDS u/s. 195 in respect of payments to a non-resident, including payments in India if such payments are chargeable to tax in India.

The Hon'ble Supreme Court in *Transmission Corporation of A.P. Ltd. vs. CIT* reported in 239

ITR 587 held that the provisions of s. 195 shall apply not only to the amounts which wholly bear the character of income but also to gross sums, the whole of which may not be income or profit, but have income element embedded therein.

This observation of the Hon'ble Supreme Court was misinterpreted by several authorities taking a view that tax withholding was required on the gross sums paid to non-residents even when only a portion of the remittance was chargeable to tax unless an application was made to AO u/s. 195(2). This led to considerable controversies and authorities taking divergent views until the decision of the Hon. Supreme Court in *GE India Technology Centre P. Limited vs CIT & Others reported in 327 ITR 456 (SC)* wherein the Hon'ble Apex Court clarified that tax has to be deducted on the income element embedded in the payment and not on the whole sum, except where income is taxable on gross basis.

The Hon'ble Supreme Court while deciding the issue categorically recognized that under the provisions of s. 195, the words used were "any other sums chargeable under the provisions of this Act" as against the term "any sum" used in the other provisions falling in Chapter XVII of the Act. The Hon'ble Court observed that obviously, what the AO was demanding is that TDS is liable to be made under the provisions of section 195 of the Act. If the provisions of section 195 are to be invoked, it is only such sum which is chargeable to tax under the Act on which TDS can be made.

The CBDT Circular No. 152 dated 27.11.1974 had clarified that when it is not possible to know or compute the exact income element, the deduction has to be on the whole (gross) amount payable unless an order under s. 195(2) of the Act is obtained from the Income-tax Office making determination of the appropriate portion as taxable income on which tax is deductible.

6.2.2 DTAA vs. the Act:

S. 90 and 90A of the Act authorize Central Government to enter into DTAA with other countries/ ratify DTAA between other specified associations for granting relief in respect of income on which tax is payable.

The purpose of such treaties is to avoid double taxation and sharing of tax revenue by two states and not to create additional charge which is non-existent under the Act or levy additional tax. Prior to insertion of s. 90(2) through the Finance (No. 2) Act, 1991, the Andhra Pradesh High Court in *CIT vs. Visakhapatnam Port Trust reported in 144 ITR 146* held that the assessee is immune from liability either wholly or partly to levy income-tax in view of the beneficial provisions of DTAA. This position was affirmed by the Hon'ble Supreme Court in *Union of India vs. Azadi Bachao Andolan reported in 263 ITR 706*. The Hon'ble Supreme Court again in *CIT vs. Kulandagan Chettiar and Other Appeals (2004) reported in 267 ITR 654 (SC)*, held that though sections 4 and 5 of the Act provide for taxation of global income, these sections, however, will have to make way wherever there are provisions to the contrary under the DTAA.

The provision of s. 90(2) inserted through the Finance (No. 2) Act, 1991 with retrospective effect from 1-4-1972 is a statutory recognition of the rule laid down by the Andhra Pradesh High Court which is subsequently affirmed by the CBDT Circular No. 333 dated April 2, 1982

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reported in 137 ITR 1 (st.). Insertion of s. 90(2) does not change the overriding nature of DTAA's.

Section 90(2) provides an option to choose beneficial provisions of the Act. It is now well established that even for the same type of income from two different countries, the assessee can opt to be governed by DTAA for country A and opt for the provisions of the Act for country B. For example, an Indian company having branches in state A and state B may opt for DTAA in state A where the branch makes profit and opt for the provisions of the Act in state B where the branch has incurred losses. It is also permissible to change the position from year to year.

The relevant provisions under the Act and corresponding Articles under UN Model Convention are summarized in the following table-

Nature of Income	Under the Act	Under the UN Model Convention
Business/Profession	S. 9(1)(i)	Articles 5, 7 & 14
Salary Income	S. 9(1)(ii)	Article 15
Dividend Income	S. 9(1)(iv), S. 115A	Article 10
Interest Income	S. 9(1)(v), S. 115A	Article 11
Royalties/ Fees for Technical Services	S. 9(1)(vi), S. 115A	Article 12
Capital Gains	S. 9(1)(i), S. 45	Article 13

6.2.3 Tax Residency Certificate (TRC):

The Finance Act, 2012 inserted a new sub-section (4) to s.90 of the Act which provided that a non-resident shall not be entitled to claim any relief under DTAA unless he provides a certificate of his being a resident in a country or specified territory outside India, as the case may be, of which he claims to be tax resident obtained from the Government of that country or the specified territory containing the prescribed particulars.

This provision led to considerable hardships. In response to representations made by various trade and professional bodies, the Government through the Finance Act, 2013 amended sub-section (4) and did away with the requirements of obtaining prescribed particulars in tax residency certificate ('TRC') and instead inserted new provision through insertion of sub-section (5) requiring the tax payers to furnish such other information or document as may be prescribed. In exercise of its powers, the CBDT notified new Rule 21AB prescribing the additional information which are required to be furnished by non-residents along with TRC in prescribed **Form 10F** as follows-

- Status of the taxpayer
- Permanent Account Number
- Nationality or country or specified territory of incorporation or registration
- Taxpayer identification number in the country or specified territory of residence and in case there is no such number, a unique number based on which the person is identified

- by the government or specified territory of which the tax payer claims to be resident
- Period for which the residential status as mentioned in TRC, is applicable
- Address of the taxpayer during the period for which TRC is applicable

The CBDT has clarified that additional information prescribed in Form 10F may not be required from the taxpayers if it already formed part of TRC. The taxpayer is required to keep and maintain the documents to substantiate the above information whenever asked by the income-tax authorities.

6.2.4 Extra territorial jurisdiction

The section covers payments made by a non-resident payer to another non-resident payee as well, even if the payment is made outside India, if the underlying income is chargeable to tax in India. TDS is also attracted for payments made in kind.

The constitutional validity of the extra territorial application of the provisions was upheld by the constitutional bench of the Supreme Court in *GVK Industries Ltd reported in 332 ITR 130 (SC)*.

6.2.5 Exempt Income

The income in the hands of the recipient must be chargeable to tax to attract tax withholding obligation. If any income is exempt in India in the hands of the non-resident, the resident payer is not required to deduct tax at source u/s 195. CBDT Circular No. 786 dated 7th February, 2000 has also clarified this issue. The exemption can arise either under provisions of the domestic tax law or on application of the relevant provisions of the DTAA.

6.2.6 No threshold exemption/No prescribed rate of TDS

No basic threshold exemption is provided u/s. 195 and therefore tax is deductible even if the payment to a non-resident which is chargeable to tax is negligible. Section does not prescribe any rate for TDS. Tax is required to be deducted at the rates in force.

6.2.7 Rates in Force [Sec. 2(37A)(iii)]

For the purpose of deduction u/s. 195, the 'rate or rates in force' means rate or rates of income-tax specified in the Finance Act of the relevant year or the rate or rates specified under the DTAA notified under s.90 or s.90A, as the case may be, whichever is beneficial to the taxpayer.

Taxpayers can also explore the benefit of reduced rate of tax by virtue of Most Favoured Nation clause ('MFN') present in certain DTAA's like France, Spain, etc.

During the period when the Finance Bill is awaiting approval, the taxpayer can adopt the rates which are more beneficial to him.

6.2.8 Levy of Surcharge & Education Cess:

The rates prescribed under the Act need to be further increased by Surcharge and Education

Cess as may be prescribed under the relevant Finance Act.

However, when DTAA is invoked, Article 2- 'Taxes covered' of almost all the treaties uses the phrase 'income-tax including any surcharge thereon'. This means the rates under DTAA are the maximum rates agreed between two sovereign states and cannot be further enhanced by Surcharge and/or Education Cess.

6.2.9 Time of tax deduction

Tax has to be deducted at source at the time of credit or payment whichever is earlier. Explanation-1 to s. 195 (1) provides that a payer is liable to TDS although amount is credited to "payable account" or "suspense account".

In case of interest payable by Government or public sector banks or public financial institutions within the meaning of s. 10(23D), TDS is to be made only at the time of payment thereof in cash or by issue of cheque or draft or any other mode.

6.2.10 Income chargeable on presumptive basis:

Business income of non-residents in certain cases is taxed on presumptive basis under the Act. The presumptive tax provisions applicable to various types of income of non-residents are contained in Chapter IV (from s. 44BB to s. 44BBB) of the Act. On account of special provisions, a specified percentage of the gross amount payable to the non-residents is deemed as income chargeable to tax in India. A question arises as to how much of the amounts paid to the non-resident is the income chargeable to tax under the Act.

Following the decision of the Hon'ble Supreme Court in *GE India Technology Centre (P.) Ltd.*, (*supra*), where in it was categorically held that the obligation to TDS is limited to the appropriate portion of income chargeable under the Act forming part of the gross sums of money payable to the non-resident, the Hon'ble ITAT, Chennai Bench in *Frontier Offshore Exploration (India) Ltd. v. Deputy Commissioner of Income-tax [2011] [ITA No. 200/Mds/2009] 10 taxmann.com 250*, held that TDS is required only on the income element. Hence, for example, income of a non-resident from operation of ships is taxable @ 7.5 percent of the gross receipts under s. 44BB of the Act. Therefore, TDS is required on the income element i.e., 7.5 percent of the sum payable to the non-resident.

However, in cases where there exists any degree of ambiguity with regard to the applicability of the provisions of presumptive taxation, it would be prudent to seek a lower withholding certificate to hedge against any potentially adverse consequences.

6.2.11 Income chargeable at concessional rates on gross basis:

Under Chapter XII of the Act, certain types of income of the non-residents such as dividend, interest, royalty, fees for technical services, etc. are taxed on gross basis at the concessional rate of tax subject to fulfillment of the prescribed conditions. For example, royalty and fees for technical services are taxed at the concessional rate of 10 percent of the gross receipt. When special provisions are invoked, TDS is required at the rates prescribed under such special provisions.

6.2.12 Exchange rate applicable for foreign currency payments:

Rule 26 of the Income-tax Rules provide a machinery provision for conversion of TDS obligation in rupees for contracts in foreign currency payments. As per Rule 26 for the purpose of TDS on any income payable in foreign currency, the rate of exchange for conversion to be used shall be the telegraphic transfer buying rate of such currency as on the date on which tax is required to be deducted at source.

Telegraphic transfer buying rate as per Explanation to Rule 26 means the exchange rate adopted by State Bank of India for buying such currency.

6.2.13 Grossing up on Income payable Net of Tax (S. 195A and S. 198)

When the resident payer agrees to bear burden of tax on payments due to the non-resident, the amount paid is considered as net of tax payment and the payment is required to be grossed up for calculation of tax liability. The grossed-up amount will be treated as the amount agreed to be paid and tax shall be calculated at the prescribed rate on the gross amount.

This can be understood with the help of the following Example:-

Particulars	Amount(INR)
Amount payable to non-resident (net of tax)	100
Tax rate applicable	20%
Grossed-up income: $100 * 100 / (100 - 20)$	125
Tax payable (INR $125 * 20\%$)	25
Net amount paid to non-resident (INR $125 - \text{INR } 25$)	100

In respect of "net of tax" payment, the CBDT Circular No. 785 dated 24-11-1999 has clarified that income grossed up under s. 195A is deemed to be income of the payee u/ s. 198 of the Act and the payer is under legal obligation to furnish a certificate of tax deducted at source in the prescribed form.

The Bangalore ITAT in *Bosch Ltd Vs. ITO – ITA No. 552 to 558/ Bangalore/2011* held that higher rate of tax deductible under s.206AA is not applicable for grossing up.

6.3 Application for lower/NIL deduction

6.3.1 Application U/s. 195(2) by the payer:

S. 195(2) enables a payer to make application to AO for determination of chargeable portion of the consolidated payment when only a part of the payment construes income chargeable to tax. Practically, application u/s 195(2) is filed for both nil as well as lower tax withholding. *Section 195(2) has been amended by Finance (No.2) Act, 2019 to provide that payer is required to make an application in a form and manner to be prescribed.*

The AO is required to follow Rule 10 of the Income-tax Rules to determine the income element.

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No time limit is prescribed under the law for passing the order. The order passed u/s 195(2) is provisional and not conclusive and the AO can take a contrary view during the assessment proceedings.

The order passed by the A.O. u/s. 195(2) is appealable u/s 248. In view of the amendments in s. 248 through Finance Act, 2007; an appeal against this order can be filed only if tax is borne by the payer. The appeal can be filed within thirty days of the receipt of the order and only upon payment of tax as directed in that order.

6.3.2 Application u/s. 195(3) by the payee:

S. 195(3) provides a machinery under which a non- resident payee may apply to his jurisdictional AO for grant of a certificate to authorize resident payer to make payment to him without any TDS i.e., nil withholding tax order.

The non-resident is eligible to make an application under s. 195(3) only if the following conditions as laid out in rule 29B are satisfied, namely –

- (i) the applicant has been regularly assessed to income tax in India and has furnished returns of income for all assessment years for which such returns became due on or before the date on which the application is made;
- (ii) he is not in default or deemed to be in default in respect of any tax (including advance tax and tax payable under s. 140A, interest, penalty, fine, or any other sum payable under the Act);
- (iii) where the person concerned is not a banking company -
 - (a) he has been carrying on business or profession in India continuously for a period of not less than five years immediately preceding the date of the application, and
 - (b) the value of the fixed assets in India of such business or profession as shown in his books for the previous year which ended immediately before the date of the application or, where the accounts in respect of such previous year have not been made up before the said date, the previous year immediately preceding that year, exceeds fifty lakhs of rupees.

The application is to be made in Form No. 15C by a banking company and Form No. 15D by any other person. The AO will issue a certificate U/s. 195(3) authorising the recipient to receive the income without deduction of tax. The “certificate” issued under s. 195(3) is not an “Order” and therefore is not appealable.

6.3.3 Application u/s. 197:

Under s. 197 a payee can make an application to the AO for grant of a certificate authorizing him not to deduct tax at source or for determination of the appropriate (lower) rate of deduction at which the payer shall make TDS. The application shall be made in prescribed Form No. 13.

The “certificate” issued under s. 197 is not an “Order”. Therefore, it is not possible to file an appeal under s. 248 of the Act or make an application for revision under s. 264 of the Act against this certificate.

6.3.4 Sections 195(2), 195(3) and 197- Comparison:

Particulars	195(2)	195(3)	197
Application by	Payer	Payee (subject to Rule 29B)	Payee
Purpose	To determine appropriate withholding rate for a specified payment	For claiming 'Nil' withholding rate for a specified receipt	For claiming 'Nil'/lower rate of withholding for all receipts
Applicability	Applicable to specified payments	Applicable to specified receipts	Applicable to all receipts
Whether appealable u/s. 248?	Yes- after payment of tax by the payer	No appeal	No appeal
Whether revisable u/s 263 or 264	Yes	Debatable	Debatable

6.4 Certification by Chartered Accountants for remittances and furnishing of information u/s. 195(6)

The Finance Act, 2008 inserted a new sub-section (6) to s. 195 requiring the person responsible for making payment to a non-resident to furnish certain information in the prescribed format.

The CBDT vide Notification No. 30/2009 dated 25th March 2009 issued Income-tax (Seventh Amendment) Rules, 2009 and prescribed following formats through insertion of Rule 37BB –

- Form 15CA – Format for furnishing of the prescribed information and verification by the payee.
- Form 15CB - Format for certificate from a chartered accountant.

These provisions became effective from 1st July, 2009.

The CBDT further vide notification no. 67 of 2013 amended Rule 37BB to revise the information reporting requirement on payments to non-residents and notified new Forms 15CA and 15CB. However, CBDT vide Notification No. 93/2015 dated 16th December, 2015 has further amended Rule 37BB to be applicable with effect from 1st April, 2016. Post amendment, Form 15CA is divided in four parts.

Part A is to be filled in if the amount of payment or the aggregate of such payments, as the case may be, made during the financial year does not exceed Rs. 5,00,000/- . Furnishing certificate from a chartered accountant in Form 15CB is not mandatory.

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Part B is to be filled in for remittances other than those specified in Part A after obtaining a certificate/order from the Assessing Officer under section 197 or 195(2) or 195(3) whereas Part C is to be filled in after obtaining a certificate from a chartered accountant in Form 15CB except 33 specified categories provided in the specified list below.

Part D of Form 15CA is to be filled in by the person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum which is not chargeable under the provisions of the Act.

Specified List

Sr. No.	Purpose as per RBI	Nature of payment
1	S0001	Indian investment abroad-in equity capital (shares)
2	S0002	Indian investment abroad-in debt securities
3	S0003	Indian investment abroad-in branches and wholly owned subsidiaries
4	S0004	Indian investment abroad-in subsidiaries and associates
5	S0005	Indian investment abroad-in real estate
6	S0011	Loans extended to Non- residents
7	S0101	Advance payment against imports
8	S0102	Payment towards imports - settlement of invoice
9	S0103	Imports by diplomatic missions
10	S0104	Intermediary trade
11	S0190	Imports below Rs.5,00,000 - (For use by ECD offices)
12	S0202	Payment for operating expenses of Indian shipping companies operating abroad
13	S0208	Operating expenses of Indian Airlines companies operating abroad
14	S0212	Booking of passages abroad- Airlines companies
15	S0301	Remittance towards business travel
16	S0302	Travel under basic travel quota (BTQ)
17	S0303	Travel for pilgrimage
18	S0304	Travel for medical treatment
19	S0305	Travel for education (including fees, hostel expenses etc.)
20	S0401	Postal services

Sr. No.	Purpose as per RBI	Nature of payment
21	S0501	Construction of projects abroad by Indian companies including import of goods at project site
22	S0602	Freight insurance- Relating to import and export of goods
23	S1011	Payments for maintenance of offices abroad
24	S1201	Maintenance of Indian embassies abroad
25	S1202	Remittances by foreign embassies in India
26	S1301	Remittance by non- residents towards family maintenance and savings
27	S1302	Remittance towards personal gifts and donations
28	S1303	Remittance towards donations to religious and charitable institutions abroad
29	S1304	Remittance towards grants and donations to other Governments and charitable institutions established by the Governments
30	S1305	Contributions or donations by the Government to international institutions
31	S1306	Remittance towards payment or refund of taxes
32	S1501	Refunds or rebates or reduction in invoice value on account of exports
33	S1503	Payments by residents for international bidding.

The distinctive features of the old and new Forms 15CA /15CB are highlighted in the following table-

Criteria	Earlier Provisions till 31 st March, 2016	New Provisions Applicable from 1 st April, 2016
Applicability of Form 15CA	<ul style="list-style-type: none"> — Reporting only in respect of payments which are taxable under the Act. This is in contradiction to s.195(6) substituted by Finance Act, 2015 w.e.f.1.06.2015 — Additionally, no reporting for 28 specified category 	<ul style="list-style-type: none"> — Form 15CA and 15CB which does not require RBI approval will be NOT be required to be furnished by an individual for remittance. — List of payments of specified nature mentioned in Rule 37BB, which do not require

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Criteria	Earlier Provisions till 31 st March, 2016	New Provisions Applicable from 1 st April, 2016
	payments — Small payments, not exceeding Rs. 50,000 individually or aggregate Rs. 2,50,000 per financial year to be reported in Part A of Form 15CA. — All other payments to be reported in Part B of Form 15CA.	submission of Forms 15CA and 15CB, has been expanded from 28 to 33 including payments for imports. — Reporting requirements in each part of Form 15CA, i.e., Part A, B, C & D is specified.
Obtaining Form 15CB	— Form 15CB is not required where Part A of Form 15CA is filled in (small payments). — For Part B payments, it appears that an AO order / certificate or 15CB may be used alternatively.	— Form 15CB is required only when Part C of Form 15CA is filled in. — In all other cases, Form 15CB is not mandatory.
Manner of furnishing	— Sub – rule (2) of the revised Rule 37BB mandates that Form 15CA shall be furnished to the authorized dealer prior to making the remittance.	
	— Sub – rule (4) of the revised Rule 37BB mandates that Form 15CA shall be furnished to the authorized dealer prior to making the remittance.	

The Finance Act, 2015 substituted sub-section (6) to s.195 with effect from 1st June, 2015. The new sub-section (6) makes it mandatory to furnish the prescribed information whether or not the sum payable to a non-resident is chargeable to tax. Simultaneously, a new s.271-I is inserted by the Finance Act, 2015 from 1st June, 2015 prescribing penalty of Rs. 1 Lac for failure to furnish or for filing inaccurate particulars.

However, till date, rules are not amended in line with the Act and continue to require furnishing of information only in relation to payments which are chargeable to tax in India. Pending amendments/new rules, remitting banks/ ADs may insist on electronic filing in Form 15CA and CA Certificate in Form 15CB before processing the remittances.

6.5 Mandatorily application to AO for determination of sum chargeable U/s. 195(7)

The Finance Act, 2008 has empowered CBDT to specify class of persons or cases (where recipient is non-resident) who will be mandated to furnish application to the AO for determination of tax withholding rate for paying any sum, whether or not chargeable under the

provisions of the Act by general or special order to determine the appropriate proportion of sum chargeable, and upon such determination, the payer is liable to deduct tax under subsection (1) on that proportion of the sum which is so chargeable.

Notification specifying such class of persons or cases is not yet issued by CBDT.

6.6 Implication of section 206AA

There are contradictory views when income of a non-resident is chargeable under provisions the Act but it is either not chargeable or is chargeable at the concessional rate of tax provided under DTAA. When the payee does not hold Permanent Account Number ('PAN'), on account of the provisions of s. 206AA of the Act, which starts with non obstante clause providing tax withholding at the higher of the following three rates: when the non-resident payee does not hold PAN–

- (a) Rate specified under the relevant provisions of the Act, or
- (b) At the rates in force (includes DTAA rates), or
- (c) At the rate of twenty percent.

CBDT Press Release dated 20th January, 2010 categorically states that provisions of S. 206AA will apply to non-residents as well.

Recently, the Pune and Bangalore Benches of the ITAT had occasion to examine the validity of this provision in following cases –

- *Pune ITAT in the case of Serum Institute of India Private Ltd- 56 taxmann 1- ITAT Pune*
- *Bangalore ITAT in the case of Infosys BPO Ltd-ITA No.1143/(B)2013 & IT(IT)A Nos.8 & 9-14 & CO Nos.83 & 84-141*

Both the Benches were of the view that rate of TDS cannot be higher than the rate prescribed under the DTAA or the Act, whichever is more beneficial to the payee. Both the authorities have followed the settled principle laid down by the Andhra Pradesh High Court in *CIT vs. Visakhapatnam Port Trust reported in 144 ITR 146* and approved by the Hon'ble Supreme Court in *Union of India vs. Azadi Bachao Andolan reported in 263 ITR 706* reaffirming the supremacy of the DTAA. However, there are still no order on this issue from any High Court or the Supreme Court of India. The implication of the provision are summarized in the following table-

PAN	Tax Residency Certificate (TRC)	Does treaty provide for a lower rate?	Applicable WHT rate
✓	✓	✓	Treaty rate
✓	×	NA	Act rate
×	✓	✓	Treaty rate (in most cases)*
×	×	×	Act rate subject to S. 206AA

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*Rule 37BC provides relaxation from deduction of tax at higher rate u/s. 206AA for a non-resident, not being a company, or a foreign company (hereafter referred to as 'deductee') which does not have PAN and provides that the provisions of section 206AA shall not apply in such case. However, the nature of payments covered for this relaxation is interest, royalty, fees for technical services, dividend and payments on transfer of any capital asset. Such relaxation is provided if the deductee furnishes the details and the documents specified in sub-rule (2) to the deductor, such as name, address, email id, contact number, Tax Residency Certificate, address, Tax identification number of the deductee or unique number by which such non-resident deductee is identified in his country of residence.

6.7 Refund of Excess TDS to the deductor

In certain situations, referred to in CBDT Circular 7 of 2007 dated 23-10-2007, where no income has accrued to the non-resident due to cancellation of contract or where income has accrued but no tax is due on that income or tax is due at a lesser rate, etc. where genuine claim for refund arises, the excess amount can be refunded to the deductor with prior approval of the Chief Commissioner of Income-tax or the Director General of Income-tax as may be concerned.

Where an assessee has paid any sum chargeable to tax under the Act to a non-resident on which tax has not been deducted or after deduction it has not been paid, then the assessee may face any of the following consequences -

Section	Nature of Default	Consequence
40(a)(i) & (iii)	Failure to deduct the whole or any part of tax	Disallowance of expenses deduction in computing income chargeable under the head, "Profits and Gains of Business or Profession"
201(1A)	Failure to deduct, pay or pay after deducting	Would be considered as an assessee in default + simple interest @ 1% or 1.5% for month or every part of the month.
221	Default in making payment of tax within prescribed time	Simple interest @ 1% + Maximum penalty to be 100% of the tax arrears
271C	Failure to deduct the whole or any part of tax	Penalty equal to 100% of whole or part of tax, as applicable
271-I	Failure to furnish information or furnishing inaccurate information under section 195.	Penalty of Rs. 1,00,000.
272A	Failure to file TDS Return	Penalty of Rs.500/- per day (maximum up to the tax deductible) for failure to file the TDS Return within time.
276B	Failure to pay tax deducted	Rigorous imprisonment for 3 months to 7 years along with fine.

Module E

Basic International Tax Structures

1. International Tax Structures

1.1 Introduction¹

The proliferation of income tax system and the increase in tax rates have made it necessary for multinational companies ('MNCs) to engage in robust tax planning to eliminate double taxation and reduce excessive tax costs. The process of globalization has also eliminated most of the barriers to cross border trade and investment, leading to increased cross border activities – hence putting global tax management on the radar of MNCs/ conglomerates.

Several other factors led to an increasing emphasis on international tax planning – Technological advancements made it possible for enterprises to do business in a country without having any physical presence there. Liberalization of the international financial system and development of new financial instruments allowed MNCs to change the source, character and timing of income and growth in the number of tax treaties facilitated international tax planning.

With heightened cross border activities, the traditional business models of MNCs were altered opening way for global operations, which also meant interaction with multiple tax regimes that sought to impose taxes on cross trade transactions based on the respective domestic laws. Each country and its revenue body face different environment within which they administer their taxation system and differ in respect of their policy/ legislative environments and their administrative practices and cultures. Given the same, MNCs engaged in global tax management (e.g., planning) by organizing into various structures/ forms and developing cross-border tax strategies to optimize global tax liabilities, while adhering to all applicable laws. Using various tax structures MNCs could benefit from differences in the tax systems (including tax rates/ method of computation of tax profits) in various countries within which they operated - the aim being minimizing of global tax costs and maximizing global after tax profits.

While, MNCs can conduct operations through various combinations of legal forms/ structures, financing methods and acquisition techniques, tax is not usually a primary or overriding factor in the decisions to engage in overseas business activities or to invest abroad. The decisions are primarily driven by commercial, economic, and even social and political considerations.

Such business decisions can have a larger tax implication given that cross-border activities suffer a higher tax liability on a worldwide basis than domestic or one-country transactions.

¹Research paper by The School of Public Policy, University of Calgary, Volume 7, Issue 29, September 2014

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Hence, organizing and operating through efficient tax structures (using tax efficient funding strategies, mergers and acquisitions, inbound and outbound restructuring etc.) assumes larger significance in ways to enable MNCs to cope with inconsistent tax laws, erratic tax administration and high taxes in various jurisdictions as well as efficiently organize business operations globally.

However, it needs to be kept in mind that, any cross border tax structuring should be backed by business and commercial considerations and not be governed by pure tax considerations. This is important especially in light of General Anti Avoidance Rule ('GAAR') and OECD's Base Erosion and Profit Shifting Project which has suggested measures to counter cross border tax avoidance strategies adopted by MNCs. Therefore, each country is adopting several anti-abuse rules in its domestic laws and double taxation avoidance agreements ('DTAAs') to be compliant with BEPS recommendations. India has adopted GAAR in its tax legislation from 1.04.2017.

1.2 Planning tax structures²

The tax impact on cross border transactions for MNCs can be at 1) source or host country 2) intermediary countries 3) residence or home country, necessitating global tax management/ planning to minimize tax costs and eliminate double taxation. Hence, it is of significance for MNCs to organize global operations in a tax efficient manner.

The taxation on profits repatriated to the home country could be reduced through:

- The use of appropriate global corporate structures
- The optimal use of available foreign tax credits and exemptions to reduce domestic tax liabilities, etc.

Further, taxes in source country can be reduced through one or more of the following ways:

- Local tax planning that optimizes the use of tax deductions, incentives, tax losses and special tax concessions available under the domestic law and tax treaties.
- Tax-exemptions from the break or fracture of the connection tax factors with either the source or the residence state (or both).

MNCs could also seek to reduce taxation on profits in the intermediary company by for instance; subject to commercial substance demonstration:

- Selecting an intermediary jurisdiction in a manner to ensure that the withholding taxes (under the treaty with home country and host country) are not very high.
- Holding intellectual property rights in a tax efficient jurisdiction etc.

Given the above, MNCs need to carefully plan global operational structure across host, intermediary and home countries. MNCs could engage in several cross border structuring

² Presentation International Taxation - Basic International Tax Planning by Dr. Richard Watanabe
Adjunct, Assistant Professor

strategies some of which are mentioned below:

International Holding Co. structuring

- Deferring taxation of dividend / income flows
- Optimizing capital gains tax on exit

Funding structuring

- Compliance with thin cap rules
- Maximizing interest deduction for overall tax efficiency

Acquisition structuring

- Mode of acquisition
- Mode of financing

Intellectual Property Rights Structuring

- Separating IPR and locating it in a separate holding vehicle in a tax efficient jurisdiction

Tax Efficient Supply Chain Management

- De-risking the various group entities so that significant profit resides with Principal Co located in a tax efficient jurisdiction
- Overall Group tax rationalization

Global Transfer Pricing

- Structure transfer prices to maximize business and tax benefits
- Minimize transfer pricing audits

Tax treaties, profit repatriation and loss utilization strategies

Structuring asset purchase transaction

Restructuring of existing overseas holding structure

By structuring operations using one or more of the above, MNCs can look at meeting their tax objectives for e.g., optimize capital gains tax on exit, generate alternate revenue streams in tax efficient jurisdiction, timing up-streaming of dividend, deduction of funding costs, etc. Apart from tax advantages, efficient structuring of global operations may also aid in achieving operational synergies (economies of scale, operating efficiencies, research & technology, marketing & distribution etc.) and financial synergies (improve shareholders value, listing options, consolidated operations have higher ROCE & stable earnings) in business.

Some of the tax planning opportunities / strategies outlined above along with case studies are explained in detail in the subsequent Chapter 2 Tax Structuring for Cross Border Transactions. The technical coverage in respect of each of the above topic will be generic in nature and will

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involve conceptual discussions with examples.

Any cross border tax structuring strategy cannot be divorced from business or commercial rationale. Also each step in the transaction needs to be backed by such rationale, as tax authorities may challenge and disregard/re-characterize a particular step in the transaction by alleging lack of substance.

When a particular transaction can be structured in more than one manner and commercial/business rationale can be demonstrated for all the options then the taxpayer may opt any one option which is most tax efficient.

Tax authorities around the world are challenging the transactions which lack substance but are undertaken only to avail tax benefits. Hence, taxpayer needs to maintain adequate documentation to demonstrate satisfaction of substance requirements and business rationale behind undertaking a transaction.

Strategies given in this chapter are only to increase awareness among future/current tax practitioners about the industry practices and should not serve as guidance in any manner. A particular strategy may only be explored if it complements business arrangement/transaction and is backed by substance.

1.3 Forms of business entity³

With globalization of business and structuring of operations, MNCs can consider various entry strategies (business entity forms) while setting up operations in another jurisdiction. Business entities can provide protection to the business owner, dictate the amount and types of taxes paid and control how the business operates and functions internally. Further, each of them would have their own advantages/ disadvantages and tax implications.

Some of the considerations by MNCs while choosing the most appropriate business form could be (1) the degree to which the business assets are at risk from liabilities arising from business; (2) how to best pursue tax advantages and avoid multiple layers of taxation; (3) the ability to attract potential investors; (4) the ability to offer ownership interests to key employees; (5) the costs of operating and maintaining the business entity (6) reaching out to potential customers etc. For instance, as operations expand, a full – time representative or dependent agent may be appointed. A branch or a company is usually established when a full business presence is justified. A partnership (general or limited) or an equity joint venture may be an alternative entity in certain situations. Other legal forms include licensing or franchising arrangements, joint ventures, economic interest groupings or consortiums, etc. A minority equity participation in a joint venture is often used for a strategic business alliance in high-risk technologies and markets. Some of the business entity forms in which MNCs may conduct business areas under:

³Basic International Taxation by Roy Rohatgi (Volume II)



1.3.1. Licensing Arrangement

A licensing agreement is a legal contract between two parties (licensor and the licensee) whereby the licensor grants the licensee the right to produce and sell goods, or use a brand name or trademark, or use patented technology owned by the licensor. In exchange, the licensee usually agrees to make payments known as royalties.

Licensing can be a low-cost alternative to setting up one's own business presence abroad. Setting up a licensing entity requires minimal investment and earns royalties (guaranteed payout and variable royalty). Further, access to an existing market share of the licensee, distribution network, business systems also benefits the licensor.

Licensing can be a tax efficient strategy. The royalty paid for usage of an intangible is tax deductible in the hands of licensee. For example, if the licensor entity is incorporated in a jurisdiction where tax is levied at a lower rate than that of a licensee entity, it shall result in tax savings.

However, one of the major disadvantages of this arrangement is that it creates competition - the licensee places the licensor on a level playing field because the licensee now has the right to use the same production processes as the licensor. A licensing company may attempt to limit competition by limiting the scope of the license as much as possible. For example, the license may contain geographic, time or quantity restrictions that protect the market of the licensing company. Further, it also increases the risk of increased exposure to confidential, proprietary production process of the licensor.

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1.3.2. Franchising

By way of a contractual relationship, the franchiser grants a limited license to the franchisee to use its business systems (trademark, associated brand, proprietary knowledge) for a prescribed period of time against which the franchiser receives varied fees such as royalties or service fees, contributions towards common expenses (e.g., marketing, advertising), etc. The franchiser offers important pre-opening support like, site selection, design and construction, financing, training along with ongoing assistance i.e., training, national and regional advertising, operating procedures, operational assistance, etc.

The franchisee operates under the brand image of the franchisor, according to the procedures and restrictions set forth by the franchisor in the agreement. These restrictions usually include the products or services which can be offered, pricing and geographic territory. For some people, this is the most serious disadvantage to becoming a franchisee.

Tax implication in case of a franchisee arrangement varies depending on the nature of income earned. Taxes may have to be withheld while making payments by the franchisee to franchisor.

Since the franchisee has to conform to the expected service level requirements and product specifications, he shall incur product and service level liability risks. The exposure to these risks may lead to adoption of a higher mark-up (for assumption of higher risk) by the tax authorities, which shall give rise to an issue from transfer pricing perspective, if applicable.

1.3.3. Liaison Office

As per FEMA regulations, 'liaison office' is defined to mean 'a place of business to act as a channel of communication between the principal place of business or Head office (by whatever name called) but which does not undertake any commercial/ trading/ industrial activity, directly or indirectly, and maintains itself out of inward remittances received from abroad through normal banking channel'. Thus, it only aids in communication between two different entities to work together. It may provide information on business environment of the country in which it is set up, market research and studies. It can also identify and co-ordinate with the customers in that country, however, it cannot conclude contracts on behalf of the head office.

Under OECD MC Article 5(4), a permanent establishment is not taxable if it confines itself to non-commercial preparatory and auxiliary activities such as advertising, or supply of information regarding customer requirements and specifications, scientific research, or servicing of patent or know-how contracts, or as a purchasing office. In certain jurisdictions, a representative office can also maintain a supply of goods for delivery or display on a tax-free basis.

1.3.4. Branch

A branch of a company assumes the same legal status as the head office and is established for undertaking permitted commercial activities. Accordingly, operating a branch office is akin

to having the foreign parent corporation operating in the host country. The financial results of a branch are usually consolidated with that of the parent company and hence this structure does not shield the parent corporation from liability incurred at the branch level.

For a branch, there are no restrictions imposed on minimum capital, no levy of capital taxes or stamp duties. The transfers of assets and funds from/to head office are not usually subject to taxation. A branch entails low compliance costs. The profits repatriated by the branch to the head office do not suffer from double taxation unless non-creditable branch tax is payable. Moreover, the controlled foreign corporation rules do not normally apply to branches since there is no tax deferral of the current income of the branch.

By virtue of Article 5 of OECD Model Convention, a branch engaged in the core business activities of the company is a taxable permanent establishment. Thus, profit generated by branch is taxable in the host country of the head office under their respective domestic rules and accounting practices, however, only to the extent profits attributable to the branch. The dual taxation of the branch profits could lead to additional taxes, even when the head office is entitled to relief for the foreign taxes paid by the branch. That is because; any variation in the method of the tax computation could result in either insufficient or excess foreign credits for the foreign taxes paid by the branch. Moreover, although the branch losses can be offset against the home profits, the foreign taxes paid by profitable branches may not be given credit in certain situations.

Many countries lack detailed rules for the allocation of the income and expenses to a branch as a permanent establishment and hence sometimes lead to adhoc allocation. Besides that, domestic taxation provisions and rules often vary. Profit allocation of the branch is also generally subject to a closer scrutiny by tax authorities and is a debatable transfer pricing issue. The rules governing the deductibility of allocated expenses to the branch by the - head office are often more restrictive than for a local company. For example, management fees, interest and royalty payments from, and to, the head office or other sister branches may be disallowed (fully or partly) for tax purposes. Thus, such a situation calls for a tax planning.

A branch structure is usually considered unsuitable for long-term overseas investment or operations. As it is not a separate legal entity, it subjects the parent company to unlimited liability on its obligations. Despite the disadvantages, it is not uncommon to set up a branch during the period of start-up losses and explore later to convert it to a subsidiary. It may also be useful tax planning for a holding company to operate overseas through a branch and not a subsidiary in certain situations. Unlike a subsidiary, the company can claim tax credit at home currently for the underlying taxes paid overseas by its branch. To avoid the exposure of unlimited liability to the parent company, it can be set up as the branch of a separate subsidiary company at home.

1.3.5. Subsidiary Company

A subsidiary is a separate legal entity from the parent, although owned by the parent corporation. A subsidiary may/ may not be wholly-owned by the parent corporation. Taxation of the subsidiary is on the subsidiary's income alone, and when properly structured

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and operated, the liabilities of the subsidiary are not attributable to the parent corporation. A subsidiary qualifies as a "resident" for treaty benefits in the other Contracting State.

A subsidiary has to act in accordance with domestic taxation and legal requirements. It is subject to anti-avoidance measures, such as thin capitalization rules, transfer pricing, etc. The profits from which the dividend is distributed may be subject to double taxation in countries imposing both, the corporate tax as well as dividend distribution tax⁴. The losses of the subsidiary are generally not eligible for setoff against the profits of the parent company. The transfer of shares of the subsidiary may also be imposed with capital gains tax in the hands of parent company.

A subsidiary company is operationally more flexible than a branch. It denotes a long-term commercial existence in a country and offers limited liability status. The laws and regulations in numerous countries require that foreign enterprises function as a company as it is easier to regulate as against a branch.

Broad Comparison between Branch versus Subsidiary

Parameters	Branch	Subsidiary
Separate Legal Entity	It is an extension of the parent Company	Yes
Operational flexibility	Restriction on the nature of activities that can be undertaken	Maximum flexibility of operations.
Registered capital requirement	Not required	Minimum share capital may be required
Financing	Inward remittances from foreign entity and internal accruals	Financed by means of various capital instruments such as equity, debt etc.
PE risk for parent	Will be considered for PE	Not PE just because of parent subsidiary relationship
Compliance cost	Relatively lower compliance cost	Greater compliances to be met

Case Study 1

Facts:

- X Ltd, an Indian Company, engaged in the business of manufacturing and selling of garments.
- X Ltd proposes to establish its manufacturing facilities in Sri Lanka for worldwide

⁴ In India, pursuant to amendment made by Finance Act, 2020, any dividend declared, distributed or paid by Indian Company on or after 1 April 2020 shall be taxable in the hands of recipient / shareholders only i.e. dividend

exports.

- Garments manufactured in Sri Lanka will be exported to various countries worldwide.
- Sri Lankan operations will be standalone operations and will have substantial value additions and the expected profitability is very high.

Issues:

Whether Sri Lankan operations should be established either through a branch office or through a subsidiary company?

The factors that need to be considered while making the decision are:

Particulars	Branch	Subsidiary
Sri Lankan corporate tax rate	28%	28%
Tax on profit repatriations	10% [Branch Profit Remittance Tax]	10% [Dividend WHT]
Availability of foreign tax credit [India-Sri Lanka Tax Treaty]	Yes Tax sparing also available	Yes No tax sparing
Tax deductibility	<ul style="list-style-type: none"> • Interest on financing cannot be claimed • Management and other service charges cannot be claimed 	<ul style="list-style-type: none"> • Interest and other management charges can be claimed with markup.
Repatriability	Permitted	Permitted
Exposure of Head Office	Yes	No
Capital Gain Tax Liability	No	Yes

1.3.6. Agency

When starting trade in another country, it is very common to outsource the activity to an agent rather than setting up a new shop/ own business premises staffed by own employees. An agent is a person who acts on behalf of the principal and can be dependent or independent, with varying tax implications.

Dependent Agent: The OECD MC specifies following conditions in which a dependent agent will constitute a permanent establishment:

Where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and

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these contracts are

- in the name of the enterprise, or
- for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
- for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in

respect of any activities which that person undertakes for the enterprise, unless the

activities of such person are limited to those mentioned in paragraph 4 of Convention which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 of Convention would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Example on Dependent Agent: A domestic custodian of non-resident, who is obliged to act in accordance with instructions of non-resident in relation to its securities in India and also liable and maintaining its bank account on its behalf.

Independent Agent: Article 5(6) of the OECD MC states reads as under:

"6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first- mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise."

Example of Independent Agent: A newspaper publishing company, whose principal business is publication of newspapers in India also carries on business of collection of advertisements for non-resident publishers may be considered as agent of independent status as it acts in the 'ordinary course' of business.

1.3.7. Partnership

Partnership is a contractual relation of two or more persons carrying business to share profit or loss in an agreed ratio. The two varieties of partnerships are general partnerships and limited partnerships. In a general partnership, the partners manage the firm and assume responsibility for the partnership's debts and other obligations. A limited partnership has both general and limited partners. The general partners own and operate the business and assume liability for the partnership, while the limited partners serve as investors only; they have no control over the company and are not subject to the same liabilities as the general partners.

In some countries like India, partnerships are regarded as separate legal entity from its partners and thus the firm bears the tax, while in few others, partnership firms are treated as

tax transparent with only individual partners bearing the tax.

Unlike companies, partnerships do not have to disclose their profits to the public (i.e., greater privacy). Changing the legal structure is relatively simple (i.e., changing from a partnership into a company at a later stage). Non-resident partners may be deemed to have a permanent establishment in the country where the partnership is organized. Such transparent partnerships may or may not benefit from tax treaties, except through the treaties with the resident Contracting State of each partner.

A partnership is easier and less expensive to set up than a company. Further, the foreign controlled corporation rules do not normally apply to fiscally transparent partnerships. However, personal liability could be a major concern in case of a general partnership.

1.3.8. Hybrid Entity

A hybrid entity is an entity which may be subject to corporate income tax in one jurisdiction but qualifies for tax transparent treatment in another.

There could also be hybrid instruments whereby an instrument can be treated as debt in one jurisdiction and equity in another jurisdiction. Thus, capital could be infused in the form of equity to an entity established in tax havens, which could in turn lend the same funds in the form of a loan to an entity established in a country levying higher tax rates. The interest charged shall be tax deductible in the hands of the entity set up in higher tax jurisdiction and the profits generated from the usage of funds raised from issue of equity capital, may be retained with the entity set up in lower tax jurisdiction.

1.4 Examples of tax efficient forms⁵

In light of the discussion above, some examples of tax efficient forms in which MNCs can organize their business are listed below:

1. Setting up presence in another jurisdiction using appropriate business entity form (as explained earlier).
 2. Set up a company providing finance and/or treasury services to group companies in appropriate tax network jurisdictions.
 3. Set up a headquarter/ management services company offshore for coordinating various services to group companies at a cost with mark-up wherein entire billing is done through the headquarter/ management services company.
 4. Form a holding company in a treaty country owning investments offshore to provide ease of exit.
 5. Transfer intellectual property rights to a licensing company in a tax efficient jurisdiction.
- However, it would also be important to keep track of the BEPS developments on these

⁵ Basic international taxation by Roy Rohatgi (Volume II)

issues which may impact these decisions.

2. Tax structuring for Cross-border Transactions

2.1 Background

The liberalization of Indian economy has encouraged several multinational enterprises to invest in India. Several reforms in respect of foreign direct investment ('FDI') have helped India to achieve cash inflow of USD 100+ billion⁶ in 2014-15. Also, the Indian companies/conglomerates are encouraged to make investments outside India within a liberal regulatory framework. Hence, many Indian companies/conglomerates have been establishing their presence outside India or making several overseas acquisitions.

Such inflow and outflow of investments may give rise to several cross border transactions. Hence, appropriate planning for such arrangements is important; as such transactions/arrangements are governed by laws of several countries.

Apart from regulatory structuring of these transactions, it is important to conduct tax structuring of these transactions to make them tax efficient. This is because, tax can prove to be a substantial cost in respect of cross border transactions and in many cases, the incidence of double or multiple taxation may make transactions financially unviable.

Flow of investments into a country may create issues in respect of funding i.e., debt (related interest pay-out) v equity, royalty, technical fees payments and profit repatriation to parent company. Also, the divestment/exit needs to be planned in advance from tax perspective so as to be certain about the tax consequences of divestment.

Such cross border tax structuring is to be done taking into account regulatory requirements (e.g., investments allowances/restrictions in particular sector, funding guidelines etc.) and compliances.

Cross border tax structuring in advance helps to avoid surprises or inefficient tax consequence while actually undertaking the transaction. It is extremely important to eliminate double or multiple taxation. A particular transaction/arrangement may be structured in more than one way and it is extremely important to evaluate the tax consequences of each and every alternative so as to make the transaction tax efficient.

An effective tax structuring may make business expansion as well as exit easy for the company. More importantly, apart from tax benefits, cross border tax structuring may help a company in getting certainty and consequently avoiding potential litigation.

However, it needs to be kept in mind that, any cross border tax structuring should be backed by business and commercial considerations and not be governed by pure tax considerations. This is important especially in light of General Anti Avoidance Rule ('GAAR') and OECD's

⁶http://dipp.nic.in/English/Publications/FDI_Statistics/2015/FDI_FactSheet_JulyAugustSeptember2015.pdf
DIPP, Ministry of commerce and industry (Data uploaded upto Sep 2015)

Base Erosion and Profit Shifting Project ('BEPS') project which has suggested measures to counter cross border tax avoidance strategies adopted by MNEs. Therefore, each country is adopting several anti-abuse rules in its domestic laws and double taxation avoidance agreements ('DTAAs') to be compliant with BEPS recommendations. India has implemented GAAR in its tax legislation from 1.04.2017.

2.2 Aspects of cross border tax structuring

There are several aspects of cross border tax structuring. We will discuss following aspects/mechanisms in subsequent paragraphs:

1. Setting up an entity - Choice of entity type
2. Tax efficient funding strategies
3. Inbound cross border tax structuring
4. Outbound cross border tax structuring
5. Cross border mergers and acquisitions
6. Profit repatriation strategies
7. Use of leasing

The technical coverage in respect of each of the above topic will be generic in nature and will involve conceptual discussions with examples.

2.2.1. Setting up an entity – Choice of entity type⁷

MNE group may operate in a jurisdiction through an entity which may be a branch (unincorporated entity), private limited company, public limited company, unlimited liability partnership or limited liability partnership ('LLP').

Legal characterization of an entity may predominantly depend on business and regulatory considerations. This is because, customers and stakeholders with whom MNE group deals will feel more comfortable to deal with certain type of entity as compared to others. Banks and financial institutions may provide higher degree of funding to a certain type of entity or regulations may allow ease of compliances, funding or entity structuring for certain type of entities as compared to others.

However, it is important for the group to consider the tax aspects/consequences of choosing a particular type of entity.

Each type of entity may have its own set of advantages/disadvantages from tax standpoint. The entity types and tax aspects can be given as under:

⁷ Also refer to Chapter 1 International Tax Structures, Para 1.4

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(a) Branch :

When a company/firm establishes its presence in the form of office in other jurisdiction, such presence is called a branch office. The branch does not have separate legal existence and is said to be part of the main enterprise.

The branch is a non-resident taxpayer for tax purposes in the jurisdiction in which it has established its presence. In case non-resident taxpayers are subjected to higher rate of tax than resident taxpayers in the country (e.g., India) then, such higher tax rate will be applicable to the branch office. In some countries, taxation of branch is also governed by separate tax regime and tax rate called branch profit tax regime (e.g., US).

A branch may be established to act as liaison office ('LO'). Generally, such LO may not undertake and may not be even allowed by regulations to undertake business operations in the jurisdiction it operates.

The LO may be allowed and may carry out activities like:

- Representing the head office ('HO') and other group companies in the LO jurisdiction
- Promoting export/import from/to LO jurisdiction
- Promoting technical/financial collaborations between HO/group companies and other third party entities in LO jurisdiction
- Acting as a communication channel between the HO and third party entities in LO jurisdiction
- Collection of information/data from LO jurisdiction

The LO may not be considered as permanent establishment of the enterprise in the LO jurisdiction as such LO does not carry such business and hence, may not be liable to tax in respect of its activities in LO jurisdiction. However, in case, the branch carries on the business activity and has fixed place of business at its disposal then, the branch office may be considered to be PE of its main enterprise.

A branch of a foreign company may be taxed both in its home as well as host (branch) jurisdiction. Hence, it is important, to evaluate the remedies both under the domestic law as well as DTAA's to remove double taxation before setting up branch office.

If the foreign company is new in a jurisdiction then there are likely to be start-up losses. Hence, it may be important to utilize such losses from tax standpoint. Hence, a branch structure may be useful in initial years. However, it is important to bear in mind that, conversion of branch to a subsidiary involves a disposal of assets of foreign branch to be purchased by a new subsidiary. Such disposal may attract capital gains tax.

(b) Company :

A company is treated as a separate legal entity than its parent company for both legal and tax purposes. It is generally treated as tax resident of the country in which it is incorporated

(unless tax residence rules of the country in which the company is incorporated determine the residence as per place of management/place of effective management).

The compliance burden of a company is usually higher than a branch or partnership firm. Such compliance burden may be highest in case of public limited company as compared to private limited company.

Further, the private limited company may be subjected to variety of anti-avoidance provisions e.g.: provisions to prevent private limited from issuing deemed dividend to shareholders in the form of loan, etc.

(c) Partnership firm/LLP:

The partnership firm may be unlimited liability partnership (which is unincorporated entity) or limited liability partnership ('LLP') (which is an incorporated entity).

In many jurisdictions, the partnership may not be recognized for tax purposes and the profits may be taxed in the hands of the partners. Problems of double taxation may arise in cases where the firm is recognized for tax purposes in one jurisdiction but not in the other jurisdiction where entity operates. This is because; the person being subjected to tax on the same income may be different in two different jurisdictions which may make it difficult for the entity to obtain credit or exemption to remove double taxation.

Hence, an in-depth analysis may be needed before choosing firm as an entity for proposed transactions.

In certain countries (e.g., India) a deduction may be available on interest on capital paid to partner of the firm subject to interest rate cap.

It is important to note that statutory and regulatory compliances applicable to the partnership firm are lesser as compared to company.

However, it needs to be noted that, in case of unlimited liability partnership firms, the tax and other liabilities may be recovered from personal assets of partners in case if the partnership assets are insufficient.

2.2.2 Tax efficient funding strategies

The capital structure of an organization plays an important role in the cost of funds to that organization. Debt may be tax efficient than equity since the interest on debt is tax deductible;

Equity shareholders are entitled to ownership rights in the company, however they receive uncertain returns; whereas debenture holders receive a steady stream of taxable interest income over a specified period of time, also debenture holders receive payment in priority as compared to all creditors.

From the company's perspective, issuance of equity is simpler than raising debt in a country where there are strict exchange control regulations. As such regulations may lay down various criteria in relation to eligible lender, end-use of funds, ceiling on amount of borrowing and

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interest payable on the same, etc. which need to be complied with.

Use of debt may provide a taxpayer with several tax planning opportunities. A prominent among them is use of hybrid instrument. The hybrid instrument may have features of both equity and debt. Such instrument may be used to fund entity using debt which may be in form of quasi equity. A hybrid instrument like compulsory convertible debenture may be compulsorily converted at a future point of time into equity.

Recently, companies are also issuing optionally convertible debentures/preference shares.

An instrument may be treated as debt in the country in which it is issued and accordingly an interest deduction may be allowed to the taxpayer issuing the hybrid instrument. On the other hand, the country of funding entity may treat instrument as equity and may characterize the pay-out by issuing entity as dividend thereby granting tax exemption on account of participation exemption regime (Special regime granting exemption to dividend income received from overseas subsidiary on account of participation in equity of such subsidiary higher than certain percentage by holding company which is tax resident/incorporated in such jurisdiction where special regime exists. Such regime is to prevent double taxation and encourage cross border investments).

However, Action 2 of OECD's BEPS project has now introduced steps to remove such mismatch by recommending that, exemption given by countries should depend on the tax treatment in the jurisdiction of issuing country in hands of such entity. Hence, countries are making changes to their tax legislations in order to remove such mismatch arbitrage.

Further, some countries may provide special tax benefits for companies raising funding through debt. This is to boost economic activity in the country and facilitating investments inflow. For example, in India, section 194LC of the Indian Income Tax Act, 1961, provides that in case of external commercial borrowings by an Indian company engaged in certain business or any business trust, tax shall be withheld at a reduced rate of 5% (plus applicable surcharge and cess) on interest payments to non-residents, on monies borrowed by it in foreign currency from a source outside India under a loan agreement or through issue of long-term infrastructure bonds.

2.2.3 Inbound cross border tax structuring

The different options available in Inbound cross border tax structuring are:

(a) Direct holding

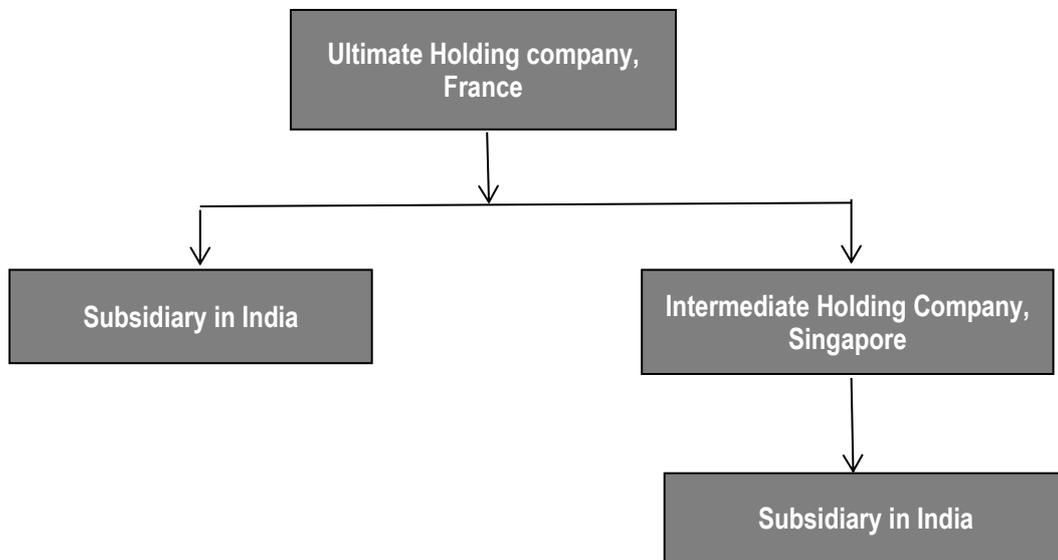
A company who wishes to invest in other jurisdiction can directly invest in the form of setting up a subsidiary or by acquiring an existing company. However, detailed evaluation may be required in respect of tax outgo resulting from both the options so as to choose the most beneficial option. Exit may not be tax efficient in case of direct holding in the absence of relevant favorable DTAA provisions as gains may be subject to high capital gains tax. Also acquiring a new company may require several regulatory compliances and other procedural and legal requirements like conducting due diligences etc. Other alternatives are discussed as below.

(b) Investment through tax efficient jurisdiction

It is common for foreign investors to invest through Intermediate Holding Company ('IHC') located in a tax efficient jurisdiction to gain tax benefits on repatriation of profits as well as on exit. For example: For Investing into India, inter alia Mauritius and Singapore are considered to be tax efficient jurisdictions. The tax treaty signed between India and these 2 countries provides for a tax exemption on capital gains earned in India. This benefit is being phased out.

India – Singapore DTAA also requires evidence of substance (active operations) in Singapore IHC for such IHC to be eligible for capital gains tax exemption on share sale.

Diagrammatic explanation of an investment in the form of a subsidiary or IHC is as below:



However, such setting up of IHC in favourable tax treaty jurisdiction has been challenged by tax authorities and has been perceived as a vehicle to obtain tax benefits without any 'commercial substance'. The tax authorities also often allege that 'beneficial ownership' (beneficial owner is the person with whom benefits attached to an asset are vested, even though he may not possess legal title attached to it.) of the capital asset located in underlying investment jurisdiction (India in above diagram) is actually vested in the ultimate owner sitting in a different foreign country.

Anti-abuse rules in the domestic tax legislation and also limitation of benefits ('LOB') provision in tax treaties need to be analysed before using the tax favourable jurisdiction for investing in underlying investment jurisdiction.

(c) Acquisition of shares of an offshore IHC

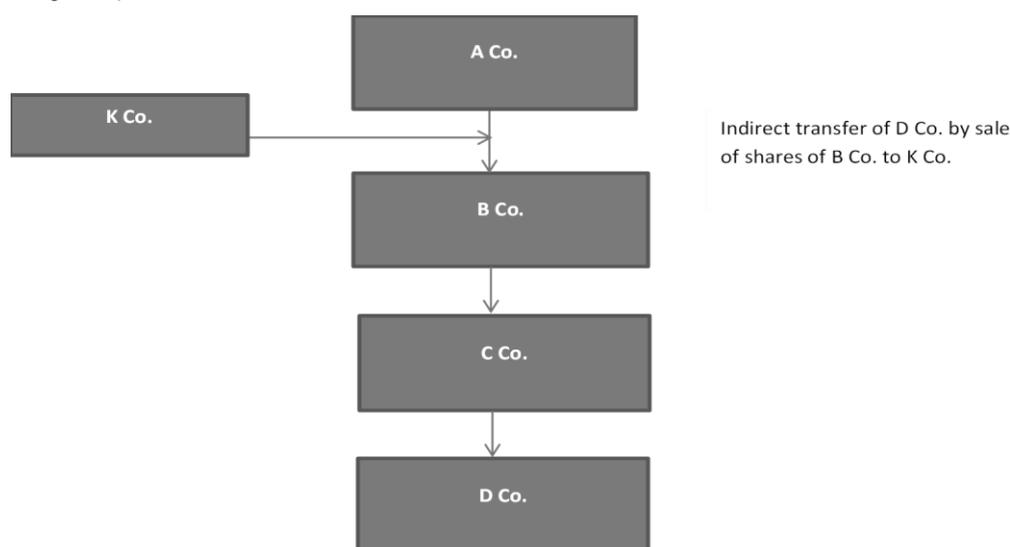
A foreign company desirous of investing in India may acquire shares of an offshore IHC already holding shares of the target company. In this case, location of IHC would not be relevant in deciding taxability on capital gains on sale of shares of the target company as it is

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presumed that, IHC may already be located in the tax favourable jurisdiction. However, the indirect transfer provisions (section 9) needs to be analysed along with relevant treaty.

(d) Acquisition of shares of chain of intermediary holding companies (Indirect transfer transaction)

This involves acquisition of an intermediary holding company from the chain of intermediary holding companies.



In the above example, D Co. is held by chain of intermediary companies. D Co. is bought by K Co. by acquiring shares of B Co. which is one of the IHC of D Co.

In the past few years, this option has been used by multinational companies to avoid capital gains in the source jurisdiction (D Co. jurisdiction) and also to avoid substantial regulatory compliances (if any) in the ultimate target jurisdiction.

These types of transactions are called as indirect transfer transactions (refer the Indian case of Vodafone⁸) where taxability of such transaction was under dispute in the Indian Supreme Court. The Hon'ble Supreme Court held that, such transactions could not be taxed in India in the absence of specific charging provisions.

However, post this decision, a number of retroactive provisions have been introduced in the Indian income tax legislation to subject such transactions to capital gains tax. The value of transferred shares of intermediary holding company would be valued on the basis of underlying assets in India for calculating the capital gains for the purpose of Indian tax.

Certain other countries, like China, have also introduced similar provisions in their domestic tax legislation.

⁸ 341 ITR 1 (SC)

(e) Outbound cross border tax structuring

The investments outside the jurisdiction of ultimate holding company can be in the form of a subsidiary, branch office or joint venture. However, such investments would be subject to regulatory restrictions and compliance requirements of both the jurisdiction of the ultimate holding company and the target investment country.

The overseas investment can be made through following channels according to the degree of product diversity and market complexity.

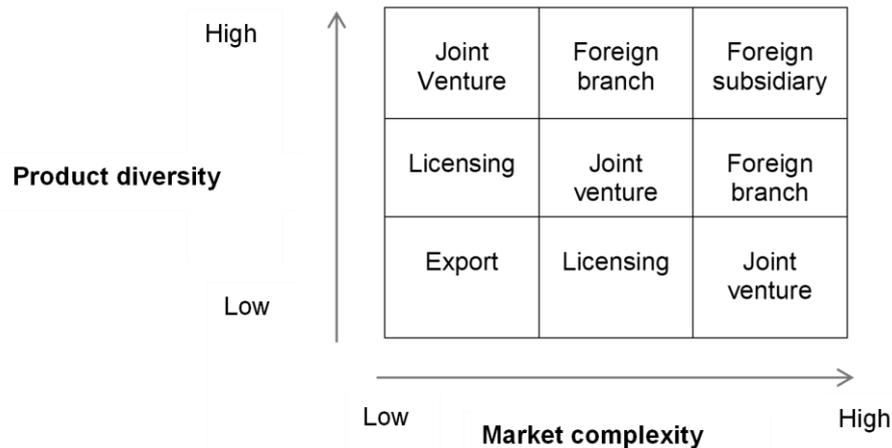


Diagram source: www.drawpack.com⁹

The different options available in outbound cross border tax structuring:

(a) Direct holding

A company looking to invest in another jurisdiction can directly invest by setting up a subsidiary or by acquiring an existing subsidiary. However, the profits generated by the overseas subsidiary, when repatriated to ultimate holding company may be taxable in jurisdiction of holding company in absence of participation exemption regime. Further, the disposal of shares held by holding company may be subject to levy of capital gains tax, in absence of favourable tax treaty provisions. Other entity options such as LO, BO, Partnership are also available (these have been analysed in detail in the section relating to outbound investments).

(b) Investment through tax efficient jurisdiction

It is more tax efficient for investors to invest through IHC located in a tax efficient jurisdiction to gain tax benefits on repatriation of profits as well as on exit. However, as discussed above, care needs to be taken by reviewing the entire arrangement from stand point of anti-avoidance provisions in local tax legislation or LOB provisions of tax treaty.

⁹ http://www.drawpack.com/index.php?route=product/product&product_id=5391

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(c) Acquisition of IHC

An investor company can acquire more than 50% of the shares of IHC located in favourable treaty/tax jurisdiction to acquire a controlling interest. This structure may be tax efficient structure to gain tax benefits on repatriation of profits as well as on exit.

However, one may need to evaluate the entire arrangement from the point of views of the CFC rules existing in the tax favourable jurisdiction which may expose the profits in IHC to be taxed in the ultimate holding company's jurisdiction. It is also important that the rules relating to the Place of effective management ('POEM') are also examined such that the overseas company does not become a resident company in India.

2.2.4 Cross border mergers and acquisitions

Cross border mergers and acquisitions entail cross border amalgamation/ purchase of two or more companies located in different jurisdictions. Such cross border mergers and acquisitions are helpful for companies to make tax efficient cash repatriation or help to make efficient use of losses or shift country of tax residence (commonly termed as inversion).

Mergers should be viewed differently from buying a company by virtue of share purchase.

Mergers and acquisitions involve transfer of one company to another and the shareholders getting shares of new company in their own right as owners of amalgamating company. Such amalgamation does not result in transfer of capital assets under normal principles of income tax as amalgamation does not result in transfer for consideration.

Similar logic is applicable even for demerger. However, this is subject to specific legislation given by a particular country (for example, in India mergers and acquisitions have several conditions which needs to be fulfilled for being eligible for tax exemption). For cross border mergers and acquisitions tax and regulatory laws of both the jurisdictions have to be examined in detail.

(a) Cross border mergers

We may consider following example: for tax efficient repatriation of profits, holding company may merge with its subsidiary. This may help the group to repatriate the cash sitting in books of subsidiary efficiently. However, the challenge is to abide by regulations and taxation provisions of the countries of the two companies involved.

Another example may be to merge the company in high tax jurisdiction with another company in low tax jurisdiction and shift the corporate tax residence to low tax jurisdiction. Such shift is called inversion. Multinational companies resort to inversion to achieve cash efficient repatriation of dividends and other payments and to switch to territorial system of taxation rather than worldwide system which may be prevalent in their home jurisdiction.

There may be many other ways to achieve tax efficiencies through cross border mergers.

(b) Acquisition through itemized sale/ slump sale/ demerger

A foreign company could set up a holding company in target company jurisdiction, which in

turn acquires the target company through itemized sale of assets and liabilities or slump sale or demerger of such target company.

Unlike in the case of a slump sale, in the case of itemized sale, the holding company has a choice to pick up certain assets; however, the gains on their transfer shall be taxable in the hands of the transferor – target company. On the other hand, slump sale entails sale of an entire business undertaking for a lumpsum consideration, which would be taxable in the hands of transferor. An evaluation of both the options from tax efficiency perspective is required before choosing to go for itemized sale or slump sale.

2.2.5 Repatriation

(a) Buyback of shares

As compared to dividend payment, buyback of shares is a more tax efficient strategy to repatriate profits to the equity shareholders. The capital gains arising on buyback of shares may be taxable. However, provisions of some tax treaties may make capital gains tax exempt in source jurisdiction.

However, tax authorities around the world have been vigilant on the intention of entering into such transactions and have viewed buyback as a colourable device to avoid tax outflows. Thus, such transactions need to be undertaken with commercial substance and for bonafide reason of distribution of profits to shareholders.

However, note that, in Indian scenario, India also has buyback distribution tax (BBT) in its tax regime. In this case, the company earning capital gains may not be able to take the benefit of provisions of Article 13 relating to Capital Gains of the DTAA in the source jurisdiction as the tax incidence of BBT is not in hands of entity buying back the shares (shareholder entity) but in the hands of the subsidiary company.

(b) Royalty and fees for technical services

Royalty is for use of tangible (industrial equipment) or intangible property (patent, know-how, trademark/trade name/brand or intellectual property). Royalty has been employed as an efficient way of profit repatriation by multinationals predominantly by granting right to use intangible assets to group entities. Further, the entity paying royalty may avail tax deduction for the same. However, such transactions among group entities may attract transfer pricing provisions. Also, the transfer pricing authorities in different countries are examining these transactions by applying the benefit test. This is done by scrutinizing if the asset is providing the benefit to the royalty paying entity or whether such transaction is only undertaken to shift profits from one jurisdiction to other.

Action 8 of OECD BEPS project - Transfer pricing aspects of intangible assets have provided a revised and detailed guidance to transfer pricing authorities and taxpayers to benchmark the intra-group transactions involving intangible assets.

Apart from royalty, the multinational companies may also have fees for technical services ('FTS') to repatriate profits.

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FTS article is absent in OECD model convention, while the same is present in the UN Model convention. Hence, the tax treaties based on OECD model do not have FTS article and the taxpayers may in these cases claim exemption from withholding tax.

The taxpayer may get the deduction of payment of management service fee. However, transfer pricing provisions continue to apply to these transactions. Management service transactions are under intense scrutiny from transfer pricing authorities and the authorities continue to apply benefit test to these transactions to assess the benefits obtained by service recipient.

(c) Entity conversion

One of the common examples of entity conversion is conversion of private limited company into limited liability partnership ('LLP').

The conversion is seen in countries where dividend is subjected to DDT. LLP facilitates tax efficient repatriation of profits.

2.2.6 Leasing

Cross border leasing is one of the strategies employed by multinational groups to finance the purchase of high value assets.

The lessor may avail deduction of depreciation on leased asset in its jurisdiction. Also in many cases, the lessor may buy such asset by obtaining loan which may also generate interest deduction. Lessee may avail the deduction of lease payments. Such arrangement may also help lessors to avail the benefits of tax losses. Cross border leasing requires careful consideration of tax laws of both lessor and lessee jurisdictions and GAAR provisions in domestic law, recent BEPS recommendations and other anti-avoidance provisions

2.3 Need for substance/commercial rationale and conclusion

Any cross border tax structuring strategy cannot be divorced from business or commercial rationale. Also, each step in the transaction needs to be backed by such rationale, as tax authorities may challenge and disregard/re-characterize a particular step in the transaction by alleging lack of substance.

When a particular transaction can be structured in more than one manner and commercial/business rationale can be demonstrated for all the options then the taxpayer may opt any one option which is most tax efficient.

Tax authorities around the world are challenging the transactions which lack substance but are undertaken only to avail tax benefits. Hence, taxpayer needs to maintain adequate documentation to demonstrate satisfaction of substance requirements and business rationale behind undertaking a transaction.

Strategies given in this chapter are only to increase awareness among future/current tax practitioners about the industry practices and should not serve as guidance in any manner. A

particular strategy may only be explored if it complements business arrangement/transaction and is backed by substance.

3. International Tax structuring for Expatriate Individuals

3.1 Background

With the advent of technological advancements, the world has become a “Global Village”. MNCs from various continents are setting up shops globally including in India and expanding their business.

While technology has bridged the gap between East and West and connectivity is no longer an issue; the need for skilled manpower to guide, supervise, control and manage the business abroad still remains a challenge for MNCs. To overcome the said challenges, MNCs typically look at sending their personnel to group companies abroad.

Typically, from an MNC’s perspective, the reasons for secondment are as follow:

- Utilisation of technical as well as leadership skills of group entities for specific time period/ projects,
- Integrating operations with group companies,
- Establishing global practices in new markets,
- Providing employees an opportunity of getting diverse international experience, etc

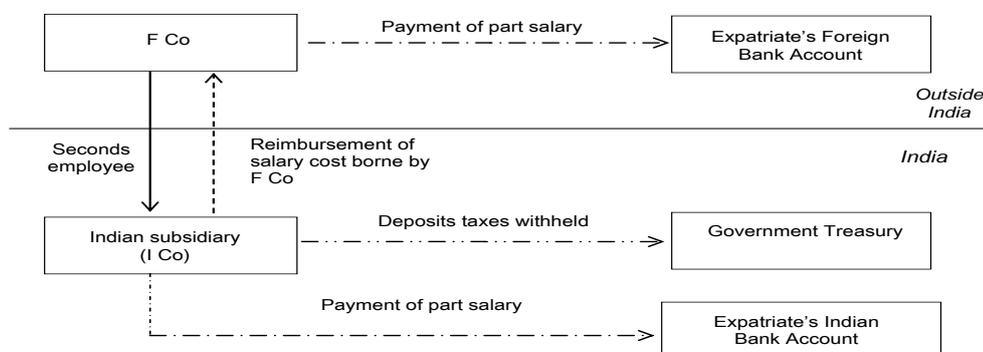
Separately, employees today are exploring avenues to work outside their “home country” to get experience and explore opportunities available to them. The idea of movement of personnel to group companies abroad for a temporary period is regarded as secondment and the person being seconded is typically regarded as an expatriate in the country of secondment.

The term “secondment” is not defined in the Income-tax Act, 1961 or the tax treaties or the OECD commentary. As per Oxford Dictionary, the term “secondment” means:

“The temporary transfer of an official or worker to another position or employment.”

It may be noted that in common parlance, the words secondment and deputation are used interchangeably.

3.2 Typical secondment arrangement



3.2.1 Typical features of a secondment arrangement:

1. F Co (Foreign Company) and I Co (Indian company) are group companies.
2. Pursuant to business and commercial reasons, F Co seconded certain employees (assignees) to work under I Co in India for a specific time period.
3. Secondment may or may not be pursuant to a specific request by I Co.
4. I Co may or may not select the seconded employees.
5. Assignees remain on the payroll of F Co and employment with F Co continues during the period of secondment. However, during the period of secondment, they work exclusively under the control and supervision of I Co. Assignees may sign employment contracts with I Co in India (resulting in dual employment with I Co as well as F Co).
6. The secondment agreement may clarify that during the period of secondment, I Co would be the employer, assignees would become part of I Co's organization, risk and reward of assignee's work will vest in I Co and I Co alone will be legally obliged to bear the cost of employment of assignees during the period of secondment.
7. F Co will not be responsible for any work or activities of the assignees during the period of secondment.
8. The salary and related employment costs of the assignees are partly paid by I Co in India and partly by F Co (on behalf of I Co) in the home country for administrative convenience only. The portion paid by F Co in home country (if any) is cross-charged to I Co on actual basis (i.e., without any mark-up/ profit element). Payment of employment costs by F Co is sometimes also driven by continuity to receive social security benefits in the home country. Since, the assignee is no longer working for F Co, such costs of employment are cross charged to or recovered from I Co.

Assignee has a right to return to F Co on completion of term of secondment from I Co.

3.2.2 Typical tax questions

As noted above, in a typical secondment arrangement, the employee remains on payroll of F Co during the period of secondment, while also being on the payroll of I Co. In this scenario, the typical question that arises is whether the seconded employee is actually working as an employee of I Co or he is rendering services on behalf of F Co. In the first scenario, the relation between the employee and I Co is that of master and servant (i.e., contract of service) while in the second scenario, it is a case of F Co rendering services to I Co via the seconded employees (i.e. contract for service).

Contract for Service vs Contract of Service

The **SC in Kishore Lal vs Chairman, Employees State Insurance Corporation (2007, 4 SCC 579)**, observed a distinction between the two (i.e., ‘contract for service’ and ‘contract of service’) which is summarized as under:

Contract for service	Contract of service
Implies a contract whereby one party undertakes to render service e.g., professional or technical service, to or for another party	Implies relationship of master and servant
In the performance of a contract for service, the party rendering service is not subject to detailed direction and control, and exercises professional or technical skill, and uses its own knowledge and discretion	Involves an obligation to obey orders in the work to be performed and as to its mode and manner of performance

OECD Commentary on ‘Contract of Service’ vs ‘Contract for service’

The OECD Commentary 2017 in the context of Article 15(2) i.e., availability of short stay exemption, recognizes a distinction between ‘contract of service’ and ‘contract for service’, between two enterprises. The Commentary indicates that it needs to be determined whether the services rendered to an enterprise of a State by an individual resident of another State constitute services rendered under (i) an employment relationship or (ii) a contract for provision of services between two separate enterprises. The OECD Commentary recognizes that the forms (formal contracts) under which services are rendered may be ignored and the focus should be on the nature of services rendered.

Certain principles laid down by the OECD Commentary for ascertainment of who should be regarded as an employer, are as under:

- Receives services and nature of services received form an integral part of its business;
- Bears the responsibility and risk to the result produced by the individual's work;
- Has an authority to instruct the manner in which work should be performed;
- Controls and has responsibility for the place at which the work is performed;

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- Bears the cost of employment;
- Provides necessary tools and materials to the employees and determines the holidays and work schedule of that individual;
- Determines the number and qualification of the Individuals performing the work;
- Has right to select the individual and terminate the contractual arrangements entered and impose disciplinary sanctions, etc.
- Determines the holidays and work schedule of that individual.

3.2.3 Tax implications in India

3.2.3.1 I Co is regarded as the employer:

In a scenario, where I Co is regarded as an employer, payment by I Co to F Co of salary cost paid by F Co is regarded as reimbursement of expenses (provided back-to-back documents are available to prove the same).

3.2.3.2 F Co is regarded as the employer:

(a) Fees for Technical Services ('FTS')

Section 9(1)(viii) of the Act deals with the taxability of income in nature of FTS paid to a Non Resident, where the fees are payable in respect of services utilised in business carried on in India. The said section also defines FTS to include payment made towards provision of services of technical personnel by the foreign company.

Article 12 or Article 13 of most of the Double Taxation Avoidance Agreements ('tax treaty') have defined FTS. FTS mean payments of any kind other than those referred to in other Articles of the Agreement to any person, in consideration for any services of a technical, managerial or consultancy nature (certain tax treaties like India – USA, India – Singapore, India – UK, India – Switzerland, India – Australia, India – Netherland, etc. state that FTS are taxable in India only if they 'make available' technical knowledge to the recipient of services).

Accordingly, if the above conditions are fulfilled, there is an exposure that the services rendered by expatriate to I Co are regarded as FTS for F Co. In such scenario, the income of F Co would be taxable at the rate prescribed under the Act or tax treaty whichever is more beneficial (as per provision of section 90 of the Act). Further, Transfer Pricing ('TP') regulations shall typically apply to F Co and I Co for the transaction.

(b) Service Permanent Establishment ('PE')

Section 9(1)(i) of the Act provides for taxability of all income accruing or arising, whether directly or indirectly, through or from any business connection in India. Further, in the case of a business of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India. Such income would be taxable at the rate of

40% (excluding applicable surcharge and education cess) on net basis (expenses deductible subject to WHT, etc.)

Article 5 of most of the tax treaties have defined PE. PE is defined to include the furnishing of services, other than those covered by Article 12/ Article 13 (Royalties and FTS), within a Contracting State by an enterprise through employees or other personnel, but only if activities of that nature continue within that State for a period or periods specified in respective tax treaty.

Accordingly, if the above conditions are fulfilled, there is an exposure that the services rendered by F Co (in the above example) through employees may constitute a service PE of the F Co. In the scenario, the income of F Co in such case would be taxable at the rate of 40% (excluding applicable surcharge and education cess) on net basis. Further, TP regulations shall apply to F Co and I Co for the transaction.

(c) Fixed place PE:

It would be relevant to note that in case of various tax treaties (e.g., Germany, Mauritius, Netherlands, etc.) which do not contain service PE clause, the tax authorities might contend that based on Paragraph 6 of the OECD commentary to Article 5 - which states that six months is the minimum threshold for existence of PE, the seconded employee may constitute a fixed place PE of the F Co. Further, existence of fixed place PE may also be evaluated if the employee has a fixed place at his disposal in I Co through which business of F Co is carried on.

Below are the conditions for fixed place PE as per Paragraph 2 of the OECD commentary on Article 5:

- the existence of a “place of business”, i.e., a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be “fixed”, i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually those persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.”

Further, TP regulations shall apply to F Co and I Co for the transaction.

3.2.3.3 The above is summarised as under:

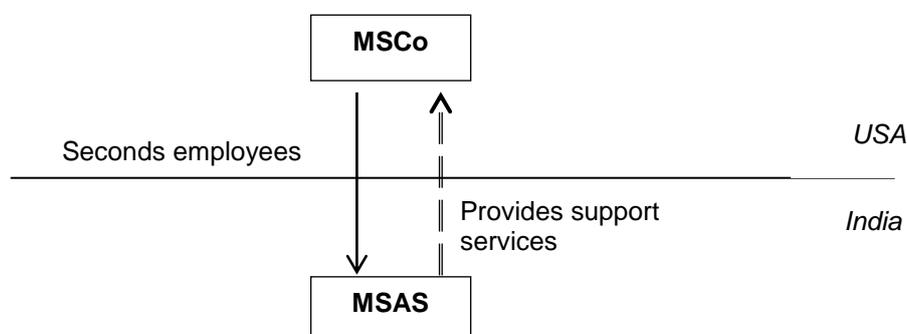
Particulars	If I Co is the employer	If F Co is the employer
Reimbursement of payments (i.e., salary) made by F Co	Not income in the hands of F Co, if no profit element is	Income in the hands of F Co

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Particulars	If I Co is the employer	If F Co is the employer
to I Co	involved	
PE for F Co in India	No, as I Co shall be the employer	Possible <ul style="list-style-type: none"> • Service PE • Fixed place PE (If the activities of employees amount to stewardship activities, PE may not be constituted) ¹⁰
Whether payment made by I Co to F Co could be regarded as FTS	No	Possible
Applicability of TP regulations to the transaction	No. But better to report reimbursement in Form 3CEB	Yes

3.3 Landmark rulings on secondment:

3.3.1 Morgan Stanley and Co Inc (Supreme Court)



Facts

Morgan Stanley and Company ('MSCO') was a US company providing various services worldwide and was part of Morgan Stanley group. One of the group companies of Morgan Stanley viz., Morgan Stanley Advantages Services Pvt. Ltd. ('MSAS') entered into an agreement for rendering certain support services to MSCO. Pursuant to the agreement with

¹⁰SC ruling in case of Morgan Stanley International – 292 ITR 416 (SC)

MSAS, MSCo proposed to send its personnel to India for the following:

- for undertaking stewardship activities to ensure that the services rendered by MSAS meet the standards of MSCo; or
- to be on deputation to MSAS and work as employees of MSAS

The salary costs of personnel deputed to work under the control of MSAS was to be initially paid by MSCo and onwards be recharged to MSAS. The salary costs and other costs of the employees who were to be sent to India for stewardship and other similar activities was to be borne by MSCo.

Held

A. Stewardship activities:

The SC held that the Stewardship activity involved briefing the MSAS staff to ensure that the outputs meet requirements of MSCo and Includes monitoring the outsourced operations. The purpose of the above agreement was to protect interest of MSCo and ensure quality control.

The SC held that since no service is provided by MSCo to MSAS and that stewardship activity by employees does not constitute a service PE of MSCo in India.

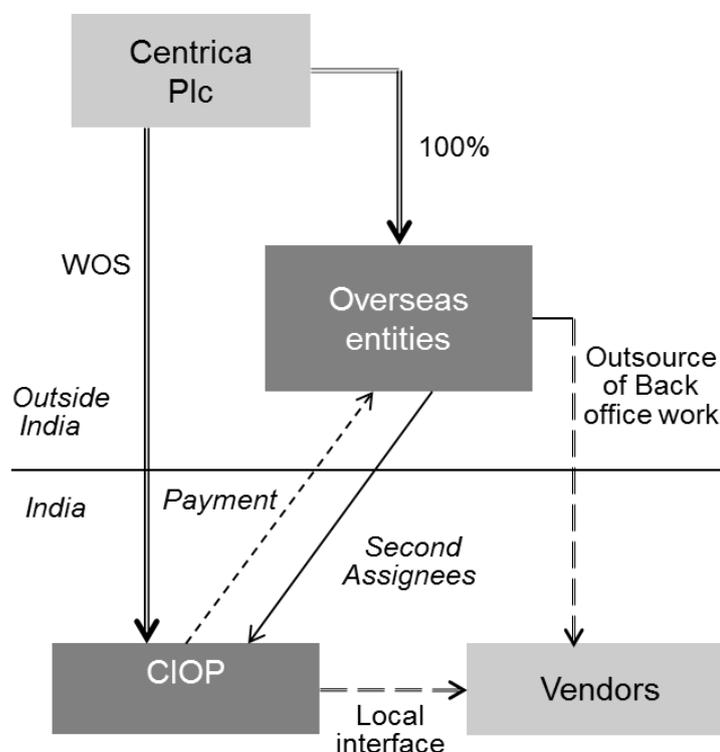
B. Deputation of personnel:

In its ruling, the SC has stated that twin conditions are to be satisfied to constitute service PE ie (i) foreign company should be responsible for the work of the assignees; and (ii) assignees are on payroll of the foreign company or they have a lien on employment with the foreign company.

In the instant case, SC held that seconded employee lends its experience to MSAS as employee of MSCo as he retained lien with MSCo. Thus, MSCo has a service PE (i.e. MSAS) in India.

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3.3.2 Centrica India Offshore Pvt Ltd (Delhi HC)



Facts

- Centrica India Offshore Private Ltd (CIOP) was a WOS of Centrica Plc., a company incorporated in UK. Centrica Plc, had two other subsidiaries in UK and Canada (collectively referred to as “overseas entities”), which were engaged in the business of supplying gas and electricity to consumers across UK/ Canada.
- The overseas entities had outsourced their back office support functions (such as consumers’ billings/ debt collections/ monthly job reporting) to third party service providers in India (Vendors).
- CIOP entered into a Service Agreement with overseas entities to provide locally based interface between the overseas entities and the Vendors in India. CIOP was required to: (a) ensure that the Vendors complied with the requisite quality guidelines (b) provide management assistance to Centrica Plc, including advice on expanding scope of potential services in India. For this, CIOP was compensated on a cost plus basis.
- Since CIOP was newly incorporated, it needed the knowledge of processes and practices of the overseas entities to successfully fulfil its role under the Service Agreement. In this regard, CIOP and the overseas entities entered into a Secondment Agreement under which the overseas entities seconded some of their assignees with requisite knowledge and experience to work with CIOP in India.

Key terms of the Secondment Agreement were as below:

1. Overseas entities would second the assignees to CIOP, at the request of CIOP.
2. The assignees will integrate into CIOP's organization.
3. Rules and regulations of CIOP were applicable to the assignees.
4. The assignees would work under the direct control and supervision of CIOP.
5. The overseas entities would not be responsible for any error or omission on the part of the assignees.
6. CIOP would bear the risks and rewards of the work of assignees.
7. CIOP had a right to specify the scope and nature of the assignees' work and the results to be achieved.
8. Assignees to retain their entitlement to participate in Centrica Plc's retirement/social security plans and other benefits in accordance with Centrica Plc's policies.
9. CIOP would bear the monthly costs of employment of assignees, including their basic salary, cost of participation in retirement/social security plans, other compensation and benefits as applicable and any other costs as agreed between CIOP and overseas entities.
10. CIOP could terminate the Secondment Agreement.
11. Each assignee would enter into an individual agreement with CIOP, which would provide for specific terms of work in India.

Further, salary of the assignees was to be disbursed overseas by the overseas entities and the amounts were to be recovered from CIOP on actual basis. Also, CIOP would withhold taxes on the salary paid to the assignees in respect of the services rendered.

Held

The HC held that the employees (assignees) seconded by overseas Group Entities to the CIOP in India did not become employees of the CIOP, but continued to remain employees of the overseas entities during the secondment period. Accordingly, the arrangement involved rendition of services by the overseas entities to CIOP through such assignees.

Further, since the assignees were imparting their technical expertise and 'made available' know-how to other regular employees of CIOP for future consumption, payments from CIOP to the overseas entities for such services was regarded as FTS/ FIS under the Act, as well as under the relevant tax treaty.

As regards service PE, the HC held as under:

- To determine existence of a Service PE, it is the substance of the employment relationship which must be considered, and not the form.

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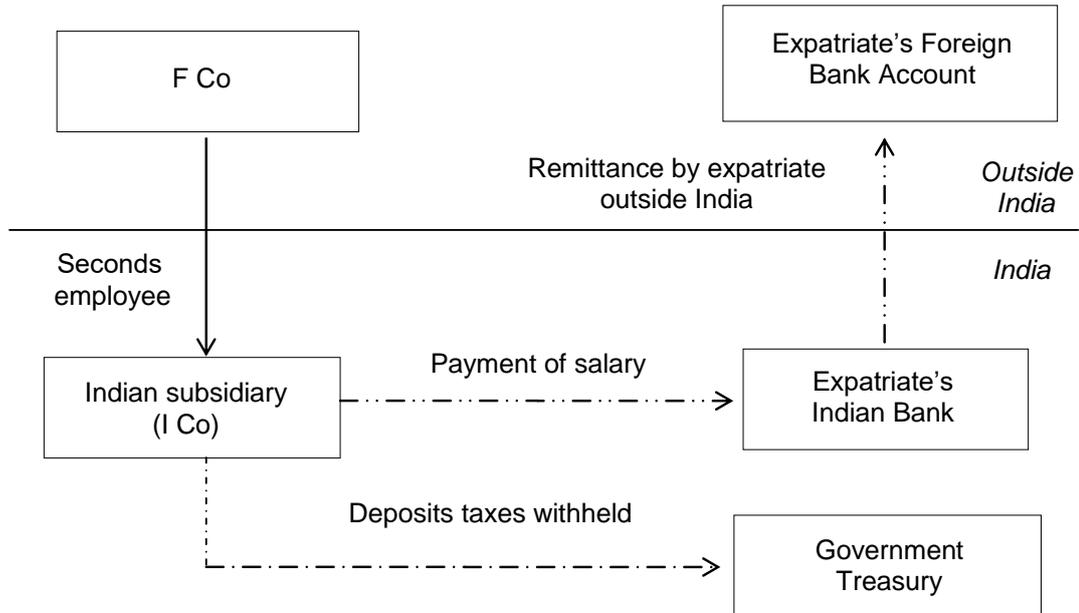
- It was noted that the assignees integrated with CIOP's business and were subject to the control, supervision, direction and instructions of CIOP. The assignees had to perform their duties in accordance with the applicable laws, regulations, and standards of CIOP who bore all the risks and rewards of the assignees' work during the period of secondment. Also, the overseas entities were not responsible for any errors or omissions by the assignees. However, there was no employer-employee relationship of the assignees with CIOP and they continued to be employed by the overseas entities for the following reasons:
 1. The assignees retained the right to participate in the retirement and social security plans and other benefits of the overseas entities.
 2. Salary was properly payable by the overseas entities which claimed money from CIOP. There is no entitlement or obligation clearly spelt out for CIOP to bear the salary costs of the assignees. All direct costs of the assignees' remuneration were ultimately paid by the overseas entity.
 3. The assignees cannot sue CIOP to recover their salary in case of default.
 4. CIOP had a right to terminate the secondment in its agreement with the overseas entities. However, CIOP had no right to terminate the services of the assignees vis-à-vis the overseas entities, which represents the original and subsisting employment relationship.
 5. The employment relationship between the assignees and the overseas entities remained independent and beyond the control of CIOP.
 6. The assignees were regular employees of the overseas entities and they would return to their original employment after completion of the secondment period. The employment relationship between the assignees and the overseas entities was not terminated at any point of time and CIOP has no right to even modify such a relationship.
 7. While CIOP had operational control over the assignees and had to bear the risks and rewards of their work, such limited and sparse factors cannot displace the larger and established context of employment with the overseas entities outside India.
 8. The SC, in the Morgan Stanley case (supra), upheld the existence of a Service PE where an employee of a foreign company rendered services to an Indian entity while retaining the lien on employment with the foreign company.

In view of the above, the HC held that Centrica Plc has a service PE in India.

It may be noted that a Special Leave Petition filed before the Supreme Court ('SC') against the above High Court's decision has been dismissed by the SC.

3.4 International Tax Structuring for Inbound Expatriate Individuals¹¹

3.4.1 Payroll shifts to India



Mechanics:

- F Co would second the employees to I Co, at the request of I Co.
- The employment of expatriate with F Co is suspended and the expatriate is on the payroll of I Co.
- I Co is responsible to pay salary to the expatriate in India and expatriate can sue I Co to recover the same
- Salary is paid by I Co in expatriate bank account in India (the expatriate later remits the same to his bank account outside India).
- I Co to deposit the Indian withholding tax on the total salary into Government Treasury.
- I Co to decide on terms of employment of expatriate including their salary, increments, bonus, leave, appraisals, etc.
- Expatriate to participate in I Co's retirement/ social security plans and other benefits in accordance with I Co's Policies.
- F Co does not contribute to the Social Security Benefits of expatriate.
- I Co has the right to terminate the employment of expatriate.

¹¹ These are personal initial views of the author and should not be considered as an opinion

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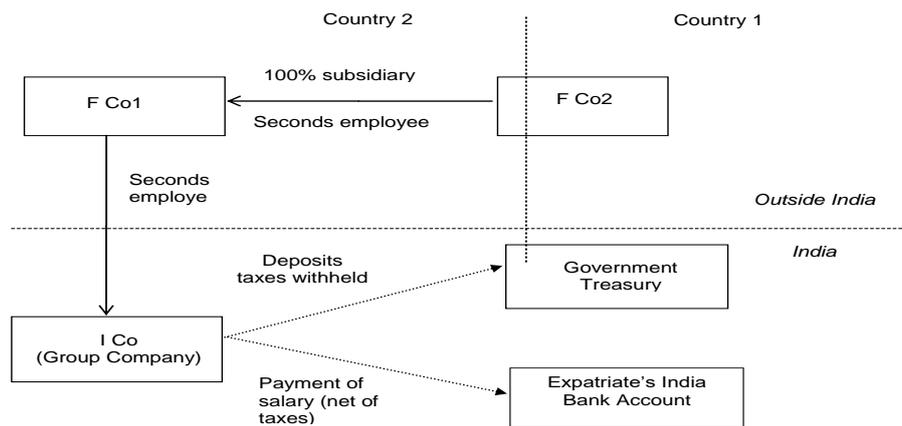
- The expatriate works under the direct control and supervision of I Co as per rules, regulations and policies applicable to I Co's employees in India.
- I Co would bear the risks and rewards of the work of the expatriate.

Implications:

In the scenario, following implications could arise:

- I Co would be regarded as the employer of the expatriate since he is on the payroll of and working for I Co while in India and is neither on the payroll of F Co nor working for F Co during his employment with I Co.
- Since, I Co is regarded as an employer, the question of F Co rendering services to the I Co shall not arise and thus taxability under FTS or as PE shall not arise.
- There shall not be any TP implications since there is no transaction between I Co and F Co

3.4.2 Manpower supply



Mechanics:

- F Co1 is a group manpower supplying company for seconding employees worldwide within the group.
- F Co2 seconds expatriate to F Co1 for say 2 years since the expatriate intends to gain international experience. Expatriate retains the right to return to F Co2 after the secondment period.
- I Co is in need of personnel and requests F Co1 to provide manpower with specific qualification/ expertise for the period of six months.
- Expatriate seconded by F Co 2 has the said qualification/ expertise and F Co 1 seconds him to I Co.
- I Co pays salary etc. of the expatriate.

- F Co1 is paid specific fee (2 months' salary cost) by I Co for recruitment of expatriate.
- Expatriate enters into employment contract with I Co and works under the supervision and control of I Co.
- I Co is responsible for the work of expatriate.
- Expatriate can sue I Co to recover salary if not paid.

Implications

(i) Implications for F Co1:

In the scenario, F Co1 is a manpower supplying company and provides manpower to various group companies. F Co2 seconded employee to F Co1 for a period of 2 years while F Co1 seconded employees to I Co for six months. F Co1 is paid services fee for providing manpower by I Co. The same may be taxable as FTS and would require detailed analysis. However, on account of the following safeguards, the risk of F Co1 creating PE in India on account of providing manpower may be low:

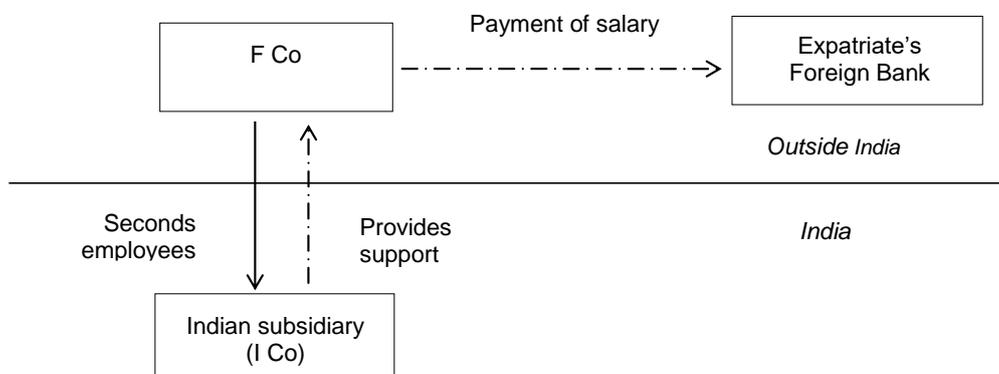
1. F Co1 is in the business of providing manpower and provides manpower to various group companies across the globe (the same would be required to be demonstrated with documentary evidence).
2. The employee is seconded with F Co1 for 2 years while F Co 1 has seconded with I Co for 6 months and may later second the employee to some other entity.
3. Expatriate has no lien on employment with F Co1 and F Co1 is not responsible for the work of expatriate.
4. Expatriate cannot sue F Co1 if I Co does not pay salary.
5. F Co1 is not carrying any business in India through the seconded employees

(ii) Implications for F Co2:

In the scenario, the expatriate retains lien on employment with F Co2. However, if it could be demonstrated with documentary evidence that F Co2 is not responsible for the work of the expatriate, it could be said that the twin conditions laid down by SC in case of Morgan Stanley are not fulfilled and hence there is no PE for F Co2 in India. However, on account of adverse ruling of Hon'ble Delhi HC in case of Centrica India Offshore Pvt Ltd, the tax authorities might contend that F Co2 has a PE in India. In the said scenario, if it could be demonstrated with documentary evidence that the expatriate is working under the supervision and control of I Co during the period of employment and not conducting any business for F Co2 in India, the risk of taxing F Co2 in India is low.

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3.4.3 Stewardship Activities



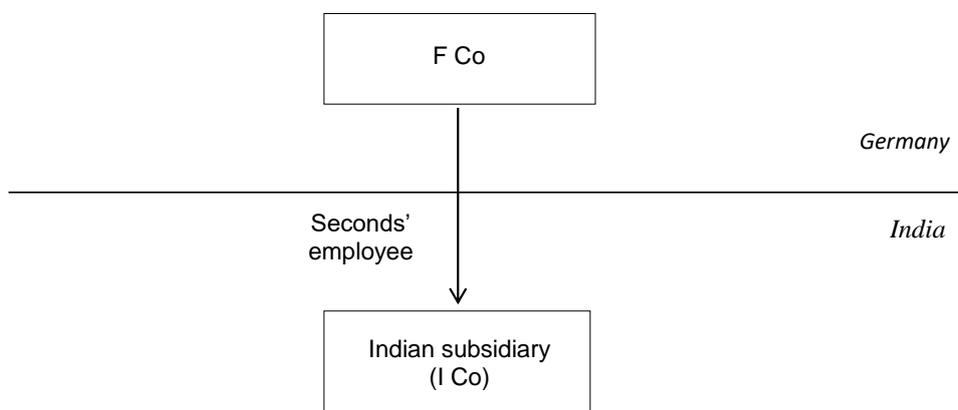
Mechanics:

- F Co and I Co are group companies
- I Co enters into agreement with F Co for rendering certain support services to F Co.
- Pursuant to the agreement with I Co, F Co sends its employees to I Co to carry out stewardship activities to ensure that the output of I Co meets the requirements of F Co.
- The salary costs and other costs of the expatriate are borne by F Co.
- The employees would be working as per the control, supervision, instruction of I Co.

Implications:

In the above arrangement in light of Hon'ble SC ruling in case of Morgan Stanley and Co Inc, it is possible to contend that there is no PE of F Co in India since the employee is carrying out stewardship activities for F Co in I Co and are not rendering any services to I Co. However, adequate documentary evidence to substantiate the same would be required.

3.4.4 Secondment from tax treaty friendly jurisdiction



Mechanics:

- I Co is in need of personnel and requests F Co (i.e., parent company) based in Germany to provide employees with specific qualification/ expertise.
- F Co would second the employees to I Co for the period of 5 months.
- The expatriate works under the direct control and supervision of I Co.
- I Co would bear the risks and rewards of the work of the expatriate.
- The expatriate retains lien on employment with F Co.
- I Co makes payment to expatriate in India.
- I Co pays taxes in India on net basis at the base rate of 30 per cent .

PE Implications:

In the scenario, following implications could arise:

- a) The India – Germany tax treaty does not have service PE clause and accordingly, the question of F Co constituting Service PE in India through its employees shall not arise.
- b) Further, to constitute Fixed Place PE, the minimum threshold is six months as per OECD commentary. The expatriate works in India for I Co for the period of 5 months and therefore, Fixed Place PE risk may not get triggered. However, facts need to be examined in more detail before concluding.

Summary

The key positions that have to be evaluated in determining the tax consequences on international tax structure for expatriate are summarised below:

- Do the facts and documentation strengthen the position of the I Co as the employer of the expatriate? If yes, payment by I Co to F Co may be regarded as reimbursement of expenses provided back-to-back supportings are available to prove there is no mark-up charged by F Co to I Co.
- Where the facts and circumstances do not lend support to the position of the I Co as the employer of the expatriate, the arrangement is likely to be viewed as services rendered by the F Co to the I Co
- In such a case, it is important to analyse whether the nature of services rendered by the F Co to I Co would fall within the definition of FTS under the provisions of the Act and the relevant tax treaty (if any)?
- Further, it shall be relevant to evaluate the risk of PE of the F Co in India under the provisions of the Act and the relevant tax treaty (if any)? Where a PE is constituted, income would need to be attributed to the PE and compliances would follow for the F Co.

3.5 Tax implications on secondment outside India

Globalisation of the Indian economy has provided opportunities for many Indian employees to work abroad. Many Indian companies are sending their employees on secondment to group companies for a few years, wherein the employee works with the overseas company and gains international experience.

Seconding people overseas is a complex business and there are a host of tax, immigration regulatory and human resource issues that need to be addressed. There are tax consequences for both the employees as well as their employer depending on the nature of the assignment. Typical assignment models are follows:

Type of assignment	Duration	Characteristics	Compensation
Short Term Business Travellers ('STBT')	<6months	STBTs are typically employees who travel outside India for business purposes and who are not on a formal assignment or transfer.	Salary continues to be paid in India. Nominal per diem is paid outside India during their travel.
Short Term assignment	6 < 12 months	Active employment contract remains with Indian company ('I Co') and additional contract governing the terms and conditions of the assignment is signed with Foreign company ('F Co'). Family usually does not accompany the employee	Stays on home country payroll. Additionally, cost of Living allowance is paid to compensate for increased cost of living.
Long Term assignment	> 12 months	Active employment contract with F Co. I Co issues a secondment contract governing the terms and conditions of the assignment and employment contract with I Co becomes dormant. Family usually accompanies the employee.	Shifts to F Co's payroll or continue with split payroll (i.e., partly paid in India and balance in host country)
Permanent Transfer	Permanent	Employment contract with I Co ends while a new	Salary is paid in foreign country as newly

Type of assignment	Duration	Characteristics	Compensation
		employment contract with F Co is established	determined by F Co

3.5.1 Basic tax provisions relating to outbound assignments

The taxability in India depends on the individual's residential status, which in turn depends on his/her physical presence in India. As per Section 6(1) of the Act, an individual is said to be resident in India in any tax year if he satisfies any one of the following basic conditions:

1. He is in India in the tax year for a period of 182 days or more; or
2. He is in India for a period of 60 days or more during the tax year and 365 days or more during the four years preceding the relevant tax year.

The period of 60 days can be extended to 182 days in following circumstances:

- For a citizen of India, who leaves India in any previous year for the purpose of employment outside India.
- For a citizen of India or a person of Indian origin who being outside India, comes on a 'visit' to India in any tax year

Further, Finance Act, 2020 proposed an amendment in case of the citizen or person of Indian origin visiting India having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year, for the words "sixty days" occurring therein, the words "one hundred and twenty days" had been substituted¹²

Deemed Residency Rule introduced by Finance Act, 2020

Finance Act, 2020 has introduced a new section 6(1A) in the Act. As per the said section, an individual, being a citizen of India, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year, shall be deemed to be resident in India in that previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

For a given tax year, an individual would qualify to be:

- Resident & Ordinarily resident ('ROR')
- Resident but not Ordinarily resident ('RNOR')
- Non-resident ('NR')

The outbound employees are likely to qualify as a ROR or a NR or RNOR of India in the year of transfer and year of repatriation. During the years of assignment, the employees are likely to qualify as a NR or NROR in India. This table outlines the most likely tax residency scenarios of Indian citizens going on overseas assignment:

¹² Amended by the Finance Act, 2020, w.e.f. 1-4-2021

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Stay in India	Status in year of departure	Status in middle year – (Visit to India)	Status in year of arrival into India
> 181 days	*ROR	*ROR	*ROR
< 182 days but > 59 days & > 364 days during preceding 4 tax years	NR	NR	*ROR
< 60 days	NR	NR	NR

**It is presumed that additional conditions specified in Annexure A are satisfied.*

As per section 5(1) of the Act, an individual who qualifies to be ROR is taxable on all income from whatever source derived which—

- (a) is received or is deemed to be received in India; or
- (b) accrues or arises or is deemed to accrue or arise to him in India; or
- (c) accrues or arises to him outside India:

Thus, ROR is taxable on their worldwide income whereas individuals who qualify to be RNOR or NR are liable to tax only on India sourced income (i.e., income directly received in India or accrued in India).

3.5.2 Typical tax questions

Outbound assignments typically trigger the following tax issues for the employer and employee:

- Usually in case of a long-term assignment, the salary is subjected to tax in foreign country since the employee is rendering services in the foreign country. However, if the salary is received in India, the same is also subjected to tax in India on receipt basis thus resulting into double taxation of salary in the hands of the employee.
- While foreign tax credit (FTC) can be claimed in India under section 91 of the Act, however India is a fiscal year country and its tax year (i.e., from April 1 to March 31) is invariably different from most of the countries, hence there may be practical challenges while claiming FTC since the foreign tax return may not have been filed at the time of filing India tax return.
- India has signed DTAA's with various countries which has Dependent Personnel Service (DPS) clause under which the salary received in India can be claimed exempt in India, if the individual qualifies to be resident of host country and the salary is received for services rendered outside India. However, a tax residency certificate (TRC) is required in order to claim the exemption. Further, the Act does not explicitly provide that employer can consider any tax relief such as DPS exemption or claiming FTC under DTAA at the time of payment of salary. Thus, employer may face practical challenge of tax withholding at the time of payment of salary.

- The assignment may affect the taxation of stock options or similar equity incentive schemes for both the employee and the employer.
- The presence of employees of I Co in foreign country may trigger PE risk for I Co abroad thus resulting into corporate tax compliances for I Co in foreign country.

3.5.3 Tax structuring of secondments

Efficient structures for international assignments help in optimizing costs while mitigating tax and regulatory risks, thereby providing a competitive advantage to the employer. The planning of employee secondments should take into account the employer's as well as the employee's tax situation.

Typical outbound Secondment arrangement

3.5.3.1 Typical features of above secondment arrangement

- I Co will depute the employee to F Co and issue an assignment letter to the employee
- I Co will pay basic salary into the employee's Indian bank account
- F Co will pay salary and allowances (other than basic salary) into the employee's overseas bank account
- I Co will continue the contributions towards retirement benefits in India
- Such employee would work under supervision, direction and under the control of F Co
- I Co would cross charge the salary cost (including contribution to retirement benefits paid by it) to F Co

3.5.3.2 Tax implications in the hands of the employee

3.5.3.2.1 Tax implications under the Act

If the deputed assignee qualifies as ROR in India, then he would be liable to tax on his worldwide income. Accordingly, he would be taxable on the entire salary received in India as well as outside India.

If the deputed assignee qualifies as RNOR or NR, then he would be liable to tax on income that accrues/arises in India or is deemed to accrue/arise in India or received or deemed to be received in India. Accordingly, the employee would be taxable on the salary that is received in India even though it pertains to services rendered outside India.

However, if the employees are tax residents of the other tax treaty country, then they may choose to be governed by the provisions of the Act or DTAA whichever are more beneficial to them.

3.5.3.2.2 Tax implications under DTAA

Generally, all DTAA's have a clause on Dependent personal services whereby if employee qualifies as NR in India and a 'tax resident of the host country' salary in respect of services rendered in the host country would be taxable only in the host country.

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Illustration: Article 16 of DTAA between India and USA reads as under:

*“1. Subject to the provisions of Articles 17 (Directors’ Fees), 18 (Income Earned by Entertainers and Athletes), 19 (Remuneration and Pensions in respect of Government Service), 20 (Private Pensions, Annuities, Alimony and Child Support), 21 (Payments received by Students and Apprentices) and 22 (Payments received by Professors, Teachers and Research Scholars), salaries, wages and other similar remuneration derived by a resident of a Contracting State **[read US]** in respect of an employment shall be taxable only in that State **[read US]** unless the employment is exercised in the other Contracting State **[read India]**. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State **[read India]**”.*

As per DTAA, salaries, wages and other similar remuneration derived by a resident of USA in respect of an employment will be taxable only in USA unless the employment is exercised in India. Therefore, salary earned by a resident of host country will be taxable in India only in respect of the period for which services have actually been rendered in India and salary received in India for service rendered in US can be claimed exempt under the DTAA. However, in case any relief is claimed under DTAA then the employee would be required to obtain a TRC.

Where an individual qualifies as a ROR in India and is also a tax resident of host country say USA, recourse would then have to be made to the tie-breaker rules under the DTAA. Generally, Article 4 deals with the tie-breaker rules which ensure that an individual’s tax residency is established in only one country based on following pre-defined parameters:

- (i) **Permanent home:** Permanent home means any form of home whether owned or rented by the individual that is available to him at all times continuously and not merely for short durations. It is not necessary that the house should be owned. Permanence of home means that the individual has arranged to have the dwelling available to him at all times continuously and not occasionally for short duration (i.e., travel for pleasure, educational travel, etc.).
- (ii) **Centre of vital interests:** Centre of vital interest means personal and economic relations of an individual and his proximity to a jurisdiction location. Some of the parameters to test his personal/economic interest are:
 - Personal Interest: employee’s family and social relations; employee’s activities (e.g., political, cultural etc.), schooling of children.
 - Economic Interest: place of occupation; income and property, assets; the place from which the employee could administer his property.
- (iii) **Habitual abode:** The dictionary meaning of habitual abode is a place in which a person resides, his residence, home or dwelling. Thus, the place where the individual plans to reside in future can be considered as habitual abode.

(iv) Nationality of the individual

Tax residency under DTAA is required to be determined on case to case basis. The following scenarios may typically arise in case an individual is a resident of India as well foreign country where he is seconded.

(a) The individual's residency tie breaks to host country under DTAA

The salary income relating to services rendered in host country would not be taxable in India since the employment is exercised outside India.

(b) The individual's residency tie breaks to India under DTAA

The employee would be taxable on his worldwide income. However, taxes paid in the host country, if any, could be claimed as credit against the tax payable in India under respective DTAA.

Illustration: Article 25 of DTAA between India and USA which provides for FTC reads as under:

"2. (a) Where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in the United States, India shall allow as a deduction from the tax on the income of that resident an amount equal to the income-tax paid in the United States, whether directly or by deduction. Such deduction shall not, however, exceed that part of the income-tax (as computed before the deduction is given) which is attributable to the income which may be taxed in the United States."

Where any income of an Indian tax resident is also liable to tax in USA, India shall allow a credit of the taxes paid in USA against the India taxes payable, in respect of such doubly taxed income. The tax credit is limited to the extent of the India tax attributable to the doubly taxed income. Generally, similar clause exists in DTAA's entered by India with other countries for grant of foreign tax credit. However, each case needs to be examined independently.

(c) The individual is a resident of host country for part of the year under DTAA- Split residency

In a situation where Indian tax year and foreign country tax years are different, it may be possible to consider an employee to be resident of India during the period of Indian employment and tax resident of host country say, US during the assignment period of US. This concept is called split residency.

For e.g. Mr. A is moving to US on 1st January 2016 and he is a tax resident of US under the treaty from 1st January 2016 onwards. Further, he is resident of India for FY 2015-16. Under the tie breaker clause of DTAA, he will be considered as resident of India for the period April 2015 to December 2015 and he would be considered as resident of US for the period January 2016 to March 2016.

Since, the employee would be on a split residency, the salary income relating to services

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rendered in USA would not be taxable in India since the employment is exercised outside India and salary pertaining to India employment only will be subject to tax in India. However, employee will be required to obtain TRC for claiming exemption for salary received in India for services rendered in USA.

Summary of taxability in case salary is paid in India

	Taxable in India
Taxability under the Act- ROR, NR and RNOR	YES
Taxability under DTAA-	
Resident in India and Non-Resident in host country	YES (FTC available)
Non-Resident in India and Resident in host country	(TRC required)
Resident in India and Resident in the host country but tie breaks to host country	(TRC required)
Resident in India and Resident in the host country but tie breaks to India	YES (FTC available)

Based on the above it can be argued that section 90 overrides section 4 of the Act, and since the income is not taxable under DTAA, withholding provisions should not apply.

- (a) The provisions dealing with tax to be deducted at source are only a mode of collection or recovery of tax. To the extent tax is not payable, the question of collection or recovery thereof by way of tax deducted at source does not arise.
- (b) Authority for Advance Ruling ('AAR')¹³:

Facts:

The applicant, an Indian company which was part of British Gas Group UK, deputed two of its employees for upto 3 years to work with British Gas Group in the UK. The two employees continued to be on the payroll of the Indian company and regularly received salary in India. The question before the AAR was as under:

- (i) whether salary received by the two employees in India for services rendered in the UK was liable to tax in India, and
- (ii) whether British Gas India P. Ltd. was required to withhold tax on salary paid in India for rendering services outside India.

Held:

The AAR held that though salary received in India in the case of non-resident employees was

¹³British Gas India P. Ltd [2006] 287 ITR 462

within section 5 of the Act that defined the scope of total income, the provisions of section 5 were subject to the provisions of this Act. This meant that section 5 was subject to section 90 which empowered the Central government to enter into agreements with foreign governments for granting tax relief and avoidance of double taxation. The AAR held that since salary received for services rendered in the UK was liable to tax in the UK as per Article 16 of the India-UK DTAA, the provisions of Article 16 prevailed over the provisions of section 5. Therefore, salary which was liable to tax in the UK was not to be made liable to tax in India. The AAR also ruled that British Gas India P. Ltd. was not required to deduct tax at source under section 192(1) if it was satisfied from the particulars furnished by the employees that tax had been paid on their salary in the UK.

- (c) The Finance Act, 2015 has also granted powers to CBDT to make rules laying down the procedures for claiming FTC. This amendment is effective from 01 June 2015, the procedure for claiming such FTC was prescribed by CBDT which is effective from April 1, 2017. In absence of a clarification to the effect by CBDT in respect of relief of section 90 while withholding tax under section 192, the assessing officer can initiate the proceedings on the employer for non-deduction of tax.

Based on the above arguments, I Co may consider DTAA relief at the time of deduction of tax at source under section 192 of the Act. However, in case any relief is claimed under the DTAA then a TRC from the foreign country will be required to be obtained.

Alternatively, to avoid litigation with the tax authorities, I Co may withhold tax on salary paid in India and the employees could claim a refund of taxes paid in India by claiming relief under DTAA at the time of filing their personal tax returns.

3.5.4 Risk of creating a Permanent Establishment in foreign country

PE is a fixed place of business through which business of the enterprise is carried on. PE amounts to a virtual projection of an enterprise of one country into the soil of another country. Generally, a company is taxed in the country in which it is a resident. However, if the same company also performs certain activities in a foreign country for instance by seconding an employee there, it might create a PE in that country. The existence of a PE gives the host country the right to levy taxes on profits.

The exposure of PE for I Co in the host countries needs to be analysed from the host country tax laws perspective. Once a PE is constituted, profits attributable to the PE are taxable as business profits of I Co in the host country.

What are the types of Permanent Establishments?

The following could be the typical kinds of PE which could exist for I Co in the host countries from deputation of employees:

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Fixed place PE

- A fixed place of business through which the business of an enterprise is wholly or partly carried on
- There are three criteria embedded in this definition – (i) existence of physical location (ii) right to use that place and (iii) carrying out of business through that place

Service PE

- Generally created when a company provides services abroad through employees or other personnel and such activities continue for a specific period.

Agency PE

- Agency PE may exist in any of the following three situations: (i) a 'dependent agent' has and habitually exercises authority to conclude contracts on behalf of the principal (i.e. I Co);(ii) the dependent agent regularly maintains a stock of goods or merchandise and delivers from the stock on behalf of the principal; (iii) the dependent agent secures contracts for the principal.

When do employees create a PE?

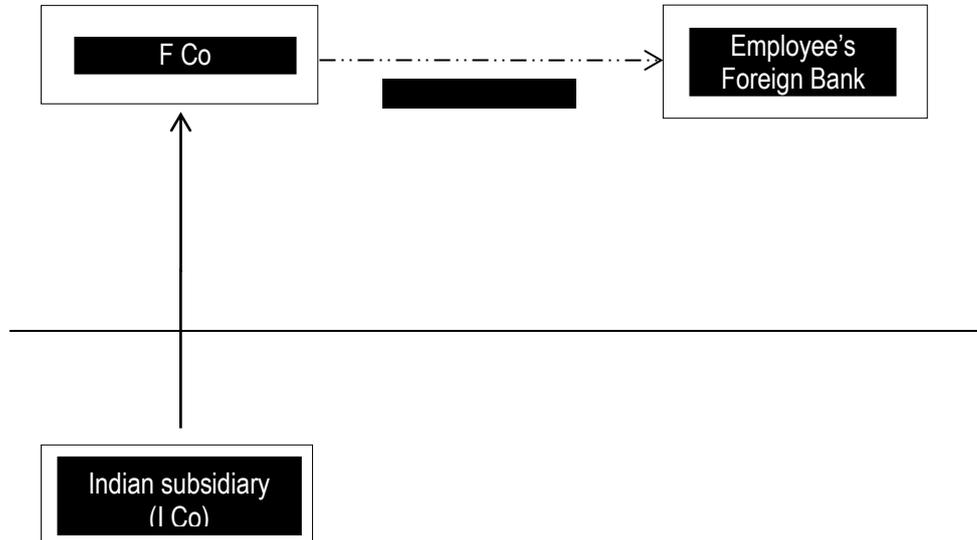
In order to determine whether or not a PE is created due to presence of employees in foreign country one should first determine who is the legal and economic employer of the employee.

The economic employer is the company which receives the benefits from the performance of the employee and essentially bears the responsibility and risks from the work of the employee while the legal employer is the company with which the employee has his working contract signed. If I Co. second an employee abroad but remains his legal and economic employer, then I Co. might create a PE abroad. As a consequence, the profits earned will be assessable to the foreign Corporate Income Tax.

If it can be demonstrated that the seconded employee is not carrying on any activities on behalf of ICo., there should not be a PE risk for I Co. The Supervision, control and responsibility of the employees should be with F Co and adequate documentation such as employment contract with F Co, secondment/ deputation agreement, global deputation policy, etc. should be maintained to support the legal and economic employment with F Co. The principles discussed in case of inbound employees would also apply in this case.

The above are general principles of determining PE exposure, however, PE analysis is required to be done on case to case basis depending on host country tax laws.

3.5.5 Preferable long term outbound secondment arrangement



3.5.5.1 Typical features of above secondment arrangement

- I Co will depute the employee to F Co and will issue a letter to the employee for a long-term secondment
- F Co will enter into an employment agreement with the employee
- F Co will pay the entire salary into the employee's overseas bank account
- Such employee would work under supervision, direction and under the control of F Co

3.5.5.2 Tax implications in the hands of the employee

3.5.5.2.1 Tax implications under the Act

The deputed employees qualifying as NR or RNOR under the Act would not be subject to tax in India as the entire salary will be received and accrued outside India. If the deputed assignee qualifies as ROR, then he would be liable to tax on his worldwide income. Accordingly, he would be taxable on the entire salary. FTC can be claimed in India on doubly taxed income.

3.5.5.2.2 Tax implications under DTAA

If the deputed assignee qualifies as RNOR or NR, then the salary received outside India is not taxable under the Act, hence DTAA need not be examined.

If the deputed assignee qualifies as ROR and is a tax resident of host country under DTAA, then DPS exemption can be claimed and he would not be liable to tax on salary pertaining to services rendered in host country. In case he qualifies as a tax resident of India under DTAA,

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then he would be taxable on entire salary, however, FTC can be claimed on doubly taxed income.

3.5.5.3 Tax implications in the hands of employer i.e., I Co

Since no salary is paid by I Co, it would not be required to withhold any tax in India. However, if the employee qualifies to be ROR then the employee may declare his salary income received from F Co to I Co and accordingly, I Co may withhold taxes on the same.

Annexure A: Residential status of an individual under the Act

Resident and Ordinarily Resident (ROR)

A resident (i.e., an individual who satisfies either of the two basic conditions) is treated as 'ROR' if he satisfies both of the following additional conditions:

- (i) He has been resident in India in at least 2 out of 10 fiscal years (according to the basic conditions noted above) preceding the relevant tax year; and
- (ii) He has been in India for a period of 730 days or more during 7 years preceding the relevant tax year.

In brief it can be said that an individual becomes 'ROR' in India if he satisfies at least one of the basic conditions and both the additional conditions.

Resident but not Ordinarily Resident (RNOR)

An individual who satisfies at least one of the basic conditions, but does not satisfy both of the additional conditions is treated as a 'RNOR'. In other words, an individual becomes 'RNOR' in any of the following circumstances: -

- a) If he satisfies at least one of the basic conditions and none of the additional conditions.
- b) If he satisfies at least one of the basic conditions and only one of the two additional conditions.

Non-Resident (NR)

An individual is non-resident in India if he satisfies none of the basic conditions. In the case of non-resident the additional conditions are not relevant. Hence, a person (being a citizen), leaving India for the first time for the purpose of employment will have the status of 'NR' if his stay in India is not more than 181 days in the relevant tax year.

4. Avoidance of Economic Double Taxation of Dividends

4.1 What is double taxation?

Double taxation refers to a situation where tax is paid more than once on the same stream of income. Typically, there are 2 types of double taxation viz., juridical double taxation and economic double taxation. Juridical double taxation refers to circumstances where a taxpayer is subject to tax on the same income (or capital) in more than one jurisdiction. Economic

double taxation refers to the taxation of two different taxpayers with respect to the same income (or capital).

4.2 What is economic double taxation?

Meaning

As discussed above, economic double taxation refers to the taxation of two different taxpayers with respect to the same income (or capital).

For example, a company earning profits may be paying corporate income tax to the government on its income. Post payment of tax, the company may be distributing some part of its post-tax profits to its shareholders as dividend. The dividend may be taxable in the hands of the shareholders as well.

In the example below, economically, the profits of the company (Refer A in the table below) [on which the company paid tax (Refer B in the table below)] and dividend (Refer D in the table below) [on which the shareholders paid tax (Refer E in the table below)] are the same income, however taxed in the hands of two different taxpayers (i.e., the company and the shareholders respectively).

Particulars	Reference	Company	Shareholder
Profits	A	100	
Less: Corporate tax @ 30%	B	(30)	
Income available for distribution	C = A – B	70	
Income received as dividend	D		70
Less: Tax @ 15%*	E		(10.5)
Post tax Income	F = D – E		59.5

*assuming the tax rate of 15% on distributed profits

Further, the OECD in its Final Report, on Base Erosion and Profit Sharing (BEPS), in Action Plan 3, contains recommendations which constitute necessary elements for CFC Rules. The intention of introducing this Action Plan was not to clamp down on outbound investments but to disincentivize passive entities in low –tax jurisdiction.

The double taxation may occur (unless credit given) on account of CFC rules as these rules treat the undistributed profits of the MNE group’s intermediary holding company located in low or no tax jurisdiction as deemed dividend of parent company and such profits are subject to tax in parent company’s jurisdiction. The profits are then again taxed in the hands of the holding company.

Further, the double taxation of dividends may happen in both domestic as well as cross-border situations. However, in some instances, the tax treaties may also eliminate or reduce the

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international economic double taxation – e.g., by providing a reduced withholding tax rate on inter-company cross-border dividends (see Article 10, paragraph 2, letter a) or by providing the obligatory corresponding adjustment in case of transfer pricing situations (see Article 9).

Effects of economic double taxation

The economic double taxation encourages investors to prefer debt to equity and creates an incentive to retain earnings and avoid dividend payments.

4.3 What is dividend?

In common parlance “dividend” means the post-tax profits distributed by a company to its shareholders.

Apart from that, i.e., dividend paid by a company to its shareholders, section 2(22)(e) of the Act gives the definition of deemed dividend. Hence, under the Act, dividend includes deemed dividend.

4.4 How is dividend taxed in India?

4.4.1 Taxability of dividend in the hands of company on distribution

Prior to 1 April 2020, dividends distributed by an Indian company were exempt in the hands of the recipient. Further, as per section 115BBDA of the Act, dividend in excess of 10 lac per annum received by resident individuals, HUFs and firms were taxable at the rate of 10% of the gross amount of such dividend. Therefore, a foreign company, receiving dividends from its subsidiary in India was not be taxed, though the subsidiary was subject to dividend distribution tax.

With effect from 1 April 2020, following amendments have been made in the Act:

- Dividend distribution tax (DDT) under section 115-O is payable only in respect of the dividends declared, distributed or paid by domestic companies on or before 31 March 2020. With effect from 1 April 2020, dividend income shall be taxable in the hands of recipients i.e., shareholders;
- The exemption available under section 10(34), to recipients of dividend income has been withdrawn
- Section 80M has been reintroduced to provide that where the gross total income of a domestic company includes dividend from another domestic company or a foreign company or a business trust, deduction under this section would be available to the recipient company to the extent of dividends distributed by the recipient company on or before one month prior to the due date of filing of return of that year.

The DDT was introduced with the Finance Bill, 1997, and justified in the Memorandum to the Finance Bill, 2003 as:

“It has been argued that it is easier to collect tax at a single point, i.e., from the company, rather than compel the company to compute the tax deductible in the hands of the

shareholder.”

The taxability of deemed dividend (sec 2(22)(e)) in the hands of recipient has posed serious problem of the collection of the tax liability and has also been the subject matter of extensive litigation. With a view to bringing clarity and certainty in the taxation of deemed dividends, transactions relating to deemed dividend undertaken on or after 1st April 2018 have also been brought within the ambit of DDT but a higher rate of 30% (without grossing up). The intent behind this legislative change is to prevent camouflaging dividend in various ways such as loans and advances.

Pursuant to amendment introduced by Finance Act, 2020 (as above), DDT regime has been abolished and tax on dividend shall now be payable by shareholder instead of company paying the dividend.

4.4.2 Taxability of dividend in the hands of shareholder

4.4.2.1. Dividend received from an Indian company

The dividend received by shareholder from an Indian company (which has suffered dividend distribution tax) is exempt from tax under section 10(34) of the Act. However, with effect from 1 April 2020, exemption u/s 10(34) is withdrawn and tax shall be payable by the shareholder only.

4.4.2.2. Dividend received from a foreign company

(a) In case of shareholder being an Individual

In case where shareholder is an individual, then the dividends received from foreign company will be included in the total income under the head “Income from other sources” and accordingly, will be charged to tax at the rates applicable to the individual.

(b) In case of shareholder being a company

In case where shareholder is an Indian company then the dividend received from a foreign company is taxed in the hands of such Indian company at the normal corporate tax rate applicable to its income.

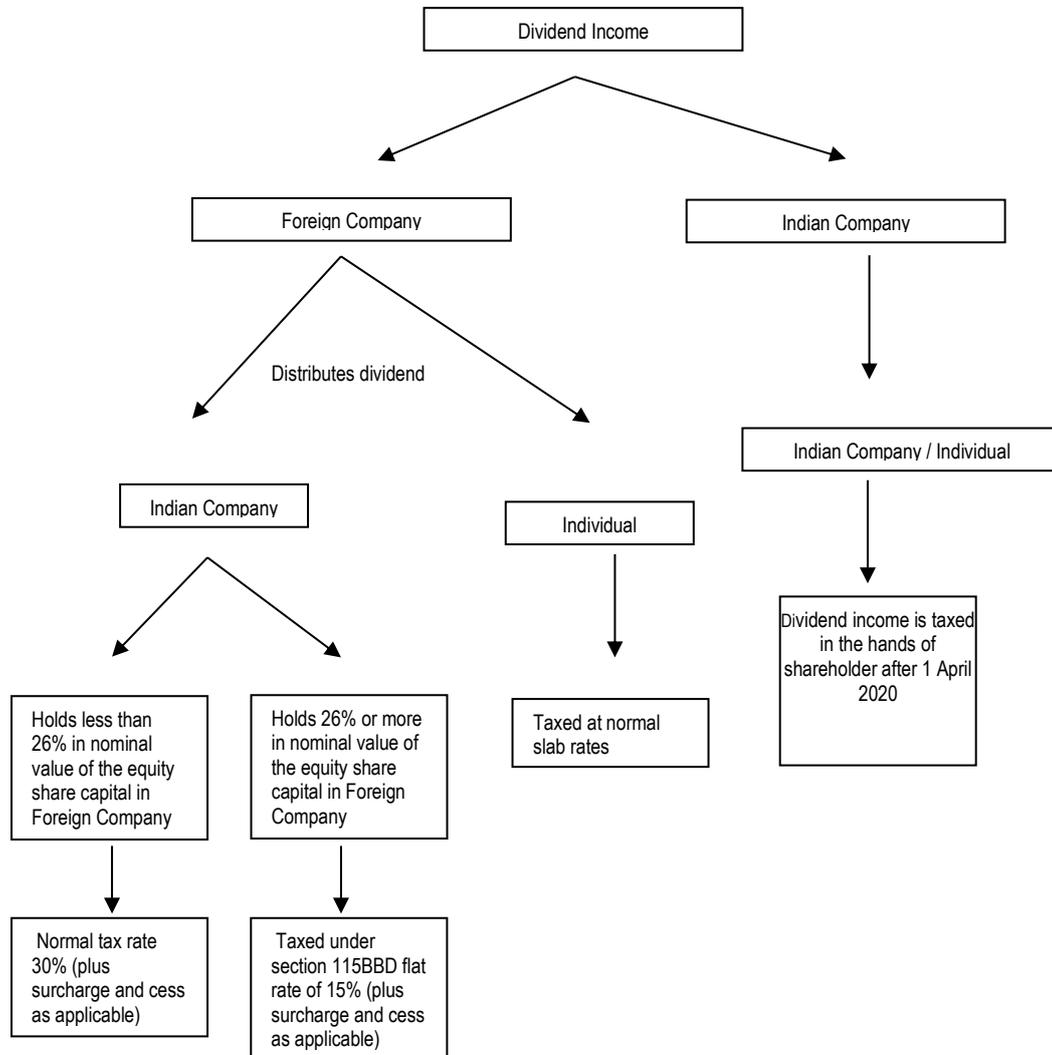
However, section 115BBD provides a concessional rate of tax in respect of dividend received by an Indian company from a foreign company in which the Indian company holds 26% or more in nominal value of the equity share capital.

By virtue of section 115BBD, dividends [as defined in section 2(22) except dividend as defined in section 2(22)(e)] received by an Indian company from a foreign company in which the Indian company holds 26% or more in nominal value of the equity share capital is charged to tax at a flat rate of 15% (plus surcharge and cess as applicable).

It should however be noted that, in the above case no deduction on account of any expenditure or allowance is allowed from the amount of the dividend covered under section 115BBD. In other words, the gross amount of dividend (without deducting any

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expenditure/allowance) will be taxed at the rate of 15% (plus surcharge and cess as applicable).



Pursuant to abolishment of dividend distribution tax under section 115-O of the Act, in order to provide parity in the tax treatment in case of dividends received by Indian companies from specified foreign companies vis a vis dividend received from domestic companies, concessional rate of taxation on dividend income prescribed under section 115BBD of the Act has been withdrawn w.e.f. 01.04.2023 by Finance Act 2022.

4.5 Is double taxation in case of dividends avoided in India?¹⁴

4.5.1 Basic mechanism

The company's profits are taxed without any distinction between distributed and undistributed profits. The after-tax profits are taxed again in the hands of the shareholders (corporate or individual) when paid as dividends. As a result, the same profits are taxed twice; first at corporate level and again when the profit is distributed to the ultimate shareholder.

4.5.2 Reason for introduction of section 10(34)¹⁵

As discussed earlier, section 10(34) is one of the more popular sections of the Income Tax Act, 1961. It is the section which declares that dividends received from a domestic company are exempt from tax.

If the investor is asked to include dividend income as a part of his total individual income for taxation, it would amount to "taxing an already taxed income", or "double taxation".

Thus, dividend income from domestic companies was made exempt from taxation. Hence, section 10(34) was inserted by Finance Act, 2003 to avoid this economic double taxation of dividends in India.

4.5.3 Effects of double taxation due to introduction of section 115-O

The dividend exempt in hands of shareholder by virtue of section 10(34) does not exactly escape double taxation. While it's only fair that a company should be free to distribute its profits after income tax amongst its members, as per the provisions of Section 115-O, it cannot do so unless it has paid an additional tax called the Dividend Distribution Tax (DDT) at the rate of 15 per cent (plus surcharge and cess as applicable) as discussed earlier.¹⁶ Consequently, the net dividend available for distribution is less by the amount of DDT paid.

Further, section 115BBDA was introduced w.e.f. 1.4. 2017. The reason cited for introduction of section 115BBDA was that under the section 10(34), dividend which suffers DDT under section 115-O is exempt in the hands of the shareholder, whereas under section 115-O dividends are taxed only at the rate of fifteen percent at the time of distribution in the hands of company declaring dividends. This creates vertical inequity amongst the taxpayers as those who have high dividend income are subjected to tax only at the rate of 15% whereas such income in their hands would have been chargeable to tax at the rate of 30%. With a view to rationalise the tax treatment provided to income by way of dividend, section 115BBDA provides that any income by way of dividend in excess of Rs. 10 lakh will be chargeable to tax in the case of an individual, Hindu undivided family (HUF) or a firm who is resident in India, at the rate of ten percent. The taxation of dividend income in excess of ten lakh rupees will be on

¹⁴ This question is discussed in the context of erstwhile regime of dividend distribution tax.

¹⁵ Exemption withdrawn in view of abolition of DDT regime

¹⁶ Finance (No.2) Act, 2014 levied dividend distribution tax by grossing up the dividend payable for the purpose of computing liability towards dividend distribution tax.

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gross basis.

4.5.4 Effects of double taxation when Foreign company pays dividend to an Indian investor

The dividend paid by foreign companies is taxable in the hand of the shareholder separately. With the unfortunate existence of DDT (known as just “Dividend Tax” in most countries), the recipients of dividends from foreign companies may undergo a worse fate “triple taxation”.

First, the foreign company pays Income Tax or Revenue Tax on operating profits (Refer B in table below) to the government of its country. Then it again pays Dividend Tax (same as Indian DDT) (Refer D in table below) to its government. Finally, when the investor in India receives his “doubly taxed” dividend, he has to again pay Income Tax (Refer H in table below), as tax received from non-domestic companies is not exempt under the Income Tax Act.

Outside India

Particulars	Reference	Foreign Company
Income	A	100
Less : Corporate tax @ 30% (assumed)	$B = A * 30\%$	(30)
Income available for distribution	$C = A - B$	70
Less: Dividend Tax (DDT in India) @ 15% (assumed)	$D = C * 15\%$	(10.5)
Post tax Income	$F = D - E$	59.5

India

Particulars	Reference	Shareholder/ Investor
Dividends received from Foreign Company	G	59.5
Less : Tax @ 30% (assumed)	$H = G * 30\%$	(18)
Post tax Income	$I = G - H$	41.5

4.5.5 ¹⁷Economic double taxation in an international tax regime

Under international tax regime many countries relieve the economic double taxation on dividends partly or fully by various methods at either the corporate or shareholder level, or at both levels.

Corporate relief system

- *Dividend deduction or credit approach:* The dividend payment is treated as a tax-deductible expense of the paying company.

Alternatively, the tax withheld on the dividend payments is creditable against the

¹⁷ Basic international taxation by Roy Rohatgi (Volume II)

corporate tax payable by the paying company.

- *Split rate method:* The distributed income is taxed at lower rate than retained income. The company is subject to a higher corporate tax and it receives a credit for the tax differential when the dividends are paid. (This system is followed in Germany pre 2001)
- *Dividend exemption system:* The company pays a higher tax on distributed profits due to an additional corporate tax (DDT in case of India) which is payable when the dividends are declared as compared to the retained income which is taxed as per the corporate tax rules in place. There is no withholding tax, and the income is tax-free in the hands of the shareholders. (This system was followed in India subject to variation caused by insertion of section 115BBDA, South Africa)

Particulars	Reference	Company	Shareholder
Income	A	100	
Less : Corporate tax @ 30%	B	(30)	
Income available for distribution	C = A – B	70	
Less: DDT @ 15%*	D	(10.5)	
Distributable profits		59.5	
Dividend income exempt in hands of Shareholder where DDT is paid (subject to section 115BBDA)	E	-	59.5

Shareholder relief systems

- *Imputation or tax credit systems ('dividend relief'):* The company is subject to corporate tax, but relief is granted at the shareholder level. The shareholders receive either:
 - (a) a full imputation credit based on the underlying tax paid by the distributing company; or
 - (b) a partial imputation as a dividend tax credit, regardless of the corporate tax paid

For example:

- (a) Company corporate tax rate - 30%

Individual tax rate – 30%

Investors who receive dividends will be taxed at difference between 30% (company tax rate) and their own marginal tax rate. So, if your individual tax rate is 30% then there will be no tax on the dividends, i.e. the dividend is tax free.

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(b) Company corporate tax rate - 30%

Individual tax rate – 46.5%

Investors who receive dividends will be taxed at difference between 30% (company tax rate) and their own marginal tax rate. So, if your individual tax rate is 46.5%, then dividends will be tax at the rate of 16.5% (ie 46.5% - 30%).

- *Shareholder relief under the classical system ('dividend relief')*: These systems follow the classical system but provide partial or full dividend relief to the shareholder. The dividends received are either-

(a) fully tax-exempt ('dividend exemption'). Under dividend exemption system regime, tax is levied at the corporate level only and there is no tax liability on shareholders (followed in India); or

Most countries have opted the above system.

(b) partial tax-exemption relief ('partial exemption'). Under partial exemption there can be following options-

- Half inclusion system- the system usually grants 50% dividend-received exemption to non-corporate shareholders;
- Flat rate system- This system gives shareholder relief through a reduced dividend tax rate;

4.5.6 Avoidance of double taxation in case of Dividends in international regime

Double taxation Avoidance Agreements ('DTAA') – A brief introduction

In view of avoiding double taxation in case of income earned by a corporate/ non-corporate assessee, India has entered into agreements with various countries know as Double taxation Avoidance Agreements ('DTAA').

A DTAA, also referred to as a Tax Treaty, is a bilateral economic agreement between two nations that aims to avoid or eliminate double taxation of the same income in two countries.

Under the Income Tax Act 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.

Further, the provisions of section 90(2) states that where the Central Government has entered into an agreement with the Government of any country or specified territory outside India for granting relief of tax or avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

Taxation of dividends in DTAA's – Country wise scenarios

Taxation of dividends in OECD model convention is governed by Article 10. As per article 10, dividends paid by a company which is a resident of a Contracting State (say Foreign Company) to a resident of the other Contracting State (say Indian Investor/ Shareholder) may be taxed in that other State (India).

However, such dividends may also be taxed in the Contracting State (Foreign States) of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (Indian Investor/ Shareholder), the tax so charged in the foreign state shall not exceed:

- a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
- b) 15 per cent of the gross amount of the dividends in all other cases.

Usually, foreign dividend income is taxable in India. However, under certain DTAA's negotiated by India with other countries, India does not have the right to tax dividends ('Exemption method'). However, in case the relevant treaty allows India to tax dividend, double taxation is typically eliminated through following tax credit methods (Chapter V "Methods for elimination of double taxation" article 23 of OECD Model tax convention UN Model Convention on Article 23):

- *Foreign Tax Credit ('FTC')* – Credit of taxes withheld on the dividend income as per the relevant tax treaty/ domestic tax law in foreign country.
- *Underlying Tax Credit ('UTC')* – In addition to FTC, taxes paid overseas on the corporate profits of the foreign company, out of which dividends are distributed, may be available for credit in India.

4.5.7 Example of the UTC

Company X is a resident of the UK and owns 60% share capital of Company Y, a resident in India. Tax rate in India is assumed to be 34% and tax rate in the UK is assumed to be 28%. Company X has no other taxable income in the UK.

Sr. No.	Particulars	Foreign company in UK holding 60% of share capital of Company Y (Company X)	Domestic dividend distributing company (Company Y)
A. 1.	Distributing Company level Pre-tax income		10,000
2.	Less : Corporate tax in		3,400

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Sr. No.	Particulars	Foreign company in UK holding 60% of share capital of Company Y (Company X)	Domestic dividend distributing company (Company Y)
	India @ 34%		
3.	Net profit after tax available for distribution to shareholder		6,600
4.	Dividend distributed out of the profit after tax		3,300
B.	Shareholder's level		
5.	Dividend paid to Co. X [3,300 X 60%]	1,980	
6.	Add : Underlying tax paid by Co. Y [1,980 X (34/66)]	1,020	
7.	Gross income of Co. X in UK [1,980 X 100/66)]	3,000	
8.	Tax payable in the UK [3,000 X 28%]	840	
9.	Less : Underlying Tax Credit Lower of i. [3,000-1,980] i.e., 1,020 OR ii. 840	840	
10.	Tax payable in the UK	Nil	

In the above scenario the UK Company was taxed in India on profit distributed (refer 4 above) by the Indian company (in which UK company holds 60% share capital). The credit of the taxes paid in India was given to UK company as the lower of:

- Taxes paid on distributed income as per the rates prevailing in India (i.e., 34%); or
- Taxes to be paid on distributed income as per rates prevailing in UK (i.e., 28%)

From the above, it is evident that the concept of UTC is very important in mitigating the economic double taxation of dividends paid to companies.

Usually, foreign dividend income is taxable in India, India does not have any domestic regulations in respect of UTC. However, India's DTAA's with around ten countries contain the provisions relating to underlying tax credit. The relevant provisions relating to underlying tax credit contained in various articles are given below:

Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
1	Australia	24(l)(b)	Methods of elimination of double taxation	(b) Where a company which is a resident of India and is not a resident of Australia for the purposes of Australian tax pays a dividend to a company which is a resident of Australia and which controls directly or indirectly not less than 10 per cent of the voting power of the first-mentioned company, the credit referred to in sub-paragraph (a) shall include the Indian tax paid by that first-mentioned company in respect of that portion of its profits out of which the dividend is paid.
2	China	23(l)(b)	Methods for the elimination of double taxation	(b) Where the income derived from India is a dividend paid by a company which is a resident of India to a company which is a resident of China and which owns not less than 10 per cent of the shares of the company paying the dividend, the credit shall take into account the tax paid to India by the company paying the dividend in respect of its income.
3	Ireland	23(3)(b) & 23(4)	Elimination of double taxation	(3)(b) In the case of a dividend paid by a company which is a resident of India to a company which is a resident of Ireland and which controls directly or indirectly 25 per cent or more of the voting power in the company paying the dividend, the credit shall take into account (in addition to any Indian tax creditable under the provisions of sub-paragraph (a) Indian tax payable by the

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Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
				<p>company in respect of the profits out of which such dividend is paid.</p> <p>(4) (a) For the purposes of sub-paragraph (b) of paragraph 3, the term 'Indian tax payable' shall be deemed to include 75 per cent of the Indian tax which would have been paid but for any exemption or reduction of tax granted under incentive provisions contained in Indian law designed to promote economic development to the extent that such exemption or reduction is granted for profits from industrial or manufacturing activities, or from the development, maintenance and operation of infrastructure facilities, or from agriculture, fishing or tourism (including restaurants and hotels), provided that such incentive provisions remain in substance unchanged since the date of signature of this Convention and that the activities have been carried out within India.</p> <p>(b) The provisions of sub-paragraph (a) shall cease to apply after twelve years from the date of entry into force of this Convention</p>
4	Japan	23(3)(b)	Double taxation avoidance	<p>(b) Where the income derived from India is a dividend paid by a company which is a resident of India to a company which is a resident of Japan and which owns not less than 25 per cent either of the voting shares of the company paying the dividend, or</p>

Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
				of the total shares issued by that company, the credit shall take into account the Indian tax payable by the company paying the dividend in respect of its income.
5	Malaysia	23(2)	Elimination of double taxation Where such income is a dividend paid by a company which is a resident of India to a company which is a resident of Malaysia and which owns not less than 10 per cent of the voting shares of the company paying the dividend, the credit shall take into account tax paid in India by that company in respect of its income out of which the dividend is paid. The credit shall not, however, exceed that part of the Malaysian tax, as computed before the credit is given, which is attributable to such item of income.
6	Mauritius	23(2)(b)	Elimination of double taxation	(b) In the case of a dividend paid by a company which is a resident of Mauritius to a company which is a resident of India and which owns at least 10 per cent of the shares of the company paying the dividend, the credit shall take into account (in addition to any Mauritius tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Mauritius tax payable by the company in respect of the profits out of which such dividend is paid.

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Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
	-do-	23(4)(b)	Elimination of double taxation	(b) In the case of a dividend paid by a company which is a resident of India to a company which is a resident of Mauritius and which owns at least 10 per cent of the shares of the company paying the dividend, the credit shall take into account (in addition to any Indian Tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Indian tax payable by the company in respect of the profits out of which such dividend is paid.
7	Singapore	25(2)	Avoidance of double taxation Where the income is a dividend paid by a company which is a resident of Singapore to a company which is a resident of India and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid. Such deduction in either case shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Singapore.
	-do-	25(4)	Avoidance of double taxation Where such income is a dividend paid by a company which is a resident of India to a resident of Singapore which owns not less than 25 per cent of the share capital of the

Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
				company paying the dividends, the credit shall take into account Indian tax paid in respect of its profits by the company paying the dividends.
8	Spain	25(3)(b)	Elimination of double taxation	(b) In the case of a dividend paid by a company which is a resident of India to a company which is a resident of Spain and which holds at least 25 per cent of the capital of the company paying the dividend, the deduction shall take into account [in addition to the deduction provided under sub-paragraph (a)] the income-tax paid in India by the company in respect of the profits out of which such dividend is paid provided that such tax is taken into account in calculating the base of the Spanish tax.
9	United Kingdom	24(l)(b)	Elimination of double taxation	(b) In the case of a dividend paid by a company which is a resident of India to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any Indian tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Indian tax payable by the company in respect of the profits out of which such dividend is paid.
10	United States	25(l)(b)	Relief from double taxation	(b) In the case of a United States company owning at least 10 per

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Sr. No	Country	Article of Treaty	Article heading	Text of the relevant portion of the Articles
	of America			cent of the voting stock of a company which is a resident of India and from which the United States company receives dividends, the income-tax paid to India by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

- Tax Sparing Credit ('TSC') – Residence country grants credit for taxes which would have been levied by Source Country had tax exemption not been granted by latter.

X Inc. has established a subsidiary A Ltd. in India. The subsidiary exports 100% of its production and is entitled to sec.10B benefit. A Ltd. earned income of INR 1,00,000 which is exempt u/s 10B. Total profits are distributed as dividend to X Inc.

Particulars	TSC not available	TSC available
Total income earned by A Ltd.	1,00,000	1,00,000
Exempt u/s 10(B) of the Act	1,00,000	1,00,000
Amount distributed as dividend	1,00,000	1,00,000
Withholding tax on dividend @ 10%	10,000	10,000
Credit for withholding tax on dividend available to X Inc.	10,000	10,000
Underlying tax credit	-	-
Tax Sparing (1,00,000 x 30% tax rate in India)	-	30,000
Aggregate tax credit available to X Inc.	10,000	40,000

4.5.8 Effects of double taxation in case of Controlled Foreign Company (CFC) rules

Multinational groups can create non-resident affiliates in low tax jurisdictions to which income is shifted, wholly or partly for tax reasons rather than for non-tax business reasons. Such overseas profits are not subjected to tax in the hands of shareholders unless distributed/repatriated to them. Thus, tax on this income is avoided until the tax haven country pays a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

The CFC rules are intended to tax these undistributed incomes as dividends in the hands of

the shareholders. The double taxation may occur on account of CFC rules as these rules treat the undistributed profits of the MNE group's intermediary holding company located in low or no tax jurisdiction as deemed dividend of parent company and such profits are subject to tax in parent company's jurisdiction. The profits are then again taxed in the hands of holding company.

Under CFC rules, certain situations could lead to double taxation which needs to be eliminated by granting credit or exemption. For instance, dividends received on actual distribution or gains on disposition of CFC shares should be exempted if the corresponding income has previously been subject to CFC taxation.

Further, the OECD in its Final Report on Base Erosion and Profit Sharing (BEPS), in Action Plan 3, contains recommendations which constitute necessary elements for CFC Rules. The intention of introducing this Action Plan was not to clamp down on outbound investments but to disincentivize passive entities in low-tax jurisdiction.

For detailed discussion please refer to the Unit III of Module F.

5. Tax Consolidation Rules (“Group Taxation”)

5.1 Introduction¹⁸

Earlier corporate structures involved only two levels: individual shareholders and their company. This was the time when the separate entity doctrine under which a company is treated as a separate entity was developed.

The rise of corporate groups in the last century has seriously challenged the traditional separate entity doctrine under which companies are treated as separate taxpayers. Generally, a corporate group under a common control of parent company often operates as a single economic enterprise. In practice, senior management of a corporate group often focus on the group as a whole instead of on individual companies. This raises the question whether the law should recognise the commercial reality and extend the rights and duties of a company within a group to reflect the activities of other group members.

The modern commercial world dictates a change of paradigm with respect to the treatment of corporate groups. Instead of universal adoption of the separate entity principle, a growing number of areas in taxation law are being supplemented by the enterprise doctrine. The enterprise doctrine focuses on the business enterprise as a whole, instead of the fragmented components. Under this doctrine, the economic substance overrides the legal form of individual companies that make up the corporate groups.

Tax legislations have introduced regimes which to a great extent apply the enterprise doctrine, under which a corporate group is treated as a single taxpayer and files a single consolidated

¹⁸ The Taxation of Corporate Groups under Consolidation by Dr Antony Ting (<http://www.cambridge.org/catalogue/catalogue.asp?isbn=9781107033498&ss=exc>)

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return.

Consolidated tax regime refers to an integrated system wherein a group of entities have an option of adhering to compliances being a group as a whole instead of separate entities. This has a basic application of nullifying the inter-company transactions and tax is paid by the group as one entity. This can be attractive to taxpayers because it gives them flexibility to organize their business activities and engage in internal restructurings and asset transfers without having to worry about triggering a net tax.

In jurisdictions where the consolidated tax regime is operational, the group of entities has to file a single consolidated tax return.

5.2 Advantages of consolidated returns¹⁹

The advantages of filing a consolidated income tax return include the following:

1. Unused losses (both ordinary and capital) and credits of an affiliate may be used to offset the income and tax liability of other affiliated group members in the current year. By utilizing these losses and credits in the current year, the group receives immediate tax benefits and thereby avoids the need for carryovers to recover the benefits.
2. Intercompany profits on the sale of property and services may be deferred until they are actually recognised when they are sold outside third parties.
3. Intercompany dividends between group members are eliminated from income and are not subject to tax. Deductions and credits that are subject to percentage limitations can be determined on a consolidated rather than on a separate company basis.

5.3 Disadvantages of consolidated returns²⁰

Some of the more important disadvantages of filing a consolidated return include the following:

1. Electing to file consolidated returns requires compliance with the consolidated return regulations. This could create additional costs and administrative burdens.
2. The consolidated return election could be binding for future years. This election can only be terminated in future by disbanding the affiliated group or by obtaining permission from the competent authorities of the country to file separate returns.
3. Separate return credits and capital losses can be limited by operating losses and capital losses from other members of the group. Thus, the credit and loss carryovers may expire unused due to heavy losses by an affiliated member.
4. A subsidiary member is required to change its tax year to the same year as that of the common parent corporation. This can create a short tax year that is considered a complete tax year for purposes of carrybacks or carryovers in the case of unused

¹⁹<http://gotosp.com/demo/intro.pdf>

²⁰ <http://gotosp.com/demo/intro.pdf>

losses and credits.

5. The rights of minority shareholders must be respected both legally and ethically. As a result, the presence of minority shareholders may create situations that may have adverse effects for the affiliated group.

5.4 Possible application of consolidation of tax

The enterprise doctrine can be applied in following ways:

1. Consolidation at country level– In this case, the tax base is defined as sum of the taxable income and losses of the group members that are resident to one country. The taxable income and losses are calculated according to the tax law of the country.
2. Consolidation at bloc or worldwide level - In this case, the tax base is defined as sum of the taxable incomes and losses of the group members that are resident to bloc or worldwide. For example – European commission council directive on Common Consolidated Corporate Tax Base ('CCCTB') which consolidates incomes of all the group companies resident in the member states of European Union.

Most national tax systems do not provide for cross-border tax consolidation. The CCCTB system aims to achieve the same result as national tax consolidation in an international context.

In case of cross border consolidation, once the income is consolidated, there are varieties of methods to allocate the taxable income. For example: a simple method is to allocate the group's tax base according to the group's overall profit margin on the costs incurred in the country. Some have suggested value added in each country. Some have discussed using other macro factors such as size of a country's economy.

Nevertheless, the formulary apportionment method has occupied the center stage in the debates on the allocation of profits of multinational corporate groups for many decades. Under formulary apportionment method, a group's tax base is allocated to a country according to predetermined formula. The formula is typically based on the weighted average of geographically specific apportionment factors, such as payroll, assets and sales. The formulary appointment method may be applied either unilaterally by a country, or multilaterally among a group of countries.

5.5 Key structural elements²¹

As a particular form of group taxation regime, consolidation regimes require the articulation of the following key structural elements:

- Application of the single entity concept;
- Definition of an eligible corporate group and mandatory versus elective application of the regime;

²¹ The Unthinkable Policy Option- Key Design Issues Under a System of Full Consolidation by Antony Ting

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- Consolidation of group results;
- Treatment of pre-consolidation losses;
- Treatment of group losses on exit;
- Treatment of assets on entry, during consolidation, and on exit.

These structural elements are discussed below in detail:

5.5.1 The single entity concept

The consolidation regimes generally treat corporate groups as single entity; however, based on the various existing regimes, there appear to be three different applications of the concept: (1) pooling, (2) attribution, and (3) absorption.

(a) Pooling

The parent company and its subsidiaries in a consolidated group are treated, to a large extent, as separate entities for income tax purposes, with the taxable income or loss of each group member being computed on an individual basis. The separate entity results are then aggregated at the group level, often adjusted for intragroup transactions, to arrive at consolidated taxable income or loss.

The major advantage of this approach is its simplicity. Most of the existing tax rules for companies are founded on the traditional separate entity doctrine, according to which each company is treated as a separate taxpayer. Each subsidiary prepares its tax computation on a stand-alone basis before aggregation at the group level. Taxability and deductibility of various items are generally determined as if the subsidiary were a stand-alone unconsolidated company.

The rules can therefore be applied comfortably to consolidated group members under a pooling system that, for the most part, preserves this separate entity treatment.

A related policy issue with respect to the pooling system is whether the individual tax computations of a consolidated group member should be prepared on a stand-alone or a group basis. For example, an expenditure of a subsidiary may be regarded as capital in nature on a stand-alone basis and thus not deductible. However, if the item is examined on a group basis, so that facts and circumstances of other group members are taken into consideration, the expenditure may be judged to have a revenue character and thus be currently deductible.

(b) Attribution

Assets, liabilities, and activities of consolidated subsidiaries are attributed to the parent company. In other words, income and expenses of the subsidiaries are deemed to be those of the parent company, thus achieving the aggregation of taxable income and losses of the group members. One important feature of this option is that the subsidiaries continue to be treated as separate entities for income tax purposes, an approach that has proved to be especially important in the application of tax treaties

(c) Absorption

Under this single entity concept, consolidated subsidiaries are deemed to have become divisions of the parent company and to have ceased to exist as individual companies for income tax purposes. As a result, unlike the treatment in above approach, intragroup asset transfers within a consolidated group are completely ignored. The transfers not only have no immediate tax implications, but also do not require the parties to trace asset movements, keep a record of any deferred gain or loss, or recapture the gain or loss when either the transferor or the transferee leaves the group.

5.5.2. Definition of an eligible corporate group and mandatory versus elective application of the regime;

Consolidation regimes tend to be restricted to resident companies under common control. The restriction to resident companies reflects the political reality that extending general residence taxing rights to non-resident companies is problematic. Extending consolidation to non-resident entities also raises revenue and anti-avoidance concerns. Therefore, consolidation, in general, is restricted to resident company groups under common control. Unincorporated entities are, in general, excluded from consolidation.

Most countries specifically exclude certain entities from consolidation. Besides non-residents, the most common exclusion is for companies that are not subject to the normal corporate income tax rates—for example, those subject to a reduced tax rate or exempt from tax. Companies in bankruptcy and liquidation are also often excluded from a consolidated group

Common Control

In practice, it is not easy to provide a simple and effective definition of common control. A bright-line definition for example, specification of a minimum percentage of voting rights—may be simple, but may not be effective. Control can be established by various means, such as options and convertible securities, control over the composition of the board of directors or key executives, or special shareholders' agreements. Most countries adopt a bright-line option based on share ownership, but protect it from abuse with supplementary tests or anti-avoidance provisions.

5.5.3 Consolidation of group results

The most common approach for computing consolidated taxable income is to compute taxable income of each member as if no consolidated return were filed, with the exception of certain items computed on a consolidated basis. Then adjustments are made for certain transactions between group members like dividends between group members are eliminated. Intercompany gain or losses on such transactions are excluded from consolidated income until a later event triggers recognition. For example, Member A sells Member B some goods at a profit. This profit is not recognized until Member B sells the goods outside the group. These complex rules require adjustments related to intra-group sales of property (including depreciable assets and

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inventory), transactions in stock or other obligations of members, performance of services, entry and exit of members, and certain back-to-back and avoidance transactions.

Tax liability for the consolidated group is determined by applying the rates as provided in the regulations to the consolidated taxable income of the group. Tax liability is reduced by consolidated credits attributable to members of the group.

5.5.4 Treatment of Pre-consolidation Losses

On entry of a company into a consolidated group, the treatment of pre-consolidation losses incurred by the company must be determined. There could be three alternative treatments of such losses: (1) quarantine, (2) transfer to the parent, and (3) cancellation.

(a) Quarantine

Under the quarantine approach, pre-consolidation losses incurred by a joining subsidiary are quarantined and are available for offset only against profits generated by that subsidiary. The policy rationale for quarantine is that since the pre-consolidation losses were incurred when the subsidiary was treated as a separate taxpayer, those losses should remain with the subsidiary and be available only for offset against its future taxable income. A prerequisite for this policy is that the subsidiary maintains its separate identity for income tax purposes during consolidation.

(b) Transfer to the Parent

Under the second of the three alternative treatments, pre-consolidation losses of a subsidiary are transferred to the parent company upon consolidation. The policy is premised on a strong single entity concept, under which subsidiaries are deemed to have ceased to exist as separate entities for income tax purposes. When their pre-consolidation losses are transferred to the parent company, they are available for offset against the consolidated group's taxable income.

(c) Cancellation

Under this approach, pre-consolidation losses of a subsidiary are cancelled upon entry into a consolidated group. This harsh policy is driven primarily by tax-avoidance concerns.

The cancellation approach is simple, avoiding the need for complex rules to control the use of pre-consolidation losses. However, this approach has been a major disincentive to consolidation for corporate groups that would qualify to elect consolidated treatment.

5.5.5 Treatment of group losses on exit

The most significant advantage of consolidation is the ability to offset taxable income and losses among consolidated group members. However, the treatment of group losses on exit (that is, when a subsidiary leaves a consolidated group) is more varied among the various regimes. There are two main approaches to this design issue: (1) stay with the group and (2) apportionment.

Under the stay with the group approach, group losses stay with the consolidated group even if

a leaving subsidiary has contributed to those losses. This option is simple to operate since there is no need for complex allocation rules to apportion the consolidated group losses to a leaving subsidiary.

Under second approach, a group's consolidated losses are allocated to a leaving subsidiary. This option requires complex allocation rules to apportion the consolidated group's losses to the leaving subsidiary.

5.5.6 Treatment of Assets

On Entry

There appears to be two alternative approaches to the treatment of assets (other than intragroup shares) on entry 1) rollover treatment and 2) mark-to-market treatment

Under the rollover approach, pre-consolidation tax attributes are rolled over to the consolidated group, and assets of a joining subsidiary are treated as owned by the consolidated group at the original cost bases. The whole amount of gain or loss on disposal, including the amount attributable to the pre-consolidation period is attributed to the group.

Under the mark-to-market approach, assets are deemed to have been passed to the consolidated group at their respective market values. Unrealized gains or losses on assets owned by a subsidiary before entry are recognized immediately on entry.

During Consolidation:

Under the single entity concept, an intragroup asset transfer during consolidation should have no immediate tax consequences for the group. That is, the transfer should be treated as if it were a transfer between divisions of a company.

Another, most common approach (ie. rollover treatment) would be to defer any gain or loss on intragroup asset transfers and the deferred gain or loss is, in general, recaptured when either the transferor or the transferee leaves the consolidated group.

On exit:

On the exit of a company from a consolidated group, policy makers must decide how to treat the assets and associated tax attributes that go with the leaving subsidiary. To some extent, the approach to the treatment of assets on exit is dictated by the treatment of intragroup asset transfers during consolidation.

Where a country adopts rollover treatment for intragroup asset transfers, the deferred gain is, in general, recaptured when either the transferor or the transferee leaves the consolidated group. Alternatively, a leaving subsidiary inherits the cost bases of assets that it takes away from the consolidated group. No immediate taxation arises on exit.

5.6 Group taxation regime

The specific rules differ from country to country as to the eligibility and stock ownership requirements of forming a tax group, the items to be included in the income and expenses,

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apportionment of the taxes, etc. Often the rules are further complicated by the fact that members of a group are treated as a single entity for many purposes, but as separate entities for other purposes.

This section provides high level provisions of the group taxation regimes in European Union.

EUROPEAN UNION²²

*Common Consolidated Corporate Tax Base specifically for countries within European Union
(Please note that this section is not exhaustive and based on secondary sources)*

5.6.1 Introduction

On 16 March 2011, the European Commission published its proposal for a Common Consolidated Corporate Tax Base (CCCTB). In June 2015, the Commission presented a strategy to re-launch the CCCTB. The CCCTB aims at a far-reaching harmonization of the corporate tax base and full consolidation of group profits across the EU while leaving tax rates at the discretion of Member States. This is that "[a] system allowing companies to treat the Union as a single market for the purpose of corporate tax would facilitate cross-border activity for companies resident in the Union and would promote the objective of making the Union a more competitive location for investments internationally". Under the CCCTB, the consolidated profit would be shared according to a formula which takes into account the location of a multinational enterprise's assets, workforce and sales.

5.6.2 Basic Features of the CCCTB

The Commission identified high compliance costs, double taxation, transfer pricing complications, limits on cross-border loss relief, and tax charges on cross-border business restructurings as major impediments to the internal market. The CCCTB has been conceived by the Commission as a comprehensive solution which would do away with all these tax obstacles in a single stroke. Four basic features of the CCCTB is briefly outlined: 1) Eligibility criteria 2) Consolidation of income and 3) Apportionment of consolidated tax base 4) Term

5.6.3 Eligibility criteria

The CCCTB would provide European groups of companies with an instrument for the cross-border consolidation of profits and losses. With regard to entities eligible for consolidation, an immediate or lower-tier subsidiary qualifies for group membership and consolidation if a threshold with regard to control and ownership is met. Further, not only companies but also permanent establishments may be part of a CCCTB group.

The parent company must hold more than 50% of the voting rights and must own more than 75% of the subsidiary's capital or must be entitled to more than 75% of its profits. With regard to lower tier subsidiaries, a holding of more than 50% of the voting rights is deemed to be a holding of 100%.

The territorial scope of consolidation is limited to the European Union. Only EU companies

²²http://online.ibfd.org/kbase/#topic=doc&url=/collections/wtj/html/wtj_2012_02_int_2.html

and permanent establishments may be part of a CCCTB group. However, companies which are tax resident in third countries may form a CCCTB group with regard to their qualifying subsidiaries and permanent establishments located in the European Union. The right to opt for the CCCTB lies with the ultimate parent company of the group if it is tax resident in the European Union, otherwise with one of its EU resident subsidiaries or permanent establishments. If the group opts for the CCCTB, all qualifying subsidiaries and permanent establishments are automatically included in the group and the consolidation extends to the entire tax base of all group members irrespective of minority shareholdings.

5.6.4 Consolidation of income

The backbone and mainstay of the CCCTB project is a harmonization of the corporate income tax base. If the CCCTB were adopted, a European company would only have to deal with one set of rules in order to calculate its profit for tax purposes – instead of having to comply with different sets of rules as at current. According to article 10 of the CCCTB draft directive (CCCTB-D), the “tax base shall be calculated as revenues less exempt revenues, deductible expenses and other deductible items”. The CCCTB-D has in detail explained the items which are considered as exempt revenues, deductible and non-deductible expenses.

5.6.5 Apportionment of consolidated tax base

The CCCTB applies in an international context where the situation is different because group members may be located in different countries subject to different national tax rates. The question then arises as to how the consolidated tax base between the competing tax jurisdictions should be distributed. The Directive does this by apportioning the tax base between the members of the group—and thus indirectly between the respective Member States, based on the ‘formulary apportionment’ approach.

The CCCTB formula consists of three equally weighted factors: “labour”, “assets”, and “sales”. The formula would share the consolidated group profit among the entities belonging to the multinational enterprise in question. Every Member State would be entitled to tax the profit share of “its” group companies and permanent establishments according to the applicable national tax rate. This means that, as with the arm’s length standard, formulary apportionment under the CCCTB would serve a double function: it would allocate a share of the consolidated profit to each group entity and at the same time allocate taxing rights to the Member States involved.

The formula is as under:

$$\text{Share A} = [1/3 * \text{Sales A} / \text{Sales Group}] + 1/3[1/2 * \text{Payroll A} / \text{Payroll Group} + 1/2 * \text{No. of Employees A} / \text{No of Employees Group}] + 1/3 * \text{Assets A} / \text{Assets Group} * \text{Consolidated Tax Base}$$

5.6.6 Term

A European company would be free to decide to calculate its profit for tax purposes according to the rules of the CCCTB or to continue to apply national tax rules. If the CCCTB is chosen, it is binding for 5 years as per Article 105 of the CCCTB-D and is thereafter prolonged

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automatically for a further 3 years unless timely notice of termination is given to the competent tax authority.

5.7 Conclusion

The application of enterprise doctrine in real world is subject to many constraints including the different political jurisdiction and economic enterprises, traditional single entity doctrine which is traditionally embedded in income tax law, etc. It has been observed that it is difficult to establish an exact family tree of the group taxation regimes around the world.

Nevertheless, Consolidation has become common considering the need of the hour. The introduction of a consolidated regime is often a major tax reform of the income tax system. International trend shows that number of countries have adopted consolidation regimes. **Though there is no consolidation regime in India, many other countries like Netherlands, France, Australia, South Korea, etc. have introduced consolidation regimes in their countries.**

Conclusion

Any cross-border tax structuring strategy cannot be divorced from business or commercial rationale. Also, each step in the transaction needs to be backed by such rationale, as tax authorities may challenge and disregard/re-characterize a particular step in the transaction by alleging lack of substance.

When a particular transaction can be structured in more than one manner and commercial/business rationale can be demonstrated for all the options then the taxpayer may opt any one option which is most tax efficient.

Tax authorities around the world are challenging the transactions which lack substance but are only undertaken only to avail tax benefits. Hence, taxpayer needs to maintain adequate documentation to demonstrate satisfaction of substance requirements and business rationale behind undertaking a transaction.

Strategies given in this chapter are only to increase awareness among future/current tax practitioners about the industry practices and should not serve as guidance in any manner. A particular strategy may only be explored if it complements business arrangement/transaction and is backed by substance.

Module F

Anti-Avoidance Measures*

Unit-I	Judicial Anti-Avoidance Doctrines
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1.1 Introduction

Tax avoidance can be called an art not to pay taxes without breaching any tax law and not reducing a tax burden. Tax avoidance is the practice of avoiding taxes through a simulated chain of transactions in consequence of which a tax payer gets tax benefit.

There is always a war between the revenue and its people to characterize their efforts for minimization of its tax liability as either tax avoidance or as tax evasions. Tax evasions are per se prohibited. To reduce tax avoidance techniques, various methods have been developed by various countries across the globe depending upon their requirement. Such measures in general are called “Anti-Avoidance measures”.

Tax avoidance measures could be divided into general anti-avoidance rules (GAAR) and specific anti-avoidance rules (SAAR). GAAR are used when facing tax avoidance methods that are not regulated by SAAR.

1.2 Need and Purpose for introduction of Anti-Tax Avoidance Measures

Internationally and in India, a constant debate has been raging over the issue of tax avoidance. Over the years, the terms “tax avoidance” and “tax evasion” are used without much distinction. The question whether it is a legitimate tax planning or an act of tax avoidance has occupied the minds of all the stake holders the world over, since early twentieth century, and no definitive answer has been found till date, when we are in the twenty first century. Therefore, to better understand the purpose of introducing Anti-Tax Avoidance measures, it is necessary to be familiar with the concept of and distinction between Tax Evasion, Tax Avoidance and Tax Planning.

OECD defines Tax Evasion as “illegal arrangements where liability to tax is hidden or ignored, i.e., taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities”. It is unlawful escaping of tax liabilities¹ e.g., if a taxpayer claims deduction under section 80C of the Act without making actual investment in eligible

*Major Source of reference for creating this background material have been obtained from books of Shri Roy Rohatgi's Basic International Taxation (Volume I & II).

¹Royal Commission on Taxation of Profits and Income, UK, 1955

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investments.

OECD defines Tax Planning as “an arrangement of person’s business and or private affairs in order to minimize tax liability.” It can be achieved through movement or non-movement of persons, transactions, or funds or other activities that are intended by legislation. It refers to tax mitigation by the use of tax preferences given under the law or by means that the tax law did not intend to tax.

Tax avoidance means arranging affairs where the main object or purpose or one of the main objects or purposes of the arrangements are to obtain tax advantages, such arrangements being entered into whilst fully intending to comply with the law in all respects. Justice Reddy² defines Tax Avoidance as an “art of dodging tax without breaking the law”. OECD defines it as an arrangement of a taxpayer’s affairs that is intended to reduce his liability and that although the arrangement could be strictly legal is usually in contradiction with the intent of the law it purports to follow”. The Carter Commission Report states that tax avoidance is “every attempt by legal means to reduce tax liability which would otherwise be incurred by taking advantage of some provisions or lack of provisions in the law”³ e.g., where investments are routed through a favorable tax treaty country with India, only with an intent to claim the favorable tax regime under such tax treaty.

There is always a thin line between acceptable tax avoidance, also known as tax planning and unacceptable tax avoidance. A distinction has also to be made between tax avoidance and tax evasions; the former is legal whereas the latter is illegal.

It is stated that tax avoidance is a situation when a tax payer reduces a tax basis simulating one or some actions, which officially fulfill the requirements of tax laws. As a consequence, the tax payer gets a tax benefit. These actions usually are fixated in accountancy not falsifying them. Tax evasion is a situation when a taxpayer transacts contradictory to tax laws generally unfixating real transactions revenue in accountancy. Amongst others there are four basic tax avoidance techniques prevailing in world:

- Deferment of tax liability
- Re-characterization of an item of income or expenses to tax at a lower or nil rate
- Permanent elimination of tax liability
- Shifting of income from a high-taxed to a lower-taxed person / jurisdiction

These techniques are carried out by using following methods:

- Treaty Shopping- use of favorable tax treaties
- Creation of artificial intermediary companies in nil/lower tax jurisdiction for utilization of passive funds without bringing them to home country

²McDowell v. Commercial Tax Officer, (1985), 154 ITR 148 (Supreme Court of India)

³Royal Commission on Taxation (Carter Commission), 1966, Canada

- Excessive use of debt over equity
- Manipulation of Transfer Pricing provisions & methodology
- Use of tax havens
- Transfer of residence

All the above tax avoidance techniques take advantage of inconsistencies and discontinuities in the tax systems through various tax arbitrage techniques. Anti-Avoidance has been introduced in the tax statute or developed by Judiciary over a period of time to curb the practice of tax avoidance.

1.3 Judicial Anti-Avoidance Doctrines

History of judicial anti avoidance could be found in the decisions rendered in US and English cases, which have been relied upon extensively by the Indian Judiciary, from time to time. The two guiding principles⁴ in judicial anti-avoidance doctrines are:

1. Business Purpose Rule (motive test)
2. Substance over form Rule (artificiality test)
3. Other Civil Doctrine

1.3.1 Business Purpose Rule

The “business purpose rule” says that a transaction must serve or test a business purpose. It requires justification of a transaction from commercial point of view, other than serving a purpose of tax avoidance. Mere tax advantage cannot be the sole or main business purpose. U.S. Supreme Court in the landmark decision Gregory v. Helvering⁵ held that existence of a corporate organization under the law solely for tax purposes did not qualify for tax benefits. Business purpose test is not seldom defined in the statutes and Courts have taken a common-sense view. While issuing a general anti-avoidance Regulation, Indian Parliament has tried to define the business purpose test objectively which we will discuss under GAAR Chapter.

1.3.2 Substance over form Rule

The principle “substance over form” is wider in scope than business purpose rule. 1987 OECD report defines it as “the prevalence of economic or social reality over the literal wording of legal provisions. Although substance test is being used very frequently, the true meaning of this test has remained unraveled. Though various countries have tried to define it by introducing GAAR provision or similar provision, it is rather impossible to codify it in its complete form as it being a very fact specific exercise. There are various faces of “substance v. form” as listed below:

⁴Fredrik Zimmer, Form and Substance in Tax Law (IFA Cahiers, Vol 87A, General Report 2002)

⁵Gregory v. Helvering, 69 F.2d 809 (2nd Cir.1934)

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- Legal v. Economic Substance
- Sham transactions
- Label Doctrine (“wrong characterization”)
- Step-transactions doctrine
- Piercing the Corporate Veil

(a) *Legal V. Economic Substance*

This applies to situations where due to the legal form used for the transactions a taxpayer has the real economic power over taxable income without the tax liability.

The most frequently quoted ruling on this subject confirming that tax avoidance is acceptable and legal comes from the court case of IRC vs. Duke of Westminster⁶. In this case Duke of Westminster entered into an agreement by which he stopped paying a non-deductible wage to his gardener and instead drew up a covenant agreeing to pay an equivalent amount, which if correctly characterized as annuities, would be tax deductible. The gardener still received the same amount in wages but the Duke gained a tax benefit because under the then applicable law, the covenant resulted in reduction of the Duke’s liability to surtax. When the case came before the House of Lords, the Judge, Lord Tomlin, stated:

“Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”

This principle at the heart of the “tax evasion- tax avoidance” impasse, also called the Westminster principle, was a landmark decision which provided legitimacy to tax planning, even if its sole motive was to save tax. In substance, this judgment indicated that legal form would govern the tax consequences and that the taxpayer could arrange his affairs for tax savings. The doctrine set forth in this case has been relied upon in a number of cases and has been the base of various decisions on questions whether the transactions fall within the four corners of “tax planning” or in the realm of “tax avoidance”.

Another important case regarding economic substance is Aiken Industries v. Commissioner⁷. In this case Mechanical Products Inc. (Aiken’s predecessor) raised debt from an Ecuadorian corporation and issued promissory notes; the Ecuadorian corporation then exchanged these promissory notes for new promissory notes issued by

⁶Duke of Westminster v. Commissioner of Inland Revenue, [1936] 1 A.C.19 (H.L.) (U.K.)

⁷Aiken Industries v. Commissioner, 56 T.C.925 (1971) (U.K.)

Industrias, a Honduran company. Aiken repaid the debt and interest to Industrias, which in turn repaid its debt along with interest to the Ecuadorian corporation. Revenue contended that the entire structure was devised solely to avoid tax since interest payments to Industrias would not be eligible to tax withholding under US-Honduras Treaty (DTAA). The Court agreed with Revenue and held that Aiken, the successor of Mechanical Products, was liable for withholding taxes on interest paid.

Other interesting judgment relating to economic substance is Northern Indiana Public Service Company v. Commissioner⁸ [hereinafter “Northern Indiana Public Service Company”]. The short summary is as follows. Northern Indiana USA intended to raise debt in Europe where interest rates are relatively lower; for this a subsidiary was set up in Netherlands to borrow from European bond holders. The terms and two notes were different and there was a small spread at the Dutch subsidiary level. Revenue contended that Dutch subsidiary was set up to avoid tax. The Court disagreed with Revenue saying financing was not with related parties and Dutch subsidiary had profit motive from the start.

(b) *Sham Transactions*

In a sham transaction, they (the ‘tax avoiders’) give effect to a transaction, which they do not carry out, or do not intend to carry out or is a cover up for another transaction or relationship. A sham transaction essentially conceals the true nature or reality of a transaction that exists in form only. In short, the legal form is retained but the underlying substance is not genuine in law.

A landmark judgment regarding sham transactions is the Knetsch case⁹. In this case, the taxpayer borrowed money at 3.5% to make a return of 2.5% from an investment in annuity issued by insurance company. Investment income was taxed at lower capital gains rate and the interest payments were fully deductible for tax purposes. The US Supreme Court treated the transaction as a sham and disallowed the interest paid on the loan. It was held that there was “nothing of substance to be realized beyond a tax deduction.”

(c) *Doctrine of the Label (“wrong characterization”)*

In this method, parties use incorrect labels to classify or characterize a transaction or relationship for tax purposes. A relevant case in this regard is the Ridge Securities case¹⁰ where the Court rejected a loan with interest at over 400% per annum as a loan transaction. In Council of India case¹¹ the Court rejected a purchase consideration

⁸Northern Indiana Public Service Co. v. Commissioner, 105 T.C.341 (1991)

⁹Knetsch v. United States, 364 U.S.361 (1960)

¹⁰Ridge Securities v. IRC, (1962) 44 T.C.373 (Ch.D)(U.K.)

¹¹ Council of India v. Sockie, T.C.618 (UK)

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described as an annuity payable over 47 years. In the Vestey case¹⁸ the taxpayer had agreed to sell his shares at a consideration payable over 125 yearly installments and treated the entire price as a capital receipt.

(d) *Step-transaction doctrine*

Certain countries (like USA, UK, Japan and Canada) regard a series of connected transactions as a single transaction under the “substance v. form” principle. In a “step transaction”, the intermediate steps in a chain of preordained, even if bona fide, transactions may be disregarded and several related transactions may be treated as a single composite transaction. Alternatively, a single transaction may be broken into distinct steps too to determine its tax acceptance.

An important case law in step-transaction is the W.T. Ramsay case¹² where the taxpayer made a large capital gain on the sale of a farm. To offset this, he entered into a series of separate share and loan transactions which generated both a non-taxable gain and fully allowable loss. The multi-step transactions as a whole were circular and self-cancelling. The taxpayer hence began and ended in the same financial position and still claimed a tax loss. The House of Lords disallowed the loss as fiscal nullity since the taxpayer had made no real financial loss and thereby established the “Ramsay doctrine” (doctrine of fiscal nullity). While delivering the judgment, Lord Wilberforce observed as under:

“Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of Inland Revenue Commissioners vs. Duke of Westminster [1936] A.C.1. This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded. For this there is authority in the law relating to income tax and capital gain tax: see Chinn vs. Hochstrasser [1981] A.C.533 and Inland Revenue Commissioners V. Plummer [1980] A.C.896.”

The true principle of the decision in Ramsay was that the fiscal consequence of a preordained series of transactions is generally to be ascertained by considering the

¹²W.T.Ramsay Limited v. Inland Revenue Commissioner, (1981), 54 T.C.101 (H.L)(U.K.)

result of the series as a whole and not by dissecting the scheme and considering each transaction separately. The “Ramsay principle” quickly became one of the Inland Revenue’s favorite arms against tax avoidance schemes and they saw it as approval of the Court to disregard steps inserted into transactions purely for tax purposes. Also in *I.R.C. Vs. Burmah Shell Co. Ltd*¹³ and *Furniss (Inspector of Taxes) vs. Dawson*¹⁴, it was held that where tax avoidance was targeted through a series of transactions with no commercial or substantial value but with only the aim of avoiding tax, the Courts have to ignore the transactions and the tax liability has to be determined as if these transactions never took place.

(e) *Piercing the Corporate Veil*

The piercing of the corporate veil is one of the most debated topics today incorporate circles. Under the corporate law, a company is has a separate and independent status as compared to its shareholder. Lifting of corporate veil refers to disregarding such separate and independent status of a corporate and to consequently tax the shareholder thereof.

The classic case for veil piercing is *Salomon v. Salomon*¹⁵ where Salomon converted the business to a limited liability corporation when it was doing well. The business then floundered and went into liquidation. The question was ‘what was the true intent behind the conversion of the business?’ The House of Lords ruled that the company had been validly formed and in the famous words of Lord Macnaghten, “The company is at law a different person altogether from the subscribers to the memorandum of association...” On this basis, the court upheld the conversion of business as bona fide.

Another case in common law for veil piercing is *Adam v. Cape Industries*¹⁶. Cape was a large MNC based in England and in the asbestos industry. NAAC (Cape’s North-American subsidiary) had damages claimed by its employees in Texas due to asbestos-related illnesses. NAAC was liquidated and activities continued by a new entity called CPC. Fact is that CPC was set up with financial support from Cape and operated in the same premises with same employees as NAAC. However CPC was controlled via a Luxembourg agency of Cape called AMC (i.e. Cape AMC CPC). When fresh damages were claimed by employees, Cape refused to appear before American Courts saying it had no interests in America anymore and that AMC (its agency) came between CPC and Cape. The Courts sided on the side of Cape Industries saying the corporate veil cannot be lifted. However in coming to their decision, most importantly, the Courts went into an analysis on the three possible grounds for piercing, i.e., fraud, agency and the

¹³*I.R.C. v. Burmah Shell Co. Ltd* [1932] STC 30 (Burmah)

¹⁴*Furniss (Inspector of Taxes) v. Dawson* [1984] 1 ALL E.R.530

¹⁵*Salomon v. Salomon & Co.*[1897] A.C.22 (H.L.)(U.K.)

¹⁶*Adams v. Cape Industries Plc*, [1990] Ch.433 (C.A.)(U.K.)

single economic unit theory.

An interesting Indian case related to corporate veil piercing in Company Law is the Wood Polymer case¹⁷. In this case, the company asked for grant of sanction of scheme of amalgamation under section 391(2) of the Companies Act, 1956. The scheme of amalgamation involved:

- (i) Amalgamation of the transferor-company (Bengal Hotels Pvt. Ltd., a private limited company) with the transferee-company (Wood Polymer, a public limited company) along with the dissolution of transferor-company without winding up.
- (ii) According to the official liquidator's report, the transferor-company (Bengal Hotels) was merely created to facilitate the transfer of "Avenue House" immovable property (belonging to the transferor-company's parent, DOC Ltd.) to the transferee-company (Wood Polymer) so as to avoid the payment of capital gains tax, which would otherwise have been payable under section 45 of the Income Tax Act, 1961
- (iii) In order to avoid this capital gains tax, the transferor-company was floated and transferor-company availed of the benefit enacted in section 47 of the Income Tax Act.

The Court looked at relevant sections of the Companies Act and held that the Court is not merely a rubber stamp in scrutinizing a scheme of amalgamation. The following questions were also examined in detail by the Court:

- (i) What was the legislative intent in introducing the second proviso to section 394 of the Companies Act?
- (ii) What is the ambit, scope and outer periphery of the concept of 'public interest' as envisaged in the second proviso?
- (iii) Is the disclosed purpose put forth by the companies who have moved the Court for sanction of merger/amalgamation, relevant consideration for the Court or could the Court probe and go behind the apparent purpose and ascertain the real purpose and take into consideration that purpose, so as to reach a conclusion that for such a purpose the Court would not permit its process to be utilized if the purpose is shown to be one which is opposed to public interest?
- (iv) If, except for the tax benefit, no other purpose for merger/amalgamation is disclosed or on probing, tax avoidance appears to be the major and only purpose for the scheme, could it not be said that the purpose is such that Court should not sanction the scheme on the ground that it is opposed to public interest?(Emphasis Supplied)

¹⁷ In re:Wood Polymer Limited (1977), 109 ITR 177 (HC)(Guj.)

- (v) Should the Court by its process facilitate avoidance of tax, even if it can be said that avoidance is legal and cannot be styled as tax evasion?

The Gujarat High Court looked at various decisions of the Indian and English Courts and came to a decision that the said scheme of amalgamation could not be sanctioned. It held that:

The scheme of amalgamation must have some purpose or object to achieve...the purpose and the only purpose appears to be to acquire capital asset of DOC Ltd. through intermediary transferor-company...it can never be said that the affairs of the transferor company sought to be amalgamated, created for the sole purpose of facilitating transfer of capital asset, through its medium, have not been carried out in a manner prejudicial to public interest...the Court will not lend its name its assistance to defeat public interest, namely tax provision....It must be confessed that it is open to a party so as to arrange its affairs so as to reduce tax liability...but it must be within the power of the party to arrange its affairs. ***If the party seeks the assistance of the Court to reduce its tax liability the Court should be the last instrument to grant such assistance or judicial process to defeat a tax liability...***here the tax cannot be avoided unless the Court lends its assistance, namely, by sanctioning the scheme of amalgamation. In other words, the judicial process is used or polluted to defeat the tax by forming an appropriate device or subterfuge. Such a situation can never be said to be in the public interest and on this ground the Court would not sanction the scheme of amalgamation. (Emphasis Supplied)

The key question is “when can the corporate veil be lifted?” The answer from judicial rulings seems to be: when the device of incorporation is used for an illegal, improper or fraudulent purpose or when mandated by specific provisions of law or contract. India’s stand in corporate veil piercing has been that the Courts typically will not pierce corporate veil in tax cases.

1.3.3 Other Civil Doctrines

Courts in many countries have tended to apply civil law doctrines to control general tax abuse. The main civil law doctrines used are:

- (a) *Abuse of Right (“Abus de Droit”)*

Several jurisdictions apply the form and purpose rules of abuse of right doctrine under Civil Law (Example: Austria, France etc). The abuse of right is the manipulation of the intention or spirit of the law. Courts typically disregard the legal form where transactions are solely undertaken to avoid tax.

- (b) *Abuse of Law (“Fraus Legis”)*

Many civil law countries apply the Roman law doctrine of *fraus legis*. A good example is The Netherlands. *Fraus legis* resembles the business purpose rule. Under this, the Court disregards any transaction entered for tax avoidance purposes and substitutes it

by a “normal” transaction.

(c) *Doctrine of Simulation*

Certain civil law countries, like Belgium, apply this doctrine to ensure ‘substance over form’. It arises when there is no real transaction or there is a hidden real transaction or relationship. In such cases tax authorities can disregard the simulated transaction and replace it with the real one. This principle resembles the sham transaction or doctrine of wrong label. Examples of simulation include sale and leaseback transactions where the respective rights and obligations of the parties are not transferred in substance.

1.4 Judicial Anti-avoidance Doctrines in Indian Scenario

In the Indian Context, few of the decisions of English Courts as discussed above came to be discussed before the Hon'ble Supreme Court of India in CIT vs. A. Raman and Co¹⁸. The Supreme Court followed the maxim of Duke of Westminster's case (supra) and held that tax avoidance by arranging commercial affairs in a manner such that charge of tax is distributed is not prohibited. The Supreme Court observed that:

“.....the law does not oblige a trader to make the maximum profit that he can get out of his trading transactions. Income which accrues to a trader is taxable in his hands. Income which he could have, but has not earned, is not made taxable as income accrued to him. Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon consideration of morality, but on the operation of the Income-Tax Act. Legislative injunction in tax statutes may not, except on peril of penalty, be violated, but may lawfully be circumvented....”

1.4.1 The McDowell- Landmark judgment

The views of the English Courts gained general acceptance by the Indian Courts over the years until the Supreme Court in McDowell & Co. Ltd. vs. CTO¹⁹ circumscribed the leeway allowed to taxpayers. McDowell was a licensed manufacturer of liquor in Hyderabad. The company had failed to disclose the excise duty paid on liquor sold by it to wholesalers. The taxing authority, through a notice, called upon the company to show cause why assessments made should not be reopened. The company challenged the validity of this notice and argued that the excise duty paid by the buyer did not become a part of the company's turnover. The Supreme Court dismissed McDowell's appeal and pronounced its judgment dissociating itself from the earlier observations made in the case of CIT vs. A Raman & Co. (supra). The Hon'ble Supreme Court, while dismissing the observation of J. C. Shah J., in CIT vs. A. Raman and Co. (supra) based on Westminster (supra) and Fisher's Executors, observed as under (page

¹⁸ CIT v. A. Raman & Co. 67 ITR 11 (SC)

¹⁹ McDowell v. Commercial Tax Officer, (1985), 154 ITR 148 (SC)

160)

"We think that the time has come for us to depart from the Westminster principle as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J., and similar observations made elsewhere." It was further stated that (page 160):

"In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

The Supreme Court further held as under:

"Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges."

Thus the principle enunciated was that a transaction could be regarded as one for avoidance of tax if no commercial justification underpinned the transaction other than reduction of income tax. The decision in McDowell's by the Supreme Court was a significant departure from the Westminster principle. It sought the aid of emerging techniques of interpretation in trying to relate tax avoidance devices to the existing legislation. It chose to rely on the famous British ruling in Ramsay's case to expose the devices for what they really are, and denied judicial benediction to such devices.

1.4.2. Azadi Bachao Andolan's case

The Supreme Court of India again had an occasion to consider the issue of tax planning vs. tax avoidance in the case of Union of India vs. Azadi Bachao Andolan²⁰ in the context of eligibility of treaty benefits to foreign investors who routed their investments to India through Mauritius. The Indian tax authorities denied tax treaty benefits to companies incorporated in Mauritius for investing funds in India on the ground that they were controlled and managed from countries other than Mauritius and were misusing the India-Mauritius tax treaty. In this context, the CBDT issued Circular No.789 of April 13, 2000, which stated that the Mauritius Tax Residency Certificate issued by the Mauritius Tax Office was sufficient evidence for accepting the status of residence and beneficial ownership for applying the Convention on the Avoidance of Double Taxation between India and Mauritius executed on April 1, 1983 and that the treaty benefits should be made available to such tax payers. The Circular was challenged before the Courts and the Supreme Court, while dealing with the aspects of tax planning, observed that the landmark decision of the House of Lords' on tax planning, namely, Duke of Westminster (supra) and the decision of the Supreme Court in case of A. Raman & Company,

²⁰ Union of India v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)

(supra) were still valid judicial precedents. The Court thus reaffirmed the view of English cases which held that while examining a legally valid transaction, the Revenue should proceed objectively and not hypothetically attribute “motives” behind the taxpayer’s action. However the Court has upheld that the use of colorable devices or dubious method to avoid tax was not permitted.

The Supreme Court also observed that it cannot be said that its decision in McDowell's case can be read as laying down that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement which is perfectly permissible under law, which has the effect of reducing the tax burden of a taxpayer, must be looked upon with disfavour. The Supreme Court observed that where the courts find that notwithstanding a series of legal steps taken by a taxpayer, the intended legal result has not been achieved, the courts might be justified in overlooking the intermediate steps, but it would not be permissible for the court to treat the intervening legal steps as non-est based upon some hypothetical assessment of the "real motive" of the taxpayer. The Supreme Court in the case of CIT vs. Walfort Share and Stock Brokers Pvt Ltd (326 ITR 1), after referring to McDowell (supra) and Azadi Bachao Andolan (supra), held that a citizen is free to carry on his business within the four corners of the law and that tax planning, without any motive to evade taxes through colourable devices, is not frowned upon even by its judgment in McDowell's case.

1.4.3 Vodafone’s Case

Tax planning once again came to the fore as a subject of discussion in Vodafone International Holdings BV vs. Union of India²¹. The issue under consideration was whether indirect transfer of assets outside India by non-resident to another non-resident outside India shall be taxable in India by disregarding legal ownership of such shares held by such non-resident.

The Tax Authority contended that the decision of the SC in Azadi Bachao Andolan (supra) on tax avoidance, would need to be overruled as it had departed from the principles laid down in McDowell (supra) where other judges had concurred with a separate ruling on the issue given by one of the judges. The Supreme Court dealt with the applicability of the McDowell vs. Azadi Bachao Andolan’s case and reconciled the same. The principles laid down by the Supreme Court are discussed as under:

- The majority ruling in McDowell had clearly held that tax planning was legitimate, provided that it was within the framework of law and that colourable devices could not be a part of tax planning. The separate ruling by the fifth judge was in relation to tax evasion through colourable devices by resorting to dubious methods and subterfuges. It is nowhere mentioned that tax planning is illegitimate or impermissible and, moreover, the fifth judge himself agreed with the majority ruling.
- As per the Westminster principle, emerging from the House of Lords decision in the

²¹ Vodafone International Holding BV v. Union of India [2012] 341 ITR 1 (SC)

case of IRC vs. Duke of Westminster (supra), a taxpayer can arrange his affairs so as to reduce the liability of tax and the fact that the motive for a transaction is to avoid tax does not invalidate it unless a particular enactment so provides.

- However, the Ramsay doctrine, emerging from a later decision of the House of Lords in the case of WT Ramsay (supra), was a new approach to artificial tax avoidance schemes, wherein, a subject could be taxed only if there was a clear intentment and the intentment has to be ascertained on clear principles and the courts could not approach the issue on a mere literal interpretation.
- The Ramsay ruling did not discard the Westminster ruling, but read it in the proper context as per which a 'device', which was colourable in nature, had to be ignored as a fiscal nullity. Thus, the Ramsay ruling lays down the Principle of statutory interpretation, rather than an over-arching anti-avoidance doctrine imposed upon tax laws.
- In Craven vs. White²², it was held by the House of Lords that the Tax Authority cannot start with the question as to whether the transaction is a tax deferment/ saving device, but that the Tax Authority should apply the 'look at' test to ascertain its true legal nature. Genuine tax planning is not to be abandoned.
- Applying the Westminster principle, the Tax Authority cannot tax a subject without a specific provision in the legislature, and every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury.

While delivering the judgment in favor of Vodafone, the Supreme Court of India held that there are no conflicts between McDowell ruling and Azadi ruling, and no re consideration of larger bench on the same is required. Burden is on the tax authority to allege and establish abuse, where there is a tax holding structure. The corporate business purpose of the transaction would be proof that the impugned transaction is not a colorable device.

1.5 Legislative Anti-Avoidance Measures

There are two kinds of Anti-Avoidance measures available viz. SAAR and GAAR. SAAR refers to Specific Anti Avoidance Rules. It is applied in a specific situation covered by such rule. Few examples of SAAR are thin capitalization rule, Controlled Foreign Corporation (CFC) Rule, beneficial ownership rule, taxation of indirect transfer, etc. These rules are passed in the domestic legislation to curb specific tax avoidance techniques.

GAAR refers to General Anti-Avoidance Rules. It is not always possible to draft a rule to avoid tax avoidance in every type of transactions. Tax avoidance schemes are becoming increasingly complex and tough to curb through SAARs. Therefore, GAAR can be introduced

²²Craveen v. White (1988) (3 ALL E.R.495)

as a catch-all scheme to curb tax avoidance in general. However, the real problem with GAAR is that it can end up promoting uncertainty which is almost dangerous to operate a tax system in a country.

1.6 Overview of various anti-avoidance measures in different countries

It is illuminating to see the anti-avoidance measures used in various countries around the world. It seems that a combination of the various techniques discussed above has been used to combat tax avoidances as indicated in below table:

Country	Short summary of anti-avoidance measures
India	<ul style="list-style-type: none"> GAAR effective from 1st April 2017. Domestic law has SAAR provisions (Transfer Pricing Provisions – section 92-92F, 40A(2), section 93, 94, 60 to 64, 14A, 73, taxation of gifts - 56, etc.) Underlying principles implemented through judicial and administrative decisions Courts have favoured taxpayer historically and generally taken a literal view
USA	<ul style="list-style-type: none"> Does not have statutory GAAR The Courts have evolved several judicial anti-avoidance doctrines Courts tend to apply substance over form
Canada	<ul style="list-style-type: none"> Enacted a GAAR in 1988; specific criteria for applying GAAR set out by the Courts and benefit of doubt given to taxpayer
Austria	<ul style="list-style-type: none"> Taxpayer is free to arrange affairs but broad limitations are placed under the GAAR However, tax avoidance must be main or only motive of taxpayer arrangement and strict burden of proof on tax authorities; it is considered irrelevant that arrangements are “unusual”
Australia	<ul style="list-style-type: none"> GAAR was introduced in 1981 Income Tax Act Courts have shifted over the years to purposive interpretation from a literal approach
Germany	<ul style="list-style-type: none"> Contains GAAR in the tax code. Legal structure can be disregarded under “abuse of form and legal structures” provision. Courts apply substance over form; use the principal of analogy. Germany has one of the highest numbers of anti-avoidance case laws
Italy	<ul style="list-style-type: none"> Follows letter of law where form takes precedence over substance Tax avoidance so far handled through SAARs Earlier efforts to introduce GAAR were unsuccessful

Country	Short summary of anti-avoidance measures
Japan	<ul style="list-style-type: none"> • Has authority to re-compute tax base of corporate income tax, amount of net loss and corporate tax payable
Switzerland	<ul style="list-style-type: none"> • Applies both business purpose and substance over form doctrine under its law • In tax avoidance cases the tax authorities can substitute the customary construction for the transaction and tax accordingly
Netherlands	<ul style="list-style-type: none"> • Dutch Law provides for a GAAR though Courts rely on <i>fraus legis</i> (abuse of law)

1.7 Evaluation of Indian GAAR Provision, its objective and enactment in law

In India, GAAR provisions were first introduced in the Direct Taxes Code in August 2009. As per the discussion paper on Direct Taxes Code, 2009 (DTC), the need for introduction of GAAR was explained as follows:

“Tax avoidance, like tax evasion, seriously undermines the achievements of the public finance objective of collecting revenue in an efficient, equitable and effective manner. Sectors that provide a greater opportunity for tax avoidance tend to cause distortions in the allocation of resources. Since the better-off sections are more endowed to resort to such practices, tax avoidance also leads to cross-subsidization of the rich. Therefore, there is a strong general presumption in the literature on tax policy that all tax avoidance, like tax evasion, is economically undesirable and inequitable. On considerations of economic efficiency and fiscal justice, a taxpayer should not be allowed to use legal constructions or transactions to violate horizontal equity. “

The second draft of DTC which was introduced in the Indian Parliament in August 2010 also contained the GAAR provisions with certain modifications. The second draft of DTC was referred to the Standing Committee on Finance headed by Mr. Yashwant Sinha for its views. The Committee submitted its report on 9th March 2012. In view of the time constraint, suggestions of such committee were not incorporated by the Finance Minister while putting the provision of GAAR in the Finance Bill, 2012 on the floor of house. Hon'ble Shri Pranab Mukherjee, the then Finance Minister made the following statement on GAAR while presenting the Finance Bill, 2012 in the Parliament.

“I propose to introduce a General Anti Avoidance Rule (GAAR) in order to counter aggressive tax avoidance schemes, while ensuring that it is used only in appropriate cases, by enabling a review by a GAAR panel.”

Further the Memorandum to the Finance Bill, 2012 provides following reasons for introducing GAAR in India;

“The question of substance over form has consistently arisen in the implementation of taxation

laws. In the Indian context, judicial decisions have varied. While some courts in certain circumstances had held that legal form of transactions can be dispensed with and the real substance of transaction can be considered while applying the taxation laws, others have held that the form is to be given sanctity. The existence of anti-avoidance principles are based on various judicial pronouncements.

There are some specific anti-avoidance provisions but general anti-avoidance has been dealt only through judicial decisions in specific cases. In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning and use of opaque low tax jurisdictions for residence as well as for sourcing capital. Most countries have codified the “substance over form” doctrine in the form of General Anti Avoidance Rules (GAAR).

In the above background and keeping in view the aggressive tax planning with the use of sophisticated structures, there is a need for statutory provisions so as to codify the doctrine of “substance over form” where the real intention of the parties and effect of transactions and purpose of an arrangement is taken into account for determining the tax consequences, irrespective of the legal structure that has been superimposed to camouflage the real intent and purpose. Internationally several countries have introduced, and are administering statutory General Anti Avoidance Provisions. It is, therefore, important that Indian taxation law also incorporate a statutory General Anti Avoidance Provisions to deal with aggressive tax planning. The basic criticism of statutory GAAR which is raised worldwide is that it provides a wide discretion and authority to the tax administration which at times is prone to be misused. This vital aspect, therefore, needs to be kept in mind while formulating any GAAR regime.

It is accordingly proposed to provide General Anti Avoidance Rule in the Income Tax Act to deal with aggressive tax planning.”

Considering the aforesaid objective of introducing GAAR provision in India, it reveals that such provisions are being enacted to give value to substance rather than form while analyzing any tax implication of any transaction. GAAR provision in nutshell codifies judicial doctrine “substance over form” under the legal tax system of India. The substantive provisions relating to GAAR, are contained in Chapter X-A (consisting of sections 95 to 102) of the Income-tax Act as introduced by the Finance Act, 2012. The procedural provisions relating to mechanism for invocation of GAAR and passing of the assessment order in consequence thereof are contained in section 144BA.

Thereafter a number of representations were received against the provisions relating to GAAR and its applicability therefore delayed. An Expert Committee was constituted by the Government with broad terms of reference including consultation with stakeholders and finalising the GAAR guidelines and a road map for implementation. The Expert Committee's recommendations include suggestions for legislative amendments, formulation of rules and prescribing guidelines for implementation of GAAR.

The major recommendations of the Expert Committee have been accepted by the Government, with some modifications in the Finance Bill, 2013 and thereafter the Finance Act,

2013 re-introduced GAAR provision with such modifications to be effective from 1st April 2016. Some of the major modifications in GAAR as introduced by the Finance Act, 2013 as compared to the Finance Act, 2012 were as under:

- The provisions of GAAR shall apply from the assessment year 2016-17 instead of assessment year 2014-15
- Under the new provision an arrangement, the main purpose of which is to obtain a tax benefit, would be considered as an impermissible avoidance arrangement. Whereas the old provision provided that tax benefit should be "the main purpose or one of the main purposes" to classify the arrangement as impermissible avoidance arrangement
- The factors like, period or time for which the arrangement had existed; the fact of payment of taxes by the assessee; and the fact that an exit route was provided by the arrangement, would be relevant but not sufficient to determine whether the arrangement is an impermissible avoidance arrangement. The old provision provided that these factors would not be relevant has been proposed to be amended accordingly.
- An arrangement shall also be deemed to be lacking commercial substance, if it did not have a significant effect upon the business risks, or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained but for the application of Chapter X-A. The old provision does not contain such condition to consider an arrangement- lacking of commercial substance.
- The Approving Panel for invocation of GAAR provisions shall consist of a Chairperson who is or has been a Judge of a High Court; one Member of the Indian Revenue Service not below the rank of Chief Commissioner of Income-tax; and one Member who shall be an academic or scholar having special knowledge of matters such as direct taxes, business accounts and international trade practices. The old provision contained that the Approving Panel shall consist of not less than three members being income-tax authorities and an officer of the Indian Legal Service has been proposed to be amended accordingly.
- Under the new provisions the directions issued by the Approving Panel shall be binding on the assessee as well as the income-tax authorities and no appeal against such directions can be made under the provisions of the Act. Whereas the old provisions provided that the direction of the Approving Panel will be binding only on the Assessing Officer

The applicability of the GAAR provisions was further deferred by another two years by the Finance Act, 2015. The memorandum to the Finance Bill, 2015 has mentioned that-

"The implementation of GAAR provisions has been reviewed. Concerns have been expressed regarding certain aspects of GAAR. Further, it has been noted that the Base Erosion and Profit Shifting (BEPS) project under Organisation of Economic Cooperation and Development (OECD) is continuing and India is an active participant in the project. The report on various

6.18 International Tax — Practice

aspects of BEPS and recommendations regarding the measures to counter it are awaited. It would, therefore, be proper that GAAR provisions are implemented as part of a comprehensive regime to deal with BEPS and aggressive tax avoidance.

Accordingly, it is proposed that implementation of GAAR be deferred by two years and GAAR provisions be made applicable to the income of the financial year 2017-18 (Assessment Year 2018-19) and subsequent years by amendment of the Act. Further, investments made up to 31.03.2017 are proposed to be protected from the applicability of GAAR by amendment in the relevant rules in this regard.”

Accordingly, the GAAR provision in India is applicable with effect from 1st April 2017.

A comparison of General Anti-Avoidance Rules and Judicial Anti-Avoidance Doctrines as a means of controlling tax avoidance

Particulars	Judicial Anti Avoidance Rules (JAAR)	General Anti Avoidance Rules (GAAR)
Nature	It is a judicial measure to curb the tax avoidance.	It is a legislative measure to curb tax avoidance,
Meaning	JAAR is the judicial interpretation to deal with the situation of tax avoidance The Courts may take either a literal, i.e., strict view or purposive view towards statutory interpretation.	GAAR standardized the approach to deal with situation of tax avoidance by codifying what constitutes tax avoidance. It is to codify the doctrine of "substance over form", where the real intention of the parties and effect of transactions and purpose of an arrangement is required to be seen, GAAR provisions are introduced under the Act.
Landscape	In India, the judicial interpretation of substance over form was given by Apex Court in Mc Dowell [TS-1-SC-1985-O] in year 1985 . As famous as McDonalds, it was a landmark ruling in the context of tax planning, tax avoidance and tax evasion. In the case of Azadi Bachao Andolan [TS-5-SC-2003-O] in year 2003 , the Apex Court gave radical finding that there is no complete go	GAAR is an extended and codified version of JAAR as spelt out by Apex Court in various decisions starting with Mc Dowell to Vodafone.

Particulars	Judicial Anti Avoidance Rules (JAAR)	General Anti Avoidance Rules (GAAR)
	<p>bye to Westminster's principle. Lately, in Vodafone [TS-23-SC-2012-O] case in 2012, the Supreme Court held that the Income-Tax Department could always apply the 'substance over form' principle or 'pierce the corporate veil' if they establish that a transaction is a sham or tax avoidant</p>	
Scope	<p>The Courts on various occasions have held that that an attempt by resident of a third party to take advantage of existing provisions of double taxation avoidance agreement is not <i>per se</i> illegal unless such entity is <i>per se</i> sham or colorable device. Tax Department cannot alter such arrangement merely because it is detrimental to revenue.</p>	<p>Scope of GAAR is much wider than what was explained by the Apex Court in Mc Dowell case. The deeming definition of lack of Commercial substance as provided under section 97(1) of the Act includes round trip financing, accommodating party, element of offsetting or cancelling effect of individual transactions, impact of arrangement on business risks and cash flows, location of assets or transaction or a place of residence of any party as one of the elements to treat any tax planning as tax avoidance.</p>
Threshold Limit	<p>No threshold limits for applicability of JAAR as essentially, JAAR revolves around the following two guiding principles-</p> <ul style="list-style-type: none"> a) Business purpose rule (motive test) b) Substance over form rule (artificiality test) 	<p>Its applicability has been restricted to cases where tax benefit exceed Rs.3 Cr. to avoid unintended harassment & cost of litigation.</p>

1.8 Overview of Indian GAAR Provisions

Following provisions of the Income Tax Act, 1961 deal with GAAR in India;

Section	Particulars
95	Applicability of General Anti-Avoidance Rules
96	Impermissible avoidance arrangement
97	Arrangement to lack commercial substance
98	Consequences of impermissible avoidance arrangement
99	Treatment of connected person and accommodating party
100	Application of this Chapter
101	Framing of Guidelines in certain cases [Rule 10U TO Rule 10UC contains such guidelines]
102	Definition
144BA	Reference to Principal Commissioner (also contains provision for approving panel and its procedure for approval to invoke GAAR provision)

Section 95 empowers the tax authority, notwithstanding anything contained in the Act, to declare an arrangement which an assessee has entered into, as impermissible avoidance arrangement. Once it is declared as “impermissible avoidance arrangement”, the consequence as regards tax liability would be determined in accordance with the GAAR provisions.

Tax authority has also power to declare a step in, or a part of, the arrangement as impermissible avoidance arrangement. The term impermissible arrangement has been defined in section 96 of the Act and the term arrangement has been defined vide section 102 of the Act. Section 102(1) defines “*arrangement*” means any step in, or a part or whole of, any transaction, operation, scheme, agreement, or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding”.

Section 96 of the Act defines the meaning of impermissible avoidance arrangement. As per the said section an arrangement is impermissible avoidance arrangement if its main purpose is to obtain a tax benefit (“Main Purpose Test”) and it satisfies one or more of the conditions mentioned in clause (a) to (d) viz.

- (a) Arrangement creates rights or obligations which are not ordinarily created between persons dealing on arm’s length
- (b) Arrangement results directly or indirectly in the misuse or abuse of provision of the Act
- (c) Arrangement lacks commercial substance whether in whole or in part

- (d) Arrangement has been entered into or carried out in manners which are not ordinarily employed for bona fide purposes.

It is also provided that onus to disprove that arrangement entered into by an assessee is not an impermissible avoidance arrangement is first on the taxpayer. Section 97 elaborates the circumstances in which arrangement to lack commercial substance e.g. round trip financing, accommodating etc. Section 98 prescribes that if an arrangement is declared as an impermissible avoidance arrangement there would be denial of the tax benefit or denial of the tax treaty benefit. It also prescribes the ways how the tax officer would determine the denial of the tax benefit/tax treaty benefit by making requisite assumptions. Further section 90(2A) of the Act specifically provides that GAAR provisions will override tax treaty provisions. Section 99 provides for manner of treatment to reveal tax benefit in case of accommodating parties, connected person etc.

Section 101, through rules 10U provides non-applicability of GAAR provision. It provides that an arrangement where the tax benefit arising in aggregate to all concerned parties does not exceed three crores, GAAR provisions will not apply. GAAR is also not applicable to FII, certain non-resident in relation to investment made by him in offshore derivative instrument. It is also provided that GAAR provisions do not have any implication in respect of income arising by way of transfer of investment made before 1 April 2017.

Section 102 provides definitions of term "arrangement, asset, benefit, connected person, fund, party, relative, substantial interest, step, tax benefit etc. as used in GAAR chapter. Section 144BA read with Rule 10UB & Rule 10UC prescribes the procedural aspect of execution of GAAR provision by tax officer, reference to commissioner of income tax, reference to an approving panel of GAAR, their manner of direction, time-limit etc.

The Government has in January 2017, issued clarifications in form of FAQs dealing with various issues relating to GAAR²³ as under:

Question no. 1: Will GAAR be invoked if SAAR applies?

Answer: It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.

Question no. 2: Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?

Answer: Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be

²³ Refer CBDT Circular No. 7 of 2017 dated 27 January 2017

tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.

Question no. 3: Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?

Answer: GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.

Question no. 4: Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.

Answer: For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.

Question no. 5: Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?

Answer: Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule

10U(1)(d) of the Income Tax Rules.

Question no. 6: The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, air craft leases) and loan arrangements, etc.

Answer: Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation. Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.

Question no. 7: Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?

Answer: No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.

Question no. 8: Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?

Answer: Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.

Question no. 9: Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.

Answer: GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.

Question no. 10: How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes

and based on cogent evidence and not on the basis of interpretation difference?

Answer: The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.

Question no. 11: **Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?**

Answer: If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.

Question no. 12: **A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4) of the IT Act.**

Answer: Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.

Question no. 13: **It may be ensured that in practice, the consequences of a transaction being treated as an 'impermissible avoidance arrangement' are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and fair manner. It should be clarified that if a particular consequence is applied in the hands of one of the participants, there would be corresponding adjustment in the hands of another participant.**

Answer: Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against

deterrence.

Question no. 14: Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).

Answer: The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of the arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs. 3 crores cannot be read in respect of a single taxpayer only.

Question no. 15: Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?

Answer: If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.

Question no. 16: No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.

Answer: Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.

Unit-II	Anti-treaty shopping measures
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2.1 General

Tax treaties are bilateral agreements between two states for allocation of taxing rights on the subject matter. It creates legal obligation for both parties under the contract once they come into force. One of the main objectives of the tax treaties is the avoidance of double taxation and prevention of fiscal evasion. The problem of tax avoidance is compounded with respect to international transactions and arrangements. The intersection of foreign and domestic tax systems and the existence of a growing network of bilateral tax treaties present increased opportunities for tax avoidance. In most countries, generally speaking and in India specifically, tax treaties prevail over domestic tax laws in the event of a conflict. Sometimes the interplay of domestic tax system and tax treaties network is so unique that it will give rise to various method of exploitation of such tax benefit. One of those methods is treaty shopping. The OECD in its Commentary on “International Tax Avoidance, Treaty Shopping, Limitation on Treaty Entitlement” states that the network of tax treaties makes possible tax maneuvers and artificial legal construction which provide a taxpayer with tax advantages both under domestic tax laws as well as in claiming relief under tax treaties. However, it is for the states concerned to adopt suitable anti-abuse provisions in order to check such instances of treaty abuse.

2.2 What is treaty shopping?

Treaty shopping connotes a premeditated effort to take advantage of the international tax treaty network and a careful selection of the most favorable tax treaty for a specific purpose. The international Tax Glossary defines “treaty shopping” as a *“situation where a person who is not entitled to benefits of a tax treaty makes use-in the widest sense of the word of an individual or of a legal person, in order to obtain those treaty benefits that are not available directly.”*

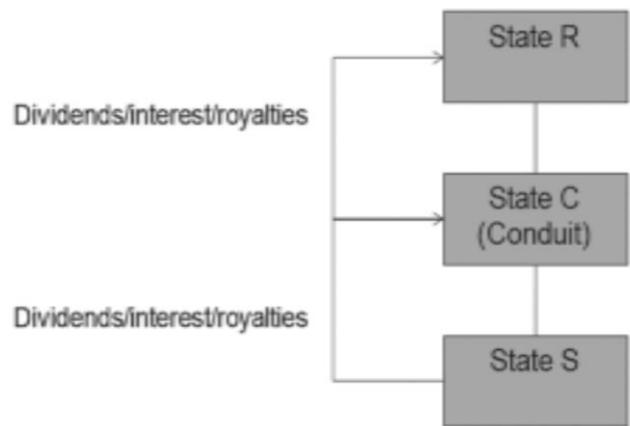
According to Becker/ Warm “treaty shopping means that a taxpayer “shops” into the benefits of a treaty which normally are not available to him and to this end he generally incorporates a corporation in a country that has an advantageous tax treaty.”

The UN Ad Hoc Group of Experts defined the term “abuse of tax treaties as the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits that the treaty were not designed to give them. It is defined as the routing of income arising in one country to a person in another country through an intermediary country to obtain an unintended tax advantage of tax treaties. E.g. a person resident of India acts through a legal entity created in another state essentially to obtain treaty benefits which India has with that states say Mauritius, which would otherwise not be available directly.

There are a variety of treaty shopping structures. Some of them are:

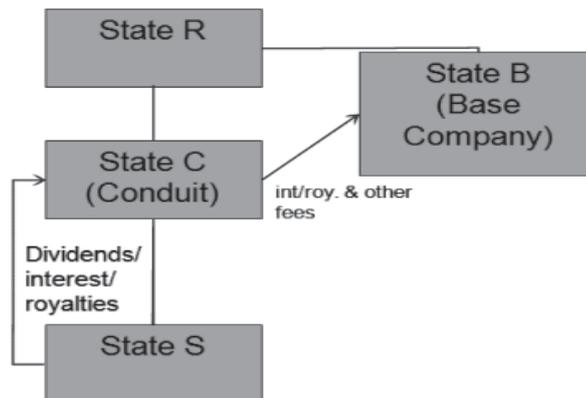
(a) *Direct Conduits*

A direct conduit works as shown in the diagram below. Parent Company in State R expects to derive dividends, interest or royalties sourced in another state (State S). So it sets up entity in a third state (State C) that will receive dividends, interest, and royalties in a more tax beneficial way than if income were paid directly from State S to R. The tax advantage results from fact that tax treaty between S and C provides for more advantageous withholding tax rate in State S if paid to State C Resident than if paid to State R resident.



(b) *Stepping stone conduit*

A stepping stone conduit works as follows: Residents of State R establish company resident in State C where it is fully subject to tax on income derived from S. However it pays high interest, royalties, service fees, commissions & other expenses to a second related foreign company (base company) set up in a fourth state (State B) and controlled by shareholders of the conduit company. These payments are deductible in State C and are either not taxed or very advantageously taxed in State B because the company enjoys a preferential tax regime there.



(c) *Other structures*

There are other treaty shopping techniques in practice; examples are triangular structures where a low or nil taxed branch of a company in a treaty country receives income from a third country. Another approach is to use hybrid entities that are characterized differently in the two Contracting States. Individuals can also treaty shop by transferring tax residence to another treaty country, i.e., 'emigration' - also a form of treaty shopping. For instance, a resident of USA owning an important shareholding in Indian company may emigrate to Belgium in view of later sale of shares because under Article 18 of Belgium-France tax treaty the right to tax the capital gain is conferred to Belgium but Belgium does not levy capital gains tax on individuals (except speculation).

Generally, developing countries favour tax treaty measures that assist them in promoting their political, social and economic goals. They usually have wider policy objectives besides fiscal goals when applying direct tax measures e.g. promotion of investment and employment generation etc. They treat treaty shopping as tax incentive. It is the consideration of non-tax gain to economy over tax revenue loss that is what is relevant for a developing country for approving treaty shopping. Countries which are unable to benefit economically from treaty shopping may regard it as unacceptable and improper as principle. They either have specific anti-treaty shopping provisions under their domestic tax law, and/or under bilaterally negotiated tax treaties. There are four main categories of anti-treaty shopping measures currently in use:

- (a) Neutral measures by combining domestic and tax treaty provisions. Example: non-domiciled residents in U.K. may be entitled to treaty benefits on foreign income only when remitted.
- (b) Specific measures that deny benefits to entities which are not subject to tax in their state of residence.
- (c) Purpose-based measures that deny certain treaty benefits set up only for claiming such benefits. Example is no tax refunds are given under Netherlands treaty with the U.K. in such cases.
- (d) Comprehensive measures imposed under domestic legislation or treaties. For example, Article 22, U.S. Model Treaty on Limitation on Benefits, 1996; Swiss Abuse Doctrine, 1962

Treaty shopping, when it is beneficial may be tacitly approved and when disadvantageous may be disapproved. For example, some of them have revoked tax treaties in cases of circular situations when the income is sourced in the same country where the shareholder is resident but the income passes through a company resident in another country for tax reasons, i.e., "round tripping". This has been considered abusive by India, Brazil, Indonesia, etc.

2.3 Anti-treaty shopping measures

Depending upon its requirement, each country develops various measures to curb the

practices of treaty-shopping. Following are the widely used anti-treaty shopping measures in various tax treaties:

- (a) Beneficial Ownership
- (b) Limitation of Benefit clause

2.3.1 Beneficial Ownership

The Concept of beneficial ownership may be of relevance in the context of conduit companies. While the term “beneficial owner” does not boast of a specific definition, simply speaking, the term implies restriction on availability to treaty benefit by persons who are “beneficial owners’ of income. This concept has been referred in various tax treaty Articles relating to interest, royalty, fees for technical services, fees for included services, dividend of model tax treaty of OECD, US, UN. Provision of beneficial ownership restricts the treaty benefit to the beneficial owner and excludes the concessional withholding tax benefit from the legal owner if he is not the beneficial owner and the beneficial owner is not a resident of that state. The term “beneficial owner” is not defined in the treaty. In general parlance it implies a division between the legal rights and the rights of enjoyment over the economic benefit recognized by law. According to Vogel the issue of control is the most important factor to decide who the beneficial owner is. He defines beneficial owner as a person who is free to decide (i) whether or not the capital or other asset should be used or made available for use by others (i.e. the right over capital), or (ii) on how the yields from them should be used (i.e. the right over income), or (iii) both. The OECD commentary excludes an intermediary, such as an agent or nominee as a beneficial owner. OECD has done extensive work to bring more clarity to this concept.

The OECD Commentary makes it very clear that that source state is not compelled to give the benefit of Article 10,11 and 12 just because the income is received by a resident of the other contracting state. The recipient must be the “beneficial owner” of the income, and this concept excludes conduit companies, agents and nominees.

2.3.2 Limitation on Benefit Clause (LOB)

This may be considered as Specific Anti-Avoidance (SAAR) approach against treaty shopping. LOB clause is specifically designed to deal with “treaty shopping”. This is also a provision which limits the use of treaties by the residents by planning restrictions. In these provisions, conditions are specified which limit the use of the treaty benefits between the residents of either of the contracting states. The residents of third countries are not allowed to use the bilateral convention between two states. This provision is found in the US Model convention which has been included by OECD in its commentary recently. The most significant advantage of these provisions is that they provide more certainty in the application of tax treaties.

The term “Limitation on benefit” is generally never defined under International tax treaties. In fact, at times, the concerned Article may not also be titled as “Limitation on benefit”, though in essence, the said Article may outline various provisions for limiting treaty benefits.

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The IBFD international Tax Glossary defines the term LOB as under:

“Provision which may be included in a tax treaty to prevent treaty shopping, e.g. through the use of a conduit company. Such provisions may limit benefit to companies which have a certain minimum level of local ownership (“look through approach”), deny benefits to companies which benefit from a privileged tax regime (“exclusion approach”) or which are not subject to tax in respect of the income in question (“subject-to-tax approach”), or which pay on more than a certain proportion of the income in tax-deductible form (“channel approach or “base erosion rule”).....”

While the aforesaid definition seems to align the concept of “limitation on benefit” mainly vis-à-vis restriction on availment of treaty benefits by a conduit entity or an entity which has been formed for the purposes of treaty shopping, in a broader sense, the concept of “limitation on benefit” could also include the following:

- Condition of “beneficial ownership” to be satisfied by the recipient of the owner vis-à-vis certain categories of income such as dividend, interest etc.
- “Subject to tax” condition under the broader “liable to tax” condition vis-à-vis definition of a tax resident, present under certain tax treaties.
- Specific condition to be fulfilled vis-à-vis exemption from particular category of income
- Specific article on Limitation on benefit generally dealing with conduit entities or Treaty shopping or entities attempting to claim double non-taxation

From Indian perspective let’s take an example of Article 24 of DTAA between India and USA. The same reads as under:

“ARTICLE 24

LIMITATION ON BENEFITS

1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if :

- (a) more than 50 per cent of the beneficial interest in such person (or in the case of a company, more than 50 per cent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States ; and
- (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not resident of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or citizens of the United States.

2. *The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).*

3. *The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means :*

- (a) *in the case of United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934 ;*
- (b) *in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contracts Regulation Act, 1956 ; and*
- (c) *any other stock exchange agreed upon by the competent authorities of the Contracting States.*

4. *A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines."*

As seen from the LOB clause supra, it will apply only to non-individuals. Unlike corporates, firms etc. an individual cannot indulge in treaty shopping. To meet the conditions of Article 24, an entity is required to satisfy various test e.g. Ownership test – Article 24(1)(a), Base erosion test – Article 24(1)(b), Active business connection test- Article 24(2), Recognized stock exchange test – Article 24(3), Competent authority test- Article 24(4). Ownership test requires that more than 50% of the beneficial interest/50% of the number of shares of each class of shares" is owned directly or indirectly by individuals, who are residents in India or USA, Government of India or USA or its political sub-divisions or local authorities, other individual subject to tax in India or USA on their worldwide income or Citizens of USA. Base erosion test requires that the income of the particular entity should not be used in substantial party, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) of persons who are not qualified entities. Active business connection test requires that income earned by an entity is in connection with or is incidental to the active conduct in trade or business in the home country. There is no need to evaluate the active business connection test if an entity fulfils both ownership test and base erosion test. Recognized stock exchange test requires that there is a regular trading of principal class of shares of an entity in a recognized stock exchange of home country. If one or both of test prescribed under Article 24(1) are not satisfied and also the active business test is not satisfied, an entity would still get tax treaty benefit between India-USA, if it fulfils recognized stock exchange test. If the conditions under

Article 24 of the tax treaty are not satisfied by an entity, then the source country has the right to deny tax treaty benefit.

2.4 Importance of LOB Clause in tax treaty with India

The decision of Supreme Court of India in the case of Azadi Bacho Andolan (supra) held that there was no inherent anti-abuse rule in Indian tax treaties and hence it required a specific Limitation on Benefit clause in the treaty itself for the denial of treaty rights. Treaty shopping is not illegal. The Court further observed as under:

“Overall, countries need to take, and to take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it dependent upon several economic and political considerations”

After the Supreme Court decision, India has included LOB clause in some of its tax treaties. In each case, the LOB provision is based on its national treaty policy and influenced by non-fiscal factors. LOB clause has been inserted, for specific purpose, by India, in the modified treaties of Singapore & UAE.

Unit-III	Controlled Foreign Corporation (CFC)
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3.1 Introduction

Tax avoidance has been accepted as an area of concern in international tax arena and that is why several countries have been legislating anti-avoidance measures in their domestic tax code. Controlled Foreign Company (CFC) Regulations are one such set of anti-avoidance measures. Taxation of foreign passive income is at the heart of CFC Regulations.

Foreign-source income is usually taxed after it is accrued or received as income in the country of residence of the recipient. Therefore, it is possible to defer or avoid the tax on foreign divided income until it is repatriated. Many residence states regard this tax deferral as unjustifiable loss of tax revenue. Moreover, it gives the residents who invest overseas a tax advantage over those who invest at home.

The CFC legislations target the income earned and accumulated in nonresident entities that are under the influence or control of its own tax residents, who are subject to worldwide taxation. It is generally presumed that in such situations they can influence the profit distribution or repatriation policies as shareholders. Different countries, depending upon their fiscal need and tax environment, develop different types of rules and regulations to tax profit earned by their controlled foreign corporations.

3.2 What is the concept of CFC?

CFCs are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State). Since each corporate entity is treated as a separate legal entity, the profits earned by such CFCs are not taxed at the owner level until they are distributed. CFCs tend to earn passive income; such income is not distributed, thereby resulting in its deferral in the Parent State. It is to curb such tax avoidance that CFC Regulations are legislated by various countries.

The International Bureau of Fiscal Documentation ('IBFD') has explained CFC legislations as under:

“The term is generally used in the context of tax avoidance rules designed to combat the diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation. Under these rules income of the controlled company is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the controlled company’s income is dealt with in this way, typically passive income such as dividends, interest and royalties (“tainted income”). Many but not all controlled foreign company regimes apply only to corporate shareholders.”

In order to protect the domestic tax base from erosion through certain tax structuring in CFC and at the same time not disadvantaging the foreign subsidiaries with regards to income from

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their genuine business in the same foreign country, many countries have introduced targeted CFC legislation.

Even though these CFC rules differ in detail from jurisdiction to jurisdiction, they generally function as follows:

A resident shareholder (e.g., corporation, partnership and/or individual) controls directly or indirectly a foreign entity in a low tax jurisdiction with passive income. As a consequence the low taxed income is attributed to its controlling shareholder(s).

Under CFC rules, CFCs depend very much on entities or structures (e.g. branches) which are treated as *separate legal entities* under the domestic tax laws of respective jurisdiction and whose profits are only taxable in the hands of the controlled shareholder *upon distribution*. One may follow a global approach for classification of a CFC, wherein the rules are applicable to every nation regardless of residency and tax rates while the others may follow a designated approach in which CFC exposure is triggered only when an entity is set up in a low tax jurisdiction.

Most CFC rules only apply to those CFCs (entity) over which the domestic shareholder or a number of domestic shareholders have a certain degree of control. Control may be defined as the voting power or factual power to influence the business of a CFC, and/or simply having a significant stake in the CFC's assets, profits or liquidation proceeds (i.e. controlling ownership). Under most CFC regimes control of more than 50% of resident shareholders is required. If there is more than one shareholder that is treated as an unrelated shareholder, a minimum stake of these unrelated shareholders may or may not be required. CFC rules apply to both direct and indirect subsidiaries of resident shareholder, so that taxpayers do not misuse easily by creating multiple layers of holding companies.

The most complicated part of CFC rules are the rules of defining what kind of income is "low taxed". What is "low" taxation is determined by comparing the taxes levied abroad on the relevant rates, which would have been payable at home country and what has actually been paid abroad.

Further, which types of incomes are included in comparison? In a broad approach, all incomes from a certain jurisdiction or only incomes from certain transactions, i.e., tainted income. When looking at this more targeted transactional approach the "good income", is normally called active income, whereas the easily shifted and therefore "bad income" is usually called passive income. If a CFC (entity) is considered having low taxed income, covered by the CFC rules, domestic shareholders – are subject to tax on the undistributed income from the CFC. What kind of income is the object of CFC rules (i.e. all income from a jurisdiction or only income from certain transactions) basically determines the domestic taxpayers' CFC income. Here CFC rules may simply disregard the CFC, hence attributing the income, or may deem the relevant CFC income to be distributed by way of a deemed dividend.

Irrespective of how the income is technically attributed / distributed to the domestic

shareholder, this nature of mechanism has the inherent danger of taxing the foreign income abroad and the same income under CFC rules at home and potentially again on distribution back home again. In order to avoid double taxation, the following normally takes place:

- A credit is given with respect to the CFC income at home with regards to foreign taxes paid; and
- On distribution, again a tax credit is given of the (entire CFC) income distributed from a CFC. Other jurisdictions exempt dividend from a CFC.

Thus, CFC can be defined as a corporate legal entity that exists in one low tax jurisdiction and is owned and/or controlled by taxpayers of another higher tax jurisdiction. In summary CFC regulations in various jurisdictions generally define the types of owners and entities affected, types of incomes or investments subject to inclusion as CFC income, exceptions to inclusion in computation of CFC income and means of preventing double inclusion of the same income.

3.3 Need for CFC rules in India

Indian resident companies are required to pay taxes on their worldwide income including foreign source income. India is a developing country, and it follows United Nations double tax avoidance treaty model, and accordingly, taxes all the income earned from a foreign source and grants credit for the taxes paid abroad for avoidance of double taxation. A non-resident company is taxable in India in respect of income accruing or deemed to be accrued from India.

Accordingly, income derived by a foreign subsidiary (wherein Indian company is a Holding company) is only taxed abroad, unless it gets distributed back to India. This non-taxation of foreign source income of an Indian company's foreign subsidiary provides a number of tax planning opportunities to Indian corporate groups enabling them:

- To reduce foreign taxes by choosing a jurisdiction with low / zero tax rates or beneficial regimes for certain types of income; and
- To defer or mitigate taxation in India on these (low) taxed overseas profits until distributed to India.

These strategies seek income being earned in a low tax regime (e.g., tax havens) and not repatriated back to India. Such an activity is possible as there are no compulsions on India's foreign subsidiary under exchange control regime to repatriate such profits into India. Such strategies include but are not limited to setting up either foreign holding company or companies holding global intellectual property (rights) or a global operating company.

In past, the Act had sections 104 to 109 to levy additional tax on undistributed profits including that of residents. The Finance Act, 1987 withdrew these provisions. Circular 495 dated 22 September 1987 explained this withdrawal as follows:

“10.1 Sections 104 to 109 relate to levy of additional tax on certain closely-held companies (other than those in which the public are substantially interested) if they fail to distribute a

specified percentage of their distributable profits as dividends. These provisions had lost much of their relevance with the reduction of the maximum marginal rate of personal tax to 50 per cent which is lower than the rate for corporation tax on closely-held companies. Sections 104 to 109 have, therefore, been omitted by the Finance Act, 1987.”

As a substitute, deemed dividend provisions in section 2(22)(e) of the Act were suitably amended to take care of the abuse. Circular 495 dated 22 September 1987 read as follows:

“10.2 With the deletion of sections 104 to 109

As per CFC Rules introduced in Direct Tax Code, profits earned by a Controlled Foreign Company, located in territory with a lower rate of taxation, will be included in taxable profits of parent company located in India. However, presently there are no statutory provisions in existing Income Tax Act for enactment of CFC Rules. Pending the legislating of DTC, the Finance Minister of India has, introduced many anti-tax avoidance provisions, the most important being General Anti Avoidance Rules (GAAR) which is effective from 1st April 2017.

Under existing Income tax Act, the Government has recently introduced concept of Place of Effective Management ("POEM"). The ensuing paragraphs detail out the concept of Place of Effective Management and also the guidelines for determination of place of effective management.

3.4 CFC Regulations – Approaches

CFC regulations typically have the following approaches

- (a) Jurisdictional approach
- (b) Transactional approach
- (c) Entity-level approach

3.4.1 Jurisdictional approach

Under the jurisdictional approach, foreign companies set-up by resident companies in low-tax jurisdictions are targeted. Accordingly, where a resident company sets up a subsidiary mainly to act as an intermediate holding company or non-operating holding company in a low-tax jurisdiction, such foreign company is deemed to be a controlled foreign company for the purpose of CFC regulations. In such a scenario, CFC regulations are deemed to be applicable on such foreign companies in low-tax jurisdiction and all the income earned by such foreign companies is taxed in the hands of the resident company.

3.4.2 Transactional approach

Under the transactional approach, the focus is generally restricted to the passive income earned by foreign subsidiaries of resident companies. Passive income would tend to include incomes like royalty, interest, rent, capital gains etc.

3.4.3 Entity-level approach

This is a hybrid approach combining the principles of jurisdictional approach and transactional

approach. Under this approach, CFC regulations are triggered both when the foreign subsidiary is setup in a low-tax jurisdiction and when the foreign subsidiary has passive income stream.

The CFC regulations proposed under DTC follow the entity level approach. Under this approach, the focus is on the CFC as an entity rather than on its income, although the nature of its income (whether active or passive income) is an important factor in the determination of whether or not the CFC rules apply. Once a foreign company qualifies as a CFC (and none of the exemptions apply), all of the income of the CFC is taxed in the hands of the resident-controlling shareholder on a proportionate basis. The future dividend distribution of the attributed income by the CFC is deductible.

3.5 Place of Effective Management in India

Section 6(3) of the Income-tax Act, 1961 (the Act), prior to its amendment by the Finance Act, 2015, provided that a company is said to be resident in India in any previous year, if it is an Indian company or if during that year, the control and management of its affairs is situated wholly in India. Vide Finance Act, 2015 the existing provisions of section 6(3) of the Act were amended to provide that a company is said to be resident in India in any previous year, if-

- (i) it is an Indian company; or
- (ii) its place of effective management (POEM) in that year is in India.

Explanation to the aforesaid section defines "place of effective management" to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. The Finance Act, 2016 had deferred the applicability of PoEM by 1 year i.e. from 1 April 2016 (FY 2016-17). Further, the Finance Act, 2016, introduced special provisions in respect of foreign company said to be resident in India on account of PoEM by way of insertion of a new Chapter XII-BC consisting of Section 115JH in the Act with effect from 1st April 2017.

CBDT Circular no. 8/2017 dated 23rd February 2017 clarified that provision of section 6(3)(ii) shall not apply to companies having turnover or gross receipts of Rs. 50 crore or less in a financial year.

CBDT has also issued detailed guidelines vide circular 6/2017 dated 24th January 2017 for determination of POEM giving various factors which needs to be considered for such determination. The guidelines provide that the process of determining POEM would be primarily based on the fact whether or not the company is 'engaged in active business outside India' (ABOI).

3.5.1 Determination of PoEM

- The determination of PoEM depends on the facts and circumstances of a given case.
- It recognizes the concept of substance over form.

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- The place of effective management differs from a place of management and an entity can have only one place of effective management at any point in time.
- Based on the facts and circumstances if it is determined that during the previous year the PoEM is in India and also outside India then PoEM shall be presumed to be in India if it has been mainly /predominantly in India
- The determination of PoEM shall be an annual exercise.
- The process of determining PoEM would be primarily based on the fact whether or not the company is engaged in active business outside India.
- In case the Assessing Officer proposes to hold a company as resident in India on the basis of PoEM, then prior approval of the Principal Commissioner or Commissioner will be required

3.5.1.1 Companies engaged in ABOI

A company shall be said to be engaged in 'active business outside India' if the passive income is not more than 50% of its total income and , -

- (i) less than 50% of its total assets are situated in India; and
- (ii) less than 50% of total number of employees are situated in India or are resident in India; and
- (iii) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

It may be noted that passive income of a company shall be aggregate of , -

- (i) income from the transactions where both the purchase and sale of goods is from / to its associated enterprises; and
- (ii) income by way of royalty, dividend, capital gains, interest or rental income;

However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as under the applicable laws of the country of incorporation.

If a company is engaged in ABOI and majority of the board meetings and management powers are exercised by board outside India, then the POEM of such entity shall be based outside India. However, if on the basis of facts and circumstances it is established that the Board of directors of the company are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person (s) resident in India, then the POEM shall be considered to be in India.

3.5.1.2 Companies engaged in other than ABOI

In cases of companies other than those that are engaged in ABOI the determination of POEM is proposed to be a two stage process , namely:-

- (i) First stage would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole.
- (ii) Second stage would be determination of place where these decisions are in fact being made.

3.5.1.3 Guiding Principles for determination of POEM for companies other than in ABOI

The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM it is the substance which would be conclusive rather than the form. The guidelines also provide that the following factors can be considered for determination of POEM:

- Location of Board Meeting
- Delegation of authority
- Location of Executive committee
- Location of Head office
- Use of modern technology
- Circular resolutions or round robin voting
- Shareholders effective management

It has been clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM.

If the above factors are not decisive for determination of POEM, other secondary factors are considered:-

- (i) Place where main and substantial activity of the company is carried out; or
- (ii) Place where the accounting records of the company are kept

The guidelines provides that determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

- (i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- (ii) The fact that there exists a Permanent Establishment of a foreign entity in India would not be conclusive evidence that the conditions for establishing POEM in India would have been satisfied.
- (iii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

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- (iv) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.
- (v) The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.
- (vi) The decision made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's POEM.

The guidelines provide that for determination of POEM no single principle will be decisive in itself. The above principles are not to be seen with reference to any particular moment in time rather activities performed over a period of time, during the previous year, need to be considered. In other words a "snapshot" approach is not to be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly/predominantly in India.

3.5.2 Illustrations

The guidelines also include illustrations on interpretation and determination of PoEM. Specifically, the illustration clarifies that,

- (i) Only transactions where both purchase and sale is from/to associated enterprise needs to be considered in computing passive income;
- (ii) All conditions viz. income, value of assets and number of employee in India and payroll expenses needs to be seen on a collective basis.
- (iii) For a company engaged in ABOI, even in a case wherein all the directors are Indian residents, the PoEM shall be presumed to be outside India if the majority of the board meetings have been held outside India.
- (iv) In case shareholders involvement results in effective management of the Company, then the same needs to be considered in determination of PoEM.
- (v) Merely because the PoEM of an intermediate holding company is in India, the PoEM of its subsidiaries shall not be taken to be in India. Each subsidiary needs to be examined separately.

For the purpose of determination of POEM, the assessing officer (AO) before initiating any proceedings is required to seek prior approval of the Principal Commissioner or the Commissioner. In case the AO proposes to hold a company incorporated outside India, on the basis of its POEM, as being resident in India then any such finding shall be given by the AO after seeking prior approval of the collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned, in this regard. The collegium so constituted shall

provide an opportunity of being heard to the company before issuing any directions in the matter

Once the POEM of the foreign company is held to be in India, then its worldwide income shall be liable to tax in India. Such foreign companies shall also be liable to undertake tax compliances in India. The CBDT has also clarified that the intent is not to target Indian Multi Nationals which are engaged in business activity outside India. The intent is to target shell companies and companies which are created for retaining income outside India although real control and management of affairs is located in India. It is emphasized that these guidelines are not intended to cover foreign companies or to tax their global income, merely on the ground of presence of Permanent Establishment or Business connection in India.

The administrative safeguards proposed and the clarification that the intent is not to target Indian Multinationals which are engaged in business activity outside India are reassuring. While the guidelines are in line with the internationally accepted principles, the determination of POEM is subjective in nature and may lead to litigation and compliance cost in India.

The ensuing paragraphs detail out the proposed Indian CFC provisions as brought out in the DTC and what it means for the taxpayers along with an inclusive analysis of the issues that this new far reaching legislation throws up.

Unit-IV	Some Other Anti-Avoidance Measures
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4.1 General

Depending upon the types and techniques of tax-avoidance, various other techniques have been developed in international tax environment as anti-avoidance to such measures. Few of such measures are exchange of information, arm's length principle, thin capitalization, transfer of tax residence and exit taxes, exchange controls, branch profit tax, stricter measures for payments made to entities based in tax havens etc.

4.2 Exchange of information

Exchange of tax information between various states also plays a vital role to identify tax-avoidance and works as an anti-avoidance measures. The exchange of information under tax treaties and other bilateral agreements between states is a further measure to ensure domestic and internal tax compliance.

The double tax treaties include an "Exchange of Information" Article. Under this Article, the tax authorities may exchange information that is necessary for compliance with the treaty provisions and domestic taxes, except when they contravene the treaty provisions. The tax authorities may share the tax information on residents and non-residents, provided it does not conflict with their own national laws and administrative policies, and the disclosure is not against public policy. Further as anti-tax avoidance assistance, such Article also enables comprehensive help to each other by the states in the collection of taxes.

The OECD Commentary clarifies that the information under such arrangements may be provided in a number of ways:

- Automatic transfer of routine tax information without any prior request e.g. list of payments made to residents of other state or any entity in which such member has interest
- A specific information request initiated from a treaty partner for specific information about a particular taxpayer
- A spontaneous exchange of information when one taxing authority discovers, during the course of an examination or investigation, non-compliance with the treaty partner's tax laws.
- In a joint audit by tax authorities of states, tax authorities in both treaty countries independently examine affiliated taxpayers in their respective jurisdictions. They may meet periodically and request each other to provide necessary information in a given case under the tax treaty provision.

The information obtained under tax-treaty may also be communicated to the taxpayer, but he has no right either to object to or to be informed about such disclosures to the tax officials.

There is also a Model Agreement drafted by OECD, under its Harmful Tax project Initiative, on Exchange of Information on Tax Matters. The Agreement binds the competent authorities of contracting states to provide assistance through exchange of information as may be relevant for the administration and enforcement of their respective tax laws. The Model contains 16 Articles including commentary on each of such articles. Some of the salient features include:

- It covers various types of direct taxes including taxes on income, capital, wealth, estate, inheritance or gift taxes etc.
- Information must be provided on request by the competent authority of the applicant party
- The requested State must make best efforts to meet the request, even if such information may not be needed for its own tax purposes
- Competent authorities of the two States must have the necessary authority to obtain and provide upon the request the tax information held by third parties, such as banks, trust etc.

The Model also provides circumstances when the request for tax information may be declined by the requested party. Few of such circumstances include;

- The information is not obtainable under its own laws by the applicant party
- Information is not relevant to the tax affairs of given taxpayers.
- Information that would disclose any trade, business, industrial, commercial or professional secret or trade process, or against public policy
- Confidential communication of information between a client and his lawyers when provided as legal advice or for use in legal proceedings
- Information that discriminates against a national of the requested party when compared with a national of the other party under similar circumstances
- Information not in the possession or control of the authorities or any person within their jurisdiction

The model also provides confidentiality to be maintained in respect of information obtained under the agreement and also provides time deadlines within which the requested competent authority must inform the applicant competent authority.

In the Indian Context, India has signed Inter Governmental Agreement (IGA) with USA to implement Foreign Account Tax Compliance Act (FATCA) of USA to promote transparency on tax matters. The United States enacted FATCA in 2010 to obtain information on accounts held by U.S. taxpayers in other countries. It requires U.S. financial institutions to withhold a portion of payments made to foreign financial institutions (FFIs) who do not agree to identify and report information on U.S. account holders. As per the IGA, FFIs in India will be required to report tax information about U.S. account holders directly to the Indian Government which will,

in turn, relay that information to the IRS. The IRS of USA will provide similar information about Indian account holders in the United States. This automatic exchange of information was scheduled to begin on 30th September, 2015. One of the peculiar conditions of the agreement is that there will be automatic exchange of information and each competent authority of India and USA will enable in their applicable law to collect and provide such information

In view of such IGA, to cover flow of such information, India has also amended provision of section 285BA of the Income Tax Act, 1961 which mandates specified persons to provide specified information of financial transactions and reportable account to income tax authority. Sharing of such information would reveal various financial and related interests in other country, of residents of respective countries. This would enable tax authority to properly monitor and assess tax position adopted by the taxpayer in respect of its assets/income lying in other contracting states.

4.3 Thin capitalization

Debt financing of cross-border transactions is often favourable than equity financing for taxpayer. This is because payment of interest is a tax deductible expense whereas payment of dividend is regarded as appropriation of profit. Further in many countries (like India) tax is also payable on distribution of profit as dividend out of tax paid profit. Further in certain cases, dividend receipts may be preferable to interest income; for example if the dividends are tax exempted and interest received is subject to a relatively high tax rate in the state of residence.

Thin Capitalization refers to excessive use of debt over equity capital; this can be via hidden equity capitalization through excessive loans (or) the artificial use of interest-bearing debt instead of equity by shareholders with the sole or primary motive to benefit from tax advantages.

Some countries have thin capitalization rules which are primarily concerned with loan capital provided by non-resident lenders, who are also substantial shareholders of a domestic company. As expected, these rules vary widely in counties that do apply the thin capitalization rules. At the basis of thin capitalization is the use of debt instead of equity; normally such use of debt instead of equity has several tax and non-tax advantages. For example:

- Interest expense is tax-deductible whereas dividend payments are not
- Unlike interest, dividends are usually subject to economic double taxation
- Debt financing avoids wealth taxes, net worth taxes and other capital duties imposed on equity contributions
- Debt allows the repatriation of capital invested as loan repayment without tax consequences
- It is possible to select currency of debt to minimize foreign exchange risks; equity is normally denominated in the currency of the host country

- Debt provides greater flexibility since it is possible to convert debt to equity but not the reverse
- Withholding tax on interest is often nil or lower than on dividends.

Approaches to thin capitalization taken by countries worldwide can be categorized as follows:

- (i) Arms-Length approach: Based on general principle of thin capitalization would an unrelated party provide debt funds on the same basis as related party loan arrangement?
- (ii) Hidden Profit distribution: Specific provisions under tax law allow loan interest to be reclassified as “constructive dividend”; these apply usually when lender and borrower are related persons or have a defined relationship. It may also apply if subsidiary company is undercapitalized and a loan from parent is of a permanent nature or on non-arm’s-length basis.
- (iii) No rules” approach: No specific rules; use GAAR and judicial doctrines
- (iv) Fixed Ratio approach: Specify maximum debt-equity ratio in the rules.

It must be noted that rules under domestic law on international thin capitalization may be limited or overridden by double tax treaties. Also, many countries, as yet, do not have any thin capitalization rules; examples are, Finland, Iceland, Ireland, Sweden, Israel, Indonesia, Brazil, Singapore, etc.

Historically India did not have Thin Cap Regulations, however recently section 94B has been inserted in the tax laws w.e.f. April 1, 2018, which provides for limitation on interest deduction in certain cases

The rationale cited for the introduction of these regulations was:

“A company is typically financed or capitalized through a mixture of debt and equity. The way a company is capitalized often has a significant impact on the amount of profit it reports for tax purposes as the tax legislations of countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible . Therefore, the higher the level of debt in a company, and thus the amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity. Multinational groups are often able to structure their financing arrangements to maximize these benefits. For this reason, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base.

Under the initiative of the G-20 countries, the Organization for Economic Co-operation

and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action plan 4. The OECD has recommended several measures in its final report to address this issue. In view of the above, it is proposed to insert a new section 94B, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.”

The provision is applicable to an Indian company, or a permanent establishment of a foreign company being the borrower who pays interest in respect of any form of debt issued to a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender.

The provisions allow for carry forward of disallowed interest expense to eight assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession to the extent of maximum allowable interest expenditure.

In order to target only large interest payments, it provides for a threshold of interest expenditure of one crore rupees exceeding which the provision would be applicable. Banks and Insurance business are excluded from the ambit of the said provisions keeping in view of special nature of these businesses.

4.4 Arms' length approach (Transfer Pricing)

Such anti-avoidance techniques are widely used across the countries to substitute arm's length price instead of actual transaction price between two related organizations. This approach is used to protect the tax base of respective country by determining arm's length prices of transactions executed within an MNC groups.

The real issue is the sharing of taxable income by countries in which the MNEs operate lawfully. Transfer pricing affects situations when goods and services are provided, knowingly or otherwise, on a non-arm's length basis by related entities.

Towards such transfer pricing issues, the arm's length principle (Article 9,OECD MC) has been evolved; it seeks to determine whether the transactions between related taxpayers (in this case the corporation and its subsidiary S) reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

Arriving at the appropriate arm's length price is done through a plethora of transfer pricing methods, which usually prove to be a point of contention between the taxpayers and the revenue. Countries typically tend to limit their transfer pricing rules to cross-border related

transactions only; however several of them include similar domestic transactions as well. Some examples are India, Canada, Belgium, Denmark, Greece, Poland, Portugal, Slovenia, United Kingdom, and United States.

Furthermore, as noted above, countries typically apply transfer pricing rules to certain related party transactions. However, some countries use a broader definition of “associated enterprises” based on mutual benefit or influence like India, China and Korea. Few countries include transactions with preferential tax regimes and tax havens under transfer pricing rules like Argentina, Brazil, Latvia and Turkey. Many countries still do not have specific transfer pricing rules in their domestic tax law and rely on other anti-avoidance rules, if they exist.

There are countries which have safe-harbour rules under which they grant partial or total relief from transfer pricing obligations. For example, in Brazil the agreed minimum percentage mark-ups based on industry norms may be used in specific transactions. India has also notified such types of rules [Rule 10TA to Rule 10THD of the Income Tax Rules, 1962] wherein if necessary conditions have been fulfilled and the value of international transaction with associated enterprises satisfied percentage of mark-up/other criteria, provision of transfer pricing is not applicable in respect of such transactions.

Many countries have established procedures to grant transfer pricing rulings under an advance pricing arrangement” (APA). These APAs provide for certainty for the taxpayer on the taxation of certain cross-border transactions. These arrangements may be bilateral or multilateral. E.g. India has notified scheme APA vide Rule 10F To Rule 10T of the Income Tax Rules, 1962 whereby tax authority and taxpayer have been empowered to enter into unilateral as well as bilateral APA which can have roll back effect (Rule 10MA and 10RA) by following necessary conditions, procedures and guidelines specified under those rules. .

The provisions of secondary adjustment are internationally recognised and are already part of the transfer pricing rules of many leading economies in the world. Whilst the approaches to secondary adjustments by individual countries vary, they represent an internationally recognised method to align the economic benefit of the transaction with the arm's length position. "Secondary adjustment" means an adjustment in the books of accounts of the taxpayer and its associated enterprise to reflect that the actual allocation of profits between the taxpayer and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee. As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD transfer pricing guidelines), secondary adjustment may take the form of constructive dividends, constructive equity contributions, or constructive loans.

W.e.f. 1 April 2018, in order to align the transfer pricing provisions in line with OECD transfer pricing guidelines and international best practices , India has inserted a new provision (section 92CE) in the tax laws to provide that the taxpayer shall be required to carry out secondary adjustment where the primary adjustment to transfer price, has been made suo-

motu by the taxpayer in his return of income; or made by the Tax Officer has been accepted by the taxpayer; or is determined by an advance pricing agreement entered into by the taxpayer or is made as per the safe harbour rules; or is arising as a result of resolution of an assessment by way of the mutual agreement procedure. Where as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, of the taxpayer the excess money which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the taxpayer to such associated enterprise and the interest on such advance, shall be computed as the income of the taxpayer, in the manner as may be prescribed. Secondary adjustment shall not be carried out if, the amount of primary adjustment made in the case of taxpayer in any previous year does not exceed one crore rupees and the primary adjustment is made in respect of an assessment year commencing on or before 1stApril,2016.

4.5 Transfer of Tax Residence and Exit Taxes

Certain countries regard a transfer of residence as a form of tax avoidance. In jurisdictions with worldwide tax regime, taxpayers when they become nonresidents are no longer liable to pay taxes on their foreign source income. Moreover, the gains on movable property accrued during period of residence but realized at time of departure also escape taxation. Such countries have enacted SAARs to prevent tax avoidance through emigration. Examples are Australia, Canada, Denmark, U.S.A., etc.

E.g. USA taxes its US Citizens/permanent Residents (Green Card holders) on their worldwide income. USA tax law provides that if an Individual gives up his or her citizenship or long-term permanent US residence, US shall continue to tax the individual as a US citizen or resident for ten years on his or her US source and effectively connected foreign source income if certain conditions have been fulfilled. Germany subjects its long-term resident nationals to extended unlimited taxation if they immigrate to a low-tax country but maintain their essential economic ties (as defined under German tax law) with Germany.

Regarding Transfer of Corporate Residence, the transfer may require company to be wound up or deemed as liquidated in several civil law jurisdictions (Example: Australia, Belgium, Denmark, Sweden). If a German company transfers its head office abroad, the law will dissolve it; a foreign company cannot transfer its registered office to Germany. Certain countries choose to impose an “exit tax” when a company ceases to be their resident - the company in such a case is subject to a capital gain on its deemed sale. Examples include United States, UK, Canada and Austria.

4.6 Branch Entities & Branch Profit Taxes

Under a classical tax system, host country taxes the corporate profits twice at company level and again when company pays dividend. Most countries do not tax remittances of after-tax branch profits to non-residents. A branch entity therefore avoids this economic double taxation.

Several jurisdictions regard the use of a branch as an unjustified loss of tax revenue that would have been due to them as dividend withholding taxes from a subsidiary. Thus, additional taxes either on branch profits or on remittances to head office is levied at Branch level. In India proposed Direct Tax Code Bill, 2010 (not enacted) contains provision of levy of branch profit tax in India.

4.7 Use of Tax Havens

Tax havens are jurisdictions which tend to have nil or low taxation. Tax havens may also be jurisdictions which have other benefits like financial secrecy, minimum reporting requirements, ring fencing, discretionary tax privileges, allowing ownership to be held in trust, no registry of companies and partnerships, no taxes on dividends and interest payments to non-residents, etc.

Several countries have SAARs, i.e., specific anti-avoidance legislation to limit the deductions of tax expense or grant of tax benefits to entities located in certain blacklisted countries. E.g. India has enacted section 94A under the Income Tax Act, 1961 which enables the Central Government to notify country or territory outside India having lack of effective exchange of information. On being notified, there could be restriction on allowability of payment made to entity situated in such areas, higher withholding tax requirement in India and applicability of transfer pricing provisions etc.

4.8 Significant economic presence

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on “significant economic presence”.

Provisions related to business connection arising due to significant economic presence (including digital transactions) are now part of section 9(1)(i) of the Act as laid down by Finance Act 2018. The Indian SEP test is divided into two limbs: The first limb is triggered if aggregate of payments arising from transactions are carried out by a non-resident in India, including the download of data or software exceeding a certain threshold in India. The second limb applies if such business activities are conducted in a systematic and continuous way in interaction with a certain number of users. The SEP applies even when there is no local agreement signed, independently of the existence of a fixed place of business of the non-resident who may or may not provide services to local customers. The Finance Act 2020, has further clarified certain aspects relating to SEP. The transaction carried out by a non-resident with any person in India will be subject to the scope of SEP. Also, the words “through digital means” has been removed, thereby intending that activity through any means may include in the scope of SEP. Vide Explanation 2A of Section 9(1)(i) of the Act, the provisions of SEP are applicable from AY 2022-23.

Further, **The CBDT has notified the Income Tax (13th Amendment) Rules, 2021 with effect from 1 April 2022. A new rule has been inserted to provide thresholds for**

determining the SEP of a non-resident in India. Now, the SEP in case of a non-resident shall be triggered if (a) aggregate amount of payment for a specified transaction with a person in India exceeds INR 20 million (during a year) or (b) non-resident undertakes systematic and continuous soliciting of business activities or engages in interaction with 300,000 or more users in India.

4.9 Exchange Controls

Exchange control and tax clearances may be used by countries as anti-avoidance measures on cross-border transactions. These transactions are subject either to prior government approvals or post-transaction reporting thereof. Many countries (mostly developing countries) have a partial or full exchange control. E.g. in India all capital account transactions under FEMA are not freely allowed unless provided otherwise and all revenue account transactions are freely allowed unless provided otherwise. Foreign exchange earned may have to be surrendered to the exchange control authorities or at least reported to them. The payment of dividend, royalty, interest payment outside India may require approval from such exchange authorities etc. Such authority may question the transfer pricing on such transactions. The purpose and the manner in which such regulations are put in place will determine how they will work as anti-avoidance measure for tax purposes.

Module G

Other Issues in International Taxation

Unit I	E-commerce: Taxation in India
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1.1 Introduction

Change is the only constant!

Order online, payment online, various innovative applications have changed the way various transactions, businesses and activities were done in traditional modes.

Simplistically put, 'e-commerce or electronic commerce can be explained as a transaction which is conducted through electronic means. Such transactions could be buying and selling/ providing services on an electronic platform, electronic transfer of funds, data exchanges, etc. The World Wide Web and mobile applications are used for trade and commerce. Websites and applications like Amazon, E-bay, Alibaba, Flipkart, Snapdeal, Makemytrip, etc. have become major mediums by which transactions are carried out and have completely revamped the way business has been carried out. Online advertising has become as significant, if not more, than traditional modes of advertising like print, television, hoardings etc.

Electronic modes have blurred the geographical boundaries and has made it difficult to identify the physical place/ point where a particular activity in the chain of transactions which takes place in electronic commerce. With this, there is a possibility of shifting the profits to other jurisdiction or minimizing the taxable base in absence of physical presence and physical delivery. E-commerce has led to making taxation complex and therefore litigations are springing up.

The manner of taxability of such transactions is being discussed and debated the world over.

1.2 Definition of e-commerce

To understand the nuances of typical e-commerce transactions and its taxation in India, it is imperative to gather knowledge on the definition/ interpretation of the e-commerce by various authorities and renowned international bodies:

(a) The High Powered Committee constituted by the Central Board of Direct Taxes:

"E-commerce, as generally defined, covers transactions involving offer and acceptance on networks. Mode of delivery and payment may be in digitized form or in traditional manner".

(b) Organisation of Economic Co-operation and Development ('OECD') Working Party on Indicators for the Information Society:

"the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations".

(c) National Association of Software and Services Companies (NASSCOM):

“E-commerce to be transactions where both the offer for sale and acceptance of offer are made electronically”.

(d) The Asia Pacific Economic Co-operation ('APEC'):

“to include all business activity conducted using a combination of electronic communications and information processing technology”.

(e) The United Nations Economic and Social Commission for Asia and the Pacific ('UNESCAP'):

“the process of using electronic methods and procedures to conduct all forms of business activity”.

1.3 E-commerce models

There are various models in which e-commerce exists which have been discussed below:

(a) Business to Consumer ('B2C') model

In this model, the business directly deals with the ultimate consumer.

Examples of such models include emails, online shopping, online travel, tour operators etc.

(b) Business to business ('B2B') model

B2B refers to a situation where one business makes a commercial transaction with another i.e. it is a commercial transaction where the seller is business organization and the buyer is also a business organization.

Examples of such a business model include online advertisements placed on websites by businesses, cloud computing services taken by organizations etc.

(c) Consumer to Business ('C2B') model

This is a recently developed model where in the consumer sells products to business.

One of such example is Cartrade.com where consumer sells the second hand cars to Car trade.com.

(d) Consumer to Consumer ('C2C') model

In this model, a consumer deals with another consumer. The seller places the product on an e-commerce site for sale. The buyer and seller interact directly for the transaction.

Examples of such business models is the second hand goods trading portals like Quickr.com, Olx.com or other portals where the website only acts as a marketplace or a match making platform between two consumers.

1.4 Taxation of e-commerce

The taxability of transactions however does not depend on the above models but on characterization as per taxability provisions. The relevant provisions which need examination are:

1.4.1 Royalty-Whether payments flowing from e-commerce can be characterized as 'royalty'

Many treaties contain provisions that payments for use of equipment qualify as being in the nature of royalty. Once characterized as royalty, they are taxable on a gross basis.

Further, the Indian domestic law has included payments made for 'transmission by cable, optic fiber or similar processes within the meaning of royalty'.

In some e-commerce transactions, the payments could actually be made before use of servers or equipment etc., (the same is discussed in detail in subsequent paragraphs).

A controversy has been created by the amendment in the domestic law. The question that needs to be addressed in the domestic law is whether the parties are making payment for transmission by cable, optic fiber etc. (which obviously is the underlying infrastructure for an e-commerce transaction) or the parties are making payments for the service / goods from an electronic platform and not concerned with the underlying infrastructure (cables etc.) which are means by which the service is delivered or goods are sold to them. This amendment has been inserted by the Finance Act 2012.

1.4.2 Fees for technical services ('FTS')

In some cases, the Tax authorities also like to contend that the e-commerce company is rendering technical services to the payer because e-commerce transactions involve use of technology.

1.4.3 Permanent Establishment ('PE')

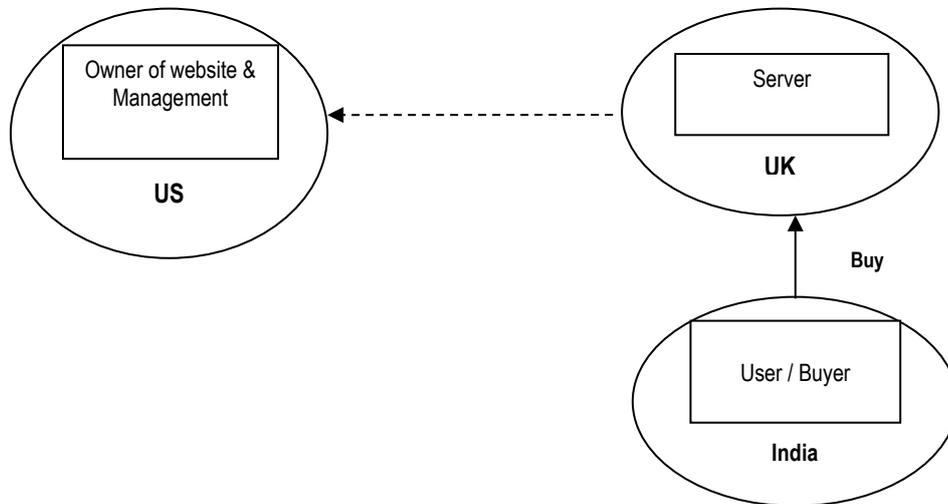
As discussed above, the physical location where the transaction is concluded gets blurred in an e-commerce scenario. The original modes of doing business within countries by way of marketing subsidiaries, distributor subsidiaries, branches which traditionally created 'PE' and therefore, taxability in countries where the revenues arise is not necessarily a reality in an e-commerce scenario.

The question is therefore where the revenues should be taxed in an e-commerce scenario:

The country where the goods are sold, or where the goods originate or the country where the server which leads to the conclusion of transaction is located.

The issue is illustrated below:

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The website owner could be registered and have the management based in USA. It could have the server in another country, say UK. The users or buyers may be anywhere in the world.

The transaction is electronically concluded on the server in the UK.

Further, the OECD commentary has mentioned that where the server on which the website is stored and through which it is accessible is a piece of equipment having a physical location it would be considered as a fixed place of business. Hence, the company shall be taxed in the country where the server is located, if the server is at the disposal of the enterprise.

1.5 Characterization aspects in various modes of e-commerce models of business.

Bilateral tax treaties or double taxation avoidance agreements (DTAAs) are entered between governments to assign taxing rights in case of cross-border transactions, thereby encouraging cross-border relationships, preventing double taxation as well as strengthening political ties between partner countries. The tax treaties allocate taxing rights between countries on the basis of income source or residency-based rules, while recognizing the rights of both countries to levy tax on such income.

The existing tax rules that were developed by a group of economists appointed by the League of Nations in the 1920s provide for a threshold for taxation of business profits in the form of "permanent establishment" (PE). According to Article 7 of tax treaties, business profits of an enterprise are taxable in the country of residence of such enterprise. However, in case the enterprise carries on its business in another country through a PE situated there, such other country may also tax business profits of the enterprise to the extent attributable to the PE. The concept of PE is largely conceived as a fixed place of business through which business of an enterprise is wholly or partly carried on, thereby establishing taxable nexus based on physical presence.

Interestingly, over the years, while the concept of PE has evolved to include within its ambit, inter alia, provision of services and undertaking of construction activities beyond certain threshold duration, undertaking activities acting on behalf of an enterprise, and habitually exercising an authority to conclude contracts on its behalf, constitution of PE is still dependent on physical presence.

However, in the digital era, digitalized businesses can be heavily involved in the economic life of a jurisdiction without any, or any significant, physical presence in that country, thereby creating opportunities to avoid taxes completely in the source country. This fundamental challenge arises in the context of international tax rules which were designed a century ago, long before advent of the digital economy where businesses can be conducted remotely.

Various e-commerce modes of transaction

1.5.1 Advertisement revenues of web sites

There are websites where one can access various services viz. content, news, e-mails, search engines, chats, etc. These websites generate revenues from advertisement, etc. LinkedIn, Google, Facebook are many such websites which earn revenues through advertisement (generally under B2B model). The websites generally earn revenues from the advertiser based on number of clicks by a viewer on a particular advertisement.

Social Commerce

When a transaction is done through the social websites such as Facebook, Twitter, Youtube, etc. then such a process / transaction is called Social Commerce. These social media websites facilitate sharing of information, reviews, product listings, etc. amongst the social media users.

On Youtube, the users upload and share interesting videos for viewing of the public at large. Advertisements are also placed alongside the streaming of the videos which a user accesses for its knowledge. Both, the web-site and the content provider, share revenues generated from such advertisements placed along with the videos.

Advertisement agencies are hired by the Indian companies to display their advertisements on these portals owned by the non-resident companies.

1.5.2 Online provision of content

In some cases, subscribers pay for information, news, case laws, any other content which they access online. Examples of such subscription are Bloomberg, Factiva etc.

In such cases, the critical points which need evaluation are:

- (a) Know-how

Whether the content for which payments are made is in the nature of know-how and therefore in the nature of royalty:

The definition of Royalty under Section 9(1)(vi) of the Income-tax Act, 1961 ('the Act') as well as in the Tax treaties includes, "imparting of any information concerning technical, industrial,

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commercial or scientific knowledge, experience or skill”.

Further, the India – USA Tax Treaty has interpreted the meaning of “information concerning industrial, commercial or scientific experience” as follows:

“The above term *alludes to the concept of **know-how** and means information that is **not publicly available** and that cannot be known from mere examination of a product and mere knowledge of the progress of technique”.*

Where online access / subscription payments are made to avail the information which may be in nature of technical, industrial, commercial or scientific knowledge, experience or skills, whether the information is technical in nature, etc. is a question of fact and accordingly the payment could be taxable as royalty for online access / subscription in India.

(b) Copyright vs Copyrighted article

Whether the content is downloaded by the subscriber or where the subscriber can share the content with others. The question arises is whether the subscriber get rights in respect of the copyright and therefore is the payment in the nature of royalty.

The controversy on rights in copyright vs. copyrighted article depends on whether the subscribers only get access or do they get rights to make copies, share the content further, modify it, monetize it etc. If these elements are involved, it could be said that there is rights in the copyright of the content which the subscriber gets and should be in the nature of royalty.

A copyright means an exclusive right to do or to authorize to do certain acts in respect of a "work", including an exclusive right, inter alia, to reproduce the copyright in the work in any material form and exploit the same by way of sale, transfer or license etc. Making copies or adaptation of computer programme to utilise or to make back-up copies as a temporary protection against loss, destruction or damage to utilise it, does not constitute an act of infringement of copyright. Even storage of computer program, *per se*, would not result in infringement. Nomenclature of the agreement between the parties does not matter and what is relevant is the real nature of the transaction having regard to the overall terms of the agreement and surrounding circumstances.

Let's look at how judicial precedents have interpreted this issue:

- ***Engineering Analysis Centre of Excellence Private Limited v. CIT [2021] 125 taxmann.com 42 (SC)***

In this case, the SC reaffirmed the principle that beyond the rights mentioned in Section 14 of the Copyright Act, 1957, the copyright holder does not enjoy any further rights. Secondly, unless the payer of consideration acquires any of the rights mentioned in Section 14 of the Copyright Act, 1957, the consideration for mere use of computer software does not tantamount to royalty. Use of the term “license” under EULA is not the same as license as understood under Copyright Act, 1957. Further, merely because the purchaser has the right to copy the computer software on his/its hardware, does not mean that the payer has a right to make copies of the software. Consequently, the consideration paid for acquisition of a computer software simpliciter is not royalty either under the Act or the applicable DTAA.

The Court held that what is "licensed" by the non-resident supplier to the distributor and resold to the resident end user or directly supplied to the resident end user is, in fact, the sale of a physical object which contains an embedded computer program. Such sale of goods does not involve transfer of a copyright in the software. Reliance in this regard was placed on the decision of the Supreme Court in the case of *Tata Consultancy Services: 2005 (1) SCC 308*.

- ***Gartner Ireland Ltd. vs. ADIT [2013] (37 taxmann.com 16)(Mumbai Tribunal)***

The Taxpayer is engaged in the business of distributing Gartner Group's Research Products in the form of subscriptions, both in Ireland and through its distributors, in those territories where the Gartner Group does not have a local presence.

The subscription research products consist of qualitative research and analysis that clarifies decision making for Information Technology buyers, users and vendors. The Taxpayer sells subscription to its Indian customers / subscribers by providing them access to its products over the internet from its data server which is located outside India. The Indian subscribers pay the subscription / access fee to the assessee. The Tax authorities alleged that the amount to be in the nature of Royalty.

It held that the subscription fee paid by Indian Customers for qualitative research and analysis was in the nature of royalty, taxable under the Act & India- Ireland Tax Treaty as royalty.

- A similar view was taken by *Delhi Tribunal in case of ONGC Videsh Ltd vs. ITO (TDS) [2013] (31 taxmann.com 119)*.

The Taxpayer has subscribed to the website of global energy and mining research unit to get information in relation to oil and gas industry in different countries by way of a research agreement.

It was held that oil and natural gas and its exploration being a field of specialized technical knowledge, specific training is required in this field; therefore, information obtained by the Taxpayer was in nature of technical consultancy, fees for which was covered under definition of 'royalty' as being in the nature of information concerning industrial, commercial or scientific experience.

- ***Fact set Research Systems Inc [2009] (317 ITR 169)(AAR)***

The Applicant is an American company. It maintains a database which is located outside India and which contains financial and economic information including fundamental data of a large number of companies worldwide. Such database contains published information collated, stored and displayed in an organized manner by applicant, though information contained in database is available in public domain. To access and view applicant's data, customers can subscribe to specific database as per their requirement and can view data on their computer screens - Applicant enters into a Master Client License Agreement (MCLA) with its customers under which it grants limited, non-exclusive, non-transferable rights to its customers to use its database, software tool, etc.

It was held that subscription fee received by applicant from customers (users of database) is

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not in nature of royalty. Hence, subscription fee can be taxed only as business income, if at all it is found by department that an agency PE exists.

- ***Reuters Limited v DCIT (ITA No.: 7895/Mum/2011) [2015] 63 taxmann.com 115***

The Taxpayer is a resident of UK, engaged in the business of providing worldwide news and financial information products. In India, the Taxpayer provides its products through its Indian subsidiary under distributor/ distribution agreement. In turn, the subsidiary distributes the products to the Indian subscriber independently in its own name.

It was held that revenue earned under from distribution of news and financial information products is not taxable in India, in absence of a dependent agent PE and service PE under India- UK Tax Treaty.

- ***SkillSoft Ireland Limited (A.A.R. No 985 of 2010) [2015] 62 taxmann.com 304 (AAR - New Delhi)***

The Applicant is Ireland based company in the business of providing on demand e-learning courses. It entered into an agreement with Skill Soft India whereby Skill Soft India has right to license the SkillSoft products as a distributor. It was held that the payments received by SkillSoft Ireland from Indian end-users (permitted to access the e-learning platforms and educational content) were covered within the ambit of 'literary work' and consequently, constituted 'royalty' under Article 12(3)(a) of India-Ireland Tax Treaty.

1.5.3 Online buy-sell of goods and services

(a) Goods

In this kind of model, goods are sold online by the e-commerce company through an online store. As discussed earlier, Amazon, Snapdeal, Flipkart, etc. are the examples of such a model.

In some cases, a website owner may own the inventory and sell it to customers. This mode of operations is, however, under the regulatory controls in India.

Another model is where the website owner is only the interface so far as the products are concerned but does not stock the products (website only acts as a market place and the sale takes place between the owner of goods and the buyer).

(b) Services

E-commerce is not just restricted to buying and selling of goods, various types of services are also rendered through the e-platform. Examples of these are:

Online travel services: There are a lot of online travel sites such as Yatra.com, MakeMyTrip, Cleartrip, Goibibo, etc. where anyone can log on and book air / train tickets or even can do the hotel bookings. The payment can be made through any of the e-modes available. 'Redbus' is one of the popular modes of booking the bus tickets.

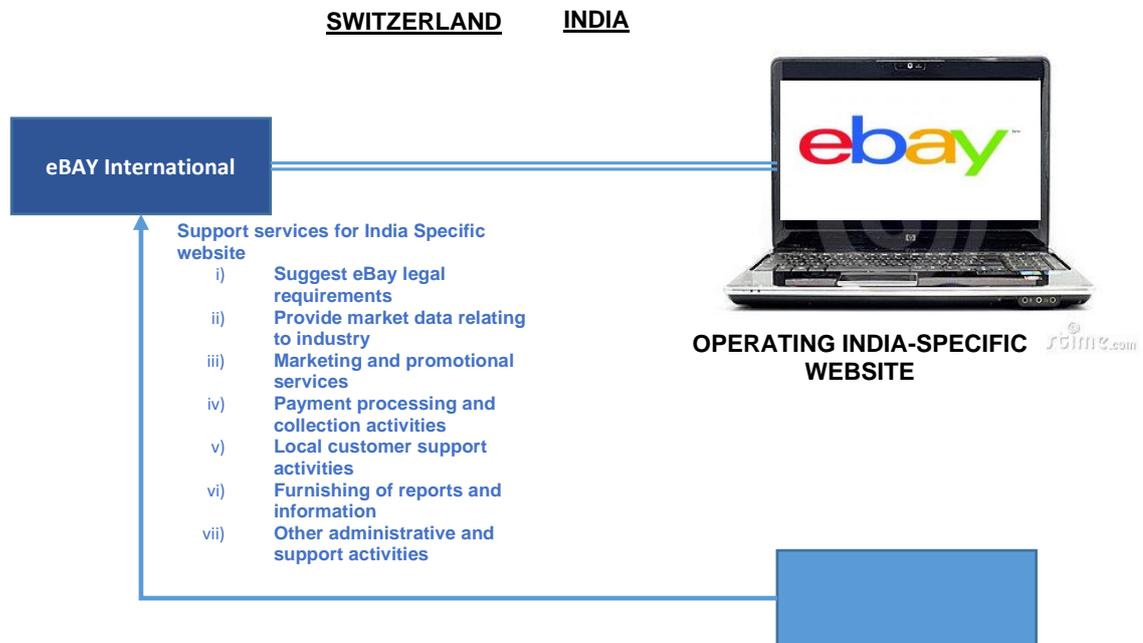
The monetization of online services is generally that service provider gets subscription

revenues (like in online matrimony) or revenues as a percentage of ticket price (as in the online travel model). Also, where the operator is a non-resident and has an Indian subsidiary, the Indian subsidiary would pay license fees to foreign company for using its web address.

There are some judicial precedents here:

- **eBay International AG v ADIT (ITA No. 6784/M/2010) (Mumbai Tribunal)**

The Taxpayer operated India specific websites providing an online platform for facilitating the purchase and sale of goods and services to users based in India. The Taxpayer entered into a Marketing Support Agreement with eBay India Private Limited (eBay India) and eBay Motors India Private Limited (eBay Motors) which are eBay group companies, for availing certain support services in connection with its India specific websites. Please refer the diagram below to understand the transaction:



It was held by the Mumbai Tribunal that fees paid to the Taxpayer for operating India specific website which provides online auction is not FTS. The Indian group entities rendering marketing support services are 'Dependent Agents'. However, they do not constitute Dependent Agent PE in India. Further the Taxpayer does not have a 'place of management' in India.

- **Galileo International Inc v DCIT (19 SOT 257) (Delhi Tribunal)**

The Taxpayer, a US based company is engaged in provision of services to hotels, airlines, etc. for reservation/ bookings through its Computerised Reservation System (CRS). Subscriber travel agents could check availability of seats/rooms in participant airlines, hotels, cab

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operators, etc. and book them through access to the CRS. Additionally, the Taxpayer also installed computer at premises of travel agents for such booking/ reservations. It was held that the fixed PE existing form of the computer installed in the premises of the travel agents through which business of the Taxpayer is carried on.

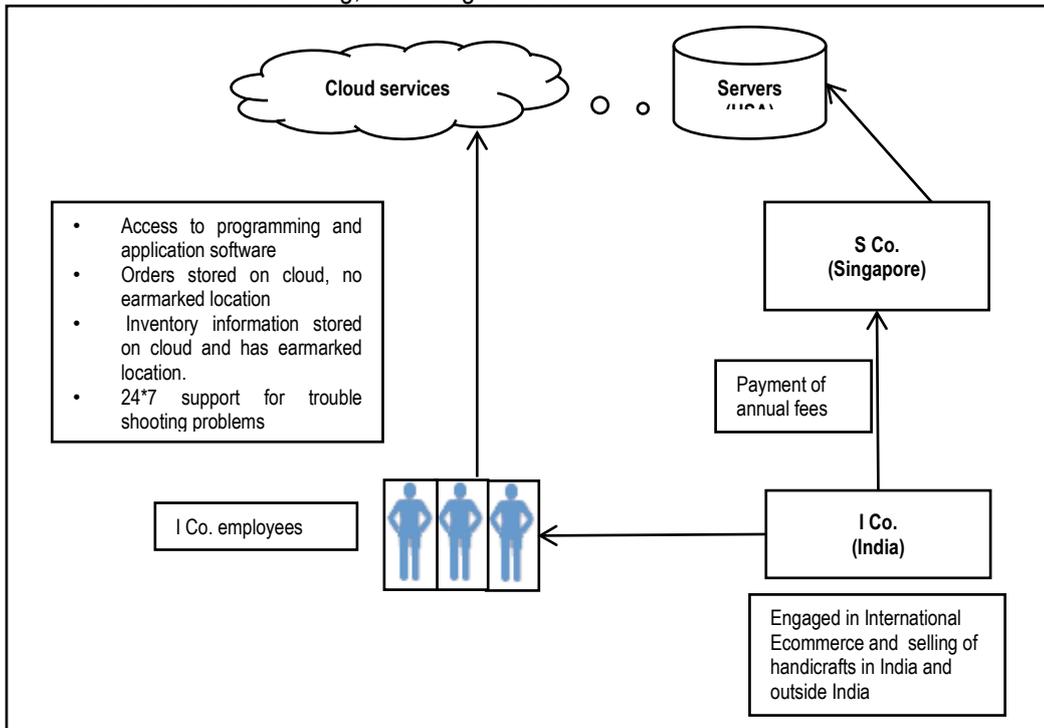
1.5.4 Cloud services

Cloud services refer to the process of sharing resources (such as hardware, development platforms and/or software) over the internet. Cloud computing and storage solutions provide users and enterprises with various capabilities to store and process their data in third-party data centers. This helps users to get to use high end infrastructure without making the entire investment and use it based on their requirement.

Infrastructure-as-a-service (IaaS)	Platform-as-a-service ('PaaS')	Software-as-a-service ('SaaS')
<ul style="list-style-type: none"> • In the most basic cloud-service model, providers of IaaS offer computers –physical or (more often) virtual machines – and other fundamental computing resources. • IaaS clouds often offer additional resources such as a virtual-machine disk image library, raw (block) and file-based storage, firewalls, load balancers, Internet Protocol (IP) addresses, virtual local area networks (VLANs), and software bundles. • The customer does not manage or control the underlying cloud infrastructure, but has control over the operating system, storage, and deployed applications, and may be given limited control of select networking 	<ul style="list-style-type: none"> • PaaS is a category of cloud computing services that provides a computing platform and programming tools as a service for software developers. • Software resources provided by the platform are embedded in the code of software applications meant to be used by end users. The client does not control or manage the underlying cloud infrastructure, including the network, servers, operating systems, or storage, but has control over the deployed applications. 	<ul style="list-style-type: none"> • A common form of cloud computing in which a provider allows the user to access an application from various devices through a client interface such as a web browser (e.g. web based email). It can be provided either to business customers (B2B) or individual customers (B2C). • Unlike in the old software vendor models, the code is executed remotely on the servers, thereby freeing the user of the necessity to upgrade when a new version is available – the executed version is always the latest, which means that new features go instantaneously to market without friction. The consumer generally does not manage or control the underlying

Infrastructure-as-a-service (IaaS)	Platform-as-a-service ('PaaS')	Software-as-a-service('SaaS')
components (e.g. host firewalls).		cloud infrastructure, including the network, servers, operating systems, storage, or individual application capabilities, with the possible exception of limited user-specific application configuration settings.

• For better understanding, refer diagram below:



Taxability:

- (a) Whether the payment are in the nature of royalty for use if equipment is a key point.
- (b) Another point which would need evaluation is whether the equipment is within the control of the customer.

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Some of the key decisions in this regard is discussed below:

- ***ACIT v. Vishwak Solutions Private Limited (56 Taxmann.com 158) (Chennai Tribunal)***

The Taxpayer paid data storage space charges to INetU, a non-resident. The issue here was on the characterization of data storage space charges. The Chennai Tribunal held that these payments are not in nature of royalty as the same is not made for use of a right of any industrial, commercial or scientific equipment. Further, the same is not fee for technical services (FTS) within the meaning of Article 12 of India –US Tax Treaty because non-resident does not 'make available' any technical knowledge to Taxpayer such that the same can be utilized by assessee without recourse to service provider. The same would qualify as business income. However, in the absence of the PE of the non-resident in India, the payment would not be taxable in India.

- ***Racksapce US, Inc. v. DCIT [2021] 124 taxmann.com 92 (Mumbai – Trib.)***

The taxpayer was a tax resident of the USA. Taxpayer earned income from cloud services, including cloud hosting and other supporting and ancillary services provided to Indian Customers. The taxpayer filed the return of income and the notes stating that the cloud hosting services were not taxable as 'royalties' under Article 12 of the India-US tax treaty. The Mumbai ITAT held that the agreement between the taxpayer and its customer was for providing hosting and other ancillary services to the customer and not for the use of or leasing of any equipment.

The Data Centre and the Infrastructure therein were used to provide these services belonging to the taxpayer. The customers do not have physical control or possession over the servers, and right to operate and manage this infrastructure or servers vested solely with the taxpayer. The agreement was to provide simpliciter hosting services and not give the underlying equipment on hire or lease. The customer did not know any server location in the data centre, webmail, websites, etc.

Thus, the income from cloud hosting services had erroneously been held as royalty within the meaning of Explanation 2 to Section 9(1)(vi) as well as Article 12(3)(b) of the India-USA DTAA by AO and DRP.

1.5.5 Mobile Applications

The combination of the smart phones and internet has led to Mobile application. Recently, the focus of doing business is shifting from website to mobile application.

Some businesses have shifted or have their business models from internet and mobile application to only mobile applications. Few of such examples are Myntra, Uber, etc. The key tax issue which arises is about characterization of consideration as royalty or fees for technical services which are received by owner / developer.

1.6 Historical background of Indian jurisprudence on digital transactions

Historically, e-commerce transactions—sale of software, provision of advertising services, subscription to online databases, etc.—have been a source of dispute in India. The Bangalore bench of Income-tax Appellate Tribunal (ITAT) in the case of Google India Private Limited¹² rendered a ruling classifying payments made by the company to Google Ireland for purchase of advertisement space on Google's AdWords program as royalties. The Bangalore ITAT distinguished this case from earlier Tribunal rulings in *Right Florists*³, *Pinstorm Technologies*⁴ and *Yahoo India*⁵, wherein the courts had held that payments made to a foreign company for banner advertisement hosting services would not constitute royalty. In the case of *Amadeus Global Travel Distribution*, the Delhi ITAT held that non-resident companies supplying a computerized reservation system providing real time access to airline fares and enabling bookings are liable to be taxed in India to the extent of the booking fees received from Indian residents.

Thus, Indian tax authorities and taxpayers have litigated on the issues of characterization of income and establishment of taxable nexus in relation to e-commerce transactions.

The OECD in its AP 1 Report acknowledges that the existing international tax rules need to be modified with evolving business models. The physical presence nexus rules developed in the brick and mortar era are no longer a useful indication of taxable nexus. The AP 1 Report discussed three options to tackle direct tax challenges arising from the digital economy: f

- a new nexus rule based on significant economic presence (SEP);
- a withholding tax on certain types of digital transactions; and f
- an equalization levy on certain specified services.

While none of these options were recommended, the AP 1 Report provides that countries could introduce any of them in their domestic laws or in their bilateral tax treaties as additional safeguards from base erosion and profit shifting (BEPS), provided they respect their existing tax treaty obligations. In May 2019, the OECD/G-20 Inclusive Framework on BEPS agreed a Programme of Work for addressing the tax challenges of the digitalization of the economy and arriving at a consensus-based solution by 2020. The OECD/G20 Inclusive Framework on BEPS,

¹Later, this case has been set aside by the Karnataka High Court [2021] 127 taxmann.com 36 (Karnataka)/[2021] 435 ITR 284. and the High Court ruled that complete material was not handed over to the assessee before the Tribunal based on which the order has been passed by the Tribunal and in light of the fact, the case was remanded back to the Tribunal for deciding its afresh on merits

2 [2017] 86 taxmann.com 237 (Bengaluru – Trib.)

3 [2013] (32 taxmann.com 99)(Kolkata Tribunal)

4 [2012] (24 taxman.com 345) (Mumbai Tribunal)

5 [2011] (11 taxmann.com 431) (Mumbai Tribunal)

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has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy.

The aim of **Pillar One** is to reach a global agreement on adapting the allocation of taxing rights on business profits in a way that expands the taxing rights of market jurisdictions. The Pillar 1 seeks to remunerate the market jurisdictions through the following:

- Amount A: Allocation of non-routine profits of the multi-national enterprises ('MNE') to market jurisdictions using a formulary approach
- Amount B: Fixed remuneration based on arm's length price for defined baseline and marketing functions that take place in the market jurisdiction.
- Amount C: The return under Amount C covers any additional profits where in-country functions exceed the baseline activities (compensated under Amount B).

While Amount A seeks to create a new taxing right for the market jurisdictions, Amount B and C would be based on the existing profit allocation rules (including the reliance on physical presence) with improved practical application of the arm's length principles.

Whereas **Pillar Two** seeks to achieve development of global minimum tax rules with the objective of ensuring that global business income is subject to at least an agreed minimum rate of tax⁶ regardless of where they are headquartered or the jurisdictions, they operate in.

1.7 Base Erosion Profit Shifting (BEPS)

In this context, the Organisation for Economic Co-operation and Development (OECD) as a part of its base Erosion and Profit Shifting (BEPS) initiative, recommended certain options to address tax challenges of digital economy under Action Plan 1 of the BEPS.

The BEPS initiative is an OECD initiative which is approved by the G20⁷ for ways of providing more standardized tax rules globally. At the request of the G20 Finance Ministers, the OECD launched an Action Plan on BEPS in July 2013.

BEPS refers to the tax avoidance strategies by the multinational companies on national tax bases. The plan also recognized the importance of the borderless digital economy and proposed to develop a new set of standards to prevent BEPS and to equip governments with the domestic and international instruments to prevent corporations from paying little or no taxes

BEPS is important because, globalization of the world economy has resulted in Multinational Enterprises ('MNEs') shifting from country specific models to global models which are usually housed in low-tax jurisdictions and are characterized by integrated supply chains or

⁶ The minimum tax rate currently proposed in the Statement is at least 15%.

⁷ The Group of Twenty (also known as the **G-20** or **G20**) is a forum for the governments and central bank governors from 20 major economies. The members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

centralization of service functions. The global models led to various issues like distortion of competition at the domestic level, critical underfunding of public investments on account of lack of tax revenue and issues pertaining to fairness leading to non-compliance of tax rules and regulations by taxpayers.

The OECD had identified 15 specific actions considered necessary to prevent BEPS and in that direction on September 16, 2014 it has released its first set of recommendations on 7 action points for combating international tax avoidance by MNEs., On 5 October 2015 OECD issued final reports in connection with all its Action Plans to address BEPS.

The above-mentioned report includes Action Plan Number 1 on Digital economy. This Action plan deals with challenges in the digital economy, new business models, taxation regime and recommendations, etc.

OECD has also released interim report of the OECD/G20 Inclusive Framework on BEPS which is a follow-up to the work delivered in 2015 under Action 1 of the BEPS Project on addressing the tax challenges of the digital economy. It sets out the Inclusive Framework's agreed direction of work on digitalisation and the international tax rules through to 2020. It describes how digitalisation is also affecting other areas of the tax system, providing tax authorities with new tools that are translating into improvements in taxpayer services, improving the efficiency of tax collection and detecting tax evasion.

1.7.1 Action Plan 1- Addressing the challenges of the Digital Economy:

The key features of Digital economy laid down in Action Plan 1 are mobility, reliance on data, Network effect, Volatility, etc. Since the existing thresholds for taxation rely on the physical presence, the Action plan recognizes that the growth of digital economy has led to many tax challenges which include:

- Ring-fencing of the digital economy from the rest of the economy
- Fragmentation of operations among multiple group entities and thereby qualify for PE exceptions
- Minimizing the income allocable to function, assets and risk
- Using a subsidiary or PE to perform marketing or technical support
- Maintaining mirrored server to enable faster customer access to the digital products sold by the group with a principal company contractually bearing the risks and claiming the ownership of intangibles generated by these activities
- Maximize the use of deduction for payments made to other group companies in the form of interest, royalties, fees etc.
- Avoiding withholding tax
- Absence of CFC regulations or CFC regime failing to apply to certain categories of income that are highly mobile or CFC regime that can be easily avoided by using hybrid mismatch arrangements

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The options proposed on the principle as under:

- *Consistency* – Residence and source countries should follow the same conceptual basis for sharing the tax base between them.
- *Neutrality* – Digital economy and traditional transactions should be taxed equivalently.
- *Efficiency* – Tax rules should not impose an undue burden on taxpayers to comply with them or impose excessive administrative costs on tax administrations to enforce them.
- *Certainty and simplicity* – Tax rules should be clear and simple to understand.
- *Effectiveness and fairness* – Taxation should produce the ‘right’ amount of tax at the right time while minimising the potential for evasion and avoidance.
- *Flexibility* – Tax rules should be dynamic enough to keep pace with technological and business developments.
- *Compatibility* – New tax rules should not infringe on existing rules of international trade.
- *Consensus* – Universally agreed rules are crucial for avoiding harmful tax competition.

The final report on this Action Plan developed alternative options viz. (1) significant economic presence nexus (nexus would be established where a non-resident has a significant economic presence evidenced by factors such as revenue from remote transactions, local domain names, localized websites, local currency payment options, number of active users in a country, online contracting and data collection); (2) withholding taxes on digital income from goods or services ordered online (tax could be a final tax or as a back-up measure to enforce net-basis taxation); and (3) ‘equalization levy’ (tax to equalize the tax burden on remote and domestic suppliers of similar goods and services, similar to an insurance excise taxes imposed upon foreign insurers). These measures could be imposed through domestic legislation and are not recommended as an international standard. However, the report states that countries may wish to impose these measures to address Digital Economy BEPS concerns that those countries believe are not adequately addressed by the OECD’s recommendations or as a ‘stop-gap’ measure until the OECD’s recommendations are fully implemented. To carry out the work given under this Action Plan, a Task Force on Digital Economy (‘TFDE’) was established which was mandated with a task to present an interim report by the end of 2018 and come up with the final recommendations by the end of 2020. India is one of the participant country to the TFDE. The TFDE released the said interim report on 16 March 2018 titled “*Tax Challenges Arising from Digitalisation - Interim Report 2018*”. The Interim Report sets out the BEPS inclusive framework’s agreed direction of work on digitalization and the international tax rules through 2020 and inter alia includes:

- In-depth analysis of value creation across different digitalised business models, focusing on the main characteristics of digital markets and processes of value creation;
- Specific measures relevant to digitalisation and the resulting impact on the behavior of highly digitalised business;
- Overview of recent tax policy developments that are potentially relevant to digitization, focusing on measures enacted to address the broader tax challenges identified in 2015

report (*supra*);

- The description of the challenges identified with respect to the continuing effectiveness of international tax standards in light of the issues raised by digitalization of the economy;
- The need for interim measures to be introduced by countries
- How digitalization is changing other parts of the tax systems, providing new opportunities and risks for policymakers and tax administrators;

Measures taken by Indian Government tap tax leakages on account of proliferation of the digital economy:

Impelled by the OECD / G-20 BEPS Report on Action Plan 1 and the recommendations of the Expert Committee constituted on Taxation of E-Commerce, the Indian government introduced the following measures to tap tax leakages on account of proliferation of the digital economy:

1. 2016: India was the first country to levy Equalisation Levy ('EQL') at 6% on Indian sourced receipts of non-resident companies engaged in online advertisement and related activities.
2. 2018: The concept of Significant Economic Presence ('SEP') was introduced in the definition of the term 'business connection' under the Income-tax Act, 1961 ('the Act') to tax income based on economic presence and not merely physical presence.
3. 2020: The scope of EQL was expanded with effect from 1st April, 2020 to include a levy of 2% on consideration received by a non-resident 'e-commerce operator' from 'e-commerce supply or services'.
4. 2020: Withholding tax provisions under section 194-O of the Act was introduced on e-commerce payments to specified Indian residents with effect from 1st October 2020.
5. 2021: India prescribed the revenue threshold of INR 20 million (USD 2,70,000) and user threshold of 300,000 for application of the SEP rules from Financial Year 2021-22.

Equalization Levy– Online advertisement and related services

The Finance Act, 2016 has introduced a new Chapter VIII titled “Equalisation Levy” in the Income-tax Act as a levy for additional resource mobilisation purportedly to address the challenges of taxation of e-commerce transactions. The Chapter constitutes a code in itself providing for the charge of levy, its exceptions, consequences of default, appellate remedy, penalties etc. The purpose behind the introduction of this Chapter appears to be to bring within the tax net transactions whose source is in India and the benefit therefrom is received by the service recipient in India, though the service provider is situated outside India.

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This Chapter extends to the whole of India except the State of Jammu & Kashmir.

The CBDT issued notification no. 37 of 2016 dated May 27, 2016 stating that the provisions of Chapter VIII relating to the equalisation levy would come into effect from June 1, 2016. In other words, any payments being made for the specified services provided on or after June 1, 2016 shall attract the equalisation levy.

Section 164(d) defines equalisation Levy as the tax leviable on consideration received or receivable for any specified service under the provisions of Chapter VIII.

Specified service means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other service as may be notified by the Central Government in this behalf.

Charge of levy

As per section 165, there shall be charged an equalisation levy at the rate of 6% of the amount of consideration for any specified service received or receivable by a person, being a non-resident from—

- (a) a person resident in India and carrying on business or profession; or
- (b) a non-resident having a PE in India;

collectively known as "*Liable persons*".

The equalisation levy shall not be charged, where—

- (a) the non-resident providing the specified service has a PE in India and the specified service is effectively connected with such PE;
- (b) the aggregate amount of consideration for specified service received or receivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a permanent establishment in India, does not exceed Rs. 100,000; or
- (c) where the payment for the specified service by the person resident in India, or the PE in India is not for the purposes of carrying out business or profession.

Furthermore, this Chapter VIII is not applicable to the State of Jammu and Kashmir as per section 163(1). In other words, when the service recipient is situated in the State of Jammu and Kashmir, the provisions of this Chapter should not apply.

Collection and recovery

Section 165, which deals with collection and recovery of the levy, places the onus on the Liable Persons to deduct the amount of levy from the amount paid or payable to a non-resident in respect of the specified service and pay the levy so collected during a calendar month to the Government by the 7th day of the immediately following month. It has also been provided that the liability to pay the equalisation levy shall trigger whether or not the Liable Person deducts the same from the payment of the non-resident. As per section 170, simple interest @ 1% per month or part thereof shall be paid by the Liable Person for delay in making

the payment of equalisation levy. There are penal consequences in case of failure to deduct or pay equalization levy and failure to furnish annual return.

Equalisation Levy Rules, 2016

The CBDT has notified the Equalisation Levy Rules, 2016, which lay down the procedural framework for implementation, including prescribing forms for filing of annual return and appeals.

Equalization Levy on E-Commerce Supply or Services

The Finance Bill 2020 was presented by Hon'ble Finance Minister on 1st February 2020 and there was no proposal in the bill to expand the scope of equalization levy. However, at the enactment stage, the scope of Equalization levy has been expanded. With effect from 1 April 2020, the ecommerce Equalisation levy will apply at 2 percent on the gross consideration received or receivable by the non-resident 'ecommerce operator' from specified transactions where such receipts exceeds INR 2 Crores.

Charge of levy

As per section 165A, on and from the 1st day of April, 2020, there shall be charged an equalisation levy at the rate of two per cent. of the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it :

- (i) to a person resident in India; or
- (ii) to a non-resident in the specified circumstances. Specified circumstance means (a) sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement through internet protocol address located in India; and (b) sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India
- (iii) to a person who buys such goods or services or both using internet protocol address located in India.

The equalisation levy shall not be charged:

- (i) where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment
- (ii) where the equalisation levy is leviable under section 165; or
- (iii) sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than two crore rupees during the previous year.

Further, section 10(50) has been amended by Finance Act 2020 so as to provide that, income arising from e-commerce supply or services, made or provided or facilitated and chargeable to equalization levy, shall be exempt under the Act.

7.20 International Tax — Practice

Amendments by Finance Act 2021

- An explanation to section 164(cb) is inserted to clarify the scope of terms “online sale of goods” and “online sale of services” to include acceptance of offer for sale, placing/acceptance of the purchase order, payment of consideration and supply of goods or provision of services, partly or wholly, taking place online to be considered as “online sale of goods” and “online provision of services.”
- Section 165A is amended by inserting sub-section (3) to provide that consideration received or receivable from ecommerce supply or services shall include:
 - consideration for sale of goods irrespective of whether the e-commerce operator owns the goods;
 - consideration for provision of services irrespective of whether service is provided or facilitated by the ecommerce operator
- Proviso is inserted in Section 163 to clarify that consideration received or receivable for specified services and for e-commerce supply or services shall not include consideration taxable as royalty or fees for technical services in India under the Income-tax Act read with the agreement notified by the Central Government under section 90 or section 90A of the Income-tax Act.

Collection and recovery

Section 166A, which deals with collection and recovery of equalization levy on ecommerce supply or services, requires every ecommerce operator to pay the equalization levy to the credit of Central Government as under:

Sr. No.	Date of ending of the quarter of financial year	Due date of the financial year
1	30th June	7th July
2	30th September	7th October
3	31st December	7th January
4	31st March	31st March

Section 170 has been amended to provide that simple interest @ 1% per month or part thereof shall be paid by the ecommerce operator for delay in making the payment of equalisation levy. Similarly, Section 171 and 172 are also amended to provide for penal consequences in case of failure to deduct or pay equalization levy and failure to furnish statement.

Significant economic presence

Explanation 2A⁸ to section 9(1)(i) was introduced vide Finance Act 2018 to widen the scope of the term 'business connection', to cover the cases of significant economic presence of a non-resident in India. The said amendment is in line with recommendations related to BEPS Action Plan 1 on addressing tax challenges of the digital economy.

The meaning of term 'significant economic presence' as amended by Finance Act 2020, is provided as-

- (a) transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed.
- (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means:

The above provisions will apply-

- Whether or not the agreement for such transactions or activities is entered in India or
- Whether or not, the non-resident has a residence or place of business of business in India or
- Whether or not, the services are rendered in India.

It is further provided that income deemed to accrue or arise in India will be only so much of income as is attributable to the transactions or activities covered at clause (a) or (b) above. The specific mechanism for computation of income if the said provisions are applied will be laid down.

Similarly, the definition of business connection which covers situations of permanent establishments created by a dependent agent has been tightened by the Finance Act 2018 in keeping with the recommendations in the BEPS action plans.

The CBDT has notified the Income Tax (13th Amendment) Rules, 2021 with effect from 1 April 2022. A new rule has been inserted to provide thresholds for determining the Significant Economic Presence of a non-resident in India.

The Significant Economic Presence in case of a non-resident shall be triggered if (a) aggregate amount of payment for a specified transaction with a person in India exceeds INR 20 million (during a year) or (b) non-resident undertakes systematic and continuous soliciting of business activities or engages in interaction with 300,000 or more users in India.

⁸ Earlier explanation 2A has been replaced by Finance 2020 by a new Explanation 2A with certain changes in the wordings of explanation. The explanation is applicable w.e.f. 1 April 2022

Interplay of SEP and EQL

Although the guidance in BEPS Action Plan 1 was for the countries to introduce one of the measures (i.e., EQL, SEP or withholding tax) to address the taxation of digital economy (although not recommended), India has adopted all the three measures due to mounting economic pressure, thereby resulting in a situation where EQL and SEP provisions could apply simultaneously.

While there is a corresponding exemption from income-tax if EQL applies, it is not clear whether EQL provisions will prevail despite non-residents having a SEP in India. A clarification in this regard would assume significance for non-treaty countries and for entities who are unable to claim relief under the tax treaty (for instance, fiscally transparent entities or entities not able to satisfy the conditions of the Multilateral Instrument). In case of treaty partner countries, taxable presence defined in the tax treaty (i.e., permanent establishment provisions) will prevail over the SEP rules.

Section 194O – TDS on Payment made to E – Commerce Participant:

Section 194O has been introduced in the Union Budget 2020. According to Section 194O, an e-Commerce operator is required to deduct TDS for facilitating any sale of goods or providing services through an e-Commerce participant. TDS on e-commerce operators under section 194-O is applicable from 1 October 2020.

Concluding remarks:

E-commerce and technology has changed not only the way business is done, but has led to a need to relook at the way taxing rights are shared between countries. Governments globally and locally have a lot of thinking to do on the sharing of taxing rights in the digital world.

Unit II	Cross-border Mergers & Acquisitions – Key Tax Aspects
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2.1 Cross-border mergers and acquisitions in India

Until a few years ago, news about Indian companies acquiring American and European organizations was seldom heard of. However, this scenario saw a sudden change since 2007. The buoyant Indian economy, cash-rich Indian corporate organizations with their ability to raise relatively large funds at low costs, helpful government policies and Indian players' new-found dynamism contributed to an upsurge in the acquisitions made by them in foreign countries.

According to a recent report by Bain & Company titled "India M&A: Acquiring to Transform", merger and acquisition (M&A) activity in India was at an all-time high in 2021, driven mainly by first-time buyers. The Bain study reports that in 2021, India saw the finalization of 85 strategic deals valued over US\$75 million, out of which first-time buyers accounted for 80 percent of the volume.

It is reported that while most acquisitions were led by first-time buyers, no mega deal over US\$5 billion was struck in the year 2021, unlike the trend in 2016-19. For the years 2020 and 2021, the percentage of first-time buyers has been the highest compared to the percentage for the years 2016 till 2019. In 2021, the nature of deals was broad based, including more mid-sized deals ranging from US\$500 million to US\$1 billion. Two-thirds of these deals finalized by insurgents are stock-plus-cash transactions.

Some worth mentioning transactions that concluded in the year 2021 are

- **Piramal Group acquires DHFL at US\$4.7 billion:** In 2021, Piramal Group completed the acquisition of Dewan Housing and Finance Limited (DHFL) for US\$4.7 billion
- **Prosus acquires BillDesk ay US\$4.7 billion:** The acquisition of Indian payments giant BillDesk by technology investors Prosus NV was the largest merger and acquisition deal in the Indian fintech industry. Prosus has its own Fintech business PayU. This acquisition will help PayU to become one of the leading online payments providers, globally, with presence in over 20 markets and increased total payments volume (TPV) of over US\$4 billion.
- **Adani Green Energy Limited (AGEL) acquires SB Energy India: In May 2021,** AGEL completed the acquisition of SB Energy Holdings Limited (SB Energy India) in an all-cash deal worth US\$3.5 billion. This is the largest acquisition in the renewable energy sector in India.
- **Tata Digital acquires BigBasket:** In a bid to build its own SuperApp, Tata Digital acquired India's biggest groceries delivery company BigBasket.
- **Merger between Sony Picture Network India and Zee Entertainment Enterprises:** Both companies have entered into an exclusive, non-binding term sheet, in order to

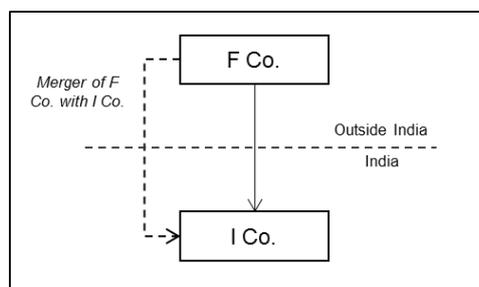
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combine their linear networks, digital assets, production operations, and program libraries. The merged company would be a publicly listed company in India with Sony Pictures Entertainment holding the majority stake.

- **PharmEasy acquires Thyrocare at US\$610 million:** PharmEasy has become the first Indian start-up to acquire a publicly listed company Thyrocare, which runs a chain of diagnostic and preventive care laboratories. The acquisition will enable PharmEasy to build an end-to-end healthcare platform from a customer's point of view.

This chapter focusses on key tax aspects relating to cross-border mergers involving Indian companies. Tax and other implications in overseas jurisdictions (being specific to each country) are not discussed in this chapter.

2.2 Can a foreign company merge with an Indian company?



Section 394(4)(b) of the Companies Act, 1956 states that for the purpose of section 394 of the Companies Act, a 'transferee company' can only be a 'company within the meaning of this Act' while a 'transferor company' can be 'any body corporate, whether within the meaning of the Act or not'. The expression 'body corporate' as defined under section 2(7) of the Companies Act, 1956 includes a foreign company. Thus, under section 394 of the Companies Act, 1956, a foreign company can merge into an Indian company on satisfying the prescribed conditions and with the sanction of the High Court. However, the Companies Act, 1956 is silent about the manner in which the consideration can be discharged in the case of such a merger.

In the case of *Moschip Semi-Conductor Technology Ltd. 2004 120 CompCas 108 AP*, a California-based company (transferor company) was merged with an Indian company (transferee company) incorporated in Hyderabad. The transferee company filed the petition for amalgamation and the name of the transferor company was not added as a party in the petition. The point that came up for discussion before the Andhra High Court was whether an Indian Court has the jurisdiction to pass an order of amalgamation in respect of a company incorporated outside India, which is consequentially wound up.

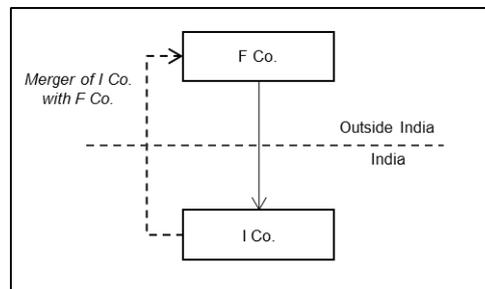
The High Court noted that the California Corporation Code allows the merger of a US corporation with a foreign one. Therefore, being satisfied that the laws of the transferor company allowed its merger with a foreign company, the High Court came to the conclusion that it had jurisdiction to sanction this scheme.

The Companies Act, 2013 allows the merger of a foreign company with an Indian Company. However, it restricts the scope of such mergers to certain notified jurisdictions. (To be notified by the Central Government from time to time.) The Companies Act, 2013 also lays down the criterion for discharge of consideration on a merger - an Indian company can make payment to shareholders of a foreign company by way of, *inter-alia*, cash or depository receipts (subject to receipt of approval from the regulatory authorities, where applicable).

On 7th November, 2016 Central Government issued a notification for enforcement of section 230-233, 235-240, 270-288 etc. w.e.f. 15th December, 2016. MCA vide notification dated 14th Dec, 2016 has issued rules i.e. The Companies (Compromises, Arrangements and Amalgamations) Rules, 2016. These rules will be effective from 15th December, 2016. Consequently, w.e.f. 15.12.2016 all the matters relating to Compromises, Arrangements, and Amalgamations (hereafter read as “CAA”) will be dealt as per provisions of Companies Act, 2013 and The Companies (Compromises, Arrangements, and Amalgamations) Rules, 2016.

The Reserve Bank of India has issued a notification under Foreign Exchange Management (Cross Border Merger) Regulations, 2018 vide Notification No FEMA.389/2018-RB dated 20 March, 2018 setting out RBI regulations relating to merger, amalgamation and arrangement between Indian companies and foreign companies

2.3 Can an Indian company merge with a foreign company?



The Companies Act, 1956 does not permit an Indian company to merge into a foreign one. According to section 394(4)(b) of the Companies Act, 1956, in any arrangement or reconstruction, a transferee company must be one within the meaning of the Companies Act. This means that a foreign company cannot be a transferee company.

Although the earlier provisions of the Companies Act, 1956 restricted the merger of an Indian company with a foreign company, the Companies Act, 2013 allows such mergers. Section 234 of the Companies Act, 2013 provides for mergers or amalgamations involving one or more foreign companies, incorporated under the jurisdictions of other countries. This section also provides that a foreign company can merge or amalgamate into a company registered under the Companies Act, 2013 with the prior approval of the RBI, or vice versa, and the terms and conditions of the scheme of merger or amalgamation can provide for payment of consideration to the shareholders of the merging company in cash or partly in cash and partly in Indian Depository Receipts.

All the provisions of the Companies Act, 2013 applies *mutatis mutandis* to schemes of mergers and amalgamations involving companies registered under the Companies Act, 1956 and foreign companies that have been incorporated under the jurisdictions of such countries, as may be notified from time to time by the Central Government.

2.4 Can the business of a foreign company in India be demerged into that of an Indian company?

The Companies Act, 2013 specifically allows both inbound and out-bound mergers and amalgamations, but is silent on the issue of cross-border demergers.

Section 234 of the Companies Act, 2013 only relates to mergers and amalgamations, unlike sections 391–394 of Companies Act, 1956, which places the demerger of the business of a foreign company into an Indian company on the same footing as the merger of a foreign company with an Indian company.

A literal reading of the provisions leads to the question whether Companies Act, 2013 does not specifically cover cross border demergers under section 234 of the Companies Act, 2013.

2.5 Appointed date

The concept of an 'appointed date' is unique to mergers and amalgamations under the Companies Act, 1956 and under the Companies Act, 2013. Schemes of amalgamation have the following relevant provisions in relation to appointed dates:

- With effect from the appointed date, the undertaking, assets and liabilities of the transferor company are transferred to and vested in the transferee company.
- On and from the appointed date up to the effective one, the transferee company is to take over the profits/losses of the transferor company.
- On and from the appointed date up to the effective date, the operations/activities carried out/to be carried out by the transferor company are to be carried out or regarded to have been carried out by the transferor company in trust for and on behalf of the transferee company.

In view of the above, the appointed date can be regarded as the date of transfer or relevant date from which the transfer of the undertaking/properties and liabilities of the transferor company takes effect.

2.6 Effective date

The 'effective date' of a merger / demerger is usually the one on which the order of the Appropriate Authority, approving the scheme of arrangement/amalgamation, is passed and the certified copies thereof are filed with the registrar of companies. However, some practical considerations in selecting the effective date include the one on which the orders of the relevant authorities in respect of the foreign company approving the scheme of arrangement/amalgamation or dissolution is passed as well as the date on which other

regulatory authorities or contractual parties approve the transfer of assets/business, which is subject to specific regulations, etc.

2.7 Treatment of a cross-border merger for tax purposes

The following questions may arise from a tax perspective in the case of a merger of a foreign company or demerger of a business of a foreign company into an Indian company:

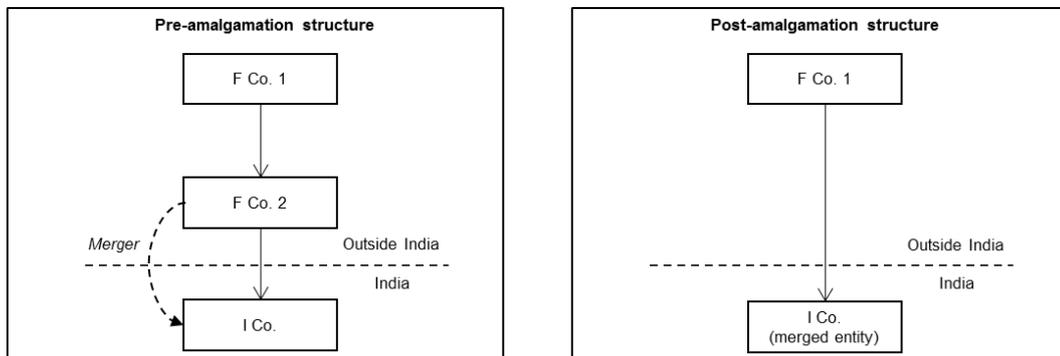
- Whether any capital gains tax would arise in India in the hands of the foreign transferor company on such cross border merger/ demerger?
- Whether any capital gains tax would arise in India in the hands of the shareholders of the foreign transferor company on such cross border merger/ demerger?

The same is explained below with the help of an example:

Example 1

- F Co. 2 owns a wholly owned subsidiary in India (I Co.)
- The company amalgamates with I Co.
- Pursuant to the amalgamation, I Co. issues shares to F Co. 2 shareholders.

The pre- and post-amalgamation structures are depicted below:



Capital gains will be exempt in the hands of the foreign transferor company (ie F Co. 2) if the following conditions as specified under section 47(vi) of the Income-tax Act, 1961 (IT Act) are satisfied:

- I Co., ie, the amalgamated company, is an Indian enterprise;
- Other prescribed conditions as specified under section 2(1B) of the IT Act have been fulfilled.

Further, capital gains will be exempt in the hands of the shareholders of the foreign transferor company (i.e. F Co. 1) if the following conditions as specified under section 47(vii) of the IT Act are satisfied:

- I Co., i.e., the amalgamated company, is an Indian enterprise;

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- I Co.'s shares constitute the consideration received by F Co.'s shareholders.
- Other prescribed conditions as specified under section 2(1B) of the IT Act have been fulfilled.

The conditions stated in section 2(1B) of the IT Act are as follows:

- (i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation;
- (ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;
- (iii) shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation; and
- (iv) The above must be achieved by virtue of the merger and not by way of purchase of properties by one company from another or by way of distribution of properties pursuant to the winding up of the company concerned

The Authority of Advanced Ruling (AAR) ruled in the case of Star Television Entertainment Ltd., In re [2010] 188 Taxman 206 (AAR - New Delhi), re-confirming the tax neutrality of cross-border mergers involving the amalgamation of foreign companies into Indian ones. It was held that the amalgamation of a foreign transferor company into an Indian transferee company, which satisfies prescribed conditions with respect to amalgamation prescribed under the IT Act, would not result in any tax liabilities in the hands of transferor companies and their shareholders.

The AAR also held that it is within the legitimate freedom of the contracting parties to enter into a transaction that has the effect of extending to the party the benefit of exemption under the taxation statute, as long as such a transaction is not a sham or a contrived device that has the sole objective of avoiding tax. This ruling also highlights the importance of embedding business purposes in transactions that seek to mitigate tax to prevent them from being regarded as designed for tax avoidance.

2.8 Changes required under IT Act for aligning with Companies Act, 2013 in respect of tax neutral cross border merger

As stated above an amalgamation inter alia needs to be compliant with the conditions prescribed under section 2(1B) of the IT Act to enjoy exemption from taxation of capital gains in the hands of the amalgamating company or shareholders of amalgamating company. Further, there are several other sections in the IT Act (illustrative list provided below) which provide for a benefit if the amalgamation is compliant with conditions of 2(1B) of the IT Act.

One of the conditions prescribed under section 2(1B) of the IT Act is that shareholders holding not less than three-fourths in value of the shares in the amalgamating company(s) become shareholders of the amalgamated company by virtue of the amalgamation. This implies that where the amalgamated company discharges the consideration by any means other than by way of issuance of its shares to shareholders holding not less than 75% in value terms in the amalgamating company, the amalgamation may not be regarded as being tax neutral and hence the exemptions/ benefits may not be available. Considering that Companies Act, 2013 provides the amalgamated company a flexibility of discharging consideration by way of cash or depository receipts to the shareholders, the same may not be beneficial since such an amalgamation would not satisfy conditions prescribed under section 2(1B) of the IT Act. Thus, it follows that the definition of amalgamation under section 2(1B) of the IT Act should be aligned with the Companies Act, 2013 for the tax neutrality to continue.

Given below is an illustrative list of tax exemptions/ benefits for a qualifying amalgamation under section 2(1B) of the IT Act:

- Exemption from taxation of capital gains in the hands of amalgamating company under section 47(vi)
- Exemption from taxation of capital gains in the hands of the shareholders of amalgamating company under section 47(vii)
- Benefit of carrying forward and set-off of losses incurred by an amalgamating company to the amalgamated company under section 72A (including definition of 'industrial undertaking')
- Benefit of availing a tax deduction by the amalgamated company for expenditure incurred by the amalgamating company on scientific research under section 35(5)
- Benefit of availing a tax deduction by the amalgamated company for amortization of amalgamation expenses incurred by the amalgamating company under section 35DD
- Benefit of availing a tax deduction by the amalgamated company in respect of preliminary expenses incurred by the amalgamating company under section 35D(5)

The IT Act presently grants tax exemptions on mergers if the transferee is an Indian company but does not recognize a situation where the transferee is a foreign company. Therefore, with the introduction of cross-border mergers under the Companies Act 2013 corresponding changes would have to be made in the IT Act. to reap the benefits of the progressive changes in the Companies Act, 2013.

2.9 Treatment of a cross-border merger or demerger involving transfer of shares of an Indian company for tax purposes

The following questions may arise from a tax perspective in the case of a merger involving two foreign companies or the demerger of the business of a foreign company into another foreign organisation, wherein the shares of an Indian company (which are held by the transferor foreign company) are transferred to the transferee foreign company:

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- Whether any capital gains tax would arise on the transfer of shares of the Indian company?
- Whether there will be any tax incidence in the hands of the foreign transferee company on receipt of shares of the Indian company?
- In case the Indian company is a closely held one with accumulated tax losses, whether such tax losses would be available on change of shareholding in the Indian company?

Regarding the first issue, section 47(via) of the IT Act (in case of merger) and section 47(vic) of the IT Act (in case of demerger) specifically provides that any such transfer of shares of an Indian company will be exempt from capital gains tax in India, provided the following conditions are satisfied:

- At least 25 percent (75 percent in the case of a demerger) of the shareholders of the transferor foreign company continue to remain shareholders of the transferee foreign organization;
- Such transfer does not attract capital gains tax in the country in which the foreign amalgamating / demerged company is incorporated.

Regarding the second issue, section 56(2)(x) of the IT Act provides that receipt of shares of a company by another company (not being a widely held company as envisaged under section 2(18) of the IT Act) for nil or inadequate consideration (ie consideration which is less than the aggregate fair market value of such shares) is taxable in the hands of the recipient as income from other sources.

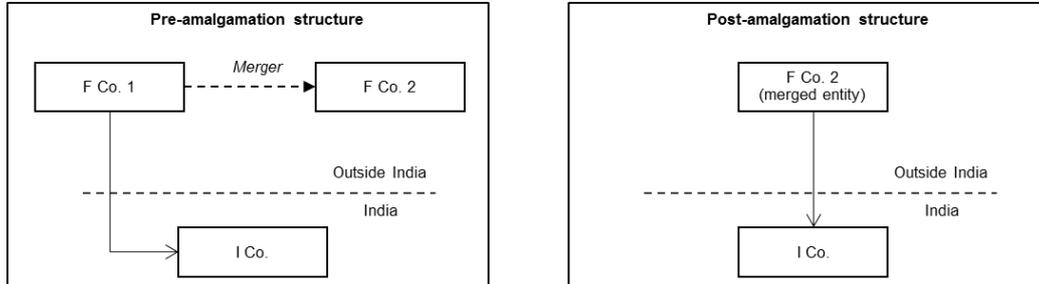
However, the transaction involving merger of two foreign companies or the demerger of the business of a foreign company into another foreign company (wherein the shares of an Indian company, held by the transferor foreign company, are transferred to the transferee foreign company) which are not regarded as transfer by virtue of Section 47(via) or Section 47(vic) are specifically excluded from applicability of these provisions.

Regarding the third issue, the IT Act provides that where the shareholding of a closely held Indian company witnesses a change of more than 49 percent, its accumulated tax losses lapse and they are not allowed to be carried forward. However, the tax losses of the Indian company will not be affected due to the provisions of the IT Act (given above), provided that at least 51 percent of the shareholders of the foreign parent continue to be shareholders of the transferee foreign company when the shareholding of an Indian company (which is a subsidiary of a foreign company) sees a change due to the foreign parent merging/demergering its business (including its investment in the Indian company) with another foreign company.

Example 2

- F Co. 1 owns a wholly owned subsidiary in India (I Co.).
- F Co. 1 amalgamates with F Co. 2.

The pre- and post-amalgamation structures have been depicted below for reference:



Transfer of shares of I Co. to F Co. 2 pursuant to the merger of F Co. 1 and F Co. 2 will not be subject to capital gains tax under the following circumstances:

- At least 25 percent of F Co. 1's shareholders are shareholders of F Co. 2.
- Such a transfer does not attract capital gains tax in the country where F Co. 1 is located.

In this regard, it is relevant to note the Advance Ruling in the case of Hoechst GmbH 289 ITR 312 (AAR). In this case, Aventis Pharma Holding GmbH (APH), a foreign company, was amalgamated with Hoechst GmbH (Hoechst), another foreign organisation. APH was a wholly owned subsidiary of Hoechst and held shares in Aventis Pharma Ltd (APL), an Indian company. The question that arose before the Authority was the following:

“Whether any capital gains chargeable under section 45 of the IT Act arose to Aventis Pharma Holding GmbH on its amalgamation with Hoechst GmbH in respect of the shares of Aventis Pharma Limited, India held by Aventis Pharma Holding GmbH”

The AAR observed that the IT Act permits amalgamation of a wholly owned subsidiary with its parent and held that that amalgamation of a wholly owned subsidiary foreign company with its parent company does not result in a transfer for consideration, and therefore, does not attract capital gains tax. The liability of capital gains tax (if any) can only be on the transferor company (subsidiary), which in the present case has lost its identity and ceased to exist. Accordingly, no capital gains chargeable under section 45 of the IT Act arose for APH on its amalgamation with Hoechst in respect of the shares of APL India held by the former.

2.10 Treatment of a cross-border merger or demerger involving transfer of shares of a foreign company deriving substantial value from Indian business for tax purposes

The IT Act provides for taxation of income that is deemed to accrue or arise in India. Section 9(1)(i) of the IT Act states that income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

Further, Explanation 5 to section 9(1)(i) of the IT Act states that shares in a company incorporated outside India would be deemed to be situated in India if the share derives,

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directly or indirectly, its value substantially from assets located in India. Accordingly, gains arising on transfer of a foreign company's shares which directly / indirectly derives its substantial value from assets located in India will be taxable in India.

The IT Act has, vide Finance Act 2015, inserted Explanation 6 to section 9(1)(i) of the IT Act, which states that shares of foreign company shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets:

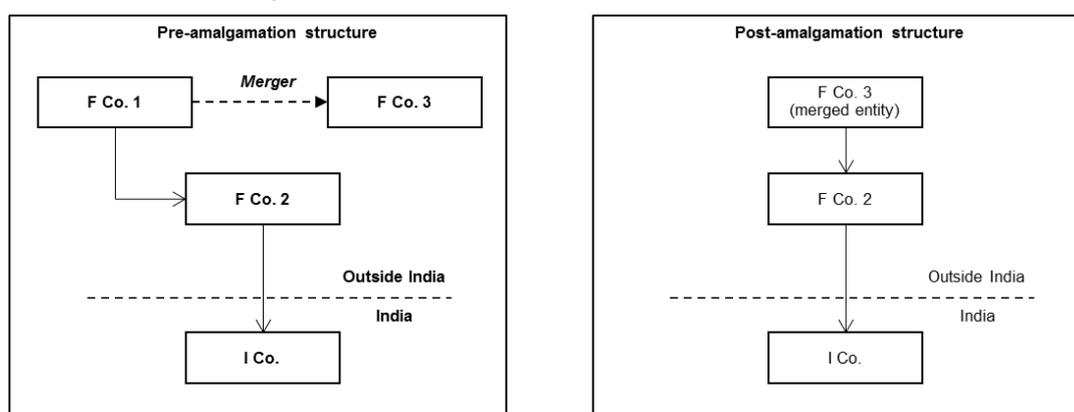
- exceeds the amount of INR 100 million; and
- represents at least fifty per cent of the value of all the assets owned by the company or entity.

The IT Act, vide Finance Act 2015, also provides for exemption from taxation of capital gains arising on transfer of shares of a foreign company, which derives directly or indirectly its substantial value from shares of an Indian company, pursuant to a scheme of amalgamation with another foreign company provided certain conditions are satisfied. The same is briefly explained below with the help of an example:

Example 3

- F Co. 1 owns a wholly owned subsidiary F Co. 2
- F Co. 2 further owns a wholly owned subsidiary in India (I Co.)
- F Co. 2 derives substantial value from shares held in I Co.
- F Co. 1 amalgamates with F Co. 3.

The pre- and post-amalgamation structures have been depicted below for reference.



In the above example, on merger of F Co. 1 with F Co.3, there is an indirect transfer of shares of I Co. Capital gains arising on such indirect transfer shall be exempt if the following conditions as stated under section 47(viab) of the IT Act are satisfied:

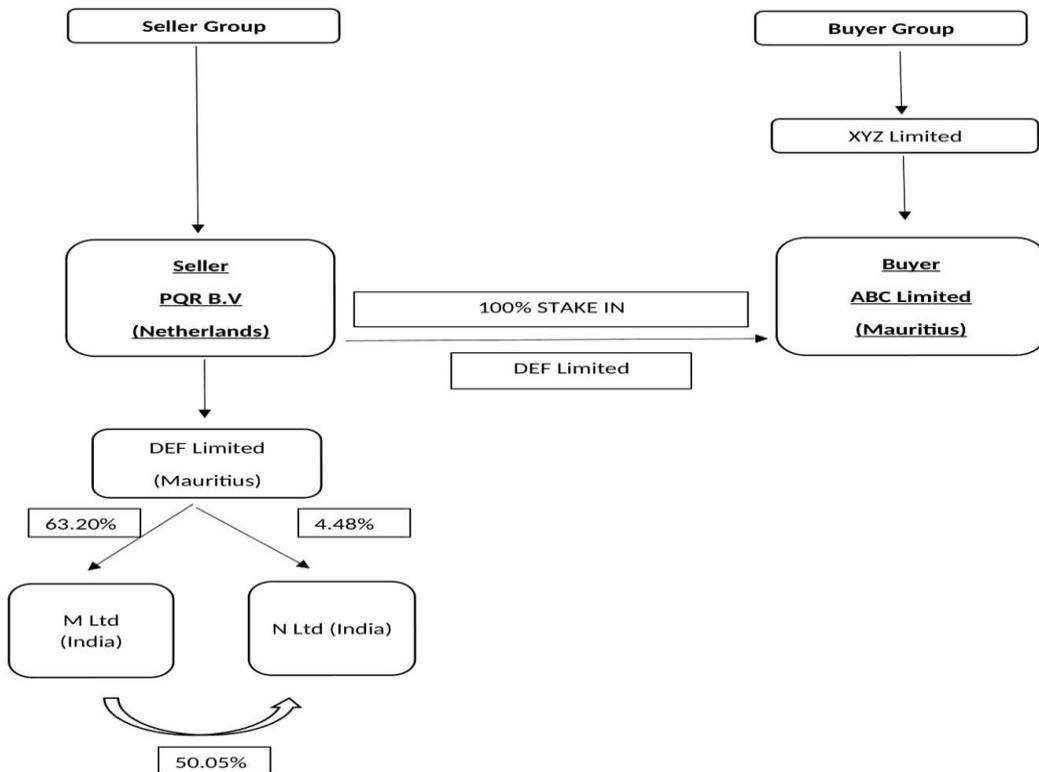
- At least 25 percent of F Co. 1's shareholders continue to remain shareholders of F Co. 3; and

- Such transfer does not attract capital gains tax in the country where F Co. 1 is located.
- Similarly, capital gains arising on demerger of business from F Co. 1 (comprising of shares in F Co. 2, which derives substantial value from I Co.) to F Co. 3 shall be exempt if the following conditions as stated under section 47(vicc) of the IT Act are satisfied:

- Shareholders holding not less than three fourth in value of shares of F Co. 1 continue to remain shareholders of F Co. 3; and
- Such transfer does not attract capital gains tax in the country where F Co. 1 is located.

Example 4

- PQR BV (Netherlands) owns a wholly owned subsidiary DEF Limited (Mauritius)
- DEF Limited (Mauritius) further holds shares in Indian Listed companies (M Limited & N Limited)
- DEF Limited derives substantial value from Indian Assets i.e. shares held in M Limited & N Limited.
- The transaction depicted in the picture below involves sale of Mauritius company (DEF Limited) holding shares of Indian listed companies (M Limited & N Limited), by a Netherland based company (PQR B.V) to another Mauritius company (ABC Limited)



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In the above illustration, the shares of Mauritius based Company – DEF Ltd substantially derive their value from Indian assets i.e. shares of M Ltd & N Ltd. The change in the ownership of the holding company of M Ltd & N Ltd (being DEF Ltd) results to transfer of ownership of these Indian Companies to another Mauritius based company – ABC Ltd. Such an indirect transfer of shares of an Indian Company is taxable vide Explanation 5 to section 9(1)(i) of the Income-tax Act, 1961. Speaking on the taxability under the Tax Avoidance Treaties, it will be pertinent to analyze as to which treaty will be applicable here:

- The income of the Netherlands Seller (PQR B.V.) shall be taxable under the Indian Domestic Laws and hence, by virtue of it being a Netherlands resident, it can avail the benefits of India-Netherlands Double Tax Avoidance (DTAA).
- Article 13 of the India-Netherlands DTAA addresses the taxing rights of both countries in context of income in the nature of capital gains.
- Paragraph 5 of Article 13 of the India – Netherlands DTAA which is applicable to the said transaction reads as under –

“5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident. However, gains from the alienation of shares issued by a company resident in the other State which shares form part of at least a 10 per cent interest in the capital stock of that company, may be taxed in that other State if the alienation takes place to a resident of that other State.

However, such gains shall remain taxable only in the State of which the alienator is a resident if such gains are realised in the course of a corporate organisation, reorganization, amalgamation, division or similar transaction, and the buyer or the seller owns at least 10 per cent of the capital of the other.”

Properties referred to in paragraphs 1 to 4 are – Immovable property, movable property forming a part of a PE, ships or aircrafts and unlisted shares of India or Netherlands who derives its value in principal from immovable property in that other state. The property referred in the above case does not falls under any of these categories.

- By referring to Article 13(5) of the treaty it can be concluded that the right to tax is with the state where the seller is a resident i.e. Netherlands in the above case.
- Domestic tax laws of Netherlands levies no tax on capital gains which results in a net zero tax transaction because of the beneficial provision of India – Netherlands DTAA.
- Further, Article 13(5) further mentions an exception that, if the shares of an Indian Company (where shares sold are >10%) are being sold to an Indian resident, the taxing rights are given to India. Since the buyer here is ABC Ltd, a Mauritius based Company, this exception is also not applicable. Therefore, the buyer and seller structure results in a tax-free acquisition.

2.11 Other laws to be considered in cross-border mergers

M&A transactions are governed by a strict regulatory framework in India requiring compliance with multiple regulations. When it comes to cross-border M&A, the number of regulations requiring compliance increase multifold, considering that it involves more than one country. Thus, apart from direct tax considerations, one needs to be mindful of several Indian laws / regulations such as:

- Exchange control regulations;
- SEBI and Takeover Code regulations in case where the Indian company is listed;
- Indirect tax laws;
- Stamp duty laws; and
- Accounting implications under Indian GAAP/ Ind AS

For instance, if by virtue of a cross-border merger of a foreign company into an Indian company, the Indian company acquires an immovable property outside India, it will have to obtain an approval from RBI to be able to hold such overseas immovable property. Similarly discharge of consideration to shareholders of foreign transferor company by means other than shares of Indian Transferee Company is not permitted under the automatic route.

Further, where the cross-border merger involves acquisition of 25 percent or more shares of a listed Indian company, SEBI's Substantial Acquisition of Shares and Takeover Regulations, 2011 could be triggered and the acquirer could have to make an open offer to acquire at least 26 percent of the total shares of the Indian company from the open market at a price determined under a prescribed SEBI formula.

Thus one has to be mindful about the various laws affecting cross-border mergers. Unless the cross-border mergers and acquisitions adhere to all the requirements under various laws, a company may not be able to leverage the benefits provided for in the IT Act.

Unit III	Treatment of Exchange Gains and losses
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3.1 Treatment of foreign exchange gains/ losses during import of fixed asset

Section 43A of The Income Tax Act, 1961 ('the Act') which provides for treatment of gain or loss on account of foreign exchange fluctuation of foreign currency loans obtained for import of fixed asset. Relevant excerpts of section 43A of the Act are below:

"Notwithstanding anything contained in any other provision of this Act, where an assessee has acquired any asset in any previous year from a country outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange during any previous year after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in Indian currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making payment—

- (a) *towards the whole or a part of the cost of the asset; or*
- (b) *towards repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset along with interest, if any,*

the amount by which the liability as aforesaid is so increased or reduced during such previous year and which is taken into account at the time of making the payment, irrespective of the method of accounting adopted by the assessee, shall be added to, or, as the case may be, deducted from—

- (i) *the actual cost of the asset as defined in clause (1) of section 43; or*
- (ii) *the amount of expenditure of a capital nature referred to in clause (iv) of sub-section (1) of section 35; or*
- (iii) *the amount of expenditure of a capital nature referred to in section 35A; or*
- (iv) *the amount of expenditure of a capital nature referred to in clause (ix) of sub-section (1) of section 36; or*
- (v) *the cost of acquisition of a capital asset (not being a capital asset referred to in section 50) for the purposes of section 48,*

and the amount arrived at after such addition or deduction shall be taken to be the actual cost of the asset or the amount of expenditure of a capital nature or, as the case may be, the cost of acquisition of the capital asset as aforesaid:

Provided that where an addition to or deduction from the actual cost or expenditure or cost of acquisition has been made under this section, as it stood immediately before its substitution by the Finance Act, 2002, on account of an increase or reduction in the liability as aforesaid, the amount to be added to, or, as the case may be, deducted under

this section from, the actual cost or expenditure or cost of acquisition at the time of making the payment shall be so adjusted that the total amount added to, or, as the case may be, deducted from, the actual cost or expenditure or cost of acquisition, is equal to the increase or reduction in the aforesaid liability taken into account at the time of making payment.”

Analysis

Section 43A of the Income Tax Act is applicable to a taxpayer who acquires any assets from a country outside India for the purpose of carrying out its business or profession. In case there is increase or decrease in the liability of the taxpayer consequent to change in rate of exchange, such differential is adjusted towards cost of the assets or repayment of money borrowed for acquiring capital asset along with interest (expressed in Indian currency). Such increase or reduction in the liability shall be added or deducted from the actual cost of assets as and when paid or received. Accordingly, section 43A is applicable in case of foreign currency loans being utilized for acquisition of imported assets purchased from outside India.

Four situations can arise where the gains/ losses shall arise from foreign exchange fluctuation on loan for purchase of assets outside India:

- *On repayment of principal amount of loan* – In such a case, since the payment is actually effected, the gains/ loss realized shall be deducted from/ added to the cost of fixed asset, respectively;
- *On payment of interest* – In such a case, since the payment is actually effected, the gains/ losses realized shall be deducted from/ added to the cost of fixed asset, respectively;
- *On annual re-instatement of loan* – In such situation, the gain shall not be taxable and the loss shall be allowed for deduction against taxable profits; and
- *On booking of accrued interest in the books* – In such a situation, the exchange gains shall be taxable and the loss shall be allowed for deduction.

3.2 Whether loss on assets acquired in India can be capitalized

Section 43A specifically deals with treatment of foreign exchange gain/ loss arising on account of loan borrowed for acquisition of assets from outside India. However, it is a litigious topic as to whether loss arising from revaluation of External Commercial Borrowing ('ECB') for assets acquired within India should be capitalized with the cost of assets or can be claimed as revenue loss.

There are a plethora of judgements on the aforesaid issue. Ratio to identify as to whether a particular receipt is capital receipt or revenue receipt is laid down by Hon'ble Supreme Court in the following cases:

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Sutlej Cotton Mills Ltd. vs. CIT⁹

CIT vs. Tata Locomotive and Engineering Company Ltd¹⁰

CIT vs Woodward Governor India Pvt Ltd¹¹

CIT vs. Tata Iron & Steel Co Ltd¹²

Besides the above, there are several High Court and Tribunal cases on the matter, viz.:

CIT vs. V.S.Dempo & Co Pvt. Ltd¹³

DCIT vs. Maruti Udhyog Ltd¹⁴

Oil and Natural Gas Corpn. Ltd vs. DCIT¹⁵

Silicon Graphics India Pvt Ltd vs. DCIT¹⁶

Rasandik Engineering Industries India Ltd vs. DCIT¹²

Relevant extracts of some of the landmark judgments are provided hereunder:

In case of Sutlej Cotton Mills Ltd. vs. CIT, it was observed by the Apex court that:

“Whether the loss suffered by the assessee was a trading loss or not would depend on the answer to the question, whether the loss was in respect of a trading asset or a capital asset. In the former case, it would be a trading loss but not so in the latter. The test may also be formulated in another way by asking the question whether the loss was in respect of circulating capital or in respect of fixed capital.”

It was also observed in the case that if the amount in foreign currency is utilised or intended to be utilised in the course of business or for a trading purpose or for effecting a transaction on revenue account, the loss arising from depreciation in its value on account of alteration in the rate of exchange would be a trading loss, but if the amount is held as a capital asset, loss arising from depreciation would be a capital loss.

In case of CIT V. Tata Iron and Steel Co. Ltd., it has been held that cost of an asset and cost of raising money for purchase of asset are two different and independent transactions and events subsequent to acquisition of assets cannot change price paid for it. Therefore, fluctuations in foreign exchange rate while repaying installments of foreign loan raised to

⁹ 116 ITR 1 (SC) (1979)

¹⁰ 60 ITR 405 (1966)(SC)

¹¹ (312 ITR 254) (2009) (SC).

¹² 99 Taxmann 459 (SC)

¹³ (206 ITR 291) (1994) (HC-Bombay)

¹⁴ 101 TTJ 760 (ITAT)

¹⁵ 77 TTJ 387 (ITAT)

¹⁶ 106 TTJ 1153 (ITAT)

¹²1997/DEL/2011 (ITAT)

acquire asset cannot alter actual cost of assets for computing depreciation.

In case of CIT vs. V.S. Dempo & Co. Pvt. Ltd which has specifically laid down principles in order to decide whether loss/gain arising out of foreign exchange fluctuations is in nature of revenue or capital, of which at para 5 of said principles which says as follow:

“Loss resulting from depreciation of the foreign currency which is utilised or intended to be utilised in business and is part of the circulating capital, would be a trading loss, but depreciation of fixed capital on account of alteration in exchange rate would be capital loss.”

In case of Hon’ble Gujarat High Court in the case of Synbiotics Limited vs CIT¹³ is worth noting. In that case, the assessee claimed loss on foreign currency loan on account of exchange fluctuation as revenue expenditure. The Hon’ble Gujarat High Court in that case disallowed the claim of assessee as revenue expenditure by making following observations:

“This issue is squarely covered by the decision of the Supreme Court in case of CIT V. Tata Iron and Steel Co. Ltd. (1998) 231 ITR 285, wherein it is held that at the time of repayment of loan, there was a fluctuation in the rate of foreign exchange as a result of which, the assessee had to repay a much lesser amount than he would have otherwise paid. It was further held that this was not a factor, which could alter the cost incurred by the assessee for purchase of the asset. The assessee might have raised the funds to purchase the asset by borrowing but what the assessee had paid for it was the price of the asset. The manner or mode of repayment of the loan had nothing to do with the cost of an asset acquired by the assessee for the purpose of his business. Following this decision, we hold that the assessee is not entitled to claim the exchange loss of Rs. 26924/- as revenue expenditure. Accordingly, question No. 2 is answered in the affirmative, in favor of the Revenue and against the assessee.”

Since loss on exchange is treated as capital expenditure, converse is true and therefore gain on exchange would be regarded as capital receipt. The above principles have been followed by various courts in deciding whether particular exchange loss or gain is of capital nature or revenue nature. As per the ratio laid down Supreme Court in case of *Sutlej Cotton Mills*, it can be concluded that it is imperative to see the nature of utilization of foreign currency loan amount. If the purpose of utilization of such loan is capital in nature, such loss should not be deductible being capital in nature. However, interest cost on said loan being an item of revenue, loss on account of interest paid and interest accrued on foreign currency loan should be tax deductible.

On the other hand, there is another school of thought that dismisses the nature of utilization of foreign exchange loan as a basis of determination of capital or revenue tax treatment. As per an analysis, at the time of raising of loan, no capital asset comes into existence and hence expenses for raising loan should be treated as revenue in nature. Further the variation in the loan amount has no bearing on the cost of the asset as the loan is a distinct and independent transaction as in comparison with acquisition of assets out of the said loan amount borrowed. It should be noted that utilization of loan amount has nothing to do with allowability of any expenditure in connection with loan repayment. Both are independent and distinct transactions in nature. It should be noted that section 43A specifically and categorically provides for

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adjustment in the cost of the asset for loss or gain arising out of foreign currency fluctuations in respect of borrowed funds in foreign currency. However, the same rationale cannot be applied to loss or gain arising from foreign currency loan utilized for purchase of indigenous assets.

On the basis of case laws cited above, every loan requires to be analyzed from the angle of usage of such loan or liability. Accordingly, criteria for determination of expenditure/loss/gain connected with loan as capital/ revenue nature shall be based on utilization of such borrowed funds.

Interest cost allowed under section 36(1)(iii) of the Act should be analysed to understand whether such loan in respect of which such interest cost pertains is used for capital account transactions or revenue account transactions. However, section 36(1)(iii) does not contemplate any such division of interest cost and plainly allows deduction of interest cost. Section 36(1)(iii) allows deduction of interest expenditure in connection with loan irrespective of ultimate utilization of such loan. The same principle is consistently followed by other sections of the Act on allowability of expenditure in connection with a liability. Accordingly, the premise on which the aforesaid judicial decisions are based is invalid and requires re-examination.

Further, an argument may be made where section 45 of the Act can be analyzed. Section 45 creates a specific charge for taxability of capital receipts or allowability of capital loss. The provisions of section 45 do not either create any charge on forex fluctuations on account of foreign exchange loan nor allows the same as capital loss.

Also, as per section 43 (1), actual cost means actual cost of the assets to the taxpayer, reduced by that portion of the cost as has been met directly or indirectly by any other person or authority. The section also has thirteen explanations, however, the section nowhere specifies that any gain or loss on foreign currency loan acquired for purchase of indigenous assets will have to be reduced or added to the cost of the assets.

Reference can be had to the provisions of section 43 (6) of the Act, which defines the term written down value. As per the section WDV means:

(a) Aggregate of WDV of the assets falling within the block of assets at the beginning of the previous year as increased by actual cost of the assets falling within the block, acquired during the previous year and reduced by the money payable in respect of any assets falling within that block which is sold or discarded or demolished or destroyed during the previous year together with the amount of scrap value, if any. However, the amount of such deduction should not exceed WDV as so increased.

The section clearly specifies the amount which can be deducted from the WDV which includes the money payable in respect of assets under different circumstances but it nowhere specifies that gain accrued on valuation of foreign currency loan at the balance sheet date should be reduced from the WDV of the asset.

Therefore, utilization of loan for either capital account or revenue account has nothing to do

with allowability of expenditure in connection with foreign currency loan.

Applicability of Accounting Standard 11 for valuation

The Companies Act 2013 mandates the financial statements of companies to be compliant with applicable Accounting Standards. Thus, exchange gain/loss is recognized in the financial statements in accordance with AS-11. As per generally accepted principles of accounting provided by various Accounting Standards issued by ICAI in absence of specific provisions in the Income Tax Act in relation to treatment of exchange fluctuation gain or loss.

Analysis of decision of apex court in case of CIT vs. Woodward Governor India (P.) Ltd. (Emphasis supplied):

In the judgement, one of the issues involved in above mentioned case was “Whether the taxpayer is entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance sheet date, pending actual payment of the varied liability?”

The above mentioned decision had considered the implication of Para 10 of AS-11 along with section 43A of the Act. While deciding the issue, it was observed by Hon'ble apex court at para 17:

“Having come to the conclusion that valuation is a part of the accounting system and having come to the conclusion that business losses are deductible under section 37(1) on the basis of ordinary principles of commercial accounting and having come to the conclusion that the Central Government has made Accounting Standard-11 mandatory, we are now required to examine the said Accounting Standard (“AS”).”

Apex court has decided in above matter to treat foreign exchange gain or loss arising on acquisition of fixed assets in foreign currency as per the treatment laid down in AS-11 (Revised 1994). Para-10 of AS-11 (revised 1994) provides as under:

“Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which are carried in terms of historical cost, should be adjusted in the carrying amount of the respective fixed assets. The carrying amount of such fixed assets should, to the extent not already so adjusted or otherwise accounted for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or a part of the cost of the assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets.”

AS-11(Revised 1994) provides for adjustment in the carrying cost of fixed assets acquired in foreign currency, due to foreign exchange fluctuation at each balance sheet date which also correspond to treatment given in section 43A. The issue accordingly decided by apex court in view of manner laid down in AS-11 (Revised 1994) at Para-10.

“However, it is now necessary to reconsider the above decision in view of AS-11 (Revised 2003) wherein at Para 13 which provides for revision in treatment of exchange gain or loss.

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The revised treatment provided at Para 13 of AS-11 (Revised 2003) is given below:

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."

It may be noted that apex court in case of *Woodward Governor India* had followed treatment of exchange loss / gain as per AS-11 (1994). In view of revision made in AS-11 in 2003, treatment of foreign exchange loss arising out of foreign currency fluctuations in respect of fixed asset acquired through loan in foreign currency is required to be provided in profit and loss account. In view of revision made in AS-11, the treatment shall be as per revised AS-11 (2003). Accordingly, exchange gain or loss on foreign currency fluctuations in respect of foreign currency loan acquired for acquisition of fixed asset should be allowed as revenue expenditure.

Accordingly, the taxpayer company may be allowed for deduction of any loss arising out of foreign currency fluctuation in respect of foreign currency loan obtained and used for acquiring indigenous assets. However, the treatment in books of account is not determinative of the tax treatment thereof for the purpose of income tax. As held by Supreme Court in *Sutlej Cotton Mills Limited* (Emphasis supplied) and also in case of *Tuticorin Alkali Chemicals and Fertilizers Limited*¹⁴, it is now well settled that the manner in which the entries are made in the books of account is not determinative of the question whether the taxpayer has earned any profit or suffered any loss. However, to put the controversy of application of accounting standards in place of computation of income under income tax act is put to rest with introduction of Income Computation and Disclosure Standards.

3.3 Effect of Income Computation and Disclosure Standards (ICDS) on taxability of foreign exchange fluctuations

The Income Computation and Disclosure Standards (ICDS) were notified under Notification No. 32/ 2015 dated March 31, 2015, effective from April 1, 2015. ICDS VI deals with the 'Effects of Changes in Foreign Exchange Rates'. ICDS are issued in terms of Section 145(2) of the Income-tax Act, 1961 (the Act) and are limited to taxpayers following the mercantile system of accounting in computing the income under the head 'Income from Business or Profession' or under the head 'Income from Other Sources'. In case there arise a conflict between the Act and the ICDS, the Act shall prevail.

ICDS VI – Effects of changes in foreign exchange rates

This ICDS primarily deals with the following three categories of transactions with foreign exchange recognition:

(a) Transactions in foreign currencies

As per the provisions of ICDS, a foreign currency transaction shall be initially recognized at

the rate prevailing on the date of the transaction. However, a taxpayer is permitted to use an average rate of a week or a month that approximates the actual rate at the date of the transaction. 'Monetary transactions' are required to be translated at year end at the year-end rate e.g. balances in Exchange Earner's Foreign Currency (EEFC) Account would be translated at the year-end rate applicable for that currency. 'Monetary items' are defined as money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money; cash, receivables and payables as also examples of monetary items. Further, recognition at below closing rate can also be affected where restrictions, etc. are likely to reduce the net realizable value of the monetary item for the taxpayer, to factor in currency restrictions, volatility, etc. Para 5(i) allows the recognized exchange difference to be treated as income or expense of the year in which such difference is recognized under ICDS. However, during initial recognition, conversion and recognition of exchange differences the provisions of section 43A of the Act and Rule 115 of the Income-tax Rules, 1962 (the Rules) shall prevail.

Non-monetary transactions should be converted into reporting currency at the exchange rate used on the date of the transaction. The exchange gain or loss should not be treated as taxable gain or loss for the year. Non-monetary items are defined as assets and liabilities other than monetary items. The ICDS cites examples of non-monetary items as fixed assets, inventories and investments in equity shares.

Import inventories that are on high seas at the year-end should be treated as monetary item and accordingly, the exchange gain or loss should be treated as taxable gain or loss. For example: In case of purchase of inventory, on the date of shipment by the supplier, the exchange rate was US \$ 1 = 62, the year-end rate is US\$ 1 = 63. In this case, the inventory may be valued at 12.4 crores whereas the liability to the supplier will be valued at 12.6 crores and the exchange loss of 20 lakhs can be treated as a deductible item.

(b) Translating financial statements of foreign operations

The term 'foreign operations' refers to operations outside India e.g. a branch. Foreign operations are classified into the following two types:

- *Non-integral foreign operations:* Non-integral foreign operations have one or more characteristics of independent operations with significant degree of autonomy of operations, mainly financed by own operations or local borrowings, sales are in a currency other than Indian rupees, cash flow for day-to-day operations are not dependent on each other, sales prices are determined by local competition in the jurisdiction of operation and such other factors.
- *Integral foreign operations:* Integral foreign operations implies to controlled operations where the taxpayer exercises control on its foreign operations. Non-integral foreign operations should be translated in the following manner:
 - (i) Assets and liabilities to be translated at year end closing rate;
 - (ii) Income and expenditure to be translated at the rates on the dates of the transactions; and

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- (iii) All resulting exchange differences to be recognized as income or expense of the year.

(c) Forward exchange contracts

A forward exchange contract should satisfy the following two conditions to qualify as a forward exchange contract:

- Forward Exchange Contract should not be intended to be entered for trading or speculation purpose
- Forward Exchange Contract should be entered into for the purpose of establishment of amount of rupees required to be paid at the time of settlement of transaction.

The premium or discount arising at the inception of a forward exchange contract shall be amortized as expense or income over the life of the contract. The term 'premium arising' does not factor in the fact that the aforesaid premium never changes hands either at inception or otherwise but is a market measure of potential movement of the currency over the period of the contract. The premium or discount is to be measured as the difference between the exchange rate on the date of inception of the contract and the forward rate specified in the contract. Exchange differences on such a contract shall be recognized as income or expense of in the year in which the exchange rates changes. Any Profit or loss arising on cancellation on renewal shall be recognized as income or expense for the previous year. The following example explains the treatment:

An importer Co. books a six month forward contract on February 1, 2016 to buy US \$ 100,000 on July 1, 2016 for aiding an import payment that may come up on August 1, 2016. On February 1, 2016, the spot rate is US \$ 1 = 60 and importer Co.'s bank offers the six month forward contract at US \$ 1 = 62. The forward exchange premium is 200,000 i.e. $100,000 \times (62 - 60)$. The importer Co. does not have to pay any amount to its bank on February 1, 2016. The importer Co. is required to set-off the premium over the six-month period of the contract i.e. for the two months up to March 31, 2016. Accordingly, the importer Co. will recognize 66,667 (one-third of 200,000) as expense for that year.

In the above case, if the importer books a three month forward exchange contract to pay to his supplier and the forward contract gives him a rate of US \$ 1 = 63, the importer should amortize 1 premium per month for each month of the contract.

Unit IV	Trusts
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4.1 Background

There are various forms of setting up business in India viz. Company, Limited Liability Partnership ('LLP') firms, partnership firm, Hindu Undivided Family ('HUF') etc. A new form of business vehicle has been introduced by Indian government in Finance Act 2014, viz. business trusts operating as either Real Estate Investment Trusts ('REITs') or Infrastructure Investment Trusts ('InvITs'). In a bid to understand the functioning of these business trusts, it is pertinent to first gain an understanding of the history of trusts, its evolution in Indian history and its gaining importance in current business set-up.

Traditionally trust structure has been applied by the rich and affluent individual taxpayers as a medium for wealth preservation and family succession planning. A business trust is an arrangement whereby a settler/ sponsor (the person creating the trust) designates a trustee/ trustees to manage the sponsor's assets on behalf of a beneficiary. Creating a trust has multiple advantages viz. in case of individual sponsors, upon the death of a sponsor, the fund of assets operated by a trust directly pass to its beneficiaries. In the post-independence era, the concept of family trusts gained prominence mainly due to tax savings attached thereto and the preservation of family assets within the family.

In 1970s, Indian government repealed all tax benefits attached to trusts. With a tax rate of 90 percent and revocation of all tax incentives, the culture of setting up family trusts also dwindled with time and trusts were increasingly being set up for carrying out limited purpose of charitable and educational nature. Several different mediums of investment were established to carry out business in a tax efficient manner and to preserve wealth in the hands of family generation after generation, viz. formation of HUFs, scripting family wills etc.

In present scenario, the mode of conducting business has changed many folds. Most business houses operate through Companies and LLPs to carry out their business operations with limited liability. Also, investment is made in a business in India and abroad through creating a maze of intermediary companies, commonly called as special purpose vehicles to carry out business operations in a tax friendly manner. Many legal and accounting experts are hired to undertake complex planning of wealth creation in a tax proficient manner and its preservation and allocation to concerned stakeholders in a seamless manner.

4.2 Definition of Business Trust

A business trust is a structure through which cash flows generated from one business or operating company are encased in a tax efficient manner by a group of investors. The services of an expert are employed to manage a pool of assets ultimately held by the sponsor and investors collectively. Unlike an investment fund that generates income from a diversified pool of portfolio for its investors, in case of a business trust, a common pool of assets in same industry are deployed to generate profits in a tax efficient manner. The trust holds debt and equity interests of an operating business through forming an intermediary.

4.3 Background of Real Estate Investment Trust ('REIT')

REIT is a form of business trust through which investors along with sponsors invest in a pool of real estate properties that generate regular rental income. In a typical REIT structure, the owners of completed real estate assets viz. sponsors raise capital from both domestic and foreign investors through issuing units to them. The real estate assets are owned and managed by an intermediary company called Special Purpose Vehicle ('SPV'). The benefits of REIT structure over current real estate market comprising of real estate developers are as follows:

- (a) REIT is an alternate investment avenue against financial markets. The shortcomings of investing in physical real estate assets can be mitigated by investing in real estate assets through REIT structure. Most REIT structures are listed on stock exchange thereby providing value appreciation on the bourses also. The entry as well as exit is also seamless and can be planned. Hence, REIT investors can maintain their investment liquidity just like equity investment even while investing in real estate;
- (b) REITs are managed by independent trustees, managers and other professionals. Generally, REIT structures are also stringently regulated thereby maintaining transparency and professionalism in working.
- (c) REIT ensures improved fund availability to real estate developers by sourcing long term finance from domestic as well as foreign investors;
- (d) REIT provides the investors a new investment vehicle with regular income viz. rental income;
- (e) REIT is a pass through structure that allows many tax exemptions in hands of REIT and investors (detailed analysis in Para 4.5 and 4.6);
- (f) Generally the real estate developer invests in commercial or residential real estate and that investment stays locked for years in those real estate assets till suitable price appreciation happens or the value can be unlocked through sale of such real estate property. In case of REIT structure, it reduces the burden of cash trap in completed assets owned by real estate developers.

4.3.1 Indian Background

Indian real estate industry has made significant expansion in past decade and a half. Many real estate companies have bought their Initial Public Offerings ('IPOs') to raise equity investment from retail investors. The real estate development activity has spread from cities to Tier II and Tier III towns also. However, Indian real estate sector has been viewed largely as an unorganised sector and corporatization of the sector is the call of the day in order to attract better foreign capital investments. With this background, REIT structure has been viewed as a preferred investment vehicle by many real estate experts to develop and unlock the value in Indian real estate business.

Therefore, several representations have been made in the past by the real estate industry before the government for setting up REITs in India. Securities and Exchange Board of India ('SEBI') has responded to the industry representations in past but the attempts were neither adequate nor timely. In a step to showcase Indian real estate business as an effective investment vehicle, SEBI issued draft (Real Estate Investment Trusts) Regulations, 2008 ('REITs Regulations, 2008') open for public comments in 2008. The draft Regulations provided that REIT scheme could be launched only through a registered trust under Indian Trust Act, 1882. As per the Regulations, the Trust should be deployed to provide for undertaking real estate investments in India in accordance with REIT Regulations. The initial REIT Regulations 2008 remained in draft format since then. However, SEBI amended SEBI (Mutual Funds) Regulations, 1996 ('MF Regulations') on April 16, 2008 introducing a new chapter 49A providing for setting up of Real Estate Mutual Funds '(REMFs)'. The draft REIT Regulations 2008 provided for investment in real estate industry with no investment in securities. On the other hand, REMFs were hybrid form of structure wherein a pool of investments was allowed to be deployed in making investments in securities as well as real estate assets.

SEBI released another set of draft REIT Regulations on October 10, 2013 open for public comments till October 31, 2013. However, due to lack of tax and regulatory reforms to incentivise the proposed scheme, REIT was not viewed as an alternative investment avenue. Relevant tax amendments were also important to optimize the effective application of REITs in Indian scenario. Therefore, the Finance Act 2014 introduced a special taxation regime in relation to business trusts and the tax incentives were announced effective from October 1, 2014. Section 2(13A) was inserted in the Income Tax Act, 1961 ('The Act') to define business trusts as comprising of REITs and Infrastructure Investment Trust registered under SEBI prescribed regulations. Subsequently, on the basis of comments received on SEBI's draft REIT regulations and the Budget announcement for 2014, on September 26, 2014, SEBI finally notified SEBI (Real Estate Investment Trusts) Regulations, 2014 ('SEBI REIT Regulations') laying down framework for setting up, registration and regulation of REITs in India.

4.3.2 Salient features of business trusts through REITs

Following are the salient features of SEBI REIT Regulations in India:

- A REIT should be structured as a trust in accordance with the provisions of the Indian Trusts Act, 1882. The trust deed should be duly registered in accordance with provisions of Registration Act, 1908;
- A REIT structure should comprise of separate entities in the form of a trustee, a sponsor/ sponsors and a manager;
- The main objective as reflected in the 'Trust Deed' should be undertaking REIT in India in accordance with the SEBI REIT Regulations;
- As per regulation 18(1), a REIT can invest only in SPVs or properties or securities or time deposit receipts in India in accordance with the REIT Regulations and in

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accordance with the investment strategy as detailed in the offer document as may be amended subsequently;

- Not less than 80% of value of the REIT assets should be invested in completed and revenue generating properties;
- Not more than 20% of the value of REIT assets should be invested in following manner:
 - (a) Not more than ten per cent of value of the REIT assets should be invested in the following properties:
 - (i) Under-construction properties to be held by the REIT for not less than three years after completion;
 - (ii) Under-construction properties that are part of the existing income generating properties owned by the REIT which should be held by the REIT for not less than three years after completion;
 - (iii) Completed and non-rent generating properties which should be held by the REIT for not less than three years from date of purchase;
 - (b) Mortgage backed securities;
 - (c) Listed / unlisted debt of companies / body corporate in real estate sector;
 - (d) Equity shares of companies listed on a recognized stock exchange in India which derive not less than 75% of their operating income from Real Estate activity;
 - (e) Government securities;
 - (f) Term Deposit Receipts acquired for the purpose of utilization with respect to a project where it has already made investment; and
 - (g) Money market instruments or Cash equivalents. However, investments in developmental properties should be restricted to 10% of the value of the REIT assets.
- A REIT should invest in at least two projects with not more than 60% of value of assets invested in one project;
- REIT should not invest in vacant land or agricultural land or mortgages other than mortgage backed securities, provided that this shall not apply to any land which is contiguous and extension of an existing project being implemented in final stages. In SPVs, a REIT shall hold or propose to hold controlling interest and not less than 50% of the equity share capital or interest;
- SPVs should not hold less than 80% of its assets directly in properties and should not invest in other SPVs;
- REIT should raise funds through an initial offer. Subsequent to the raising of funds through initial offer, funds may be raised through follow-on offer, rights issue, qualified institutional placement, etc.

- For the purpose of making an initial offer, the value of the assets owned/proposed to be owned by REIT should be of value not less than INR 500 Crore. Moreover, the minimum issue size for initial offer should be INR 250 Crore;
- The minimum subscription size for units of REIT should be INR 2 Lakhs. The units offered to the public in initial offer shall not be less than 25% of the number of units of the REIT on post-issue basis;
- REIT units shall be mandatorily listed on a recognized Stock Exchange and REIT should make continuous disclosures in accordance with the listing agreement. Further, the trading lot for such units should be INR 1 Lakh;
- The trustee of a REIT should not be an associate of the sponsor / manager. Also, the trustee should be registered under SEBI (Debenture Trustees) Regulations, 1993;
- A REIT may have multiple sponsors subject to a maximum of three. Further, each sponsor should hold at least 5% of the total number of units of the REIT. Such sponsors should collectively hold not less than 25% of the units of the REIT for a period of not less than 3 years from the date of listing. After 3 years, the sponsors, collectively, should hold minimum 15% of the units of REIT, throughout the life of the REIT;
- The net worth of each sponsor in a REIT should not be less than INR twenty crores while the collective net worth of all sponsors in a REIT should be at least INR hundred crores;
- The sponsor should have a minimum five years experience in development of real estate or fund management in the real estate industry. In case where the sponsor is a developer, at least two projects of the sponsor should have been completed;
- In case the manager is a body corporate, the manager should have a net worth of not less than INR ten crores. In case the manager is a LLP, the tangible value of its assets should not be less than INR ten crores;
- The manager should have a minimum five years experience in fund management or advisory services or property management in the real estate industry or in development of real estate;
- The manager should have at least two key personnel, each of whom have not less than five years experience in fund management or advisory services or property management in the real estate industry or in development of real estate;
- The manager should have at least half of its directors/ members of governing body in case of a body corporate/ LLP respectively of an independent stature and not as directors/ members of the governing Board of another REIT;
- The manager and trustee should enter into an investment management agreement providing for the responsibilities of the manager in accordance with Regulation 10;
- The trustee should be registered with the Board under SEBI (Debenture Trustees) Regulations, 1993 and should not be an associate of the sponsors or manager;

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- The Trustee should generally be overseeing the activities of the REIT. The manager should assume operational responsibilities pertaining to the REIT;
- REIT should distribute not less than 90% of the net distributable cash flows, subject to applicable laws, to its investors, at least on a half yearly basis;
- REIT should undertake full valuation on a yearly basis through a valuer. Updation of the valuation should be done on a half yearly basis. The Net Asset Value should be declared within 15 days from the date of such valuation/ updation;
- The borrowings and deferred payments of the REIT at a consolidated level should not exceed 49% of the value of the REIT assets. In case such borrowings/ deferred payments exceed 25%, approval from unit holders and credit rating should be required.

4.4 Investment Trusts

Infrastructure Investment Trusts are typical investment structures that make investment in income generating infrastructure sector of India through owning and managing infrastructure assets like roads, seaports, airports etc. InvITs invest in both under-completion and completed infrastructure projects. SEBI received various suggestions from stakeholders regarding setting up of a tax effective investment avenue in the infrastructure sector in India on lines of similar structures being available in Singapore, Hong kong etc. Based on the suggestions, SEBI introduced a consultation paper open for public comments on InvITs on December 20, 2013. Another set of draft regulations were introduced on July 17, 2014 open for public comments till July 24, 2014. SEBI issued the final regulations dated September 26, 2014. The benefits of investing through InvITs are similar to that of REIT including attracting foreign capital in Indian infrastructure sector, unlocking of cash trapped projects for developers, tax benefits coupled with lowering loan exposure through availability of low cost capital availability.

4.4.1 Salient features of Investment Trusts in India

- a) InvIT should be registered with SEBI and its units should be listed on a stock exchange. In case of public InvITs, minimum 25 per cent of total outstanding units of InvIT should be offered as offer document open for public subscription.
- b) Investors have the right to remove the manager, trustee, request delisting etc.
- c) A sponsor can set up an InvIT with not more than three sponsors along with other investors. For qualifying as a sponsor, a body corporate or a company should have a net worth of at least INR 100 crores. A Limited Liability Partnership may also set up an InvIT provided it has net intangible assets of INR 100 crores. Further, the body corporate or LLP should also have a minimum experience of at least five years and should have completed at least two projects.
- d) InvIT to hold investments on behalf of the Trust. A Trustee should be registered with SEBI and should not be an associate of a sponsor or investment manager. Further, a Trustee should have sufficient resources as specified by SEBI
- e) InvITs should be managed by professional investment managers having skill and

experience in development of Infrastructure Projects. For qualifying as an investment manager, following criterion should be fulfilled:

- i. In case of body corporate, the company should have a net worth of at least INR 10 crores. A LLP should have net intangible asset of INR 10 crores or more.
 - ii. The directors/ members of an InvIT should not be directors/ members of another InvIT. Further, not less than half of the directors/ members should be independent.
 - iii. The investment manager should have a minimum experience of five years in fund management and advisory services in infrastructure development.
- f) Investment in InvITs can be made by both residents and non-residents with no lock-in restrictions on investments made by Non-residents in case of public InvITs. Foreign investment shall be subject to Reserve Bank of India guidelines.
- g) The minimum investment by an investor in case of privately placed InvIT is INR one crore and in case of public InvIT is INR 10 lacs. Holding by an investor in either case should not be more than 25 per cent of the units of InvITs.

4.5 Taxation of REITs and InvITS in India

From a taxation perspective, both REITs and InvITs are categorised under the definition of 'Business Trust' under section 2(13A) of the Act that states as under:

'business trust' means a trust registered as:

- (i) *An Infrastructure Investment Trust under the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992); or*
- (ii) *A Real Estate Investment Trust under the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992)*

4.6 Business Trust – Special tax regime

Section 115UA was introduced under Chapter XII-FA of the Act for the purpose of determining the taxability of income of unit holder and business trust. As per provisions of section 115UA, the distributed income in the hands of unit holders should be deemed to be of the same nature and in the same proportion in the hands of unit holder as the income in the hands of Business Trust.

As per clause (2) of section 115UA, the total income of Business Trust other than capital gain will be taxed in the hands of business trust at the maximum marginal rate. The capital gains should be taxable in accordance of provisions of section 111A and 112.

4.6.1 Interest income

(a) Interest income received by Business Trust from SPV

Interest income in hands of Business Trust – As per section 10(23FC), any interest income received or receivable by a Business Trust from a Special Purpose Vehicle shall be exempt in the hands of the Business Trust. Accordingly, provisions of section 194A(3)(xi) was inserted in Finance Act 2014 thereby exempting applicability of withholding tax provisions on interest income received by REIT/InvIT from SPV.

For the purpose of the above section, 'Special Purpose Vehicle' is defined by way of any *Explanation* as an Indian Company in which the Business Trust holds controlling interest and any specific percentage of shareholding or interest, as may be required by the regulations under which such trust is granted registration. Registration of both REITs and InvITs is granted under respective SEBI Regulations that require shareholding of 51 per cent or more by a REIT in a SPV.

By virtue of interplay of section 115UA and section 10(23FC), only interest income received from SPV is exempt in the hands of Business Trust. However, interest received from non-SPV sources shall be taxable at maximum marginal rate.

(b) Interest income received by unit-holders as distribution

As per provisions of clause (3) of section 115UA of the Act, any distributed interest income of the same proportion as interest received from SPV received by a unit holder from a Business Trust shall be deemed to be income of the unit holder and shall be subject to tax. Hence, it can be said that section 115UA is the charging section for business trusts that provides for pass-through status to business trusts wherein the interest income is exempt in the hands of business trust and in return is taxable in the hands of unit holder at the time of distribution.

- (i) **Interest income in hands of resident unit-holder** – Interest income received by business trust from SPV distributed to resident unit-holder shall be subject to applicable withholding tax rates in the hands of unit holders i.e. 10 per cent.
- (ii) **Interest income in hands of non-resident unit holder** – Interest income received by business trust from SPV distributed to non-resident unit-holder shall be subject to concessional withholding tax rate of 5 per cent in the hands of non-resident unit holder in accordance with provisions of section 194LBA of the Act.

(c) Interest paid on ECB

Interest paid on ECB by Business Trust – As per provisions of section 194LC read with provisions of section 115A (1)(a)(iiaa)(BA), a REIT/ InvIT is required to deduct a concessional withholding tax rate of 5 per cent on interest payments made to non-resident unit-holders or other foreign non unit-holder lenders on the funds borrowed from such non-resident unit-holders or foreign non unit-holder lenders (subject to fulfillment of External Commercial Borrowings ('ECB') requirements under Foreign Exchange Management Act, 1999.

4.6.2 Capital gains

- (a) **Capital gains tax in hands of Business Trust** – Capital gains realized by a Business Trust on sale of its capital assets viz. shares of SPV, sale of properties held by SPV etc. shall be subject to normal capital gains tax rates. However, by virtue of applicability of section 10(23FD), capital gain component of distributed income will be exempt in hands of unit holders. Accordingly, Business Trusts are statutorily mandated as a tax pass-through structure wherein capital gains are levied on business trust and is subsequently exempt in the hands of unit-holders at the time of distribution.

Capital gains implications on sale of units by unit-holder –As per section 112A inserted by Finance Act 2018 w.e.f AY 2019-20, long term capital gains exceeding 1 lakh rupees arising on transfer of units of a business trust by a unit holder, shall be taxable at the rate of 10% if securities transaction tax ('STT') is paid on the transfer of such units.

A new proviso to section 10(38) has been inserted by Finance Act, 2018, which provides that no exemption u/s 10(38) would be available on any income arising from transfer of long term capital assets being unit of business trust made on or after 01-04-2018.

As per provisions of section 111A(1) of the Act, a concessional rate of short term capital gains at 15 per cent shall be levied on unit-holders on sale of units provided STT is paid on the transfer of such units.

- (b) **Capital gains implications on share swap Implications** – In accordance with section 47 (xvii), any transfer of a capital asset being share of a SPV to a business trust in exchange of units allotted by such business trust to the transferor is exempt from the ambit of capital gains tax in India. Accordingly, no capital gains tax arises in the hands of sponsor at the time of swapping of SPV shares with units in business trust.
- (c) **Capital gains implications on future sale of units by unit-holder (ex-sponsor)** – In accordance with provision of section 111A(1) and Section 112A(1) of the Act, any transfer of units of a business trust which were acquired in consideration of transfer referred to in clause (xvii) of section 47, shall be subject to provisions of capital gains tax. Accordingly, the unit-holder (ex-sponsor) needs to pay capital gains tax based on the period of holding in case it sells its units in the business trust in future.

Important provisions applicable for computation of capital gains tax in hands of unit-holder (ex-sponsor):

- **Cost of acquisition of units** – In accordance with clause (2AC) of section 49, the cost of acquisition of units for the purpose of computing capital gains shall be the cost of acquisition of shares of SPV;
- **Period of holding of units** – In accordance with clause (hc) of Explanation 1 of section 2(42A) of the Act, for computing capital gains on future transfer of units by unit-holder

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(ex-sponsor), period of holding of shares in SPV shall be included in the holding period of the units;

- The exemption from Long term capital gain and concessional rate of short term capital gains is not available for the purpose of computing capital gains in the hands of unit-holder (ex-sponsor) on future sale of units held in the business trust; and
- As per provisions of section 2(42A), holding period for computing short term capital gains is less than thirty-six months.

4.6.3 Rental income

- (a) **Rental income earned by REIT** – The rental income earned by REIT through renting, leasing or letting out of any real estate asset owned directly by such business trust is exempt in the hands of REIT in accordance with section 10(23FCA).
- (b) **Rental income earned by unit-holders** - As per provisions of clause (3) of section 115UA of the Act, any distributed rental income of the same proportion as rent received/accrued to REIT received by a unit holder from REIT shall be deemed to be income of the unit holder and shall be subject to tax. Hence, it can be said that section 115UA is the charging section for business trusts that provides for pass-through status to business trusts wherein the rental income is exempt in the hands of business trust and in return is taxable in the hands of unit holder at the time of distribution.
 - (i) **Rental income earned by resident unit-holders** – As per section 194LBA (1), any distributable income in the nature of rental payment made by a business trust to its unit-holders is subject to deduction of income tax thereon at the rate of ten per cent.
 - (ii) **Rental income earned by foreign unit-holders** – As per section 194LBA (3), any distributable income in nature of rental payment made by a business trust to its foreign unit-holders being a non-resident or a foreign company is subject to deduction of income tax thereon at the rate in force.

Unit V	Base Erosion and Profit Shifting
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5.1 An overview

With the development of technology and globalization of businesses, Multinational enterprises (MNEs) have started designing their business operations in a way to minimize their global tax costs through making effective use of tax rules and applicable exemptions available under tax treaties. On the other hand, International tax rules have not been able to keep pace with developments in the world economy, resulting in double non-taxation and stateless income.

Due to aggressive tax planning strategies adopted by many large MNEs, there was a lot of hue and cry around morality of such harmful tax practices. As a result, on specified request of the G20 Finance Ministers, Organization for Economic Cooperation and Development (OECD) started to shape out a plan to mitigate harmful tax practices to ward off the negative effects of MNEs' tax avoidance strategies on national tax bases. The existing bilateral tax treaties had been designed in a pre-digital age with the aim to avoid double-taxation of same income. However, in recent past many instances of double non-taxation have been observed due to integration of tax rules and legislations followed in different sovereign states.

In the background of the above repercussions, in February 2013, the OECD published a report on "Addressing Base Erosion and Profit Shifting" iterating the need for analyzing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing an Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions.

The Action Plans were structured around three fundamental pillars viz.:

- (1) Reinforcing of 'substance' requirements in existing international standards;
- (2) Alignment of taxation with location of value creation and economic activity; and
- (3) Improving transparency and tax certainty.

An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards. In September 2014, the OECD released the first 7 elements of the Action Plan. The final package of measures was released on October 5, 2015 and the 13 Final Reports were duly approved by the G20 Finance Ministers on 8 October 2015.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other states involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

- *New minimum standard* - New minimum standard implies application of a new rule to be implemented by all states; the new minimum standards are identified to fight harmful tax practices, prevent tax treaty abuse, including treaty shopping, improve transparency

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with Country-by-Country Reporting, and enhance the effectiveness of dispute resolution.

- *Revision of a standard which already exists* – Such revisions should be binding but with the caveat that all BEPS participants have not endorsed the revisions; and
- *Best practice* – A best practice is not a standard but optional recommendations for states to follow.

G20 and OECD countries have continued working on an equal footing to carry out follow-up work to these reports since the release of Final Reports. More importantly, 2017 update to the OECD Model Tax Convention primarily comprises changes to the OECD Model that were approved as part of the BEPS Package or were foreseen as part of the follow-up work on the treaty-related BEPS measures. The changes to the OECD Model arise out of Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements), Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) and Action 14 (Making Dispute Resolution More Effective).

OECD also released 2017 edition of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in July 2017 reflecting a consolidation of the changes resulting from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project as under:

- Substantial revisions introduced by the 2015 BEPS Reports on Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation and Action 13 Transfer Pricing Documentation and Country-by-Country Reporting;
- Revisions to Chapter IX to conform the guidance on business restructurings to the revisions introduced by the 2015 BEPS Reports on Actions 8-10 and 13;
- Revised guidance on safe harbours in Chapter IV.

Below is the brief summary of Final Action Plans and what it entails:

5.2 Action Plan 1 – Addressing the challenges of the Digital Economy

A virtual PE comes into existence due to tax mismatch arising from nexus created between income generation and physical presence. Each tax jurisdiction which comes across a digitized enterprise doing trade in its jurisdiction has to confirm if the significant revenues are generated from in country customers. If this is the main cause for substantial economic presence being created, then that country can consider bringing in a suitable law to tackle BEPS issues. Further, the following guidance is placed in the report apart from changes suggested in definition of PE covered in Action Plan 7.

- *Updating the arm's length principle* – The cross-border transactions between related parties shall be analyzed from TP stand point to mitigate the harmful effects due to convergence of Information and communication technology (ICT). However, it is

confirmed that low risk distributors are not caught by the new provision and is suitably covered under transfer pricing changes.

- *Revision in CFC rules* – OECD proposes to cover income attributable to digital sales & services to be covered under CFC rules. Such a step will ensure that an active business test is established against passive or low value contribution theory, being one of the prime causes for letdown of CFC rules.
- Collection of VAT/GST on cross border sales on destination basis.

Building on the 2015 BEPS Action Plan 1 Report, the OECD released an Interim Report on 'Tax Challenges Arising from Digitalisation' in March 2018 which includes an in-depth analysis of the changes to business models and value creation arising from digitalization and identifies characteristics that are frequently observed in certain highly digitalised business models.

The Interim Report observes that Members of the Inclusive Framework on BEPS have different views on the question of whether, and to what extent, the features identified as being frequently observed in certain highly digitalised business models should result in changes to the international tax rules. In particular, with respect to data and user participation, there are different views on whether, and to what extent, they should be considered as contributing to a firm's value creation, and therefore, what impact they may have on the international tax rules. These different approaches towards a long-term solution range from those countries that consider no action is needed, to those that consider there is a need for action that would take into account user contributions, through to others who consider that any changes should apply to the economy more broadly. Acknowledging these divergences, members agreed to undertake a coherent and concurrent review of the "nexus" and "profit allocation" rules – two fundamental concepts relating to how taxing rights are allocated between jurisdictions and how profits are allocated to the different activities carried out by multinational enterprises, and seek a consensus based solution. Inclusive Framework would carry out this work with the goal of producing a final report in 2020, with an update in 2019.

In addition, the Interim Report discusses interim measures that some countries have indicated they would implement, believing that there is a strong imperative to act quickly. In particular, the Interim Report considers an interim measure in the form of an excise tax on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services.

The Interim Report also looks at how digitalisation is affecting other areas of the tax system, including the opportunities that new technologies offer for enhancing taxpayer services and improving compliance, as well as the tax risks, including those relating to the block chain technology that underlies crypto-currencies.

5.3 Action Plan 2 - Neutralise the Effects of Hybrid Mismatch Arrangements & Branch Mismatch Arrangements

The Final Report on Action Plan 2 is detailed and complex, running into 450 pages with over 80 examples on operational practicality of various proposals for amendments to domestic law.

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The Report provides recommendations for both general changes to domestic law followed by a set of dedicated anti-hybrid rules. Treaty changes are also recommended.

Recommended general amendments are as follows:

- A rule denying transparency to entities where the non-resident investors' resident country treats the entity as opaque;
- A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;
- A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity; and
- Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.

Treaty changes - Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a state can tax a resident entity generally unrestricted by treaty.

Anti-hybrid rules - The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either

- (i) Those payments will not be included in the recipient's ordinary income, or
- (ii) The same amount is being simultaneously deducted by another entity.

The Examples in the Final Report demonstrate these outcomes (deduction and non-inclusion, or double deduction) arising from various hybrid financial instruments, financing transactions and under entity recognition and de-recognition rules.

The OECD released a further report on Action Plan 2 in July 2017 which sets out recommendations for branch mismatch rules that would bring the treatment of these structures into line with the treatment of hybrid mismatch arrangements as set out in the 2015 Report.

Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 Report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches: deduction / no inclusion (D/NI) outcomes, double deduction (DD) outcomes, and indirect deduction / no inclusion (indirect D/NI) outcomes.

The recommendations are as follows:

- A rule limiting the scope of branch exemption;
- A rule denying deduction for branch payee mismatches by the payer jurisdiction on account of differences in the allocation of payments between the residence and the branch jurisdiction or between two branch jurisdictions; or payment to a branch that is disregarded by the payer jurisdiction;
- A rule denying deduction for the payment to the extent it gives rise to a branch mismatch resulting from fact that such payment is disregarded under the laws of payee jurisdiction;
- A rule for denying deduction in investor jurisdiction, failing which denying deduction in the payer jurisdiction for double deduction outcomes;
- A rule denying deduction by payer jurisdiction of any payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

5.4 Action Plan 3 - Strengthen Controlled Foreign Company (CFC) Rules

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, OECD regards CFC rules as being important in tackling BEPS and has made a series of best practice recommendations in relation to the 'building blocks' of an effective CFC regime. The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states' tax bases from earnings stripping.

The OECD recommended 'building blocks' are as follows.

- *Computation and attribution of CFC income* - CFC income should be calculated under a notional application of the parent jurisdiction's tax laws and attribution should be subject to a control threshold and based on proportionate ownership.
- *Prevention and elimination of double tax* - CFC rules should not result in double tax. The specific measures suggested are to provide a credit for foreign tax paid on CFC income, provide relief where a dividend is paid out of attributed income or where a taxpayer disposes of their interest in a CFC where there has been attribution.
- *CFC definition* - CFC rules apply to foreign subsidiaries controlled by shareholders in the parent jurisdiction, exercising legal and economic of around 50% controlling interest. OECD recommends application of CFC rules to non-corporate entities, if those entities earn income that raises BEPS concerns and such concerns are not addressed.
- *CFC exemptions and threshold requirements* - Companies should be exempted from CFC rules where they are subject to an effective tax rate that is not below the applicable tax rate in the parent jurisdiction.

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- *Definition of CFC income* - CFC rules should have a definition of income that ensures that BEPS concerns are addressed, but countries are free to choose their own definition.

5.5 Action Plan 4 – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

The Final Report proposes the following key approaches to limit deductions of interest and similar finance expenses:

- (a) *Cap based on EBITDA* - The preferred approach is an earnings stripping rule wherein an entity's net actual interest expense would be capped at a legislated percentage of its EBITDA both expressed in tax terms (with a tolerance of 10%-30%). However, the Report does not prescribe the percentage of EBITDA.
- (b) *Safe harbor* - The Report analyses that an earnings stripping approach could be harsh for some industries and highly-leveraged groups. Therefore, it also proposes a second rule which would reinstate the interest deduction if the interest expense of the local subsidiary was at or below the group's global earnings, viz. EBITDA ratio.
- (c) *Targeted anti-abuse rules*: Countries should enact dedicated rules to buttress their operation and to attack interest expense in a number of identified situations, such as interest incurred to earn exempt income or under back-to-back arrangements.

The report also addresses banks and insurance companies wherein it recommends that there should be targeted rules addressing base erosion and profit shifting in such sectors. The basic rules might not work for them because they will typically have net interest income.

OECD and Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) have recently invited comments on a draft practice note that will help developing countries address profit shifting from their mining sectors via excessive interest deductions.

5.6 Action Plan 5 – Counter Harmful Tax Practices

BEPS Action Plan 5 is one of the four BEPS minimum standards which all Inclusive Framework members have committed to implement. The report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc. A minimum standard has been set up based on an agreed methodology to assess whether there is substantial activity in a preferential regime. For instance, in case of R&D activities, a minimum standard has been advocated that establishes nexus test as the means of identifying the R&D activities which provide the substance justifying the tax concession including tracking of expense and income on a particular products/product line.

The Action 5 minimum standard consists of two parts. One part relates to preferential tax regimes, where a peer review is undertaken to identify features of such regimes that can

facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. The second part includes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.

OECD has published Peer Review Reports on the Exchange of Information on Tax Rulings in December 2017 which reflects the outcome of the first peer review of the implementation of the Action 5 minimum standard. The review of the transparency framework assesses countries against the terms of reference which focus on five key elements: i) information gathering process, ii) exchange of information, iii) confidentiality of the information received; iv) statistics on the exchanges of rulings; and v) transparency on certain aspect of intellectual property regimes.

OECD has also published a Progress Report on Preferential Regimes which contains the results of the review of all Inclusive Framework members' preferential tax regimes that have been identified. The results will be updated from time to time as approved by the Inclusive Framework.

5.7 Action Plan 6 – Preventing Treaty abuse

Treaty abuse has been one of the most contentious areas in the BEPS. The main problem emerging from the issue of treaty abuse is the increasing optionality permitted to countries on international tax issues by tax treaties. While the 2014 report indicated that such issues can be handled, it is doubtful that the degree of optionality now proposed was then in contemplation.

- A simplified limitation of benefits (LOB) rule proposed to combine the LOB rule with a principal purpose test (PPT) rule;
- Multilateral treaties should be entered into;
- States are not obliged to apply the rule in their treaties if they have no objection to treaty shopping as the state of source of income;
- Detailed LOB rule plus anti-conduit rule to be incorporated in the treaty or domestic law;
- Adoption of simplified PPT rule and LOB rule;

In terms of the details, the LOB material has become very complex in recent past. There are a number of reasons adding to the confusion viz. the existence of two versions of the LOB rules, several parts of the two rules are scattered in the Commentary making it difficult for the readers to view the complete version at one place. Therefore, recommendation of introducing simplified LOB rule along with PPT rule is suggested.

5.8 Action Plan 7 – Prevent the Artificial Avoidance of Permanent establishment (PE) Status

The minimum standards have been re-phased to advocate the following steps:

- *Reworking exceptions to PE definition* – The minimum standard has been changed to advocate that an anti-fragmentation rule should be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. Determining whether activities in a state are preparatory or auxiliary. The above test should be applied to understand whether the activities undertaken by an enterprise in a state are ‘preparatory or auxiliary’.
- *Analyzing arrangements entered through contractual agreements* – OECD proposes to include Commissionaire business model under the definition of PE. The emphasis is not on the taxable presence for a commissionaire arrangement unless it is performed as an independent business activity. As per the revised agency PE rule, a person who “habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”, leading to a contract in the name of the foreign enterprise or provision of goods or services by that enterprise (even if it is not a party to the contract, it is covered under the definition of agency PE).

OECD published additional guidance in March 2018 on the attribution of profits to permanent establishments resulting from the changes in the Report on BEPS Action Plan 7 to Article 5 of the OECD Model Tax Convention. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1)

5.9 Action Plan 8 – Transfer Pricing Outcomes in Line with Value Creation/ Intangible

5.10 Action Plan 9 – Transfer Pricing Outcomes in Line with Value Creation/ Risks and Capital

5.11 Action Plan 10 – Transfer Pricing Outcomes in line with Value Creation/ Other High-Risk Transactions

The aforesaid Action plans represent the OECD’s work on transfer pricing which has been a core focus of the BEPS Action Plan. The specific Actions focus on Intangibles, Risks and capital and other high-risk transactions. These are the hard areas of transfer pricing and are summarized together in the Final Report ‘Aligning Transfer Pricing Outcomes with Value Creation’.

As per the final report, the following are important steps:

- The OECD's view is that contractual allocation of functions, assets and risks between associated enterprises leaves the arm's length principle vulnerable to manipulation leading to outcomes which do not correspond to the value created through underlying economic activity. In order to deal with this, the revised TPG requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct. This kind of approach invites intense factual scrutiny.
- The Report determines that a party that cannot exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will not be allocated those risks and consequential returns. Rather, those risks and returns will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.
- The Report does not allocate the returns to the party which merely owns the assets rather, those returns are allocated to the MNE group members which perform important functions, control economically significant risks and contribute assets, as determined through the accurate delineation of the actual transaction. Similar considerations should apply to MNE group members who provide funding but perform few activities. Accordingly, the passive funder may only be entitled to a risk-free return, or less.
- The OECD advocates that effort should be made to determine the actual nature of a transaction and then to price it, where the economic substance differs from form, or arrangements viewed in totality differ from those that would be made by independent enterprises.
- Pricing methods should ensure that the profits are allocated to the most important economic activities. On low value adding intra group services, the guidance provides for an elective approach covering a wide category of services which command a very limited mark up on costs and which provide a consistent allocation key for all recipients for such services.

Further, final guidance on transactional profit split method is awaited which shall provide additional guidance on the ways in which this method can be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains. Similarly, further guidance is awaited on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm's length conditions; and on implementation of the approach to pricing transfers of hard-to-value intangibles.

5.12 Action Plan 11 – Measuring and Monitoring, BEPS

The report discusses reasons behind harmful tax practices that result in no or low effective tax rate, lack of transparency, negotiable tax rate or base etc. A minimum standard has been prescribed to maintain transparency in dealings based on an agreed methodology to assess

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whether there is substantial activity in a preferential regime. A framework has been specially designed for exchange of information on international tax rulings in relation to preferential tax regimes viz.:

- Cross-border unilateral APAs and other transfer pricing related rulings ;
- Cross-border rulings giving downward adjustments not reflected in financial accounts;
- PE rulings (existence and attribution); and
- Related party conduit rulings.

The ruling has to be exchanged with other affected states as well as the states of the immediate and ultimate parent of the taxpayer. To prevent information overload only summary information should be provided at first later added by more information on request. Past rulings (within certain time parameters) and all future rulings are covered and the timeframes for implementation and on-going exchanges are specified.

5.13 Action Plan 12 – Disclosure of Aggressive Tax Planning Arrangements

Action 12 provides a framework for a mandatory reporting regime against ‘aggressive tax planning and forms the basis of the BEPS best practice guidance. The OECD feels that mandatory reporting regimes are important because of the following reasons:

- Reporting regime applies to both promoters and taxpayers;
- Reporting acts as a greater deterrent since the tax planning scheme must be reported;
- Reporting regime allows such schemes to be identified far earlier, thus allowing greater flexibility in attacking the scheme, including being able to stop it before use; and better protects against revenue loss.

The final report suggests the use of different hallmarks to identify cross-border schemes, given that the tax benefit of a cross-border scheme may arise in a different country. Such hallmarks include use of hybrids arrangements that separate legal and tax ownership of depreciable assets and cross-border transfers of assets at other than market value. Action 12 then notes that disclosure of schemes identified under a mandatory reporting regime should form part of the ever-increasing exchange of information platforms between jurisdictions.

Responding to a request of the G7, the OECD has issued new model disclosure rules in March 2018 that require lawyers, accountants, financial advisors, banks and other service providers to inform tax authorities of any schemes they put in place for their clients to avoid reporting under the OECD/G20 Common Reporting Standard (CRS) or prevent the identification of the beneficial owners of entities or trusts. The design of these model rules draws extensively on the best practice recommendations in the BEPS Action Plan 12 Report while being specifically targeted at these types of arrangements and structures. Further, OECD is also expected to address cases of abuse of golden visas and similar schemes to

circumvent CRS reporting.

5.14 Action Plan 13 – Re-examine Transfer Pricing Documentation

The Final Report iterates the new minimum standard for transfer pricing documentation for improving transparency through providing the tax administrations with a global picture of the operations of MNEs.

Action 13 contains a three-tiered standardized approach to transfer pricing documentation which consists of:

- (a) *Master file*: Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations.
- (b) *Local file*: Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to local tax administrations.
- (c) *Country-by-country (CBC) report*: CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism.

These new reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million.

OECD has been issuing further guidance for tax administrations and MNE Groups on Country-by-Country reporting on a continuous basis since the release of BEPS Action Plan 13.

The automatic exchange of Country-by-Country Reports under the Multilateral Competent Authority Agreement on the Exchange of CbC Reports ("the CbC MCAA") would start in June 2018 and will give tax administrations around the world access to key information on the annual income and profits, as well as the capital, employees and activities of Multinational Enterprise Groups that are active within their jurisdictions. As of April 2018, there are over 1500 bilateral exchange relationships activated with respect to jurisdictions committed to exchanging CbC Reports.

Further, in May 2018 the OECD released the first peer reviews of the Country-by-Country (CbC) reporting initiative covering 95 jurisdictions which provided legislation and/or information relating to the implementation of CbC Reporting with finding that practically all

countries that serve as headquarters to the large MNEs covered by the initiative have introduced new reporting obligations compliant with transparency requirements.

5.15 Action Plan 14 – Making Dispute resolution Mechanisms More Effective

The final report advocates setting up a Forum on Tax Administration (FTA), a subset of MAP Forum to deal with practical issues, as a minimum standard. States have agreed to join the FTA MAP Forum, report MAP statistics and agree to have their MAP performance monitored. In this way, a peer review mechanism has been set in place to ensure transparency in the area of exchange of information. In addition, there is a list of 11 best practices, being matters which either are not readily measurable or could not be agreed by all states involved.

In October 2016, the OECD released key documents, approved by the Inclusive Framework on BEPS, that will form the basis of the MAP peer review and monitoring process under Action 14 of the BEPS Action Plan. The peer review and monitoring process will be conducted by the Forum on Tax Administration MAP Forum in accordance with the Terms of Reference and Assessment Methodology, with all members participating on an equal footing.

The Stage 1 peer review for the first batch of assessed jurisdictions started in December 2016 to ensure the implementation of the minimum standard to strengthen the effectiveness and efficiency of the MAP. Stage 1 peer review assessment is expected to be completed by December 2019 with the completion of 10th batch. In Stage 2 of the peer review process, each jurisdiction's effort to address the recommendations identified in its Stage 1 peer review report will be assessed. As of May 2018, OECD has released Stage 1 peer review reports of three batches covering 21 assessed jurisdictions.

5.16 Action Plan 15 – Developing a Multilateral Instrument

The report explores the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures. The report suggests possible alternatives based on a significant economic presence, such as a virtual PE concept, withholding tax or excise tax on the digital economy. It concludes that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.

5.17 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Based on the Action 15 interim report, a scheme to set up Ad hoc Group for the development of a Multilateral Instrument ('MLI') was developed by the OECD Committee on Fiscal Affairs (CFA) in February 2015 and endorsed by the G20 Finance Ministers and Central Bank Governors, which was open to the participation of all interested countries on an equal footing. After adoption of BEPS package in October 2015, in November 2016, the Ad hoc Group concluded the negotiations and adopted the Text of the MLI as well as its accompanying Explanatory Statement. In June 2017, a high-level signing ceremony took place with over 70 governments participating. At this ceremony, the MLI was signed by 67 countries and

jurisdictions, covering 68 jurisdictions from all continents and all levels of development. As on 1 June 2022 a total of **99 countries** have signed the MLI out of which around 76 have already been ratified, deposited and made effective (including India). MLI, negotiated by more than 90 countries and jurisdictions under a mandate from G20 Finance Ministers and Central Bank Governors, will modify existing bilateral tax treaties to swiftly implement the tax treaty measures developed in the course of the OECD/G20 BEPS Project overcoming the need for burdensome and time-consuming bilateral renegotiations. Signatories of the MLI may choose which existing tax treaties they would like to modify using the MLI. Once a tax treaty has been listed by the two parties, it becomes an agreement to be covered by the MLI. The current signatories have listed over 2,500 treaties, already leading up to over 1,200 matched agreements.

Treaty measures that are included in the MLI include those on hybrid mismatch arrangements, treaty abuse and permanent establishment. MLI also strengthens provisions to resolve treaty disputes, including through mandatory binding arbitration, which has been taken up by 28 signatories.

MLI entered into force on 1st July 2018 following the deposit of the fifth instrument of ratification by Slovenia on 22 March 2018. Earlier, the Republic of Austria (22 September 2017), the Isle of Man (19 October 2017), Jersey (15 December 2017), and Poland (23 January 2018) deposited their instruments with the OECD. The entry into force of the MLI on 1st July 2018 will bring it into legal existence *in these five jurisdictions*. In accordance with the rules of the MLI, the first modifications to covered treaties will become effective from early 2019. The timing of entry into effect of the modifications is linked to the completion of the ratification procedures in the jurisdictions that are parties to the covered tax treaty.

India, amongst 67 countries, had signed the MLI in Paris on 7 June 2017 to implement tax treaty related measures to prevent BEPS. Recently, on 25 June 2019, India has also deposited its instrument of ratification on MLI with OECD Depository along with the final list of reservations and notifications.

Accordingly, for India, the MLI shall enter into force on the first day of the month after the expiry of three months from the date of deposit of ratified instrument of the MLI with OECD i.e. on 1 October 2019.

5.18 Challenges ahead

The Final reports have generated good response with around 100 countries having joined the Group as members, and 5 regional tax organizations joined as observers. However, there are certain challenges that lie ahead on the journey of BEPS viz. inclusiveness, consistent implementation and monitoring impact. After widespread agreement among countries on the measures for tackling BEPS, implementation becomes a key. Following the G20 and OECD call for even increased inclusiveness, a new framework for monitoring BEPS has been conceived and put in place, with all interested countries participating on an equal footing. Inclusive Framework on BEPS (as regard its four minimum standards) have put peer reviews in place, a process through which all members are assessing each other's implementation of the agreed standards. While the Global Forum's process has been in place since 2010 for

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exchange of information on request and has produced comprehensive ratings, the review of the implementation of the BEPS minimum standards and the implementation of AEOI is more recent and so the results of evaluations and recommendations for improvement are in an earlier stage. Many of these reviews are being relied upon by other organisations to identify non-cooperative jurisdictions, including the EU. Some of the measures may be immediately applicable, such as the revised guidance on transfer pricing, while others require changes in domestic laws and in bilateral tax treaties, hence may take time for implementation.

Unit VI	MULTILATERAL INSTRUMENTS (MLI)
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6.1 Introduction

As discussed in earlier chapters, OECD and G-20 developed BEPS Action Plans in 2013, which identified 15 actions to address BEPS in a comprehensive manner and set out deadlines to implement the plans.

The BEPS final reports contained recommendations that fall into above stated categories, under various Action Plans: -

Particulars	BEPS Action
Minimum Standard	Action 5 – Harmful tax practice Action 6 – Treaty Abuse Action 13 – Country by Country reporting Action 14 – Dispute Resolution
Revision of a standard which already exists	Action 7 – Permanent Establishment Action 8 to 10 – Transfer Pricing
Best practice	Action 2 – Hybrid Mismatches Action 3 – Controlled Foreign Company Action 4 – Interest Limitation
Other reports	Action 1 – Digital Economy Action 15 – Multilateral Instruments

6.2 MLI developed to implement treaty related measures

Implementation of certain action plans require changes to model tax conventions as well as to the bilateral tax treaties based on those model conventions. The sheer number of bilateral treaties i.e. more than 3000, makes bilateral updates to the treaty network burdensome and time consuming, limiting the effectiveness of multilateral efforts.

In order to swiftly implement the treaty related BEPS outcomes, the OECD formulated BEPS Action Plan 15 - Developing a Multilateral Instrument to Modify Bilateral Tax Treaties to modify the bilateral tax treaties. Multilateral Instrument (MLI) provides an innovative approach to enable countries to modify their bilateral tax treaties to implement BEPS measures.

Based on the Action 15 interim report, a mandate to set up the Ad hoc Group for the development of a MLI was developed by the OECD Committee on Fiscal Affairs (CFA) in February 2015 and endorsed by the G20 Finance Ministers and Central Bank Governors, open to the participation of all interested countries on an equal footing. After adoption of BEPS package in October 2015, in November 2016, the Ad hoc Group concluded the negotiations and adopted the Text of the MLI as well as its accompanying Explanatory Statement. In June 2017, a high-level signing ceremony took place with over 70 governments participating. At this ceremony, the MLI was signed by 68 jurisdictions including India. Further, 25 additional

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jurisdictions have signed the MLI after the first ceremony.

The MLI entered into force on 1st July, 2018 after the first five jurisdictions (i.e., Austria, the Isle of Man, Jersey, Poland and Slovenia) deposited their instrument of ratification, acceptance or approval of the MLI with the OECD.

The MLI is a multilateral treaty, which would operate to modify bilateral tax treaties between two or more jurisdictions. The objective of the MLI is to swiftly amend tax treaties to reflect BEPS related measures in a synchronized and consistent manner. Instead of carrying out multiple negotiations and multiple ratifications, the MLI facilitates countries to modify existing tax treaties in a simplified manner in the form of one negotiation, one signature and one ratification.

MLI does not amend the tax treaties just like a protocol to a tax treaty. It has to be read alongside the existing tax treaties.

The MLI modifies a tax treaty only if it qualifies as “covered tax agreement” (‘CTA’) i.e. where both the countries to the tax treaty have signed the MLI, ratified the MLI and have deposited the ratified copy of MLI with OECD.

6.3 Status of MLI

As of 1 June 2022, 99 jurisdictions committed to participate in the MLI (the list of signatories can be found on the OECD website). In addition, three countries expressed their intention to join the MLI: Algeria, Eswatini (former Swaziland), Lebanon

Out of the 99 jurisdictions, 76 have ratified the MLI and deposited their instruments of ratification with the OECD.

— Albania — Andorra — Australia — Austria — Bahrain — Barbados — Belgium — Belize — Bosnia & Herzegovina — Burkina Faso — Cameroon — Canada — Chile — China — Costa Rica — Croatia — Curacao — Cyprus — Czech Republic — Denmark — Egypt — Estonia — Finland — France — Georgia — Germany — Greece — Guernsey — Hong Kong — Hungary — Iceland — India — Indonesia — Ireland — Isle of Man — Israel — Japan — Jersey — Jordan — Kazakhstan — Korea — Latvia — Liechtenstein — Lithuania — Luxembourg — Malaysia — Malta — Mauritius — Monaco — Netherlands — New Zealand — Norway — Oman — Pakistan — Panama — Poland — Portugal — Qatar — Romania — Russia — San Marino — Saudi Arabia — Senegal — Serbia — Seychelles — Singapore — Slovakia — Slovenia — Spain — Sweden — Switzerland — Thailand — Ukraine — United Arab Emirates — United Kingdom — Uruguay
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For above countries, the MLI measures will be effective after both parties to the treaty have deposited their instrument of ratification, acceptance or approval of the MLI and a specified time has passed.

6.4 Functioning of MLI

MLI is a single instrument that modifies multiple tax treaties. MLI does not amend the tax treaties just like a protocol to a tax treaty. A Protocol to the tax treaty directly amends the text

of that particular tax treaty. MLI, on the other hand, does not replace the tax treaty. It has to be read alongside the existing tax treaties. The same is also clarified by the explanatory statement to MLI as under:

“The Convention operates to modify tax treaties between two or more Parties to the Convention. It will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the Covered Tax Agreement; instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures. As a result, while for internal purposes, some Parties may develop consolidated versions of their Covered Tax Agreements as modified by the Convention, doing so is not a prerequisite for the application of the Convention. As noted below, it is possible for Contracting Jurisdictions to agree subsequently to different modifications to their Covered Tax Agreement than those foreseen in the Convention.”

Further, not every tax treaty is modified by the MLI. The MLI shall modify a tax treaty only if it qualifies as “covered tax agreement” (‘CTA’) i.e. where both the countries to the tax treaty have signed the MLI, ratified the MLI and have deposited the ratified copy of MLI with OECD.

6.5 Structure of the MLI

Text of MLI is divided into 7 parts and 39 Articles as under:

- i. **Articles 1 and 2** - set out the scope of MLI and the interpretation of terms used therein,
- ii. **Articles 3-17** - deal with BEPS tax treaty measures,
- iii. **Articles 18-26** - cover provisions related to mandatory binding arbitration, and
- iv. **Articles 27-39** - Contain procedural provisions such as provisions relevant to adoption and implementation of the MLI including ratification, entry into force and entry into effect dates, withdrawal etc.

Part	Description	Articles
I	Scope and Interpretation of terms	Article 1 – Scope of the Convention Article 2 – Interpretation of Terms
II	Hybrid Mismatches	Article 3 - Transparent Entities Article 4 – Dual Resident Entities Article 5 – Application of Methods for Elimination of Double Taxation
III	Treaty Abuse	Article 6 – Purpose of a Covered Tax Agreement Article 7 – Prevention of Treaty Abuse Article 8 – Dividend Transfer Transactions Article 9 – Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

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Part	Description	Articles
		<p>Article 10 – Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions</p> <p>Article 11 – Application of Tax Agreements to Restrict a Party’s Right to Tax its Own Residents</p>
IV	Avoidance of permanent establishment status	<p>Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies</p> <p>Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions</p> <p>Article 14 – Splitting-up of Contracts</p> <p>Article 15 – Definition of a Person Closely Related to an Enterprise</p>
V	Improving dispute resolution	<p>Article 16 – Mutual Agreement Procedure</p> <p>Article 17 – Corresponding Adjustments</p>
VI	Arbitration	<p>Article 18 – Choice to Apply Part VI</p> <p>Article 19 – Mandatory Binding Arbitration</p> <p>Article 20 – Appointment of Arbitrators</p> <p>Article 21 – Confidentiality of Arbitration Proceedings</p> <p>Article 22 – Resolution of a Case Prior to the Conclusion of the Arbitration</p> <p>Article 23 – Type of Arbitration Process</p> <p>Article 24 – Agreement on a Different Resolution</p> <p>Article 25 – Costs of Arbitration Proceedings</p> <p>Article 26 – Compatibility</p>
VII	Final Provisions	<p>Article 27 – Signature and Ratification, Acceptance or Approval</p> <p>Article 28 – Reservations</p> <p>Article 29 – Notifications</p> <p>Article 30 – Subsequent Modifications of Covered Tax Agreements</p> <p>Article 31 – Conference of the Parties</p> <p>Article 32 – Interpretation and Implementation</p> <p>Article 33 – Amendment</p> <p>Article 34 – Entry into Force</p> <p>Article 35 – Entry into Effect</p> <p>Article 36 – Entry into Effect of Part VI</p> <p>Article 37 – Withdrawal</p> <p>Article 38 – Relation with Protocols</p> <p>Article 39 – Depositary</p>

6.6 MLI Implementation

(a) Adoption

The text of MLI and the related Explanatory Statement (ES), which explains the MLI provisions, were formally adopted on 21 November 2016 by approximately 100 countries at a ceremony hosted by the OECD at Paris and the MLI was opened for signature to all countries.

(b) Signing

Countries that intend to implement the MLI need to sign the MLI and at the time of signature, each signatory is expected to submit the provisional list of tax treaties that the country wishes to modify by MLI, and provisional list of various options selected.

(c) Ratification

Finally, in order to modify existing tax treaties with the MLI, each signatory jurisdiction needs to ratify the MLI as per its domestic procedures and ratified copy of MLI needs to be filed with the OECD Depository along with final list of reservations and notifications

6.7 MLI Timelines

(a) Entry into force

Article 34 of the MLI deals with entry into force provisions. The date of entry into force of MLI for a particular jurisdiction depends on date of deposit of ratified copy of the MLI by that jurisdiction with the depository at OECD.

MLI enters into force on the first day of the month following the expiry of 3 calendar months from the date on which 5 signatories have deposited their instrument of ratification, acceptance or approval.

MLI was signed by India on 7th June 2017 by the then Hon'ble Finance Minister Sh. Arun Jaitley at Paris. In June 2019, Indian Government approved the ratification of MLI and deposited the ratified copy of MLI with the OECD Depository i.e. the Secretary- General of OECD along with India's final positions on MLI Articles.

The countries who have already deposited their instrument of ratification with OECD prior to India and are covered in the list of Covered Tax Agreements ('CTA') provided by India, MLI will 'enter into force' with respect to such country within end of 3 months from the end of month of date of deposit of ratified instrument with OECD by India.

In case, where the countries in the CTA deposit their instrument after India had deposited, the MLI will 'enter into force' with respect to such country within end of 3 months from the end of month of date of deposit of ratified instrument with OECD by such country.

(b) Entry into Effect

Article 35 of the MLI deals with entry into effect provisions of the MLI in respect of bilateral tax treaties. The date of entry into effect is linked to the date of entry into force of MLI. The date of entry into effect is computed from the latest date of which the MLI enters into force for each of

the treaty partners of a CTA. Hence, this date is referred here as 'relevant date'.

Further, the timelines for the MLI to come into effect with respect to a CTA differ based on the type of taxation to which the modifications apply, as under:

For taxes withheld at source, MLI will enter into effect where the event giving rise to such withholding tax occurs on or after the first day of the next calendar year / taxable period that begins on or after the relevant date

For all other taxes, MLI will come into effect for taxable periods that begins on or after expiry of 6 calendar months from the relevant date.

6.8 MLI Framework

i. Compatibility Clause

The provisions of the MLI may overlap or conflict with provisions of Covered Tax Agreements on the same tax matters. To clarify the relationship between the provisions of the MLI and Covered Tax Agreements, there are four major types of compatibility clauses, whose uses depend on policy considerations and factual circumstances as under:

- (a) **“In place of”**: A provision that applies “in place of” an existing provision is intended to replace an existing provision if one exists and is not intended to apply if no existing provision exists. Parties shall include in their MLI positions a section on notifications wherein they will list all CTAs that contain a provision within the scope of the relevant MLI provision, indicating the article and paragraph number of each of such provision. A provision of the MLI that applies “in place of” shall replace a provision of a CTA only where all Contracting Jurisdictions have made a notification with respect to that provision.
- (b) **“Modifies” or “Applies to”**: A provision that “applies to” provisions of a CTA is intended to change the application of an existing provision without replacing it, and therefore may only apply if there is an existing provision. Parties shall include in their MLI positions a section on notifications wherein they will list all CTAs that contain a provision within the scope of the relevant MLI provision, indicating the article and paragraph number of each of such provision. A provision of the MLI that “applies to” provisions shall change the application of a provision of a CTA only where all Contracting Jurisdictions have made a notification with respect to that provision.
- (c) **“In absence of”**: A provision that applies “in the absence of” provisions of a CTA is intended “to add a provision” if one does not already exist. Parties shall include in their MLI positions a section on notifications wherein they will list all CTAs that do not contain a provision within the scope of the relevant MLI provision. A provision of the MLI that applies “in the absence of” provisions shall apply only in cases where all Contracting Jurisdictions notify the absence of an existing provision of the CTA.

- (d) **“In place of or in absence of”:** A provision that applies “in place of or in the absence of” provisions of a CTA is intended “to replace an existing provision or to add a provision.” This type of provision will apply in all cases in which all the parties to a CTA have not reserved their right for the entirety of an article to apply to its CTAs. If all Contracting Jurisdictions notify the existence of an existing provision, that provision will be replaced by the provision of the MLI to the extent described in the relevant compatibility clause. Where the Contracting Jurisdictions do not notify the existence of a provision, the provision of the MLI will still apply. If there is a relevant existing provision which has not been notified by all Contracting Jurisdictions, the provision of the MLI will prevail over that existing provision, superseding it to the extent that it is incompatible with the relevant provision of the MLI (according to the explanatory statement of the MLI, an existing provision of a CTA is considered “incompatible” with a provision of the MLI if there is a conflict between the two provisions). Lastly, if there is no existing provision, the provision of the MLI will, in effect, be added to the CTA.

ii. **Reservation Clause**

Where a provision of MLI does not reflect a minimum standard, a Party is generally given the flexibility to opt out of that provision entirely (or, in some cases, out of part of that provision). This is accomplished through the mechanism of reservations, which are specifically defined for each substantive Article of the Convention. Where a Party uses a reservation to opt out of a provision of the Convention, that provision will not apply as between the reserving Party and all other Parties to the Convention. Accordingly, the modification foreseen by that provision will not be made to any of the Covered Tax Agreements of the reserving Party.

The ad hoc Group recognised that even where a Party intends to apply a particular provision of the Convention to its treaty network, it may have policy reasons for preserving the application of specific types of existing provisions. To accommodate this, in a few cases the Convention permits a Party to reserve the right to opt out of applying a provision to a subset of Covered Tax Agreements in order to preserve existing provisions that have specific, objectively defined characteristics. Except as otherwise provided, such reservations are not mutually exclusive. As a result, where a Party makes one or more such reservations, all such reservations will apply as between the reserving Party and all Contracting Jurisdictions to the Covered Tax Agreements that are covered by such reservations.

Where a provision reflects a BEPS minimum standard, opting out of that provision is possible only in limited circumstances, such as where a Party’s Covered Tax Agreements already meet that minimum standard. Where a minimum standard can be satisfied in multiple alternative ways, the Convention does not give preference to a way of meeting the minimum standard. To ensure that the minimum standard can be met in such circumstances, however, in cases where Contracting Jurisdictions each adopt a different approach to meeting a minimum

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standard that requires the inclusion of a specific type of treaty provision, those Contracting Jurisdictions must endeavour to reach a mutually satisfactory solution consistent with the minimum standard. It should be noted that whether a Covered Tax Agreement (as it may be amended through bilateral negotiations) meets the minimum standard would be determined in the course of the overall review and monitoring process by the Inclusive Framework on BEPS, which brings together a large number of countries and jurisdictions to work on the implementation of the Final BEPS Package.

iii. Notification Clause

Where a provision of MLI supersedes or modifies specific types of existing provisions of a CTA, countries are generally required to make a notification specifying which CTA contain provisions of that type. Countries are also required to identify all provisions that are within the objective scope of the compatibility clause.

Notification is required to ensure that depository can reflect exact change / amendment / addition that will happen to a particular CTA based on notifications by respective countries.

6.9 India's Position on MLI

Article	MLI Provision	India's Position
Article 3 - Transparent Entities	Tax treaty benefits to be allowed to fiscally transparent entities for the income earned to the extent that such income is taxed in the jurisdiction in which the entity is a resident	India has made a reservation thus, Article 3 shall not to apply to India's covered tax agreements.
Article 4 – Dual Resident Entities	CAs of both jurisdictions to mutually agree on the manner to determine the residential status of dual resident non-individuals regarding place of effective management, place of incorporation or constitution, and any other relevant factors. In the absence of such agreement, treaty benefits to be denied to such a person (unless otherwise agreed by them)	India has opted for application of Article 4 to its CTAs. Therefore, said article shall apply to all CTAs unless reservation is made by other jurisdiction.

Article	MLI Provision	India's Position
Article 5 – Application of Methods for Elimination of Double Taxation	Provides three alternative option to address the problems arising from exempting the income in Resident state which are not taxed in the Source State	India has chosen to apply Option C i.e. credit method. Accordingly, the said option shall apply to all India's CTAs
Article 6 – Purpose of a Covered Tax Agreement – Minimum Standard	Requires countries to include an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements	Being minimum standard, such MLI provision to apply to all CTAs
Article 7 – Prevention of Treaty Abuse	Envisages following three anti-abuse measures to meet the minimum requirement: (a) Principle Purpose Test (PPT) – General Rule; (b) PPT along with Simplified or a detailed Limitation of Benefit (LOB) (c) Enter into bilateral negotiations to include a detailed LOB provision plus a PPT or anti-conduit rules.	
Article 8 – Dividend Transfer Transactions	Minimum shareholding to be met throughout 365 days for beneficial dividend tax rate. The Company receiving the dividend should be a beneficial owner or the recipient and should owns, holds or controls of shares.	India has opted to apply such provision (except in case of India-Portugal tax treaty, which already contains similar provision)

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Article	MLI Provision	India's Position
<p>Article 9 – Capital gains from alienation of shares or interests of entities deriving their value principally from immovable property</p>	<p>Gains to be taxable if value threshold met at any time during 365 days preceding alienation (including alienation of interest in a trust / partnership)</p>	<p>India has choose to apply this for shares deriving more than 50% value from immovable property (real property) In case optional provision is not adopted by treaty partner then main provision will apply.</p>
<p>Article 10 – Anti abuse Rule for Permanent Establishments Situated in Third Jurisdictions</p>	<p>Provides that benefit of Tax Treaty shall not be available to the taxpayer where income is derived from the source state by the permanent establishment of such taxpayer situated in third State, if</p> <ul style="list-style-type: none"> • Such income of the PE is not taxable in the resident state of the taxpayer, and • Tax in the third state on income of the PE is less than 60% of the tax in the resident State. <p>The article makes an exception for cases where the income is derived in connection to or incidental to an active trade or business carried out through the PE and allows discretionary relief to be requested when treaty benefits are denied under this article.</p>	<p>India is silent on its position. Accordingly, the said provision shall apply to all its CTA unless reservation is made by other CTA jurisdiction.</p>
<p>Article 11 – Application of Tax Agreements to Restrict a Party's Right to Tax its</p>	<p>Contains a so-called “saving clause” rule that preserves a country's right to tax its own</p>	<p>India is silent on its position. Accordingly, the said provision shall apply to all</p>

Article	MLI Provision	India's Position
Own Residents	residents. It provides that a CTA shall not affect taxation right of a country in respect of its residents.	its CTA unless reservation is made by other CTA jurisdiction
Article 12 - Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies	Widens the definition of PE given in tax treaties to include cases where a person habitually concludes contracts or plays a principal role in conclusion of contracts of another enterprise	India has opted to apply the said provision.
Article 13 - Artificial avoidance of Permanent establishment Status through the Specific Activity Exemptions	<p>Provides two options to counter artificial avoidance of PE status through specific activity exemptions.</p> <p><i>Option A:</i> The activities listed therein will be deemed not to constitute a permanent establishment only if they are of a preparatory or auxiliary character.</p> <p><i>Option B:</i> Specific activity exemption applies irrespective of whether activity is of auxiliary or preparatory character.</p>	<p>India has chosen to apply Option A;</p> <p>Accordingly, the said option shall apply to India's CTA only if other CTA jurisdiction has chosen same option.</p>
Article 14 - Splitting up of contracts	Addresses avoidance of PE by splitting the contracts between related enterprises to circumvent the threshold of PE creation	India is silent on its position. Accordingly, the said provision shall apply to all its CTA unless reservation is made by other CTA jurisdiction.
Article 15 - Definition of a Person Closely Related to an Enterprise	Defines the term "person closely related", in the context of Articles 12, 13, and 14 of	India is silent on its position. Accordingly, the said provision shall apply to all

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Article	MLI Provision	India's Position
	the MLI	its CTA unless reservation is made by other CTA jurisdiction.
Article 16 – Mutual Agreement Procedure	This article lays down the best practices recommended for improving dispute resolution and the procedural requirements for MAP implementation.	India has reserved its right for not adopting the modified provisions on the basis that it would meet the minimum standard by allowing MAP access in the resident state and by implementing a bilateral notification process
Article 17 – Corresponding Adjustments	In order to avoid economic double taxation arising due to Transfer Pricing adjustments, this article recommends corresponding adjustments to be provided by competent authorities in the other jurisdiction.	India has chosen to apply the said provision except in cases where provision already exists in its CTA.
Article 18 to 26 – Arbitration	Provides mandatory binding arbitration in cases where competent authorities are unable to reach an agreement to resolve a case under Mutual Agreement procedure	India has not opted for mandatory arbitration

6.10 Provisions of Finance Act pursuant to Union Budget 2020

6.10.1 Section 90 and 90A aligned with revised preamble of the DTAA as amended by MLI

Sections 90 and 90A empower the Central Government to enter into an agreement with another country or specified territory respectively for:

- (a) granting relief on income on which income-tax has been paid both, in India and that other country or specified territory;
- (b) avoidance of double taxation;
- (c) exchange of information; and
- (d) recovery of income-tax under the Act or laws of the other country or specified territory.

6.10.2 India is a signatory to the MLI under the OECD G20 project to tackle BEPS.

Article 6 of the MLI provides for modification of a CTA to include text of the preamble that will modify India's DTAA's to curb revenue loss through treaty abuse and BEPS strategies by ensuring that profits are taxed where substantive economic activities generating the profits are carried out.

With a view to align the enabling provisions of the Act with those of the MLI, it is proposed to amend sections 90 and 90A to include the text of the preamble in Article 6 of MLI in these sections. It is proposed that Central Government may enter into an agreement with another country or specified territory for, inter alia, the avoidance of double taxation of income under the Act and the corresponding law in force in that country or specified territory without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of any other country or territory).

This amendment is applicable from AY 2021-22 and onwards.

6.10.3 SECTION 90 OF THE INCOME-TAX ACT, 1961- DOUBLE TAXATION AGREEMENT – Cabinet approves Protocol amending Agreement between India and Sri Lanka for avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to taxes of Income- Press Release Dated 12.2.2020

The Union Cabinet, chaired by the Prime Minister Shri Narendra Modi, has approved the Signing and Ratification of the Protocol amending the Agreement between India and Sri Lanka for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

Impact

Updation of preamble text and inclusion of Principal Purpose Test, a general anti abuse provision in the Double Taxation Avoidance Agreement (DTAA) will result in curbing of tax planning strategies which exploit gaps and mismatches in tax rules.

Details

- i. The existing DTAA between India and Sri Lanka was signed on 22nd January 2013 and entered into force on 22nd October 2013.
- ii. India and Sri Lanka are members of the Inclusive Framework and as such are required to implement the minimum standards under G-20 OECD BEPS Action Reports in respect of their DTAA's with Inclusive Framework countries. Minimum standards under BEPS Action 6 can be met through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) or through agreement bilaterally.
- iii. India is a signatory to the MLI. However, Sri Lanka is not a signatory to the MLI as of

now. Therefore, amendment of the India-Sri Lanka DTAA bilaterally is required to update the Preamble and also to insert Principal Purpose Test (PPT) provisions to meet the minimum standards on treaty abuse under Action 6 of G-20 OECD Base Erosion & Profit Shifting (BEPS) Project.

6.11 Matching Concept

MLI functions basis the matching concept. In other words, the substantive provisions of the MLI would apply to a CTA only where both the countries have opted for such provision known as matching concept. Where both countries have chosen different options or where one or all of them have opted out of the option, it would not apply to a CTA between those 2 countries.

In order to keep track of the various MLI positions of countries, the OECD has released an MLI Matching Database which provides tabulated data extracted from the list of reservations and notifications provided by each signatory to the MLI upon signature or when applicable, the MLI position deposited on ratification. The database enables users to select two contracting jurisdictions from drop down menu and identify if the relevant tax treaty is a CTA and also check impact of MLI provisions on the CTA.

6.12 Conclusion

MLI is a significant step in BEPS implementation process and involvement of number of jurisdictions in MLI implementation indicates commitment and proactive approach in combating BEPS.

Unit VII | Diverted Profit tax**7.1 Background**

With the advent of e-commerce and availability of new IT technologies, most multinational enterprises ('MNE') plan their worldwide business operations in a way so as to avoid taxes. Most MNEs structure their businesses in different countries through creating a maze of companies in different taxing jurisdictions with the effect that profits earned in a high taxing jurisdiction are diverted to other low-tax jurisdictions, effectively contributing to an overall lower tax cost in the hands of MNE on its worldwide income. An increasing amount of MNEs have been devising complex structures like 'Double Irish Dutch Sandwich' that result in double non-taxation of profits in two or more tax jurisdictions effecting low or no tax in the hands of such MNEs.

In the past, there was a lot of hue and cry about the negligible amount of taxes paid by big companies like Google, Facebook, Microsoft and Starbucks in countries like UK through diverting all the profits made in UK to Ireland. They do not pay much tax in Ireland also through creation of complex corporate structures that enables money being shifted to Dublin-registered company of Google located in Bermuda for tax purposes. In 2013, it was revealed that Starbucks paid nothing in corporation tax between 2009 and 2012, despite sales of £400m in 2011, and had only paid £8.56m in corporation tax since it began trading in the UK in 1998. Starbucks maintained it had made a loss in those years when it paid no corporation tax¹⁷.

Various meetings were arranged by G20 finance ministers worldwide to address issue of tax avoidance and double non-taxation and similar international tax issues that culminated into setting up of the Base Erosion and Profit Shifting ('BEPS') Action Plan Project in 2014. Parallely, UK Government proposed to introduce Diverted Profits Tax ('DPT'), popularly known as 'Google tax', a term coined by the media, being a punitive tax imposed on large companies on diversion of profits out of UK for avoiding taxes.

HM Revenue & Customs ('HMRC') has introduced DPT in its taxing statute with effect from April 01, 2015. DPT is a new tax form with extraterritorial powers imparted to UK Tax authorities, having wide applicability to both UK based and non-UK based business enterprises carrying out activities in UK. Under the new tax regime, a tax rate of 25 per cent shall be levied on large multinational enterprises with business activities in UK who enter into 'contrived' arrangements in order to divert profits from UK by either avoiding formation of Permanent Establishment ('PE') in UK or through entering into 'contrived' arrangements between related enterprises. The current UK corporation tax rate is 19 per cent. DPT is higher than UK corporation tax since it is intended as a penal tax to discourage businesses from structuring their business arrangements resulting in profit diversion outside UK. A lower UK corporation tax rate of 20 per cent in comparison poses as an incentive to MNEs while

¹⁷ BBC business news

structuring their business arrangements.

7.2 Applicability

The DPT, popularly also described as ‘Google Tax’ is widely perceived as a tax principally targeting the type of tax planning which has been most effectively used by web-based businesses that involve effective use of technology. However, the DPT has a much wider scope and applies to all types of business that meet the relevant conditions. Large companies that are in the business of manufacturing/ distribution models, insurance and reinsurance structures, fund management structures and real estate transactions could also be potentially exposed to the applicability of DPT. However, the applicability of DPT may not arise if the following conditions are met:

1. Companies have substance in the business carried out by their offshore asset owning subsidiaries;
2. Companies enter into arm’s length transfer pricing through their international value chain
3. A taxable presence in UK through either a PE or an onshore distributor/reseller

Considering the above exceptional situations, it may so happen that DPT will not give rise to any charge on certain Companies or the charge will be relatively modest. The above is reflected in the budgeted revenue from the DPT. Since the categorization of DPT is not that of a corporate tax/ income tax, it is unlikely that DPT shall be subject to any tax relief under existing double tax treaties. In this backdrop, the response that DPT generates from other countries shall be crucial. Though there is a possibility of questioning and protracted litigation over the exceptionally extraterritorial ambit and legality/enforceability of the DPT by many covered corporations, it is also likely that other countries may take cue from HMRC and devise similar taxing regimes. Australian government issued its Multinational (Tax) Anti-Avoidance Law in May 2015 Budget that is similar to DPT. The potential ambit of the DPT is broad enough to ensure an increase in transparency related to transfer pricing policies and presence of substance outside the UK.

7.2.1 Circumstances where DPT applies:

DPT is attracted in case the following tests are met:

- **Insufficient economic substance test** - Where a company, subject to UK corporation tax (whether UK company or non-UK company) has entered into an arrangement with another entity outside UK and such arrangement lacks economic substance.

For example: Where the *Intellectual property rights of a UK company are transferred to a subsidiary in a low tax jurisdiction and royalty payments are claimed as a deduction against UK company’s taxable income. The subsidiary does not have the technical and management capacity to develop and maintain such IP and it can be sufficiently proved that the transfer is only being undertaken for tax purposes.*

Arrangements having “*insufficient economic substance*” can be broadly classified in two ways:

- (a) **Transaction-based approach** – wherein the related/ un-related entities enter into a transaction specifically designed to secure a tax reduction and the non-tax benefits of such transaction do not exceed the financial benefits of the tax reduction. The tax and non-tax benefits associated with a single transaction are evaluated to gauge the intrinsic substance in the conduct of parties.
- (b) **Entity-based test** – wherein separate entity is formed in order to secure the tax reduction and where the non-tax benefit of the contributions made by such entity (in terms of the functional profile or activities of staff employed) does not exceed the financial benefits of the tax reduction. Entity-based test is directed at non-resident Special Purpose Vehicle (‘SPV’) entities set up for tax purposes that do not have the necessary capabilities in terms of skilled staff necessary to undertake the relevant transaction and are guided by skilled staff located elsewhere.
- **Avoidance of permanent establishment test** – Where a non-UK foreign company carries on activities in UK but those activities are specifically designed to avoid creating a permanent establishment of that foreign company in the UK

For example: a foreign company makes sales to UK customers. Such sales are generated on the basis of sales and marketing efforts undertaken by its subsidiary in UK wherein the sales/marketing activities are specifically designed to exclude formation of permanent establishment under Article 7 of the Treaty. ‘Effective tax mismatch’ conditions need to be met wherein the main purpose of setting up of subsidiary is to avoid tax can be established.

An “effective tax mismatch outcome” arises, broadly, where the UK tax reduction derived from the arrangements by one party exceeds any increase in tax payable by the other relevant party to the arrangements, and the tax payable by the other party is less than 80% of UK tax reduction derived by the first party.

7.2.2 Tax credit under DPT

DPT is a separate tax from corporation tax and any payment of DPT should be ignored to its entirety while computing UK’s corporation tax. However, as per clause 19 of DPT, where the profits on which the DPT is charged are also subject to UK corporation tax or a non-UK equivalent of corporation tax, such tax will be credited against the DPT liability to avoid double taxation. As per HMRC’s guidance, the design of the DPT is such that it is not covered by existing double taxation treaties and therefore liability to DPT cannot be avoided pursuant to a double tax treaty. This position however could be subject to challenge by taxpayers in the court of law.

7.2.3 General exemptions from DPT

Arrangements may be exempt from the DPT in the following circumstances:

- Sales threshold exemption - Small and medium sized enterprises (‘SMEs’) are not subject to the DPT. The determination of SME depends upon the total sales revenue of

a company (whether foreign or connected company). The total sales revenue arising from sale of goods and services in UK should not exceed 10 million pounds for a twelve month accounting period;

- Certain loan relationships are not subject to the DPT;
- Where a tax mismatch arises solely due to the persons being tax exempt solely by reason of being a charity, pension scheme or having sovereign immunity;
- Where a non-UK person does not have a PE in UK due to fact that the entity undertaking operations in UK being of independent status that is not connected with such non-UK person.

7.3 Assessment and collection procedure

Any company for which it is reasonable to assume that it has any profits in a financial year that fall within the scope of DPT is duty bound to notify an officer of revenue and customs within three months from the end of accounting period in which DPT might arise. In case self-notification is not made by a company, penalties are applicable. The DPT notification provisions are intended as a wide, information gathering exercise to enable HMRC to assess potential liabilities to DPT. The DPT notification provisions are very wide and quite broadly a self-notification must be made to HMRC in the following circumstances:

- Where a UK company has entered into arrangements lacking economic substance that result in a 'substantial' effective tax mismatch;
- Where a non-UK company has an 'avoided PE', resulting in an effective tax mismatch which must be 'substantial'; and
- Where there is no mismatch, instead of the tax avoidance purpose condition, a notification obligation can arise where the arrangements have resulted in an overall reduction in tax, regardless of the motive for the arrangements.

On receipt of self-notification, a designated HMRC officer issues a provisional notice for the purpose of estimating the taxable diverted profits. The designated officer exercises a best judgment estimate of the amount chargeable to DPT. On receipt of charging notice by the taxpayer, payment must be made within 30 days. The tax demanded will include an amount equivalent to interest from six months after the end of the relevant accounting period to the date of the charging notice. The tax can be recovered from related companies, if not paid by the assessed company. In case the company challenges the quantum of amount charged by HMRC officer, such company is precluded from effecting any delay in payment of DPT. There is a twelve months review period within which the company can agree with the final DPT charge with HMRC.

7.4 Way forward

DPT has attracted much flak due to its self-contradictory nature wherein there is a self-

disclosure requirement by the taxpayer and later the same taxpayer plays defensive by iterating that its activities are not designed to divert profit outside UK. DPT may mostly pose as a preventive tax with corporations modifying their restructuring arrangements such that there are no 'diverted profits' and their incomes are subject to lower UK corporation tax of 19%. Depending on the factual position, it may also be possible to modify the arrangements to fall outside of the DPT while still not being Subject to UK corporation tax.

Any advance clearance from HMRC regarding the non-application of the DPT is not contemplated in the DPT law. However, it is anticipated that going forward, Advanced Pricing Agreements (APA's) may pose as a combat mechanism for transfer pricing purposes wherein application of the DPT can be alleviated on a case to case basis. However, even APAs may provide partial comfort in respect of DPT risk only and might not protect against risks of re-characterization and other non-transfer pricing tax avoidance matters.

Unit VIII	Partnership
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8.1 Introduction

Partnership is one of the well-recognized and widely used forms for conducting business operations across the world.

A basic characteristic of partnership is that the partners are generally jointly and severally liable for the activities of the firm.

An Indian partnership is governed by The Indian Partnership Act, 1932 (“Partnership Act”). While the said legislation does not restrict the participation of foreign individuals and/or entities in a partnership, there is no automatic permission granted for investing in a partnership firm under the Foreign Exchange Management Act, 1999 and the Rules specified therein (“exchange control regulation”). Thus the partnership firm structure is generally restricted to Indian individuals, Non-resident Indians and/or Indian entities.

A Limited Liability Partnership (“LLP”) is a hybrid structure containing the key characteristics of a partnership as well as a company. The Government of India enacted the Limited Liability Partnership Act, 2008 after the receipt of the assent of the President of India on 7 January 2009. The said legislation explicitly permits a foreign individual and/or entity to be a Partner in a LLP (not being a designated partner). Further, the exchange control regulations have been liberalized to permit investment by foreign individual and/or entities in LLP under approval route with effect from 20 May 2011. Thus, a LLP can have foreign individuals and/or entities as its partner.

8.2 Legislation governing partnership

8.2.1 Indian partnership

An Indian partnership in India is governed by the Partnership Act.

Section 4 of the Partnership Act defines a partnership as relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

As per section 5 of the Partnership Act, the relationship of partnership arises from a contract.

The key characteristics of such partnership are as under:

- (a) A partnership should have minimum two partners.
- (b) Sharing of Profits is an important characteristic of partnership. The profits of the firm are shared among the partners in an agreed ratio as per the partnership deed.
- (c) There exists a principal-agent relationship in partnership. As agents, the partners can bind the partnership firm and other partners for their action in ordinary course of business.
- (d) The liability of the partners is unlimited i.e. they are jointly and severally liable for the liabilities of the partnership firm.

- (e) If the assets of the partnership firm are inadequate to meet the liabilities of the firm then the personal assets of the partners may be used to meet the liabilities of the partnership firm.
- (f) Subject to contract between the partners, a person shall not be introduced as a partner into a firm without the consent of all the existing partners.

8.2.2 Limited Liability Partnership

A LLP in India is governed by The Limited Liability Partnership Act, 2008 (“LLP Act”). Section 2(n) of The LLP Act defines a limited liability partnership as a partnership formed and registered under the Act.

A LLP is a hybrid entity which contains the features of both a corporate entity as well as a traditional partnership. It provides the partners with the flexibility of conducting the business as a traditional partnership though retaining the characteristics of a corporate entity.

The key characteristics of a LLP are as under:

- (a) LLP should be registered with Registrar of Companies;
- (b) LLP is a body corporate having a legal entity separate from its partner;
- (c) LLP has a perpetual succession;
- (d) An individual or a body corporate can be a partner in LLP;
- (e) Changes in partners does not affect the existence, rights or liabilities of a LLP;
- (f) LLP should have minimum two partners;
- (g) LLP should have two designated partners who are individuals and resident in India – under the exchange control regulations;
- (h) The partners are required to enter into partnership agreement, which will lay down the eligibility to appoint a partner, relationship of partners, cessation of partnership agreement, obligation to contribute, transfer of partnership interest, etc.
- (i) Partnership interest is transferable and the same would not by itself cause dissolution or winding up of LLP;
- (j) Partner is an agent of LLP but not of other partners;
- (k) Partner is not personally liable for an obligation of LLP, except where the same arises from his own wrongful act or omission or in case of a fraud;
- (l) LLP to maintain proper book of accounts; and undertake audit (turnover exceeds Rs. 40 lakhs or contribution exceeds Rs. 25 lakhs)
- (m) It is permitted to convert firm/company into LLP and vice versa;
- (n) LLP can be wound up either voluntarily or by the order of National Company Law Tribunal.

8.3 Key income tax provisions

Income Tax Act, 1961 (“ITA”)

8.3.1 Definition

Section 2(23) of the Income Tax Act, 1961 (“ITA”) defines “firm” to have the meaning assigned to it in the Partnership Act and shall include a limited liability partnership as defined in the LLP Act.

The definition of “company” as per section 2(17) of the ITA includes anybody corporate incorporated by or under the laws of a country outside India.

Section 2(31) of the ITA defines a person to include a firm and a company.

Whether a partnership formed and/or registered outside India qualify as a partnership for the purpose of ITA?

Section 4 of the Partnership Act defines a “partnership” as a relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

Any partnership, including a foreign partnership, which satisfies the above definition, should be recognized as a firm under the ITA.

Whether a foreign LLP qualifies as a firm for the purpose of Act?

The definition under the ITA specifically provides that a LLP as defined in LLP Act should be considered as firm for the purpose of the ITA.

Section 2(n) of the LLP Act defines a “limited liability partnership” as a partnership formed and registered under the LLP Act. Further, section 3 of the LLP Act provides that a LLP is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

Thus a LLP formed and registered under the LLP Act is considered as a firm for income tax purpose.

The question thus arises on what should be the status of a foreign LLP not formed and registered under the LLP Act.

The answer to the aforesaid question may depend on the legislation in the country of registration which may govern the respective LLP. The following guidance may be helpful in the matter:-

Company	If the foreign LLP is considered as a body corporate as per the laws of the country of incorporation then it may be considered as a “company” for the purpose of the ITA
Firm	If the foreign LLP satisfies the definition of partnership as per the Partnership Act, then it may be considered as “firm” for the purpose of ITA

Association of persons or body of individuals	If the foreign LLP does not qualify as “firm” or “company”, then it may need to be examined whether it may be considered as an “association of persons” or “body of individuals” as the case may be.
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The tax implication under the ITA would depend on the status of the foreign LLP.

8.3.2 Residential status

Section 6(2) of the ITA provides that a firm is said to be resident in India in any previous year in every case except where during that year the control and management of its affairs is situated wholly outside India.

Section 6(3) of the ITA provides that a company, not being an Indian company, is to be resident in India if its place of effective management, in that year, is in India. “Place of effective management” has been defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as whole are, in substance made.

8.3.3 Scope of taxation

A firm or LLP is considered as a taxable entity for income tax purposes.

Section 5(1) of the ITA provides that a resident firm or LLP should be subject to tax on the following income:

- (a) Income received or deemed to be received in India
- (b) Income accruing or arising or deemed to accrue or arise in India
- (c) Income accruing or arising outside India

Section 7 of the ITA deals with income deemed to be received in India while section 9 of the ITA deals with income deemed to accrue or arise in India

A non-resident firm or LLP should however be subject to tax only on income received or deemed to be received in India or income accruing or arising or deemed to accrue or arise in India as per section 5(2) of the ITA.

8.3.4 Computation of taxable income

The provisions of the ITA relating to determination of taxable income, tax liability and tax compliances are applicable to the firm taxable as a distinct taxpayer (i.e. separate from the partners).

The following however are specific provisions in relation to determination of the tax liability of partnership and the partners.

Normal provisions

- In view of section 10(2A) of the ITA when a partnership is assessed as such then the

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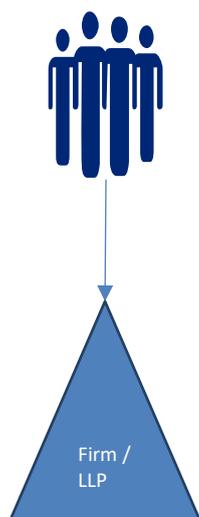
share of the partner in the total income of the partnership shall not be taxable in the hands of the partners.

- Explanation 2 to section 15 of the ITA provides that any salary, interest, bonus, commission, or remuneration due to or received by a partner from the partnership shall not be regarded as “salary”. Further, as per section 28(v) of the ITA, any salary, interest, bonus, commission, or remuneration shall be taxable under the head “Profits and gains from business or profession” in the hands of partners.

Alternative Minimum Tax provisions

- As per section 115JEE, any person other than company having total adjusted income more than Rs. 25 lakhs (subject to assessee claiming certain specific deductions) shall pursuant to section 115JC, is liable to pay alternate minimum tax i.e. tax at 18.5% on adjusted total income, where the tax liability under normal provisions is lower.

For computing adjusted total income, total income is increased by deduction claimed under chapter VI-A (other than 80P), deduction claimed under section 10AA and deduction claimed under section 35AD. Certificate in prescribed form to be obtained certifying adjusted total income and alternate minimum tax is computed as per the provisions prescribed in this relation.



Partners

- Where the partnership is separately assessed, the share of profit of partners in the total income of the partnership is not taxable in the hands of partners [Section 10(2A) of ITA]
- Salary, interest, bonus, commission, or remuneration paid to partners taxable as business income [Explanation 2 to sec 15 read with section 28(v) of ITA]
- Tax under paid if higher than normal tax

Firm / Partnership

- Firm is a separate taxpayer subject to income tax and related compliances
- Salary, interest, bonus, commission, or remuneration paid to partners is deductible subject to limit and satisfaction of conditions specified

8.3.5 Double Taxation Avoidance Agreement

Section 90(2) of the ITA provides that where the Central Government has entered into an agreement with the Government of any other country outside India or specified territory outside India for granting of relief of tax or avoidance of double taxation, then the provisions of ITA shall apply to the extent they are more beneficial. Section 90(4) of the ITA further provides that no relief under such agreements can be claimed by a resident of other country unless a certificate confirming the residence in the country outside India is obtained from Government of that country.

Thus, a firm / LLP should be eligible to claim benefit under the DTAA entered into by India. However, a firm / LLP which qualifies as a resident of other country would require a Tax Residency Certificate from its country of resident and provide a declaration in Form 10F, as applicable duly signed in order to claim the benefit provided by the DTAA in India.

The provisions of the respective DTAA need to be examined in entirety to determine the benefit or relief provided thereunder. However, the following articles¹⁸ of the DTAA may, in general, need to be examined in the case of a firm / LLP for determining the taxable income depending on the facts of the case:

- (a) General Scope
- (b) Taxes covered
- (c) General definition
- (d) Residence
- (e) Permanent Establishment & Business Profits
- (f) Associated enterprises
- (g) Interest
- (h) Royalty and fees for technical services
- (i) Gains
- (j) Independent Personal services
- (k) Income earned by Entertainers and Athletes (accruing not directly to such Entertainers and Athletes)
- (l) Other income
- (m) Limitation of benefits
- (n) Relief from Double Taxation
- (o) Non-Discrimination clause
- (p) Mutual agreement procedure

8.3.6 Challenges in application of DTAA to a foreign partnership / LLP not being a body corporate

Under the ITA, as discussed above, a partnership qualifying as a firm is considered as a separate tax payer. However, in the other country a partnership firm may be considered either as an independent taxable unit or as a fiscally transparent entity (i.e. partnership is not

¹⁸ (Kindly refer to the respective chapters the in Module for further elaboration on the purposes, interpretation and implication of each of the above articles under the DTAA)

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considered as a taxable unit and the income is taxable in the hands of its partners).

The DTAA applies to persons who are residents of one or both of the Contracting States. In relation to a partnership which is taxable as an independent taxable unit in both the Contracting States (India treats partnership as independent taxable unit), it may be possible to apply the provisions of Article on residence to determine the Resident State and resulting tax implication as per the provisions of DTAA.

However, the nature of treatment of the partnership as fiscally transparent in the other Contracting State may trigger the following challenges.

- (a) As the firm is fiscally transparent, it is not a taxable entity under the domestic income tax law of the other country. Further, the firm is not liable to tax in that other states (It is the partners who are liable to tax). In view thereof, the provisions of Residence under DTAA as regard the firm may fail.

Further, in such a situation, the other country may also not issue a Tax Residency Certificate to the partnership.

- (b) The partners may be taxable on the income of the firm in their individual capacity. Thus while the firm may be taxable in India, the individual partners may be taxed in the other country. The application of the provisions of the DTAA for granting relief in such scenario may pose difficulty. A further complexity may arise where the partnership is a resident of other Contracting State and the partner is a resident of a country other than the Contracting State in which case there would be three jurisdictions involved posing challenge of triangular treaty situation.

The OECD in its commentary on the Articles of the Model Tax Convention have dealt with the challenges on the application of the Convention to partnership firm and suggested the manner in which the issues may be dealt. The relevant extract of the commentary is provided in the Annexure enclosed to the Chapter.

The above referred commentaries dealing with partnership are based on the recommendations and suggestions of the working group set up by the committee of fiscal affairs of OECD provided vide its report titled "The Application of the OECD Model Tax Convention to Partnership". The said report dealt with the application of the provisions of OECD Model Tax Convention and indirectly of bilateral tax conventions based on the Model to partnership and was adopted by the committee on 20 January 1999.

The OECD commentaries are not binding in relation to the DTAA entered into by India. However, it may have persuasive value in determining the intention of the provisions of the DTAA entered into by India.

8.3.7 Credit for tax paid outside India – No DTAA

Section 91(1) of the ITA provides that with respect to income which accrued or arose outside India and which is not deemed to accrue or arise in India, if a resident taxpayer has paid income tax in other country with which there is no DTAA, then the taxpayer should be entitled

to claim a deduction from Income tax payable of a sum calculated on such double taxed income as under:

- at the Indian tax rate or the rate of tax in such country whichever is lower, or
- at the Indian tax rate, if both the rates are equal

Section 91(3) of the ITA further provides that if any non-resident person is assessed on his share in the income of a registered firm assessed as resident in India in any previous year and such share includes any income accruing or arising outside India during that previous year (and which is not deemed to accrue or arise in India) in a country with which there is no DTAA and he proves that it has paid income-tax by deduction or otherwise under the law in force in that country in respect of the income so included he shall be entitled to a deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income as under:

- at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or
- at the Indian rate of tax if both the rates are equal.

8.4 Scenarios resulting in double taxation

Enumerated below are the various scenarios in which double taxation may arise either in the hands of the partnership and/or the partners, thus warranting the examination of DTAA entered into by India.

- (a) Indian partnership or Indian LLP deriving income outside India
- (b) Taxation of partners of Indian LLP who are based outside India
- (c) Taxation of foreign partnership and/or partners in a foreign partnership, where the partnership is deriving income from India and none of the partners are based in India
- (d) Taxation of foreign partnership, where one of the partners is based in India.
- (e) Taxation of partners of a foreign partnership who are based in India

The said scenarios are discussed in detail below:

8.4.1 Scenario I - Indian partnership or Indian LLP deriving income outside India

An Indian partnership or an Indian LLP should be qualifying as a tax resident in India as per the provisions of section 6(2) of the ITA. Accordingly, the income derived outside India should be taxable in India as per the provisions of section 5(1) of the ITA.

The said income may however be also taxed in the other country from which the income may be derived under its domestic tax law. Thus there may be double taxation in the hands of the Indian partnership or Indian LLP.

To avoid the said double taxation, the provisions of DTAA require examination if entered into by India with the said country. Alternatively, the provisions of section 91 of the ITA may be applicable.

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It may be noted that an Indian partnership is not a body corporate. However, as per the LLP Act, an Indian LLP is a body corporate.

The steps, considerations and challenges in determining the application of DTAA are summarized as under:

Steps	Considerations	Challenges
Examine whether qualifying as a person as defined in the DTAA	<ul style="list-style-type: none"> • Indian firm and Indian LLP is taxable unit in India Accordingly, they should qualify as a person from India perspective and accordingly provisions of DTAA should be applicable to them while determining tax liability in India. • The Indian LLP being a body corporate may qualify as a company¹⁹ for the purpose of the DTAA and accordingly, the other country may consider applying the provisions of DTAA while determining the tax liability of Indian LLP in that country 	<ul style="list-style-type: none"> • If the Indian firm is not a taxable unit in the other Contracting State and therefore not qualifying as person, whether the other Contracting State may grant the DTAA benefit to the firm? [The response to the aforesaid may depend on the interpretation of DTAA by the other Contracting State] • Whether in such case, the partner may claim benefit of the DTAA in his individual capacity? [If the partner is taxable in his individual capacity in the other Contracting State, then for the purpose of application of DTAA, the other Contracting State may consider to apply provisions of DTAA to partners in their individual capacity.]
Determining the residence under the DTAA	Depends on the provisions of the domestic tax law of the respective Contracting State. [Generally, Indian partnership and Indian LLP controlled and managed from India may	<ul style="list-style-type: none"> • If the Indian firm is not a taxable unit in other country, whether the residential status of partner needs to be examined? [If the partner is taxable in

¹⁹ The term "company" in DTAA is generally defined to mean a body corporate

Steps	Considerations	Challenges
	qualify as a resident of India for the purpose of DTAA even in the case the tie-breaker provisions are triggered]	his individual capacity in the other Contracting State, then for the purpose of application of DTAA, the other Contracting State may consider to apply provisions of DTAA to partners in their individual capacity].
Determining the right of taxation in the other state	The conditions as prescribed in the relevant Article may need to be examined to determine the Article governing the income received outside India and the taxing rights of the other Country in relation to said income.	<ul style="list-style-type: none"> • Whether the activity of partnership firm in the other Contracting state may trigger a PE exposure to the Partner in the other country if he is taxed in the other country in his individual capacity. [As per the OECD commentary, for determining the residential status of a partner of a fiscally transparent firm in the other Contracting State, the activity of the partnership firm may require to be considered. If the partnership firm triggers a permanent establishment in other Contracting State, then the partner individually may be considered to trigger PE in other contracting State] • Article on Business Profits v/s. Article on Independent Personal Services A challenge may arise where the conditions of one Article are satisfied vis – a – vis the other. For

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Steps	Considerations	Challenges
		<p>example, presence of employee triggers a Service PE in the other Contracting State however, not resulting in fixed base in other Contracting state. Will the said situation result in triggering tax liability in other contracting state? Can it be argued that the Article on Independent Personal Services should apply and therefore, in the absence of fixed base, the other country does not have right of taxation under DTAA?</p> <p>[The response to the above is subject to the interpretation of the provisions of DTAA by the respective country. However, view of one country may not be bidding on the other country. This could result in litigation. In such a case, it may be decided to resolve the issue under mutual agreement procedure]</p>
<p>Determining the eligibility to claim tax credit in the state of residence</p>	<p>The DTAA's entered into by India are generally following the credit method.</p> <p>As India is likely to be the resident state of the Indian partnership and Indian LLP, the credit under the DTAA may be required to be granted by India.</p>	<ul style="list-style-type: none"> • Whether a partner is taxed in the other Contracting State in his individual capacity. The question may arise on whether credit of the tax paid in the other country on the profits of the partnership firm would be allowed to the partnership.

8.4.2 Scenario II - Taxation of partners of Indian LLP who are based outside India

The share of profit received by a foreign partner from an Indian LLP is exempt in India in the hands of the foreign partner under section 10(2A) of the Act.

The foreign partner may however be taxed in the other jurisdiction on his/her/its share of profits as per its domestic tax laws.

Thus, there may be double taxation of the share of profit received by the foreign partner.

In India, as the share of profit is exempt under the ITA in the hands of individual partners, ITA being beneficial, the examination of the DTAA may not be required.

However, as regards tax payable in the other country in the hands of foreign partner, the following questions may arise:

- (a) Whether it could be argued that under the DTAA, Indian LLP is likely to qualify as a resident of India and accordingly, only India should have the right to tax the share of profit of the Indian LLP (having no operations outside India) derived by a foreign partner?
- (b) Whether under the DTAA, credit of tax paid in India by the Indian LLP may be allowed to be claimed against the tax liability of the foreign partner in the other country.

The response to the above would depend on the interpretation of the provisions of DTAA and the local tax laws by the other country.

The aforesaid scenario may also apply to a foreign partner of an Indian partnership.

8.4.3 Scenario III - Taxation of foreign partnership and/or partners in a foreign partnership, where the partnership is deriving income from India and none of the partners are based in India

The foreign partnership may be a firm or a registered LLP.

Under the ITA, the status of the foreign partnership (firm/company/association of person/body of individuals) would depend on the legislation in the country of registration (refer discussion above). Depending on the status, the provisions of section 6 would require examination to determine the residential status.

It is likely that a foreign partnership may qualify as a non-resident in India under the ITA. Accordingly, as per section 5(2) of the ITA, India may have a right to tax only income accruing or arising or deemed to accrue or arise in India or income received in India.

The income received from services rendered in India may be taxable in India on accrual basis. Further, the payment received for services rendered outside India by the partnership may be taxable under the source rule (deemed to accrue or arise in India) as provided under section 9 of the Act in relation to services utilized by service recipient for business or profession carried out in India or earning any income from any source in India.

Further, the income may also be taxable in the other country resulting in double taxation. The

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provisions of the DTAA may therefore require examination to deal with the double taxation.

The steps, considerations and challenges in determining the application of DTAA in the given case are summarized as under:

Steps	Considerations	Challenges
Examine whether qualifying as a person as defined in the DTAA	<ul style="list-style-type: none"> The foreign partnership could qualify as a company or a taxable unit in India and thus, qualify as a person as defined in the DTAA from India perspective 	
Determining residence under the DTAA	<p>Depends on the provisions of the domestic tax law of the respective Contracting country.</p> <p>[Generally, foreign partnership controlled and managed wholly from outside India may qualify as a non-resident of India for the purpose of DTAA. Further, the provisions of DTAA may only apply if the partnership firm qualifies as a resident of the other country]</p>	<ul style="list-style-type: none"> If the foreign partnership is not a taxable unit in the other jurisdiction (i.e. it is a fiscally transparent), it may not qualify as a resident of the other Country. In such case, whether the India may grant the DTAA benefit to the firm? If the foreign partnership is not a taxable unit in other Contracting State and therefore does not qualify as a person, whether India may grant the DTAA benefit based on the residential status of the partners of the firm? If answer to the above question is in affirmative, which DTAA should be considered if the partners of the firm do not belong to the same jurisdiction? <p><i>[The aforesaid are currently an area of contention and there is no clear guidance in the matter at present]</i></p>

Steps	Considerations	Challenges
<p>Determining the right of taxation in the other state</p>	<p>The conditions as prescribed in the relevant article may need to be examined to determine the Article governing the income received outside India and the taxing rights of the other country in relation to said income.</p>	<ul style="list-style-type: none"> • Article on Business Profits v/s. Article on Independent Personal Services <p>A challenge may arise where the conditions of one Article are satisfied vis – a – vis the other. For example, presence of employee triggers a Service PE in the other Contracting State however, not resulting in fixed base in other Contracting state. Will the said situation result in triggering tax liability in India? Can it be argued that the Article on Independent Personal Services should apply and therefore, in the absence of fixed base, India does not have right of taxation under DTAA?</p> <p>[There in no clear guidance in the matter from an India perspective at present. However, view of one country may not be bidding on the other country. This could result in litigation. In such a case, it may be decided to resolve the issue under mutual agreement procedure]</p>
<p>Determining the eligibility to claim tax credit in the state of residence</p>	<p>As India is likely to be the non-resident state of the foreign partnership, the credit under the DTAA may be claimed in the other country.</p>	<ul style="list-style-type: none"> • If the partner is taxed in the other Contracting State in his individual capacity, the question may arise on whether credit of the tax paid in the India on the profits of the partnership firm would be allowed to the

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Steps	Considerations	Challenges
		partner. [The above is subject to the interpretation of the provisions by the other contracting state]

8.4.4 Scenario IV - Taxation of foreign partnership, where one of the partners is based in India

As per section 6(2) of the ITA, a firm is considered as a resident in every case except whether the control and management of its affairs is situated wholly outside India. In this context, it may be highlighted that if one of the partners of the foreign partnership is generally based in India and is involved in the management of the firm, the said firm may qualify as a “resident” of India.

Further, as per section 6(3) of the ITA, a company, not being an Indian company, is said to be a resident of India in any previous year if its place of effective management in that year is in India. Accordingly, a foreign LLP being a body corporate may also qualify as a resident in India if it could be held that the place of effective management is in India.

If the foreign partnership is held to be resident in India, then it may be subject to tax in India on its global income.

This will result in double taxation requiring the examination of the provisions of the DTAA.

The steps, considerations and challenges in determining the application of DTAA in the given case are summarized as under:

Steps	Considerations	Challenges
Examine whether qualifying as a person as defined in the DTAA	<ul style="list-style-type: none"> The foreign partnership could qualify as a company or a taxable unit in India and thus, qualify as a person as defined in the DTAA for India perspective 	
Determining the residence under the DTAA	<p>Depends on the provisions of the domestic tax law of the respective Contracting country.</p> <p>[In the given case, the foreign partnership may qualify as a tax resident of both the countries. Under the tie-breaker test to determine the country of residence, the key criteria should</p>	<ul style="list-style-type: none"> If the foreign partnership is not a taxable unit in the other jurisdiction (i.e. it is a fiscally transparent), it may not qualify as a resident of the other Country. In such case, whether India may grant the DTAA benefit to the firm?

Steps	Considerations	Challenges
	<p>generally be the place of effective management. Whether the place of effective management of the partnership is in India would depend on the facts of the case. However, a view of one country in the matter may not be binding on the other country. This could result in litigation. In such case, it may be decided to resolve the issue under mutual agreement procedure, but the same may involve time and cost.]</p>	<ul style="list-style-type: none"> • If the foreign partnership is not a taxable unit in other Contracting State and therefore does not qualify as a person, whether India may grant the DTAA benefit based on the residential status of the partners of the firm? • If answer to the above question is in affirmative, which DTAA should be considered if the other partners of the firm do not belong to the same jurisdiction? <i>[The aforesaid are currently an area of contention and there in no clear guidance in the matter at present]</i>
<p>Determining the right of taxation in the other state</p>	<p>The conditions as prescribed in the relevant article may need to be examined to determine the Article governing the income received outside India and the taxing rights of the other country in relation to said income.</p>	<ul style="list-style-type: none"> • Article on Business Profits v/s. Article on Independent Personal Services A challenge may arise where the conditions of one Article are satisfied vis – a – vis the other. For example, presence of employee triggers a Service PE in the other Contracting State however, not resulting in fixed base in other Contracting state. Will the said situation result in triggering tax liability in India? Can it be argued that the Article on Independent Personal Services should apply and therefore, in the

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Steps	Considerations	Challenges
		<p>absence of a fixed base, India does not have right of taxation under DTAA?</p> <p>[There in no clear guidance in the matter from India perspective at present. However, view of one country may not be bidding on the other country. This could result in litigation. In such case, it may be decided to resolve the issue under mutual agreement procedure]</p>
<p>Determining the eligibility to claim tax credit in the state of residence</p>	<p>The credit under the DTAA may be claimed in the country in which the partnership qualifies as a resident for DTAA purposes.</p>	<ul style="list-style-type: none"> • If a partnership is taxed in the other Contracting State as a fiscally transparent unit, if India is a resident country, the question may arise on whether India would grant credit of tax paid in other country by the partner in his/her individual capacity. Further, if other country is a resident country, the question may arise on whether credit of the tax paid in India on the profits of the partnership firm would be allowed to the partner. <p>[The above is subject to the interpretation of the provisions by the Contracting states]</p>

8.4.5 Scenario V – Taxation of partners of a foreign partnership who are based in India

If the foreign partnership is taxable in India on account of partner being based in India (refer Scenario IV above), then in view of the section 10(2A) of the ITA, the share of profit should be exempt in the hands of the partners.

However, if the foreign partnership is not assessed to tax in India, then the share of profits from the foreign partnership may be taxable in the hands of the partner if he qualifies as

“Resident and Ordinarily Resident” in the relevant assessment year.

This may result in double taxable requiring the examination of the provisions of the DTAA.

The steps, considerations and challenges in determining the application of DTAA in the given case are summarized as under:

Steps	Considerations	Challenges
Examine whether qualifying as a person as defined in the DTAA	The partner should qualify as a person as defined in the DTAA for India perspective	
Determining the residence under the DTAA	Depends on the provisions of the domestic tax law of the respective Contracting country. [If the partner may qualify as a tax resident of both the countries, the tie-breaker test may require examination.]	
Determining the right of taxation in the other state	The conditions as prescribed in the relevant article may need to be examined to determine the Article governing the income received outside India and the taxing rights of the other country in relation to said income.	<ul style="list-style-type: none"> • Whether the presence of partnership in other country may trigger a Permanent Establishment exposure for the partner in the other country? [The above is subject to the interpretation of the provisions by the other Contracting states]
Determining the eligibility to claim tax credit in the state of residence	The credit under the DTAA may be claimed in the country in which the partner qualifies as a resident for DTAA purposes.	<ul style="list-style-type: none"> • Whether a partnership is taxed in the other Contracting State as a firm, if India is a resident country, the question may arise on whether India would grant credit to the partner of tax paid in other country by the partnership. Further, if other country is a resident country, the question may arise on whether credit of the tax paid in the India on the profits of

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Steps	Considerations	Challenges
		the partner in his individual capacity would be allowed to the partnership. [The above is subject to the interpretation of the provisions by the Contracting states]

Further, in the aforesaid scenario, the other question that may need to be examined is:

Whether it could be argued that under the DTAA, foreign partnership may not be subject to tax in India and accordingly, only the other country should have the right to tax the share of profit of the foreign partnership (having no operations inside India)?

8.5 Concluding remarks

It could thus be observed from the above, that there are complexities and challenges involved in the determination of the tax liability of partners as well as partnership subject to tax in more than one jurisdiction. The challenges are higher where the tax treatment of the partnership (i.e. if it is a fiscally transparent or a separate taxable unit) differs in the jurisdictions under consideration.

Further, the partnership involving partners based in multiple jurisdictions requires review of multiple DTAAs (referred to as triangular cases).

A careful review of the tax implication is therefore required.

It may be noted that this Chapter seeks to discuss the income tax implications in relation to partnership. The implication under the Foreign Exchange Management Act, 1999 and regulations prescribed thereunder, The Indian Partnership Act, 1932, Limited Liability Partnership Act, 2008 and any other relevant legislation needs to be considered independently.

Unit IX	Recent judicial developments in India
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Introduction

The subject of taxation keeps on evolving with the changes in the business environment. International tax, in India and globally, is also going through constant evolution based on the dynamic business arrangements vis-a-vis legal framework and accordingly the judicial developments act as a 'lighthouse' for the tax administration, taxpayers as well as for tax professionals to sail through the sea of tax provisions.

In this chapter some of the key decisions handed down over the period January 2013 to June 2020 are discussed. These decisions have laid down significant principles based upon interpretation of domestic tax law and treaty wordings.

9.1 Formula One World Championship Ltd. v. CIT [2017] (80 taxmann.com 347) (SC)

Understanding of facts: Formula One World Championship Ltd. ('FOWC') is a UK tax resident company. FOWC entered into an agreement with the Federation Internationale de l'Automobile ('FIA') and Formula One Asset Management Limited ('FOAM'). As per the terms of this agreement FOAM licensed all commercial rights in the FIA Formula One World Championship to FOWC for 100- year term effective from January 1st 2011.

FOWC further entered into a "Race Promotion Contract" ('RPC') with Jaypee Sports International Limited ('Jaypee Sports') dated September 13, 2011. Under this agreement, Jaypee Sports was awarded the right to host, stage and promote the Formula One Grand Prix of India event for a consideration of USD 40 million.

The taxability of the revenues of USD 40 million earned by FOWC was a matter of concern for both, the assessee as well as the Revenue. The matter was taken to the AAR to determine the taxability of the revenues earned by FOWC. The AAR held that the amount paid/ payable by Jaypee Sports to FOWC would be treated as Royalty as per India UK Double Taxation Avoidance Agreement ('DTAA'); FOWC did not have Permanent Establishment ('PE') in India. However, Jaypee Sports is bound to make appropriate deductions from the amount payable to FOWC under Section 195 of the Income tax Act, 1961 ('Act').

When the matter reached Delhi High Court ('HC') 390 ITR 199, the Delhi HC, vide order dated 30 November 2016, reversed the ruling of the AAR and held that the amount paid/ payable by Jaypee Sports to FOWC would not be treated as royalty; FOWC had a fixed place PE at the circuit and therefore RPC fee attributable to PE in India is taxable in India. Further, the HC has not accepted the plea of the Department on dependent agent PE ('DAPE'). Accordingly, Jaypee Sports is bound to make appropriate deductions from the amount payable to FOWC under Section 195 of the Income tax Act, 1961. Aggrieved, the taxpayer filed an appeal before the Supreme Court ('SC').

Ruling of the Supreme Court: The major issues and ruling of SC thereof are under;

➤ **Whether FOWC had a PE in India through the Racing Circuit and whether it carried on any business activity through the Circuit?**

SC referred to the Organisation for Economic Co-operation and Development ('OECD') Model Tax Convention commentaries by Philip Baker and Klaus Vogel, and noted that as per Article 5 of the DTAA, the PE has to be a fixed place of business 'through' which business of an enterprise is wholly or partly carried on.

SC observed and held that the international circuit is a fixed place and since races are conducted from this circuit, it is an economic/business activity. The Buddh International Circuit from where different races, including the Grand Prix was conducted was undoubtedly an economic/business activity. The SC completely agreed with the HC's stern view that Formula One "monetized" every commercial right that it possessed in conducting the event in India (in its capacity as the commercial rights holder). The Apex Court referred to the arrangement between assessee and its affiliates on one hand and Jaypee Sports on other hand. SC held that various agreements cannot be looked into by isolating them from each other and their wholesome reading was necessary to bring out the real transaction between the parties. Such an approach is essentially required to find out as to who is having real and dominant control over the Event.

SC observed that FOWC is the Commercial Rights Holder ('CRH'). These rights can be exploited with the conduct of the F1 Championship, which is organised in various countries. It is FOWC and its affiliates which have been responsible for all activities required for conduct of a race (for example, racing track, participating teams, spectators, revenue from advertisement and media rights, etc). FOWC acquired all commercial rights in championship by way of an agreement with FIA which was entered way back in 2001 according to which said rights could not be transferred to any party outside Formula One group. It was observed that on the same day when assessee entered into RPC with Jaypee, another agreement was signed between Jaypee and three affiliates of FOWC whereby Jaypee gave back circuit rights, mainly media and title sponsorship, to Beta Prema 2 and paddock rights to All sports.

SC further observed that "FOAM is engaged to generate TV Feed. All the revenues from the aforesaid activities are to go to the said companies, namely, Beta Prema 2, Allsports and FOAM respectively. These three companies are admittedly affiliates to FOWC." Accordingly, SC held that the aforesaid arrangement demonstrated that the entire event was taken over and controlled by FOWC and its affiliates.

SC rejected assessee's stand that it is Jaypee who was responsible for conducting races and had complete control over the Event in question. SC clarified that mere construction of the track by Jaypee at its expense will be of no consequence. Further, it clarified that its ownership or organising other events by Jaypee was also immaterial.

SC observed that "There cannot be any race without participating/ competing teams, a circuit and a paddock. All these are controlled by FOWC and its affiliates. Event has taken place by conduct of race physically in India. Entire income is generated from the conduct of this event

in India.” Thus, SC held that the commercial rights of this race were with FOWC which were exploited with actual conduct of race in India. It is also difficult to accept that FOWC had no role in the conduct of the Championship and its role came to an end with granting permission to host the event as a round of the Championship. Entire income generated in India from the conduct of the event in India. Exploitation of the commercial rights of FOWC became possible only with actual conduct of the races and active participation of FOWC in the said races, with access and control over the circuit.

Further, by virtue of the Concorde agreement 2009, FOWC enabled participation of the teams and FIA undertook to ensure that events were held and FOWC, as CRH, undertook to enter into contracts with event promoters and host such events. Thus, omnipresence of FOWC and its stamp over the event was loud, clear and firm

The SC relied upon:

- Andhra Pradesh HC Ruling in the case of Visakhapatnam Port Trust [(1983) 144 ITR 146] to hold that there was a virtual projection of the foreign enterprise, namely, Formula-1 (i.e. FOWC) on the soil of this country.
- Philip Baker wherein to constitute PE three characteristics: stability, productivity and dependence need to be satisfied. According to the Court all such characteristics were satisfied in the present this case.

In light of the above, the Court held that the aesthetics of law and taxation jurisprudence left no doubt in their mind that taxable event has taken place in India and the non-resident FOWC is liable to pay tax in India on the income it has earned on this soil. Most of the DTAA's provide a minimum threshold in terms of the number of days for the non-resident to form a PE in a country. Accordingly, the assessee was of the view that FOWC conducted business in India for a limited duration of three days of the event.

SC rejected assessee's stand that the total duration for which limited access was granted to it, was not sufficient duration to constitute the degree of permanence necessary to establish a fixed place PE. Assessee had submitted that duration of the event was three days and, therefore, control, if at all, would be for that period only. On this, Revenue had pointed out that the duration of the agreement was five years, which was extendable to another five years.

SC clarified that “The question of the PE has to be examined keeping in mind that the aforesaid race was to be conducted only for three days in a year and for the entire period of race the control was with FOWC.”

SC affirmed HC finding that having regard to the duration of the event, which was for limited days, and for the entire duration FOWC had full access through its personnel, number of days for which the access was there would not make any difference. While pondering over the duration tests, reliance was placed on the following rulings:

- Joseph Fowler v. M.N.R. (1990) 90 D.T.C. 1834; (1990) 2 C.T.C. 2351 (Tax Court of Canada)
- Antwerp Court of Appeal, decision of February 6, 2001, noted in 2001 WTD 106-11

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- Universal Furniture Ind. AB v. Government of Norway (Stavanger Court, Case No. 99-00421, dated 19-12-1999 referred to in Principles of International Taxation by Anghard Miller and Lyn Oates, 2012)

➤ **Whether the Circuit was under the control and disposal of FOWC?**

SC held that entire arrangement between FOWC and its associates on the one hand and Jaypee on the other hand, was to be kept in mind. Various agreements cannot be looked into by isolating them from each other.

Their wholesome reading was essentially required to find out as to who is having real and dominant control over the Event, thereby providing an answer to the question as to whether Buddh International Circuit was at the disposal of FOWC and whether it carried out any business therefrom or not.

SC observed that the fixed place of business in the form of physical location, i.e. Buddh International Circuit, was at the disposal of FOWC through which it conducted business. SC ruled that, based on the materials placed on record, the entire event was “taken over” and “controlled” by Formula One and its affiliates. According to the SC, this was borne out from the facts; The event was held physically in India and income was generated from the event in India; Commercial rights vested with Formula One, which were exploited by conducting the event in India; The physical control of the circuit was with Formula One and its affiliates from the inception till the conclusion of the event; and The participating teams and paddock were controlled by Formula One and its affiliates.

Accordingly, SC rejected assessee’s argument that international circuit was not at its disposal. In light of the above, SC held that payments made by Jaypee Sports to FOWC under the RPC were business income of the FOWC through PE at the Buddh International Circuit, and, therefore, chargeable to tax. Jaypee Sports was bound to make appropriate deductions from the amounts paid u/s. 195 of the Act.

However, SC accepted assessee’s submission that only that portion of the income of FOWC, which is attributable to the said PE, would be treated as business income of FOWC and the Tax Deducted at Source obligation is limited to the appropriate portion of income which is chargeable to tax in India and in respect of other payments where no tax is payable, recourse is to be made under Section 195(2).

SC directed Assessing Officer to arrive at the profits attributable to PE in India, which would be chargeable to tax. SC further clarified that “At that stage, Jaypee Sports can also press its argument that penalty etc. be not charged as the move on the part of Jaypee Sports in not deducting tax at source was bona fide.

SC, thus, dismissed assessee’s appeal.

9.2 Palam Gas Services v CIT [2017] (81 taxmann.com 43) Supreme Court

Understanding of facts: The provisions of the Income Tax Act ('the Act') impose a statutory obligation on a person, who is making payments of a specified nature, to deduct tax at source ('TDS') at the time of credit to the account of the payee or at the time of payment thereof, whichever is earlier ('TDS provisions'). Furthermore, such taxes withheld are required to be deposited with the Government of India ('GOI') within the prescribed time.

In order to augment the compliance of the TDS provisions, the Act provides for various consequences for failure to deduct taxes, which include disallowance of expenses "payable", on which tax is deductible at source but such tax has not been deducted or, after deduction, has not been paid on or before the due date of filing return of income. However, deduction of such expenses is permitted in the subsequent year in which an assessee complies with the TDS provisions and pays tax to the GOI.

Use of the expression "payable" in the disallowance provision gave rise to an issue of whether the disallowance applies only in respect of expenses remaining "payable" as on the last day of the tax year or whether it is also applicable in respect of expenses "paid" during the tax year without deducting tax.

Various High Courts ('HCs') dealt with the issue and took divergent views. While most of the HCs (viz., Calcutta HC in the case of CIT v. Crescent Export Syndicate [216 Taxman 258], Gujarat HC in the case of CIT v. Sikandarkhan N Tunvar [357 ITR 312] and Punjab & Haryana HC in the case of P.M.S Diesels v. CIT [374 ITR 562]) took the view that disallowance is triggered even if expenses are "paid", the Allahabad HC (CIT v. Vector Shipping Services (P) Ltd. [357 ITR 642]) took the view that disallowance is triggered only when the TDS default is in respect of the amount which is "payable" as at the end of the year.

Taking note of the conflicting judicial precedents on the issue, the Central Board of Direct Taxes ('CBDT') issued a Circular No. 10/DV/2013 dated 16 December 2013 which clarified that disallowance is triggered regardless of whether the amounts are payable as at the end of the tax year or actually paid during the year.

In the present case, the assessee Palam Gas Services ('PGS') was engaged in the business of trading in LPG cylinders. It had paid freight charges to sub-contractors towards transportation of LPG cylinders to its customer's place. Such payments were made without deduction of applicable taxes.

The Income Tax Department ('ITD') disallowed such payments on account of the PGS's failure to deduct taxes, by holding that disallowance is triggered even if expenses are paid during the year and are not outstanding as at the end of the tax year.

Being aggrieved, the assessee filed successive appeals before the CIT(A) and ITAT. The CIT(A), the ITAT and the Himachal Pradesh HC dismissed the assessee's appeal by upholding the ITD's contention.

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Being aggrieved, the assessee preferred further appeal before the SC.

Ruling of the Supreme Court: Applicability of the disallowance provision where expense is already “paid” and no amount remains “payable”

Hon'ble SC observed that the TDS provisions impose a statutory obligation on the assessee to deduct taxes at the time of credit of the sum to the account of the payee or at the time of payment thereof, whichever is earlier. Thus, the TDS provisions contemplate tax deduction not only on the occasion when the payment is actually made, but also at the time when the amount is credited to the account of the payee, if such credit is earlier than the payment.

Further, the SC also observed that if the scheme of the TDS provisions is read holistically, it is clear that the expression “payable” used in the disallowance provision covers not only cases where the payment is yet to be made, but also cases where payment has actually been made.

Though the expressions “payable” and “paid” denote different meanings grammatically, such distinction is irrelevant for interpretation of the disallowance provision since withholding tax is triggered in both cases.

In view of the SC, the disallowance provision is applicable as much to assessees which follow the mercantile system of accounting as to assessees following the cash system of accounting. By use of the expression “payable” in the disallowance provision, the Legislature included the entire accrued liability which, in the context of assessees following the mercantile system of accounting, will cover the amount credited to the account of the payee and, for assessees following the cash system of accounting, will cover the actual payment of liability.

Further, SC observed that the purpose of the disallowance provision is to augment the compliance of TDS provisions, as also to bring more persons within the tax net. Once it is found that the TDS provisions mandate a person to deduct tax not only on the amounts payable but also when the sums are actually paid to the payee, the assessee which does not adhere to such statutory obligation has to suffer related consequences, which include disallowance of expenses. This is made clear by TDS provisions which provide that the consequence of a assessee being regarded as an “assessee-in-default” for committing TDS tax default shall be without prejudice to any other consequence under the Act. Accordingly, tax is also required to be deducted on the amount of provisions made in the books of accounts.

Allahabad HC decision in the case of Vector Shipping Services overruled-The Allahabad HC did not consider the amplitude of the TDS provisions while concluding that the disallowance provision would apply only when the amount is “payable”. Hence, the said judgement was held incorrect and overruled.

It is true that the Special Leave Petition (‘SLP’) of the ITD against the Allahabad HC’s ruling was rejected by the SC earlier, but it is well settled that a mere rejection of an SLP does not amount to an HC ruling being confirmed by the SC.

Accordingly, the SC decision puts the controversy to rest by confirming that the scope of the disallowance provision covers not only amounts payable as at the end of the year, but also

amounts paid during the year. This view also fortifies the view expressed earlier in the CBDT Circular.

9.3 Sale of shares of Indian company by Dutch company covered under Article 13(5) of the India – Netherlands DTAA and hence not taxable in India. Revenue’s approach of treating sale of shares as sale of immovable property as per Article 13(4) of the DTAA is not tenable - DIT(IT) v Vanenburg Facilities BV [2017] 82 taxmann.com 433 (HC of Andhra Pradesh)

Understanding of facts: Vanenburg NL, is a company incorporated in the Netherlands and has a wholly owned subsidiary, namely Vanenburg IT Park India Private Limited (VITIPL), in India. VITIPL is engaged in the business of developing, operating and maintaining infrastructure facilities in India. Vanenburg NL sold 100% shares of VITIPL to Ascendas, a Singapore based company.

The question arose regarding the gains arising on transfer of shares of VITIPL to Ascendas is taxable as capital gains in India in view of the India –Netherland Tax Treaty under para (1),(4) or (5) of Article 13.

Ruling of the High Court: Andhra Pradesh and Telangana HC upheld ITAT order for AY 2005-06 in favour of Vanenburg NL, capital gains arising to Vanenburg NL (a Dutch company) on sale of shares of its Indian subsidiary (holding investment in IT park) to Singapore buyer, not taxable in India under India-Netherlands DTAA.

The HC directed Revenue to expeditiously issue refund to assessee of the TDS deducted and deposited by the purchaser. The HC noted that AO and CIT(A) erred in applying Article 13(1) of the DTAA by equating alienation of a company’s shares to alienation of its immovable property and held that the ludicrous logic that shares partake the character of immovable property be applied here.

The HC cited legal distinction between ‘share sale’ and ‘asset sale’ as summed up by SC in Vodafone case. The HC also approved ITAT’s findings that alienation of shares by assessee does not fall under Article 13(1) of the DTAA and by virtue of residuary clause in Article 13(5), gains will be exempt from taxation in India. Article 13(4) of the DTAA deals with taxability of gains arising from alienation of company shares, the value of which is principally derived from immovable property other than that used in the business of such company. Article 13(5) of the DTAA is the residuary clause which provides that gains from the alienation of any property other than that referred to other paragraphs shall be taxable only in the State of which the alienator is a resident.

Further, the HC accepted assessee's objection to Revenue's claim raised first time before the HC of seeking to tax the transaction under Article 13(4) of the treaty. HC noted that both AO and CIT(A) explicitly held that Article 13(4) did not apply to the transaction and later neither CIT nor AO/CIT(A) took remedial steps. The HC also rejected Revenue's argument that

applicability of Article 13(4) to share sale is a pure question of law and observed that "Whether immovable property from which the company's shares principally derived their value was property in which the business of the company was carried on or not is a question of fact".

With respect to interest paid by the purchaser to compensate for the delay in remitting the sale consideration, HC upholds ITAT order that such interest was not taxable u/s. 9(1)(v) of the Act as "there is no evidence of a debt being incurred or monies being borrowed for any business purposes in present case" Sec. 9(1)(v) of the Act provides that income by way of interest payable by a person who is a non-resident would be deemed to be income accruing or arising in India, where such interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India.

Further, HC affirmed applicability of Article 11 of the DTAA (which provides taxability in Netherlands), and rejected Revenue's stand that Article 11 was not applicable as it excludes penal interest. Article 11(1) of the DTAA provides that interest arising in one of the States and paid to a resident of the other State would be taxed in that other State. Article 11(6) defines 'interest' to mean income from debt-claims of every kind, but penalty charges for late payment shall not be regarded as interest for the purpose of the said Article. Referring to the Share Purchase agreement, HC observes that the purchaser "voluntarily undertook to pay interest for such late payment of the sale consideration, the same does not partake the character of penalty charges"

Accordingly, the HC in the above discussed case held that the shares in a company owning immovable property cannot itself be considered as immovable property.

9.4. CIT v Hero Motocorp Ltd. [2017] (81 taxmann.com 162) (Delhi High Court)

Understanding of facts: The Assessee is engaged in the business of manufacture and sale of motorcycles using technology licensed by Honda Motor Co. Ltd., Japan ('HMCL'). The Assessee set up its plant in the year 1984 to manufacture models of motorcycles by using know-how of HMCL through a Technical Collaboration Contract dated 24th January, 1984 under which the Assessee was provided with technical assistance not only for manufacture, assembly and service of the products but was also provided with information, drawings and designs for the setting up of the plant.

The said agreement expired in 1994. On 2nd June, 1995 a License and Technical Assistance Agreement ('LTAA') was entered into between HMCL and the Assessee on fresh terms for a further period of ten years. By another LTAA dated 2nd June, 2004, the earlier LTAA was extended for an additional period of ten years. On 21st June, 2004 a separate Export Agreement ('EA') was entered into between HMCL and the Assessee whereby HMCL accorded consent to the Appellant to export specific models of two wheelers to certain countries on payment of export commission @ 5% of the FOB value of such exports.

The Transfer Pricing Officer ('TPO') held that the payment of export commission by the Assessee to its AE i.e., HMCL was unnecessary; that it was detrimental to the Assessee and

only with a view to benefitting the AE's units/subsidiaries in those countries to which the Assessee was permitted to export the vehicles. On this basis, the TPO proceeded to hold that the Arm's Length Price ('ALP') of the said transaction i.e., the payment of export commission was nil.

After the Dispute Resolution Panel ('DRP') concurred with the AO, the Assessee filed an appeal before the ITAT. By the impugned order, the ITAT reversed the above orders of the TPO, the DRP and the assessment order by holding that there was no basis for treating the payment of export commission as an international transaction.

The Revenue urged the Court to frame a question on the alternative plea viz., that the payment of export commission was in fact payment of royalty which required the Assessee to deduct tax at source and the failure to do so led to disallowance of the deduction under Section 40(a)(i) of the Act.

Ruling of the High Court: The Hon'ble High court, referring to the specific wording of the clauses of both the LTAA and the EA, observed that it was not possible to accept the contention that the export commission was in fact the monetisation of the negative covenant of the LTAA viz., abstaining from exporting to territories outside India.

The Hon'ble High Court further observed that there was no question of having to be a principal-agent relationship to justify the payment of the export commission. The amount spent on that score by the Assessee was for the benefit of its business and in fact resulted in a benefit. The Hon'ble High Court distinguished CIT v. Shiv Raj Gupta 52 taxmann.com 425 (Delhi) by holding that the two agreements i.e., the LTAA and EA were distinct and independent. The Revenue had not been able to show that the EA was a colourable device and that the export commission was a disguised royalty payment. It was not a payment for technical services either.

The Hon'ble High Court concluded that the payment of export commission by the Assessee to HMCL was not in the nature of payment of royalty or fee for technical services attracting disallowance under Section 40(a)(i) of the Act. The appeal was, accordingly, dismissed.

Key Takeaways: Payment of export commission by way of export agreement and using the technology licenced by AE abroad, could not be regarded as royalty or fee for technical services taxable in India since no managerial, technical or consultancy services were rendered.

9.5 Domestic software purchase payments not royalty -CIT vs Vinzas Solutions India Pvt Ltd-[2017] 77 taxmann.com 279 (Madras HC)

Understanding of facts: The Assessee was a dealer in computer software and was engaged in buying and selling software from various companies.

The AO made disallowance under section 40(a)(ia) on the ground that the consideration for purchase was of the nature of 'royalty' by the virtue of explanation 4 & 5 to section 9(1)(vi) and tax ought to have been deducted at source in accordance with the provisions of section 194J of the Income-tax Act, 1961 (Act).

Ruling of the High Court: The HC stated that the assessee was engaged in buying and selling of software in open market and 'royalty' cannot be made applicable to a situation of outright purchase and sale of a product. The HC noted that there is a difference between a transaction of sale of a 'copyrighted article' and one of 'copyright' itself and section 9(1)(vi) would stand attracted to sale of 'copyright' and not on 'copyrighted article'.

Thus, the HC ruled in the Assessee's favour.

9.6 New Skies Satellite BV (382 ITR 114)(Delhi HC) (2016)

Understanding of facts: The non-resident tax-payer, a Thailand Company for two assessment years and a Netherlands Company for other assessment years out of total four, was engaged in the business of providing digital broadcasting services through satellite "Thaicom 3" and consultancy services. Its customers were both Indian residents and non-residents, specifically TV channels. AO sought to tax income earned in India under section 9(1)(vi) of the Act as royalty and also contended that beneficial provision of Article 12 of India – Thailand on Royalties would not apply.

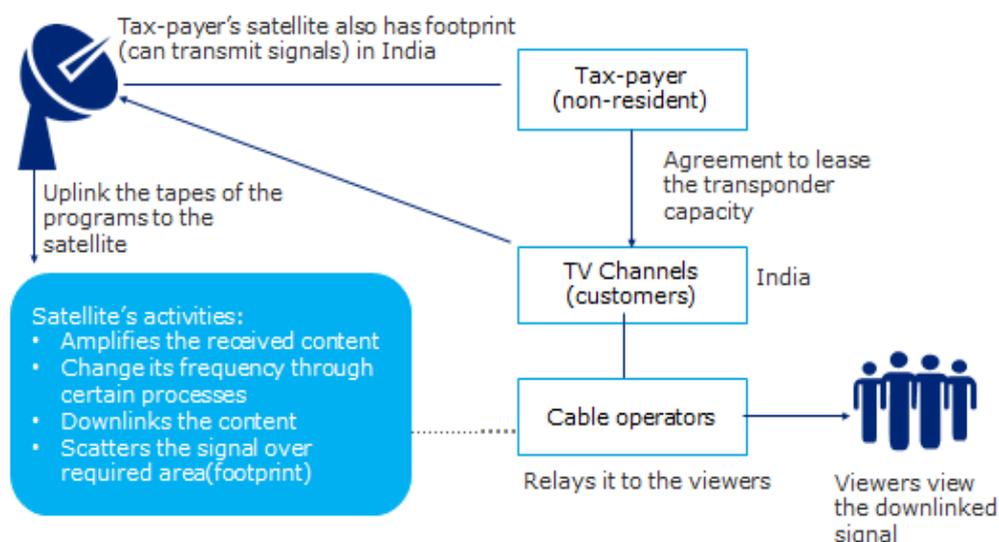
ITAT held in favor of tax-payer considering that customers did neither use satellite nor it is a process and they were given only access and hence such income could not be termed as royalty.

The issue before the Delhi High Court was whether the income earned in India by providing data transmission services would fall under section 9(1)(vi) of the Act? If yes, would tax-payer be eligible for India – Thailand DTAA / India – Netherlands DTAA benefits?

Landmark verdicts

New Skies Satellite BV - (Delhi High Court) (2016)

Pictorial representation of the arrangement



The Revenue contended that the programs were created for Indian audience and India was a territory of commercial exploitation by tax-payer since services were actually utilized in India and hence taxable under the Act. The operative words in the definition of royalty given under section 9(1)(vi) would be “use” and “process” and tax-payer performed critical processes required for satellite television broadcast and satellite internet service which amounts to “use” or “process” and not for hiring the transponder. Revenue further contended that Post Finance Act, 2012 amendment to the said section by way of insertion of clauses which are clarificatory in nature, the said income is royalty. Also DTAA benefits should not be available since it was in relation to pre-amended statute.

The taxpayer contended that the agreement was for lease of transponder capacity and not use of the same. Any change in domestic law could not automatically effect the position that would be as per the provisions of the DTAA, i.e., Treaty cannot be amended unilaterally.

Ruling of the High Court:

Delhi High court dealt with the clarificatory amendment in detail so as to come to a conclusion whether it is retrospective in nature or not. Owing to difficulty and since this was not argued by the tax-payer, High court assumed it to be retrospective in the present case and did not answer any question in this regard. However, it upheld that no amendment to the Act can be extended in operation to the terms of an international treaty and hence the provisions of DTAA are applicable in the current case. Even though the secrecy of the process is immaterial in domestic law, in the definition given under Article 12 of the India – Thailand DTAA / India – Netherlands DTAA the process should be a secret one.

This view was also affirmed by the commentaries of OCED as well as Klaus Vogel on double tax conventions. OCED commentaries particularly views that such an arrangement, as in case of tax-payer, is the lease of the transponder capacity and in no way be viewed as "for use of or right to use". Also it cannot be termed as equipment. Klaus Vogel commentary states that use of a satellite is a service and not rental. Relying on other judicial precedents in this matter, HC upheld that the beneficial provisions of DTAA are applicable in the case.

Key takeaways:

- Robust documentation and agreement showing clearly the benefits and risks to be maintained
- Is to be substantiated if the same would fall within the ambit of business profits / business income and not royalty per se
- Since provisions of treaty would override the domestic act provisions, tax payers may take the treaty benefits upon satisfying conditions for availing the same.

9.7 T. Rajkumar Vs. Union of India (Madras HC) 68 taxmann.com 182 (2016) (Cyprus Notification – constitutional validity)

Understanding of facts: A tripartite agreement was entered by and between an Indian Company, Cyprus Company and three petitioners herein by which Cyprus Company sold

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equity shares and compulsorily convertible debentures of an Indian Company to the petitioners.

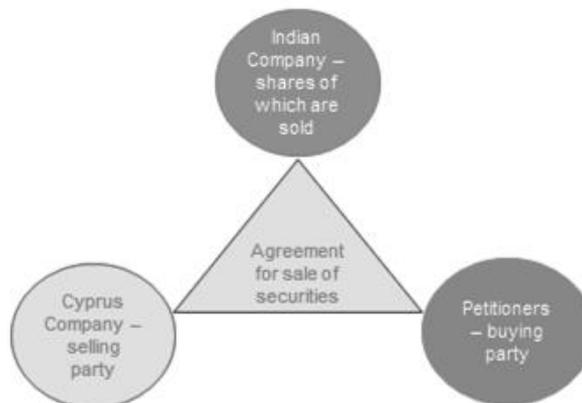
Petitioners did not deduct the tax at source while remitting the sale consideration to Cyprus Company. AO issued show cause notices inviting their attention to section 94A(1) and Notification No. 86 of 2013 dated 1-11-2013 warranting to treat tax-payer in default.

Tax-payer contended that there was no obligation to deduct tax under section 195. They pleaded that purchase was at less than fair value and the Cyprus Company had in fact suffered a loss. However, AO passed orders under section 201(1)/201(1A) along with notice of demand under section 156 to pay the demand.

Petitioners filed appeals before Commissioner (Appeals) and simultaneously filed writ petition before High Court challenging the validity of section 94A(1), related notification and press release.

Ruling of the High Court: The issues before the Madras HC were whether section 94A(1), Notification No. 86 of 2013 dated 1-11-2013 and related press release dated 1-11-2013 is constitutionally valid?

Pictorial representation of the arrangement



The petitioner contended that a Bilateral treaty is already entered into between India and Cyprus; strong reliance was placed on the case of Azadi Bachao Andolan, wherein it was held that a treaty cannot be unilaterally amended and that it takes precedence over the provisions under the Act. Treaty itself provides for exchange of information and mutual agreement procedure and hence recourse to section 94A is unwarranted. Section 90(1) contains non obstante clause which is missing in section 94A.

The High Court took note of the relevant articles of constitution, Vienna convention, G20 leader's statement and other relevant notification or press release or materials such as judicial precedents to reach its conclusions that section 94A has constitutional validity.

Further, the argument that section 90(1)(c) cannot be diluted by section 94A(1) overlooks fundamental fact that if the purpose of the Central Government entering into an agreement

under section 90(1) is defeated by the lack of effective exchange of information then section 90(1)(c) is actually diluted by one of the contracting states and not by section 94A(1).

It was held that the treaty specifies the obligations therein and not breach of the same. Section 94A uses the phrase "any country or territory" irrespective of whether there is treaty or not and as such non-obstante clause contained in section 90(1) also would not impact its position.

Key takeaways:

The same issue was also dealt in another of Expro Gulf Limited Vs. Union of India (Uttarakhand High Court) (2015) wherein a similar view was upheld. Hence the courts are taking a view in favour of tax authorities considering the underlying circumstances which led to this development.

9.8 Steria (India) Ltd. (2016) (386 ITR 390)(Del HC) (Most Favoured Nation clause under the India-France DTAA):

Understanding of facts: The assessee is an Indian public Co providing IT-driven services for its clients' core businesses. Steria France, a French group entity of the assessee, centralizes skills for carrying on management functions. The assessee entered into a Management Service Agreement (MSA) with Steria France for receipt of various management services with a view to rationalize and standardize its Indian business. The services availed broadly related to corporate communication, group marketing, development, information systems, legal, human relation, etc. Steria France rendered these services through telephone, fax, emails, & none of its personnel visited India for the purpose. It also did not have an office or PE in India. The assessee approached the AAR for the withholding tax implications of the sum payable under the MSA. The AAR held that the sum was chargeable to tax in India. Aggrieved by the AAR's order, the assessee filed a Writ Petition before the Delhi HC.

The assessee contended that by virtue of the Protocol signed between India and France, the restricted scope of FTS in the India-UK DTAA is applicable to FTS under the India-France DTAA. A similar proposition was accepted in [2002] ITCLtd (82ITD239)(Kol. ITAT). As the services provided by Steria France do not 'make available' technical knowledge, skill, etc. to Steria India, the same would not constitute FTS under the India-France DTAA.

The AAR's ruled that a Protocol, though an integral part of the DTAA, cannot be treated as the same as the provisions contained in the DTAA itself. The restrictions imposed by the Protocol are only on the rates, and in the absence of a specific notification to incorporate the restrictive provisions of the India-UK DTAA, the 'make available' clause cannot be read into FTS under the India-France DTAA.

Ruling of the High Court:

In respect of Protocol to the India -France DTAA, the HC held that the words, "a rate lower or a scope more restricted" envisaged that there could be a benefit of either kind i.e. a lower rate or a more restricted scope. One did not exclude the other. The benefit could accrue in terms of lower rate or a more restrictive scope under more than one DTAA which may be signed after 1 September 1989 between India and another OECD member State.

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The purpose was to afford to a party to the India-France DTAA, the most beneficial of the provisions that might be available in any DTAA between India and another OECD country. The wording of the Protocol made itself operational and an integral part of the notified DTAA.

Separate notification of the Protocol was not required. The benefit of the lower rate or restricted scope of FTS under the India-France DTAA was not dependent on any further action by the respective governments.

In respect of taxability of sum payable to Steria France it was held that FTS under the India-UK DTAA, excludes 'managerial services'. It was hence not even necessary to examine the 'make available' requirement in the second limb of the definition. Since it was projected that the fee paid to Steria France par took the character of FTS, the question whether the French entity had a PE in India under Article 7 of the India-France DTAA did not arise.

The payment made for managerial services provided by Steria France could not be taxed as FTS and TDS under section 195 did not apply.

Key takeaway

Unless specifically provided, Protocol need not be separately notified. Restrictive scope of FTS in subsequent DTAA can be read into India-France DTAA.

9.9 CUB Pty Ltd. (388 ITR 617) (Del HC) (2016) – Situs of intangibles

Understanding of facts: The assessee, an Australian Co. engaged in the business of brewing beer, owned trademarks & IPRs related to its business. It entered into Brand License Agreements (BLA) for licensing the IPR to its subsidiaries globally including its Indian step-down subsidiary (FIL). Four of these trade marks were also registered in India. The BLA allowed FIL, an exclusive right to use the trade marks in the Indian territory, for a royalty which was subject to WHT in India. The assessee entered into an India Sale & Purchase Agreement (ISPA) with SAB Miller group for selling shares of its Mauritian down-stream subsidiary along with the trademarks & Brand IP (including those licensed to FIL) and for grant of a perpetual license relating to its Brewing IP confined to India.

Vide a Deed of Assignment, SAB Miller group nominated its Indian subsidiary as the transferee in terms of the ISPA, following which the exclusive, perpetual and irrevocable licence relating to the Brewing IP, was assigned to the nominee. The assessee simultaneously terminated BLA with FIL.

The assessee approached the AAR for ascertaining whether the consideration arising on transfer of its right, title and interest in and to the trademarks and Brand IP and for grant of an exclusive perpetual licence of the Brewing IP, was taxable in India.



The AAR while holding the income from licensing of the Brewing IP as not taxable in India held that the transfer of right, title, interest in the trade marks & Br and IP was taxable as:

- there was no legal principle that the situs of intangible assets would always go with ownership, and that they would have no situs other than the owner's country of fiscal residence.
- The trademarks registered in India & the other brand features, had generated appreciable goodwill in the Indian market & the same had been nurtured by the coordinated efforts of the assessee & FIL.

The IPR hence had tangible presence in India & was a capital asset situated in India.

Ruling of the Court: Before the High Court the assessee contended that a trademark did not derive its existence from any statute, and was protected even in its absence. By the common law maxim of 'mobilia sequuntur personam', the situs of an intangible asset had to be determined based on the situs of the asset owner. Registration of a trademark did not entail its creation or impact its location. Merely that the trademarks were registered in India did not mean that the situs shifted from Australia to India. Since Indian laws did not specifically provide for the situs of trademarks, the common law of 'mobilia sequuntur personam' would apply.

The Revenue relied upon the AAR's order. The brand had no value on initial introduction in India. The substantial proceeds received on the sale thereof clearly represented the value that the brand had gained from its India operations. It was hence transfer of a capital asset situated in India.

The Court held that the issue of situs of an intangible asset was a tricky issue as opposed to that of tangible assets which had a physical presence in India. The legislature could have, through a deeming fiction, provided for the location of an intangible capital asset such as IPR, but, it has not done so, insofar as India is concerned. Explanation 5 to section 9(1)(i) provides for the situs of a share or an interest in a foreign Co in specific scenario. There is no such provision for intangible assets like IPR. The well accepted principle of 'mobilia sequuntur personam' would hence have to be followed i.e. the situs of the owner of an intangible asset would be the closest approximation of the situs of that asset. The income accruing to the assessee from the transfer of its right, title or interest in the trademarks and Brand IP was hence not taxable in India under the ITA.

9.10 Bharti Airtel Ltd. (76 taxmann.com 256)(Del HC) (2016)- Reasonable time limit applies to TDS proceedings for payments to NR

Understanding of facts:

The deductor was a non-resident telecommunication provider, engaged in providing interconnection services to its users. It engaged with non-resident entities for interconnections, for which it made payments to such non-residents. The tax Officer issued notices for various periods, seeking to treat the deductor as an assessee in default u/s201, for non-deduction of TDS on the interconnection charges paid to the NR operators. Aggrieved, the deductor filed a writ petition before the HC.

Ruling of the High Court:

The issues before the HC were; would section 201 also apply to payments made to non-residents? Were the impugned show cause notices barred by limitation?

The deductor contended that Section 201 did not expressly mention "non-residents", and prescribed a time limitation for deeming one to be a tax payer in default for residents. Accordingly, in the absence of express provision of time limitation, the reasoning in earlier HC decisions (NHK Japan Broadcasting Ltd, Hutchison Essar Telecom Ltd, Vodafone Essar Mobile Services Ltd, etc. would set the limitation period at four years i.e. within a reasonable time.

The amendment made in 2010 only reiterated that the power to issue show cause notice was to be exercised within a defined time limit, and therefore, the reasoning in the aforesaid decisions has not been disturbed. Any other interpretation would invalidate the provision itself as it led to an artificial distinction that treated domestic deductees more favourably than foreign deductees. For the purposes of treatment u/s201, such artificial distinction was invidious and an impermissible classification, and was thus a violation of Article 14 of the Constitution of India. If there was a time limit for completing the assessment, then the time limit for initiating the proceedings must be the same, if not less.

The Revenue contended that the Parliament made a conscious distinction between resident and NR beneficiaries, based on good reasons. There was a sound rationale for such

distinction because in remittances to NRs, the true nature of the transactions, and whether deductions were to be made, could not be easily gathered i.e. due to administrative inconvenience'. When the earlier HC rulings were decided, the amendment had not been brought about, and therefore, the issue of existence of a period of limitation, did not arise. The court therefore considered, on the basis of available authority, that a four-year period was a reasonable period as the outer limit for issuance of notice u/s 201. However, the Parliament had consciously amended section 201 to prescribe a limitation only for residents. Instead of actively barring the applicability of the provision to NRs, it appears that the Parliament chose to passively do so by remaining silent on NRs and only amending the provision for residents.

The High Court held that the Amendment to section 201 by the Finance (No. 2) Act, 2009 ipso facto is silent about the limitation applicable to payments to NRs. Hence, the legislative history in the form of statements of objects & reasons becomes relevant. At all material times, payments to residents & NRs were treated alike. The revenue does not state what necessitated the distinction made through the amendment for the first time. The reasoning is not given in the statement of objects & reasons

The only clue to be found to this silence is in that part of the Circular No. 5/2010 dtd.3 June 2010, which states that limitation for NR's payment is unfeasible "as it may not be administratively possible to recover the tax from the NR." However, the basis of 'administrative convenience' in respect of TDS provisions had already been rejected by the Apex Court in GE India Technology Centre (P.) Ltd (327 ITR 456)

In Vodafone Essar Mobile Services Ltd [2016](385 ITR 436)(Del HC) the Court considered the entire issue & was conscious of the absence of any limitation for payments to NRs. Yet, it was held that proceedings could be initiated within reasonable time. This decision is hence a precedent

The Court held that in the absence of a specific limitation, 'reasonable time' would also apply to TDS proceedings in the case of NR payees. Administrative convenience cannot outweigh the harsh and onerous consequence of maintaining books & documents for an uncertain time period.

9.11 DIT v. B4U International Holdings Ltd (2016) 71 taxmann.com 182 (SC)-Whether advertisement revenue earned by B4U International taxable in India

Understanding of facts: B4U International Holdings Ltd ('B4UInternational'), a Mauritius company having the Tax Residency Certificate is engaged in the business of telecasting of TV channels. B4U International carried out all its activities and concluded all contracts in Mauritius. B4U International's revenue from India was collections from time slots given to advertisers in India;

The Indian companies namely B4U Multimedia International Ltd and B4U Broadband Ltd (collectively referred as 'B4U India/Agents'), were granted general permission by RBI to act as advertisement collecting agents of the taxpayer; B4U India was remunerated by B4U International at arm's length for rendering collecting agent services.

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Ruling of the High Court: The issues before the High Court were:

- Whether the taxpayer has a dependant agent PE in India under Article 5(4) / Article 5(5) of the India-Mauritius tax treaty?
- Whether the agent being remunerated at arm's length no further profits is attributable despite agent being dependent?
- Whether, advertisement-revenue earned by B4U International, a Mauritian based company was taxable in India?

The assessee contended that the only activity which is carried out in India is incidental or auxiliary / preparatory in nature which is carried out in a routine manner as per the direction of the principal without application of mind and hence B4U India is not a dependent agent. Assessee claimed that it had no PE in India under Article 5 and hence, its income was not taxable as per Article 7 of the Indo-Mauritius DTAA; Further, Assessee also claimed that since the agents were remunerated at an arm's length service fee of 15%, it had no further tax liability in India.

The Revenue contended that the Assessing Officer (AO) held that the taxpayer has a PE in India in the form of B4UIndia; and The payment of arm's length remuneration does not extinguish the tax liability of the taxpayer in India;

The High Court held that on a plain reading of the agreement it indicates that agents are not the decision makers and it did not have authority to conclude contracts. The agents have no authority to fix the rate or to accept an advertisement. It can merely forward the advertisement and the taxpayer has the right to reject. In the present case, there is neither legal existence of such authority, nor is there any evidence to prove that the agent has habitually exercised such authority. Under Article 5(5) of the tax treaty, the wordings when the activities of such an agent are devoted exclusively or almost exclusively on behalf of the enterprises, refer to the activities of an agent and its devotion to the non-resident and not the other way round.

During the year under consideration the income of B4U India from the taxpayer constituted merely 4.69 percent of its total income, B4U India cannot be treated as dependent agent of the taxpayer. Accordingly, neither Article 5(4) nor Article 5(5) of the tax treaty was attracted in this case. Therefore, the taxpayer has no PE in India. Even if the assessee did have a PE, it was remunerated at arm's length and thus no further profits could be taxed in the hands of the assessee. Therefore, advertisement revenue earned by assessee, was not taxable in India as assessee had no dependent agency PE or PE in India.

Revenue's SLP against the aforesaid order by Bombay HC is admitted by the SC vide order dated July 1, 2016

9.12 M Tech India Pvt Ltd. [2016] 67 taxmann.com 245 (Delhi) [TS-19-Delhi HC-2016]

Understanding of facts:

M. tech India Pvt. Ltd is a Value Added Reseller (VAR) of the software related to healthcare and hospitality in India. The assessee entered into an VAR agreement with Track Health Pty. Limited, Australia ("THPL") for software purchase. The agreement entered with THPL expressly indicated that it had appointed assessee to market and sell the products in territory of India. The assessee made software purchase payments to THPL without deducting TDS.

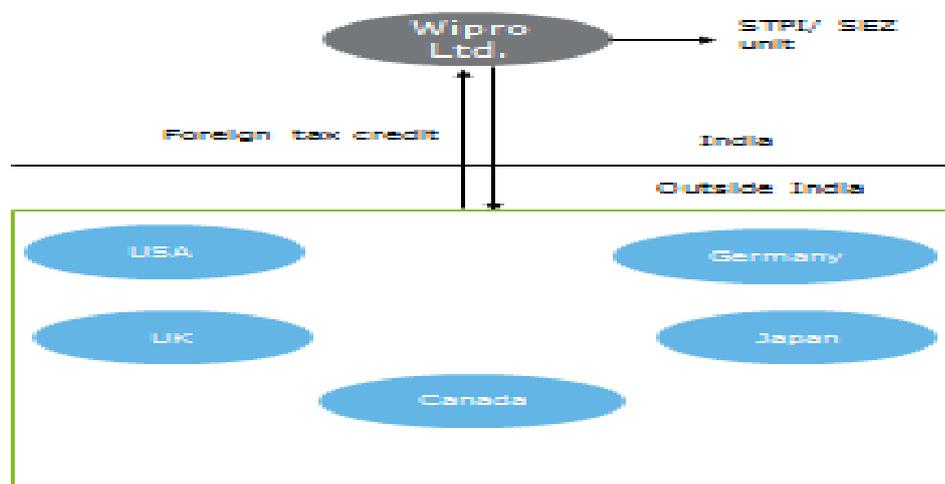
Ruling of the High Court: The issue before the High Court was whether consideration paid for purchase of goods can be considered as 'royalty'; Whether it is necessary to make a distinction between the cases where consideration is paid to acquire the right to use a patent or a copyright and cases where payment is made to acquire patented or a copyrighted product /material.

The assessee submitted that the said software was purchased from THPL under the 'VAR Agreement' and the same was resold to various end-users in India. Similar purchases made in the preceding years, had been considered as purchases and allowed as a deduction in computing its taxable income; being a reseller of products, the payments made by the Assessee for acquiring the products could not be considered as royalty.

The Revenue contended that payments made by the Assessee were in the nature of royalty and therefore, the Assessee was obliged to withhold tax on such payments. Since, the Assessee had failed to do so, the expenditure incurred by the Assessee was liable to be disallowed under Section 40(a) of the Act.

9.13 Wipro Limited – Karnataka High Court [2015] 62 taxmann.com 26 (Karnataka) - Foreign tax credit

Understanding of facts: The tax-payer operates from a STPI/SEZ unit in India and qualifies for tax holiday under section 10A of the Act. Tax-payer provides on-site software development services in countries such as United States, United Kingdom, Canada, Japan, and Germany through its permanent establishments and pays the applicable taxes in those countries. In respect of these foreign taxes, the tax-payer has claimed a tax credit in India. The tax officer refused the claim for foreign tax credits for taxes paid in the foreign countries.



The question before the Karnataka High Court, was whether credit for taxes paid in a country outside India in relation to income eligible for deduction under Section 10A of the Act would be available under section 90 of the Act read with the relevant DTAA?

Ruling of the High Court: Before the High Court the taxpayer contended that Section 90 provides that if the income is subjected to tax, both in India and in a foreign country, the foreign income taxes paid attributable to such income is allowed as credit in India. Relief for double taxation is to promote mutual economic relations, trade and investment. Section 10A income is chargeable to tax in view of Section 4 of the Act. However, subject to the tax-payer satisfying the conditions prescribed, income under section 10A of the Act is exempted. It was also stated that once the tax-payer is made to pay tax on such exempted income in the other contracting State then section 90(1)(a)(ii) of the Act enables him to claim credit of the tax paid in the contracting country. Further, as per section 90(2) of the Act, the tax-payer was always entitled to the said benefit as the provision of the agreement was more beneficial than the statutory provisions.

The Revenue contended that the income exempt under section 10A of the Act does not form part of the total income chargeable to tax as per the provisions of section 4 of the Act. The provisions of section 90(1) of the Act are applicable in respect of income which is doubly taxed. Based on the above, as the income exempt under section 10A of the Act was not taxed in India, tax-payer's claim for foreign tax credit was not admissible.

The High Court examined the availability of relief for foreign tax credit under the following provisions:

- Section 90(1)(a)(i) of the Act – if income is subject to tax, both in India and foreign country, the foreign income taxes paid is allowed as credit in India.
- Section 90(1)(a)(ii) of the Act – income-tax chargeable under this Act and under the corresponding law in force in the foreign country to promote mutual economic relations, trade and investment.

- Relief under section 10A is in the nature of exemption although termed as deduction. If such exemption is given under the Act, but the same is taxed in a foreign jurisdiction, then there is no relief to the tax-payer. Thus, in order to promote mutual economic relations, trade and investment, section 90(1)(a)(ii) of the Act was inserted by the Finance Act, 2003.
- Section 10A income is chargeable to tax under section 4 of the Act and is includible in the total income under section 5 of the Act. The exemption provision under section 10A of the Act has the effect of suspending collection of income tax for a period of 10 years. Therefore, the case of the tax-payer falls under section 90(1)(a)(ii) of the Act.

Based on the above, the High Court analyzed the position of availability of credit in respect of tax paid in United States and Canada as given:

Federal Tax paid in United States– Based on Article 25 of India-U.S. DTAA, India shall allow deduction from tax of an amount equal to income-tax paid in U.S. The said article does not mandate of any income-tax being paid in India as a condition precedent for claiming credit of taxes paid in U.S. Thus, this clause is in conformity with section 90(1)(a)(ii) of the Act. Accordingly, under India-U.S. DTAA, credit can be claimed of taxes paid in U.S. even if such income is exempt in India.

The High Court also clarified that prior to insertion of section 90(1)(a)(ii) of the Act, the tax-payer can claim foreign tax relief based on section 90(2) of the Act by applying the provisions of India-U.S.

Federal Tax paid in Canada– As per Article 23 of the India-Canada DTAA, foreign tax credit would be available in India only in respect of income which has been subject to tax both in India and Canada. Relief is available if tax-payer has paid tax both in India as well as in Canada on the same income. This clause is in conformity with section 90(1)(a)(i) of the Act.

Thus, if the income is exempt under section 10A, no credit for taxes paid in Canada on such income shall be granted in India. However, the High Court did not discuss the applicability of section 90(1)(a)(ii) of the Act which is more beneficial as compared to the provisions of India-Canada DTAA.

State Taxes paid in United States and Canada – The High Court held that even though no agreement is entered into with the State of a Country, if the tax-payer has paid income-tax to that State, the same is also eligible for foreign tax credit in India based on the Explanation to section 91 of the Act.

Key takeaways:

Wordings of the tax treaty play an important role and hence foreign tax credit availability is subject to the mechanism provided and manner prescribed in the respective tax treaty. With respect to unilateral relief, if income taxes were paid to the state where there exists no tax treaty specifically, then unilateral relief is available on such income taxes paid as per the provisions of the Act.

9.14 GVK Industries Limited Vs ITO (Supreme Court) (2015) 54 taxmann.com 347 - Taxability of Fees for Technical Services

Understanding of facts: The Company, incorporated in India, was in process of setting up a 235 MW Gas based power project at Andhra Pradesh at an estimated cost of INR 839 crores. With the intention to utilize the expert services of qualified and experienced professionals who could prepare a scheme for raising the required finance and tie up the required loan, it sought services of a consultant which was resident of Switzerland. Those services included, inter alia, preparation of financial structure and security package to be offered to the lender, making an assessment of export credit agencies world-wide and obtaining commercial bank support on the most competitive terms, assisting the appellant loan negotiations and documentation with lenders and structuring, negotiating and closing the financing for the project in a coordinated and expeditious manner. For its services the Consultant was to be paid, what is termed as, “success fee” at the rate of 0.75% of the total debt financing. The Consultant rendered professional services from Zurich by correspondence as to how to execute the documents for sanction of loan by the financial institutions within and outside the country.

After successful rendering of services, the Consultant sent invoice to the Company. The company approached the concerned income tax officer, for issuing a ‘No Objection Certificate’ to remit the said sum to the Consultant without any tax deduction since Consultant had no place of business in India and that all the services rendered by it were from outside India. The income tax officer refused to issue the ‘No Objection Certificate’, against which Company preferred appeal before the higher authorities including writ petition before the High Court. The High Court after due consideration of facts opined that the business connection between the petitioner company and the Consultant had not been established, however the High Court further observed that “success fee” would come within the scope of technical service within the ambit of Section 9(1)(vii)(b) of the Act. Being of this view, the High Court opined the Company was not entitled to the “No Objection Certificate”. The appeal was filed before the Supreme Court against this decision, by the Company.

Ruling of the Supreme Court: Considering the Explanation to the Section 9(2) substituted by the Finance Act 2010 with retrospective effect from June 1, 1976 along with another Explanation inserted by the Finance Act, 2007 with retrospective effect from June 1, 1976, Court stated that the relevant provisions lay down the principle what is basically known as the “source rule”, that is, income of the recipient to be charged or chargeable in the country where the source of payment is located, to clarify, where the payer is located. The clause further mandates and requires that the services should be utilized in India.

The expression, managerial, technical or consultancy service, have not been defined in the Act, and, therefore, it is obligatory for the Court to examine how the said expressions are used and understood by the persons engaged in business. The general and common usage of the said words has to be understood at common parlance. While interpreting the word ‘consultancy’ the Court had referred meaning of ‘consultation’ in Black’s Law Dictionary wherein it has been defined as an act of asking the advice or opinion of someone (such as a lawyer). It means a meeting in which a party consults or confers and eventually it results in

human interaction that leads to rendering of advice. Accordingly Court has held that in the present case, non-resident entity had acted as a consultant, as it had the skill, acumen and knowledge in the specialized field i.e. preparation of a scheme for required finances and to tie-up required loans. Therefore, Court while ruling in favor of the Tax Department has held that the nature of service provided by the non-resident can be said with certainty would come within the ambit and sweep of the term 'consultancy service' and, therefore, it has been rightly held that the tax at source should have been deducted as the amount paid as fee could be taxable under the head 'fee for technical service'.

Key takeaways: This ruling of Supreme Court lays down the principle which needs to be adopted under the provisions of amended Section 9(1)(vii) of the Act ending the uncertainty surrounding this provision, and upholding that for taxation of fees for technical services rendering of services within India is not a pre-requisite. This ruling also summarizes the discussion on constitutional validity of Section 9(1)(vii) and applicability as well as evolvement of 'source rule' or 'situs of source of income'.

It is to be noted that Supreme Court has delivered this ruling based on the provision of the Income Tax Act as the provisions of relevant Tax Treaty was not invoked by the Company, hence principle laid down in this ruling will have limited implications where the provisions of the relevant Tax Treaty differs from the provisions of section 9(1)(vii).

9.15 Centrica India Offshore Private Limited Vs. CIT (Delhi HC)(2014) - Taxability of Secondment Arrangements in India

Please refer 3.3.2 of Module E- International Tax Structures for details.

9.16 CIT Vs. Van Oord ACZ Equipment BV (Madras HC)(2014) 51 taxmann.com 356 – Equipment leasing

Understanding of facts: The Company was resident of Netherlands. The Company during the year 2002-2003 let out dredging equipment to their Indian group company, Van Oord ACZ India Private Limited. The Company filed its return of income along with a brief note elucidating the provisions of the India-Netherlands Tax Treaty and stating that the income earned by letting out of industrial equipment would not be taxable in India. However, the Tax Officer held that since the definition of royalty, as enumerated in Section 9 of the Act, means consideration for use or right to use any industrial, commercial or scientific equipment, the consideration received by the Company falls within the definition of royalty in Section 9 of the Act and accordingly, the same is liable to tax in India. The Company preferred appeal before the Commissioner of Income Tax (Appeals) wherein the appeal was allowed in favor of the Company by relying on the provisions of the relevant Tax Treaty. The order of Commissioner of Income Tax (Appeals) was confirmed by ITAT. The appeal was filed before the Madras High Court against this decision, by the Tax Department.

Ruling of the High Court: The perusal of the amendments done in the India-Netherlands Tax Treaty would show that for all practical purposes, the 'payments for the use of equipment'

originally found in clause (1) of Article 12 as defined in clause (6) was incorporated in the definition of the term Royalties in clause 4 w.e.f. April 1, 1991 and subsequently deleted w.e.f. April 1, 1998 and thereby completely taken out from clause (1) and (2) of Article 12. This means that the payment for the use of equipment or any consideration for the use of, for the right to use industrial, commercial or scientific equipment is deleted and it is not taxable in the contracting State in which they arise viz., in the given case India.

Section 90 of the Act enables and empowers the Central Government to issue Notification for implementation of the terms of Tax Treaty. If a tax liability is imposed by the Act, the Tax Treaty may be resorted to for negating or reducing it; and, in case of difference between the provisions of the Act and the Tax Treaty, the provisions of the Tax Treaty would prevail over the provisions of the Act and can be enforced by the appellate authorities and the court. Even accepting that the powers exercised by the Central Government under section 90 are delegated powers of legislation, there is no reason why a delegatee of legislative power, in all cases, has no power to grant exemption. When the requisite notification has been issued under section 90, the provisions of sub-section (2) of section 90 spring into operation and Non-resident taxpayer who is covered by the provisions of the Tax Treaty is entitled to seek the benefits thereunder, even if the provisions of the Tax Treaty are inconsistent with those of the Act.

In the case on hand the dredging equipment was leased out on bareboat basis viz., without Master and Crew. Therefore, it will not come under the permanent establishment and the entire control over the equipment was not with the Foreign Company, but with the Indian Company. Accordingly, the amount received by the Company for hiring out Dredgers to an Indian Company for use in Indian Ports is not taxable in India.

Key takeaways: This ruling of Madras High Court prescribes the framework and interplay between the provisions of the Act and the Tax Treaty. This also signifies that provisions of Tax Treaty differ from country to country and accordingly each Tax Treaty needs to be analysed and dealt separately.

Further, in case of equipment leasing, this decision lays down an important principle that if the equipment is leased on bareboat basis i.e. without the master & crew and control over the equipment lies with the customer, then it will not constitute permanent establishment of the non-resident equipment provider in India.

9.17 Zaheer Mauritius Vs. DIT (Delhi HC)(2014) - Taxability of Compulsorily Convertible Debentures

Understanding of facts: The Company was resident of Mauritius and engaged in the business of investment into Indian companies engaged in construction and development business in India. In 2007, the Company invested into Zero Percent Compulsorily Convertible Debentures (CCDs) issued by an Investee Company incorporated in India under an agreement which provided call option to Investee Company to acquire the aforementioned securities during the call period and likewise, a put option given by Investee Company to the Company

to sell the aforementioned securities during the determined period. In 2010, Investee Company exercised the call option and purchased the CCDs from the Company. The company filed an application under Section 197 of the Act before the Tax Officer requesting for a 'nil' withholding tax certificate to receive the total consideration from Investee Company for transfer of CCDs without deduction of tax. The Tax Officer held that the entire gain on the transfer of CCDs would be treated as interest and tax at the rate of 20% (*plus surcharge and cess*) should be withheld on the same. Thereafter the Company filed an application before the Authority for Advance Ruling on the question of taxability of income from sale of CCDs. Authority of Advance Ruling ruled in favor of the Tax Authority and held that that the entire gains on the sale of CCDs held by the Company are not exempt from income tax in India by virtue of the provisions of India-Mauritius tax treaty and that the gains arising on the sale of CCDs are interest within the meaning of Section 2(28A) of the Income Tax Act and Article 11 of the relevant tax treaty. The appeal was filed before the Delhi High Court against this decision, by the Company.

Ruling of the High Court: Court stated that under normal circumstances, it is undeniable that gains arising from transfer of a debenture, which is a capital asset in the hands of the transferor, in favor of a third party, would be capital gains and not interest. In other words, if a debenture (which is a capital asset) is transferred by a holder to a third party, the gains that arise i.e. difference between the costs of purchase and the sale consideration would be capital gains in the hands of a transferor. The dispute in the present case arises only because it has been held that the transaction between the Company and the Investee Company is a sham transaction and is essentially a transaction of loan to Investee Company which has been camouflaged as an investment in CCDs. The Court observed that a plain reading of the Shareholders Agreement indicates that it is essentially a joint venture agreement and it is common in any joint venture agreement for the co-venturers to include covenants for buying each-others' stakes. Although, the Shareholders agreement enables the petitioner to exit the investment by receiving a reasonable return on it, and in that sense it is assured of a minimum return, the same cannot be read to mean that the CCDs were fixed return instruments, since the Company also had the option to continue with its investment as an equity shareholder of the JV Company. Further, Shareholder agreements also clearly indicate that the affairs of the JV Company were to be managed separately and distinctly from that of Investee Company. The reading of the agreement as a whole clearly indicates that the Company was entitled to participate in the management and affairs of the JV Company, not only by appointing its nominee directors but also by ensuing independent auditors and an independent Asset Manager.

High Court also referred to Foreign Direct Investment policy for real estate sector and observed that as per relevant Circular issued by Reserve Bank of India, an instrument which is fully and mandatorily convertible into equity shares within a specified time would be reckoned as part of equity under the Foreign Direct Investment Policy. Thus, in terms of the policy of the Government, the petitioner could invest in a project of the requisite size/nature and an investment into CCDs would be reckoned as equity. The policy with regard to external commercial borrowings had other conditions and it is apparent that the petitioner found the

investment in CCDs as the most appropriate route for making its investment in real estate, in accordance with the policy of the Government of India. In these circumstances, it ought not to be readily inferred that the entire structure of the transaction was designed solely for the purposes of avoiding tax. Accordingly, Court opined that there is, thus no reason to ignore the legal nature of the instrument of a CCDs and accordingly the treatment given by the Company was upheld by the Court.

Key takeaways: This ruling of Delhi High Court also touches upon the principles of General Anti Avoidance Rules wherein the Court has perused the relevant business agreements and applicable commercial laws to arrive at a conclusion of not lifting the corporate veil and treating the transaction on as-is basis i.e. 'look at test' principle laid down by Supreme Court in the case of *Vodafone International Holdings BV (2012)*. This ruling also clarifies some key fundamentals with regard to the taxability of financial instruments which has always been a subject of dispute between the tax authorities and taxpayers. The SLP has been granted or accepted by the Supreme Court in this case in [2016] 76 taxmann.com 85 (SC)

9.18 DIT Vs R & B Falcon Offshore Limited (Uttarakhand HC)(2015) (235 Taxman 457)- Equipment PE

Understanding of facts: The Company was resident of United States of America who brought in a rig in India and operated that rig for and on account of its client in India. That rig was in India on November 21, 2002 and it was ready for use, however prior to actual commencement of work the rig underwent some repairs. The Tax Officer held that the provisions of 'Article 5(2)(j) - *Permanent Establishment*' of Tax Treaty between India and United States of America uses the word "used" without furnishing meaning to the said word and, accordingly, meaning thereof should be culled out from the Income Tax Act. Under the Income Tax Act, the word "used" includes in its ambit the words 'ready for use' and accordingly Tax officer held that even during the time of repair and maintenance, the rig was lying ready for use and, as such, the rig having been used for more than 120 days during the relevant assessment years, the Company, in the form of the said rig, had a permanent establishment in India. The Company preferred appeal before the Commissioner of Income Tax (Appeals) wherein the appeal was allowed in favor of the Tax department. The order of Commissioner of Income Tax (Appeals) was challenged by the Company before the ITAT which ruled in favor of the Company. The appeal was filed before the Uttarakhand High Court against this decision, by the Tax Department.

Ruling of the High Court: The High Court while upholding the ITAT's decision and ruling in favor of the Company, held that word 'used' has been sufficiently explained in the Tax Treaty requiring no further explanation and, for that matter, there is no scope of entering into the Income Tax Act. Inasmuch as, the word 'used' has been used in conjunction of 'an installation or structure for exploration or exploitation of natural resources and only if so used for a period of more than 120 days in 12 month period' and, thereby, made it absolutely clear that the Tax Treaty meant use of installation and structure for exploration or exploitation of natural resources and not merely being ready for use.

Tax Department, before ITAT also argued on the point that the repairs of the rig were carried on in the territories of India in pursuance of the agreement with Customer. The Company even received consideration for such repairs from the Customer and hence it has been argued that the rig has been used for more than 120 days in India. ITAT after considering the arguments and relevant provisions of Tax Treaty, has held that primary condition is that it must have been so used for a period of 120 days in any twelve-month period. The words "so used" clearly show that the installation or the structure should have been used for exploration or exploitation of natural resources for it to constitute a PE. In other words, the rig should have been used for exploration or exploitation of natural resources, i.e., the mineral oil for more than 120 days, however the rig was not used for exploration or exploitation of the mineral oil when it was under repairs or being moved to the appointed place for exploitation of mineral oil. That activity was a preparatory activity so as to make the rig to be fit for exploitation of natural resources as per the requirement of Customer and it was used for exploitation of mineral oil when it was positioned at the appointed place for exploitation of mineral oil. Accordingly, it has been held that the Company did not have the PE in terms of article 5(2)(j) of the tax Treaty.

Key takeaways: This ruling of Uttarakhand High Court assumes significant importance due to its pragmatic interpretation of the provisions of Tax Treaty wherein the business nuances have also been considered appropriately. This decision is of vital importance to the businesses in connection with exploration of natural resources, as it laid down the clear parameters for determination of PE wherein only the actual working days need to be considered while applying the prescribed threshold. It also underlines the importance of proper recording of facts with the evidence which is important in such cases.

It is to be noted that Tax department had filed Special Leave Petition before the Supreme Court against this decision, however during the hearing Tax department sought withdrawal of this Special Leave Petition to file review petition before the High Court. Accordingly, the Supreme Court dismissed the Special Leave Petition as withdrawn.

9.19 LindeAG, Linde Engineering Division Vs. DCIT [2014] 44 taxmann.com 244/224 Taxman 43 (Mag.)/365 ITR 1 (Delhi) (Delhi HC)(2014) - Taxability of Turnkey Contracts

Understanding of facts: In April 2007, Indian customer floated a Tender Notice inviting bids for executing the work (including undertaking all activities and rendering all services) for the design, engineering, procurement, construction, installation, commissioning and handing over of the plant for the Dual Feed Cracker and Associated Units of Petrochemical Complex in accordance with the Bid Documents. The project was to be executed on turnkey basis. Two non-residents, one resident of Germany and other resident of Korea, entered into a Memorandum of Understanding ('MOU') whereby both the parties agreed to form a Consortium, for jointly submitting a bid to secure the contract for execution of the aforesaid project. The MOU was followed by an 'Internal Consortium Agreement' dated March 2008 executed between them. The price bid was submitted by the Consortium in July 2008 and

Indian customer awarded the work to the consortium on December 2008. The bid award was followed by the definitive agreement in February 2009 between the Indian customer and Consortium.

The non-resident of Germany, filed an application before the Tax Officer under section 197 of the Act claiming that no portion of the amount payable to it for supply of equipment, material & spares and for providing basic & detailed engineering services was liable to be subjected to withholding of tax under section 195 of the Act as it was contended that the said transactions were performed as well as completed outside India and payments for the said transaction were also received outside India, therefore not chargeable to tax in India. The Tax officer did not accept the plea of the Company and directed the Indian customer to withhold the tax. Thereafter the Company filed an application before Authority for Advance Ruling with respect to its tax liability in India. The Authority for Advance Ruling while disposing the application has held that the Consortium of two non-residents constitutes an Association of Persons ('AOP'). It further held that Contract was indivisible contract and was incapable of being spilt up into different components/parts, where for due performance of contract the liability of both the Consortium members is joint and several. The Authority for Advance Ruling also held that since Consortium members continued to be responsible for the supplies up to the stage of acceptance of the work in relation to the erection, procurement and commissioning of the project, the title of the equipment/material supplied could not be accepted to have been transferred to Indian customer overseas and accordingly the income is subject to tax in India. The appeal was filed before the Delhi High Court against this decision, by the Company.

Ruling of the High Court: The principle emerges from the judicial precedents that the Association of Persons is one in which two or more persons join together for a common purpose or common action and there is a joint management or joint action by the said two or more persons. In order to treat persons as an association, it is necessary that the members must have a common intention and must act jointly for fulfilling the object of their joint enterprise. However, it is also necessary to bear in mind that the purpose of treating two or more persons as an association of persons is to impose tax on the income that may be attributed to their joint enterprise. It is, thus, obvious that it would be necessary to consider the extent and the nature of the common purpose and the common action, in order to determine whether the said persons form an association for the purposes of imposing tax or not. However, treating every instance of such cooperation between two or more persons as resulting in an Association of Persons would militate against the purpose of considering an association as a separate tax entity. Whether an arrangement or collaborative exercise between two or more persons results in constituting an Association of Persons as a separate taxable entity would depend on the facts of each case including the nature and the extent of collaboration between them. A mere cooperation of one person with another in serving one's business objective would not be sufficient to constitute an Association of Persons merely because the business interests are common. A common enterprise, which is managed through some degree of joint participation, is an essential condition for constituting an Association of Persons.

Based on the review of the agreement, the Court observed that the allocation of the work was done in such a manner that each member was required to perform work which was within its field of expertise and could not be performed by the other party. The work to be performed by both the members was separate, definite and divisible. Therefore, as far as execution of the project was concerned, each party had to work independent of the other. The only area of cooperation and management envisaged under the MOU was in respect of sharing of information and material, to enable the other member to perform its work. This level of cooperation is necessary for execution of any project where multiple agencies are involved. The Court further observed that the internal consortium agreement between the parties clearly specified that the scope of works of two entities were separate and independent. The agreement also made a specific provision that in case the scope of work of the respective members was altered and either of the members was required to execute additional work, then the price for additional work would be payable to that party. It was also provided in the agreement that prices and payment for the respective works to be performed by the members would be stipulated separately in the bid and separate invoices will be raised by the consortium members on the Indian customer. Further, the agreement clearly provided that neither of the members would be liable to each other on account of any loss or damages including non-payment by the Indian customer.

Court held that while it is relevant as to how a third party deals with the members of a consortium, the same would not be conclusive in determining whether the consortium members constitute an Association of Persons. In the instant case, both the parties shared neither the costs nor the risks. Both managed their own deliverables and accordingly the facts of this case do not indicate a sufficient degree of joint action between the parties either in execution or management of the project to justify a conclusion that they had formed an Association of Persons. Accordingly, Court reversed the ruling of Authority for Advance Ruling and ruled in favor of the Company.

Next question which was considered by the Court was pertaining to taxability of income received by Company for design and engineering prepared solely for manufacture and/or procurement of equipment outside India and supply of equipment, material and spares, outside India. Court has stated that the principle of apportionment of income on the basis of territorial nexus is now well accepted. Explanation 1(a) to section 9(1)(i) of the Act also specifies that only that part of income which is attributable to operations in India would be deemed to accrue or arise in India. It necessarily follows that in cases where a contract entails only a part of the operations to be carried on in India, the Taxpayer would not be liable for the part of income that arises from operations conducted outside India. In such a case, the income from the venture would have to be appropriately apportioned. The taxable income in execution of a contract may arise at several stages and the same would have to be considered on the anvil of territorial nexus. In the facts of the present case, where the equipment and material is manufactured and procured outside India, the income attributable to the supply thereof could only be brought to tax if it is found that the said income therefrom

arises through or from a business connection in India. However, in view of the decision of the Supreme Court in *Ishikawajima-Harima Heavy Industries* it cannot be concluded that the Contract provides a “business connection” in India and accordingly, the Offshore Supplies cannot be brought to tax under the Act.

On the aspect of taxability of offshore services, the Court remanded back the matter stating that in the event, it is found that the offshore services rendered by Company are not inextricably linked to the manufacture and fabrication of equipment overseas so as to form an integral part of the supply of the said equipment, the income arising from the said services would be taxable in India as fees for technical services. By virtue of Section 9(1)(vii) of the Act, fees for technical services paid by a resident are taxable in India (*except where such fees are payable in respect of services utilised by such person in business and profession carried outside India*). In view of the Explanation to Section 9(2) as substituted by Finance Act 2010 with retrospective effect from June 1, 1976, the decision of the Supreme Court in *Ishikawajima-Harima Heavy Industries*, in so far as it holds that in order to tax fees for technical services under the Act the services must be rendered in India, is no longer applicable.

Key takeaways: This ruling of Delhi High Court clarifies some fundamental principles for Turnkey Contract involving non-residents. This deals with various key aspects of Turnkey Contracts including Association of Persons, Offshore Supplies and Offshore services. It also underlines the importance of prudent structuring of business arrangements and effective documentation before commencement of the business which was upheld by the Court in favor of the taxpayer.

Further, the implications of amendments in Finance Act 2010 over the decision of the Supreme Court in *Ishikawajima-Harima Heavy Industries*, has also been clarified in this decision by the Court.

9.20 GE Energy Parts Inc. Vs. ADIT 47 taxmann.com 284 (Delhi ITAT)(2014) - Use of Social Media Profiles as Evidence

Understanding of facts: The Company, a Tax Resident of United States of America, was carrying its activities in India through Liaison Office in India. Survey under section 133A of the Act was conducted at the office premises of Company on March 2, 2007 by the Tax Authorities. During the course of survey, copies of various documents were obtained and statements of various persons were also recorded. Pursuant to the Survey, the Tax Authorities were of the view that this Group was engaged in various sales activities in India for which the business head were generally expats, who were appointed to head Indian operations with the support staff provided by its Indian group company and also by various third parties. These expats were on the payroll of one of the group company of United States of America but working for various businesses of this Group. As per the application made to Reserve Bank of India and permission obtained, the liaison office was to act as a communication channel between the head office and the customers in India. However, as a

result of survey, it was found that the Company instead of undertaking the permitted activities was employing various persons and providing the services of such persons to the group entities worldwide. The activities indicated that the Company was carrying out business in India through a Permanent Establishment (PE) and the income attributable to such PE was taxable in India. In the assessment order, the Tax Authorities observed that the expatriate employees of the Group were responsible and looked after the business of the Group as a whole, irrespective of any group company making sales in India. The bifurcation of sales by various entities was decided by the Group management, as was evident from the documents seized during the course of survey. After detailed analysis of documents found during the course of survey, it was observed that these expats and their team had at their disposal a fixed place of business in the form of office premises of Company in India. From these survey documents it was also revealed that the activities of the non-resident group entities being conducted from the fixed place of business referred to above were not of the preparatory or auxiliary character but constituted the PE as provided in paragraph 2 of Article 5 of respective tax treaties. The Company preferred appeal before the Commissioner of Income Tax (Appeals) wherein the decision was made in favor of the Tax Authorities. The appeal was filed before the Delhi Tribunal against this decision, by the Company.

Ruling of the Tribunal: Tax Authorities has presented the profiles of expat employees in India on LinkedIn.com which was social networking website, as additional evidence. Accordingly, Tribunal first dealt with the power of Tribunal with regard to admission of 'additional evidence' during the appellate proceedings. Tribunal stated that the basic ingredient for exercising powers under Rule 29 for admission of additional evidence is that Tribunal should come to the conclusion that a particular document would be necessary for consideration to enable it to pass orders or for any other substantial cause. The document can be brought to the notice of Tribunal by either party. The Tribunal is final fact finding body and, therefore, the powers have been conferred on it under section 131 and Rule 29 to enable it to record a factual finding after considering the entire evidence. Tribunal held that in order to enable the Tribunal to decide disputes before it in a lawful, fair and judicious manner, it necessarily is required to look into and consider such and other material having a direct nexus and bearing on the subject matter of the appeal i.e. existence of PE in the instant case.

While dealing with the aspect of treating LinkedIn profile as hearsay evidence as contended by the Company, the Tribunal has stated that LinkedIn profiles are not in the nature of hearsay because it is the employee who himself has given all the relevant details and the same relate to him. These details are akin to admission made by a person. No third party is involved in creating of this LinkedIn profiles and therefore, it cannot be said to be hearsay evidence. Accordingly Tribunal has accepted the LinkedIn profiles produced by the Tax Authorities as evidence and held that it is well settled law that admission though not conclusive is binding and decisive on point unless it is successfully withdrawn or proved to be erroneous.

Key takeaways: This ruling explains the laws relating to use of additional evidence before the Tribunal and also demonstrates the importance of modern communication modes & its significance in the tax domain. Also it shows the progressive approach adopted by the Indian

Tax Authorities while dealing with complex issues of international taxation, and accordingly Tax Practitioners also need to be well equipped while dealing with such subjects.

In this ruling, the Tribunal has not concluded on the taxability of the transactions in the question as the said matters were fixed up for hearing on merits subsequently.

9.21 GFA Anlagenbau Gmbh Vs. DDIT (Hyderabad ITAT) TS-383-ITAT-2014(Hyd).– Supervisory PE

Understanding of facts: The Company was resident of Germany and engaged in supervision, erection, commissioning of plant and machinery for steel and allied plants in India. During the relevant assessment year, the Company rendered services to four Indian customers. The Company engaged experienced foreign technicians at the work sites and other places in India and the receipts were categorised as in the nature of ‘fees for technical services’ under the provisions of tax treaty between India and Germany. On going through the information furnished, Tax Officer noticed that some of the contracts undertaken by the Company in India have continued for a period exceeding six months. Accordingly, Tax officer held that the Company has PE in India under the provisions of Article 5(2)(i) of the India-Germany tax treaty and its taxable income will be determined as per provisions Article 7(3) of the Tax Treaty. The Company raised objections before the Dispute Resolution Panel which was not accepted by the Dispute Resolution Panel. The appeal was filed before Tribunal against this order, by the Company.

Ruling of the Tribunal: On perusal of Section 92F(iiiia) of the Act, the Tribunal observed that the supervisory activities do not constitute a fixed place of business in as much as the Taxpayer renders its services at the project sites of its clients and does not by itself own or operate such sites independently but rather provided under contract terms by its clients. Tribunal further states that just because the technicians of the Company stayed in India while supervising the work undertaken by the Company in India, it cannot be considered that their place of stay can be ‘fixed place of business’ for the Company.

Tribunal while dealing with provisions of Article 5(2)(i) has stated that a literal reading of the Article leads to the conclusion that supervisory activities by themselves cannot constitute a PE; they are to be in connection with a building, construction or assembly activity of the non-resident which is not the case here as the Company provides only supervisory activities and do not have any building site or construction site of its own. Tribunal also noted it is incorrect to aggregate all contracts of the foreign company in India and consider it as one. Unless otherwise linked with each other, contracts should be individually assessed with respect to the duration test. In conclusion, in light of the facts and circumstances of the instant case, Tribunal opined that the Company’s supervisory activities do not constitute a Permanent Establishment in India under the provisions of the Act as well as Article 5 of the India-Germany tax Treaty. The Company should be assessed for its supervisory activities under Article 12 of the India-Germany DTAA.

Key takeaways: This ruling of the Tribunal lays down the parameters for interpretation of

provisions dealing with Supervisory PE wherein it underlines the requirement of existence of project or site to attract the supervisory PE implications. It also provides guidance that mere stay of employees in India will not result their place of stay into Fixed Place PE in India.

9.22 Nortel Networks India International Inc. Vs DDIT 49 taxmann.com 147 (Delhi ITAT)(2014) - Profit attribution in case of Cross-border Turnkey Contracts

Understanding of facts: The Company was resident of United States of America. During the relevant assessment year, the Company has supplied telecommunication hardware to its Indian Customer. The Indian subsidiary of Nortel Group M/s Nortel Networks India Pvt. Ltd. (Nortel India) entered into a contract with Indian Customer for supply of hardware equipment on June 8, 2002. Immediately, after the signing this contract was assigned by Nortel India to the Company without any consideration. The equipments supplied by the Company to the Indian Customer was purchased from a group company i.e. M/s Nortel Canada. From the examination of the financial statements, the Tax Officer was of the opinion that the Company does not have any manufacturing or trading infrastructure, and it does not have any financial or technological capability of its own. The Company had not filed its return of income voluntarily for the relevant year and did not have any audited accounts. The Tax Officer also noted that the profit and loss account of the Company during the year under consideration of proceedings were unaudited and certified by Manager (Tax). In the said profit and loss account, the Company has booked huge gross losses.

Tax officer further observed that the contract in this regard is a turnkey contract which indivisible contract for supply, installation, testing, commissioning etc. yet the contract for installation and commissioning were assigned to Nortel India. The entire responsibility of the execution of turnkey contract remained with the Guarantor. Tax officer observed that this arrangement shows that the Company was getting its work executed through Nortel India. Nortel India was working so intimately with the Company, that the contract awarded to Nortel India was assigned to the Company and the contract awarded to the Company was assigned to Nortel India. This shows that both of them are working in unison and are acting as one entity for all practical purposes. In view of this analysis, the tax Officer reached to the conclusion that Company is only a paper company incorporated for the sole purpose of evading taxes in India accruing from the supply contract. Tax Officer thus held that Nortel India is a fixed place of business and depended agent permanent establishment of the Company in India. The Company filed an appeal before the Commissioner of Income Tax (Appeals) who decided the appeal in favor of the Tax authorities. The appeal was filed before Tribunal against this order, by the Company.

Ruling of the Tribunal: Tribunal after perusal of the facts has stated that contract entered between the Company and the Indian customer is a turnkey contract, indivisible contract for supply, installation, testing, commissioning etc. Nortel India has undertaken the responsibility for negotiating and securing the contracts. The contract for installation and commissioning was also undertaken by Nortel India. Thus, Tribunal upheld the proposition of the tax

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authorities that these arrangements show that Company is getting its work executed through Nortel India. The Company is merely a shadow company of Nortel Group and for all practical purposes, all the facilities and services available to the Nortel Group of Companies are equally available to the Company. The hardware supplied through it is installed by Nortel India. The contracts were pre negotiated by Nortel India. Thus, Tribunal agreed with the Tax authorities that Nortel India is a fixed place of the business and dependent agent PE of the Company. Further, Tribunal also held that Liaison Office in India of its group company of Canada i.e. Nortel Canada also constitutes fixed place PE of the Company, since the LO of Nortel Canada was rendering all kinds of services to all the group companies including this Company.

Tribunal further observed that the contention of sale being completed overseas and installation was done under a separate contract is also not tenable, as the Company through Nortel India and LO of Nortel Canada approached the Indian customer, negotiated the contract, bagged the contract, supplied equipment, installed the same, undertook acceptance test after which the system was accepted. The equipment remained in the virtual possession of Nortel Group till such time the equipment was set up and acceptance test was done. The tribunal further stated that the compensation which has been represented to be the sale consideration for the equipment represents the payment for works contract where entire installation and customisation has been carried out in India. That the subsidiary has not only acted as a service provider for the Company, but at the same time acted as a sale outlet cooperating with after sale service and also providing any assistance or service requested by the Company. Further the employees of group companies did visit India in connection with Project in India which indicates that the employees of the group companies did carry out business of the Company through the premise of LO of Nortel Canada or the premise of the India subsidiary i.e. Nortel India. Thus, Tribunal concluded by stating that the entire business enterprise activities of the Company were managed by the subsidiary in India. Tribunal upheld the decision of CIT(A) stating that activities of the Company in India constitute PE of the Company in terms of Article 5 of the India-USA tax treaty.

The next issue that was considered by the Tribunal was, how much of the profits arising to the Company from supply of telecom hardware to Indian customer is attributable to the PE in India. Tribunal stated that the accounts of the Company were not audited and the gross trading loss incurred from transactions within the group by the Company cannot possibly be explained, except for the reason that it has been designed as such to avoid taxation in India. Hence, for all purpose of the law, accounts of Nortel Group would give the true and correct picture of profit of the Company. As per the global accounts the profit arising from the Indian transactions cannot be definitely ascertained hence following the provisions of Rule 10, the financial statement of the Company has to be recast to arrive at the correct percentage of profit that is likely to accrue to the Company from its Indian operations. As per the global accounts of Nortel, the gross profit margin percentage for Nortel Canada was held to be the Company's margin of the relevant year from the specific contract, which was 42.6% in the instant case. Specific deduction was to be allowed for other general and marketing expenses on reasonable basis and accordingly 5% of the turnover was considered as the average rate of expenses incurred under this head. After considering Taxpayer's arguments of citing other

decisions where profit attributed to the PE was in the range of 20%-35%, the Tribunal held that income of the PE has to be computed on the facts of each case and accordingly considering the facts in the instant case tribunal upheld the attribution of 50% of the global profits to the activities of PE in India as a reasonable attribution.

Please note that this decision has been set aside by the high court (Nortel Networks India International Inc. v DIT [2016] 69 taxmann.com 47 (Delhi)). The Court held that where pursuant to an agreement with Indian company all rights and obligations to sell, supply and deliver equipments were assigned to assessee US company by its Indian AE and in terms of assignment contract supplies and payments were directly made between assessee and the Indian Company and Indian AE did not maintain any stock in India, no part of assessee's income could be brought to tax in India Further where Indian AE did not exercise any authority on behalf of assessee US company to conclude contracts in India or no officer of Indian AE were at disposal of assessee, Indian AE would not constitute assessee's PE in India

SLP has been granted against this ruling [2017] 81 taxmann.com 166 (SC)/

Key takeaways: Tribunal being the ultimate fact finding authority, this ruling assumes importance as it signifies the approach adopted by the judicial authorities while evaluating the tax implications of the turnkey contract. In this decision, Tribunal has reviewed various aspects of the contractual arrangements, entity standings and its roles in the business, further Tribunal also decided on the profit attribution to the PE which was 50% of the global profits earned from this contract by the Group, however Tribunal also made it clear that profit attribution to PE is facts sensitive and hence could vary on case to case basis.

9.23 Renoir Consulting Ltd. Vs. Dy DIT 45 taxmann.com 112 (Mumbai ITAT)(2014) - Fixed Place PE

Understanding of facts: The Company was resident of Mauritius and engaged in providing management consulting services to Indian customers. In the relevant year, the Company disclosed income, as business income, from contracts executed in India and claimed absence of its Permanent Establishment (PE) in India. The Tax officer took a view that there was a PE in existence in India within the provision of India-Mauritius tax treaty. Tax Authorities held that the implementation programme was to be carried over three phases, aggregating to 80 weeks and accordingly the hotel rooms where the consultants/principal consultants stayed in India must in that case necessarily be regarded as their place of work and for carrying out their activity in India i.e. PE. The decision of the Tax Officer was upheld by the Commissioner of Income-tax (Appeals). The appeal was filed before the Mumbai Tribunal against this decision.

Ruling of the Tribunal: The basis of the concept of PE is that profit of an enterprise of one contracting state is taxable in the other state only if the enterprise maintains a PE in the latter state and, further, to the extent that profit is attributable thereto. The PE thus seeks to compromise and harmonize the taxing jurisdiction between the source state and residence state for the purposes of taxation of business profits. The same must be understood with a view to arrive at the degree of economic penetration as per the applicable treaty that justifies a

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nation in treating a foreign person in the same manner as a domestic person. It needs to be clarified as well as emphasized that the word 'permanent' in the term 'permanent establishment' does not in any manner signify or denote a permanent character, or that the right to use the place should be perpetual, but that there must be a certain degree of permanence. A fixed place would though not exclude a movable place of business, viz. a petroleum drilling rig may constitute a PE if it is moved frequently from one location to another. How the fixed place or the right to use the same is however secured is though of little consequence, so that the same may be owned, rented or otherwise acquired in any other manner. Even a right which is not legal in its nature may, therefore, be of no adverse consequence.

Court after analyzing the facts of the case has commented that, it is to be appreciated that it is for the Company to specify as to how and from where it has performed its' work. If the team of its personnel deputed on the contract have not functioned from the Customer's premises, in that case specify the place/s from where they have functioned over their continued stay in India, which is stated to be at 874 man-days for the consultants and 81 days for the principal consultants, and how. The communications between them and the head office, which is again a part of their work, has again admittedly been carried out in India and, as stated, from a place in the vicinity of the place of the stay. Whether the communication has taken place from the hotel room through the medium of internet using laptops – a tangible asset/s, by the personnel, or similar facilities provided by the hotel or by a retail outlet providing such services is of little moment. Therefore, some place was at the disposal of the Company or its employees during the entire period of the stay in India is, thus, manifest and eminent and follows unmistakably from the work nature/profile and the modus operandi followed. In our clear view, therefore, the Company clearly has a PE in India during the relevant years.

Key takeaways: Even though this ruling is based on the peculiar facts of the case, but it demonstrates the practical approach being adopted by the Judicial authorities which involves the scrutiny of business arrangements, work methodology and also the modern work techniques. The interpretation of Fixed Place PE provisions and criteria applied therein in its analysis by the Tribunal will be a useful guidance in similar cases.

9.24 Samsung Heavy Industries Company Limited Vs DIT [2020] 117 taxmann.com 870 (SC) - Profit attribution to PE

Understanding of facts: The Company was tax resident of Korea and has entered into contract with Indian customer. While filings its return of income for the relevant year, the Company claimed that under the contract with Indian customer it has received certain income in connection with activities carried on inside India and certain income in connection with activities carried on outside India. In its income tax return for the relevant year, the Company showed 'Nil' income as it has incurred certain expenses and after deducting such expenses, it has earned a loss and accordingly, earned no income taxable in India. The Tax Officer in its order refused to accept this contention of the Company and held that 25% of the revenues, thus received allegedly for outside India activities, should be brought within the

taxing network of India. The order of the Tax Officer was upheld by the higher appellate authorities including Tribunal. The appeal was filed before the Uttarakhand High Court (HC) against this decision. The HC held the tax liability could not be levied without establishing that the same was attributable to the tax identity or PE of the taxpayer in India. Accordingly, in the absence of any finding that 25% of the gross revenue of the taxpayer outside India was attributable to the business carried out by the PO, the HC passed the order in favour of the taxpayer. Aggrieved by the HC's order, the Revenue filed an appeal before the Hon'ble Supreme Court (SC).

Ruling of the Supreme Court:

The SC relied on the following principles laid down in its earlier rulings – i.e. DIT v. Morgan Stanley & Co. Inc. [2007] 7 SCC 1 (SC); DIT v. E-Funds IT Solution Inc. [2018] 13 SCC 294 (SC); Ishikawajma-Harima Heavy Industries Ltd. v. DIT [2007] 3 SCC 481 (SC); CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 7 SCC 422 (SC) (which had dealt with tax treaty provisions similar to India-Korea tax treaty) which were relevant for examination of existence of a fixed place PE:

- To constitute a fixed place PE as per Article 5(1) of the tax treaty, there should be an establishment “through which the business of an enterprise” was wholly or partly carried on;
- The profits of the foreign enterprise were taxable only when the said enterprise carried on its core business through the PE;
- Maintenance of a fixed place of business, which was of a preparatory or auxiliary character in the trade or business of the enterprise would not be considered as a PE under Article 5 of the tax treaty;
- Only profits attributable to the PE were taxable.

The SC verified the Board Resolution dated 3 April 2006 relating to the setting up of the PO by the payer and noted that the PO was established to co-ordinate and execute “delivery of documents in connection with construction of offshore platform for ONGC”. Accordingly, the SC, amongst others, set aside the following findings of the ITAT:

- The PO was not a mere liaison office, but was involved in the core activity of execution of the project;
- Rejection of the taxpayer's contention that the PO had not incurred expenditure relating to the execution of the Project, on the basis that mere mode of maintaining the accounts alone could not determine the character / existence of the PE.
- Ignoring the fact that the two persons who worked in the PO were not qualified to perform any of the core activity of the taxpayer.
- The onus was on the taxpayer and not on the tax authorities, to demonstrate that the PO constituted a PE in India

In view of the above and on the following basis, the SC dismissed the appeal of the Revenue against the order of the HC, holding that:

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- The PO was not a fixed place of business through which the core business activities of the taxpayer were (wholly or partly) carried out;
- The PO was covered under exclusion of fixed place PE under Article 5(4)(e) of the India-Korea tax treaty, as based on facts it was solely an auxiliary office for liaisoning between the taxpayer and ONGC.

Key takeaways: The issue of existence of PE in India has been a subject matter of litigation based on facts of case. This ruling affirms the following principles in relation to existence of a fixed place PE under Article 5 of the India-Korea tax treaty:

- Fixed place PE is constituted only when core business activities are carried out in India;
- In case, auxiliary activities are carried out then the same could be covered under the exclusion under Article 5(4)(e) of the India-Korea tax treaty

9.25 CIT Vs. Nike Inc (Karnataka HC)(2013) 34 taxmann.com 170 - Taxability of Liaison Office

Understanding of facts: The Company, tax resident of United States of America, was engaged in business of sports apparels, and has various associated enterprises or subsidiaries in various parts of the world. The Company from its office in United States of America used to arrange for all its subsidiaries all over the world the various brands of sports apparels for sale to the various customers. The arrangement was through procurement from the manufacturer who used to directly dispatch the apparels to the various subsidiaries spread all over the world. The Company, with prior permission of Reserve Bank of India, has opened a liaison office in India with a view to spread its wings mainly from the point of view of procurement of various apparels from manufacturers in India. In the application for permission before the Reserve Bank of India, the Company had categorically stated that the liaison office will not undertake any activity of trading, commercial or any industrial nature or enter into any business contracts in its own name without the previous approval of the Reserve Bank. Accordingly, the Company opened the liaison office and employed persons in various categories defining qualifications for each post and this was with reference to its main activity of purchase or procurement of apparels from India for the purpose of export by those manufacturers directly to the various subsidiaries spread at various places in the world. The liaison office used to keep a close watch on the progress, quality, etc., at the manufacturing workshop. Further it also used to keep a watch on the time schedule to be followed and render such assistance as may be required in the dispatch of the goods including the actual buyer and the place for export.

A Survey was conducted by Tax Authorities at liaison office in India under section 133A of the Act and the activities carried on by the Company through this office were verified. The Tax Authorities held that the activities of the Company in India are actually beyond its activities as required as a liaison office. The Company gets the goods manufactured through various factories by providing various data like the availability of raw materials, list of suppliers of raw materials, cost of raw materials etc, further it also helps the manufactures in audit/quality

checks and dispatching of goods. Thus, a part of the entire business is done in India, more specifically by Apparel Product Integrity Department and the quality checks, through the India Liaison office. Therefore, the income accrues or arises is deemed to arise in India in view of Clause (b) of Sub-Section (2) of Section 5 of the Act and therefore, the income of the Company is chargeable to tax to the extent of income, which is attributable to the activities done in India. The Company preferred appeal before the Commissioner of Income Tax (Appeals) wherein the order of the Tax Authorities was upheld by the Commissioner of Income Tax (Appeals). The order of Commissioner of Income Tax (Appeals) was challenged before the Tribunal wherein Tribunal upheld the contention of the Company and set aside the order of the Commissioner of Income Tax (Appeals). The appeal was filed before the Karnataka High Court against this decision, by Tax Authorities.

Ruling of the High Court: Court discussed the various amendments in Section 9(1) and observed that in respect of the Assessment Year 1964-65 and subsequent years, a non-resident will not be liable to tax in India on any income attributable to operations confined to purchase of goods in India for export, even though the non-resident has an office or agency in India for the purpose, or the goods are subjected by it to any manufacturing process before being exported from India. Court further noted that the object of establishing the liaison office is to identify the manufacturers, give them the technical know-how and see that they manufacture goods according to their specification which would be sold to their affiliates. The person who purchases the goods pays the money to the manufacturer, in the said income the Company has no right and hence the said income cannot be said to be a income arising or accruing in the tax territories vis-a-vis the liaison office. Once the entire operations are confined to the purchase of goods in India for the purpose of export, the income derived therefrom shall not be deemed to accrue or arise in India and it shall not be deemed to be an income under Section 9 of the Act. The Court stated that if we keep the object with which the proviso to clause (b) of Explanation 1 to Sub-section (1)(i) of Section 9 of the Act was deleted from Assessment Year 1964-65 onwards, the object is to encourage exports thereby the Country can earn foreign exchange. Accordingly, Court upheld the order passed by Tribunal in favor of the Company.

Key takeaways: In this ruling Court has dealt with the taxation of liaison office which is set up through which goods are supplied to global entities. Considering India's cost advantage in manufacturing vis-à-vis its global peers and also increased focus of the Indian Government on developing India as a favored manufacturing destination, this ruling will act as a guiding principle in structuring the operations of the liaison office of similar multinationals in India.

9.26 Brown And Sharpe Inc. Vs CIT 51 taxmann.com 327 (Allahabad HC)(2014) - Taxability of Liaison Office

Understanding of facts: The Company, tax resident of United States of America, established a liaison office in India with prior approval from Reserve Bank of India. The Company, for the relevant year, filed its return of income and returned a loss. The Company during the assessment with the Tax Officer submitted that remuneration of its employees was divided

into two component i.e. fixed and sales incentive plan. When called upon to disclose the details of the targets which were fixed and the receipts under the sales incentive plan, the Company submitted that during the relevant assessment year no incentive had been paid to its employees. The Tax Officer recorded the statement of the Chief Representative Officer of the Indian liaison office and came to the conclusion that the activities of the liaison office were not restricted only to providing a channel of communication between the buyers of the products sold by the parent company but the activities were, it was found, extended to searching for prospective buyers, providing required information and persuading them. Accordingly, the Tax Officer held that the activities of the Company involved marketing activities in India and that the liaison office was, in fact, carrying on business activities. On this basis, Tax Officer computed the taxable income of the Company as the profit from business activities carried on in India. The order of the Tax Officer was first confirmed by Commissioner of Income Tax (Appeals) and thereafter by Tribunal. The appeal was filed before the Allahabad High Court against this decision, by the Company.

Ruling of the High Court: The Court observed that the disclosures which were made by the Company before the Tax Officer clearly indicate that during the relevant assessment year, the activities of the liaison office were not confined only to being a channel of communication between the Head Office in the United States of America and prospective buyers in India. The activities of the liaison office included explaining the products to buyers in India, furnishing intimation in accordance with the requirements of the buyers and discussing commercial issues pertaining to the contract through the technical representative, after which an order was placed by the buyer directly to its overseas entity. Apart from this, it is significant that the performance of the personnel in India was, as disclosed by the Chief Representative Officer, judged by the number of direct orders that the Company received and by the extent of awareness of the Company that was generated in India.

The Company had an incentive plan, and it is not in dispute, as was disclosed by the Chief Representative Officer, that in the sales incentive plan an employee was allowed to receive upto 25% of its annual remuneration as Sales Incentive. Whether or not any incentive was, in fact, paid to an employee during the year in question, is not material. What is relevant is that the nature of the incentive plan would clearly indicate that the purpose of the liaison office in India was not merely to advertise the products of the Company or to act as a link of communication between the Company and a prospective buyer but involved activities which traversed the actual marketing of the products of the Company in India because it was on the basis of the orders generated that an incentive was envisaged for the employees. The Court noted that the activity of the liaison office during the relevant assessment year was not of a preliminary or preparatory nature so as to attract the exclusion under Article 5(3)(e) of the India-USA Tax Treaty. Accordingly, the Court upheld the order of the Tribunal wherein Tribunal affirmed the action of the Tax officer of holding that the income attributable to the liaison office was taxable in India.

Key takeaways: In this ruling while assessing the taxability of liaison office the Court has deliberated on the difference between 'advertising' and 'marketing', where the former is

eligible for the exemption provided in the tax treaty but latter is not. The observations and principle laid down in this ruling are vital for examining the tax implications of liaison office operating or proposed to be operating in the similar circumstances.

9.27 Production Resource Group, In re [2018] 89 taxmann.com 219 (AAR - New Delhi) -Permanence test is to be linked to nature and requirements of the business for constitution of a PE

Understanding of facts - Applicant a Belgium company was rendering, lighting and searchlight services to Organizing Committee, Commonwealth Games 2010, Delhi (OCCG) under Service Agreement (SA) dated 9-7-2010 and received consideration for same. For providing lighting and searchlight services, applicant had to do all related activities, such as obtaining all authorizations/permits, engaging personnel with requisite skills, supply and/or procure all necessary equipment, subcontracting and shipping and loading, insurance *etc.* For carrying out its aforesaid business and related activities, applicant was provided lockable office space as well as on-site space. The applicant's employees were present in India for a period of 66 days for preparatory work, installation, provision of service and dismantling of the equipment. The issue was whether the consideration under the SA was taxable in India under the Income-tax Act, 1961 (the Act) or Double Taxation Avoidance Agreement (tax treaty) between India and Belgium.

Ruling of the AAR- The degree of permanence was necessitated by the nature and requirements of the business. The applicant's activities and presence was spread for a sufficiently long period of time over the entire duration of the event, thus fulfilling the permanence test. The lighting facilities created and erected by the applicant coupled with the space available with the applicant constituted a part of place of business. The place of business may not be fixed to the soil, as long as it forms an intrinsic part of the income generating activity. Therefore, the determination of the existence of a PE would be based on the specific facts of the case and no general threshold of duration could be read into the requirements of fixed PE. Applicant had met each of criterion for establishing a PE, viz. place of business, power of disposition, permanence of location, business activity and business connection which cumulatively and collectively are sine qua non of a PE; consideration received by applicant could only be held to be taxable in India as Business Profits, as per provisions of Article 7 of DTAA as also under section 9(1)(i).

Key takeaways

The AAR relied on the SC ruling in the case of Formula One and upheld that the degree of permanence should be seen vis-à-vis the nature of business. The AAR also ruled out the applicability of threshold of duration to the fixed PE clause. This could be relevant for analysing PE exposure in future.

9.28 CIT v Mahindra And Mahindra Ltd. [2018] 93 taxmann.com 32 (SC) -Waiver of loan taken for procuring assets not taxable as business income

Understanding of facts- The taxpayer decided to expand its product line by including two different business models. For this purpose, an agreement was entered into with an American Company (A Co.) which agreed to supply tooling and other equipment. A Co. supplied dies, tooling and equipment to the taxpayer through its subsidiary (SA Co.). To procure tooling, A Co. agreed to provide loan to the taxpayer at the rate of 6%, repayable after 10 years on instalment basis. Later, B Co. took over A Co. Subsequent to such take over, B Co. agreed to waive-off the principal amount of loan advanced by A Co. to the taxpayer. The taxpayer filed its return claiming such waiver of loan to be capital receipt, not chargeable to tax. The tax officer (TO) concluded that the waiver of the loan represented income and not liability, and held that the same would be taxable under section 28(iv) of the Act. On appeal, the Commissioner of Income- tax (Appeals) [CIT(A)] taxed such waiver under section 41(1) of the Act, rather than section 28(iv), and upheld the addition made by the TO. On appeal the Income-tax Appellate Tribunal (Tribunal) set aside CIT(A)'s order and deleted the addition made by the TO. This was subsequently upheld by the HC. The issue before the Supreme Court was whether the waiver of loan by creditor was taxable as perquisite under section 28(iv).

Ruling of the Supreme Court - On the applicability of section 28 of the Act it was held that income to be taxed under clause (iv) should have been in some form other than money. The waiver of loan resulted in extra cash in the hands of the debtor and the condition of benefit received in form other than money was not satisfied. Hence, provisions of section 28(iv) of the Act did not apply. The taxpayer was paying interest but did not claim deduction under section 36(iii) of the Act for such interest payments, as the equipment purchased were capital assets in the hands of taxpayer and was not debited to its Profit and Loss account. Therefore, they could not be classified as a trading liability. Section 41(1) of the Act deals with the remission of trading liability, whereas the waiver of loan amounts to cessation of liability other than trading liability. Hence, the provisions of section 41(1) of the Act shall not be applicable. Therefore, neither does section 28(iv) of the Act, nor does section 41(1) of the Act applies to waiver of the principal portion of the loan taken on capital assets.

Key takeaways- This ruling supports the view that the provisions of section 28(iv) shall only apply in cases where the benefit or perquisite was in a form other than that of money, and waiver of a loan does not satisfy this requirement. This ruling reaffirms that provisions of section 41(1) applies only in case of cessation of trading liability and does not apply in case of cessation of any liability other than trading liability.

**9.29 ACIT v E-Funds IT Solution Inc. [2017] 86 taxmann.com 240 (SC)-
Support services performed by an Indian subsidiary, which enables the foreign company to render IT and IT-enabled services to its client abroad, will not create a PE of the foreign company in India.**

Understanding of facts - A Group Inc. and B Corporation, USA (hereinafter, collectively referred to as "AB USA" were resident companies in the USA. AB USA were in the business of

providing ATM management services, electronic payment management, decision support and risk management and global outsourcing and professional services (IT and IT-enabled services) to its customers outside India. AB USA were assessed to tax in USA on their global income. C Private Limited (C India) was a company resident in India. It provides various support services to AB USA in relation to its IT and IT enabled services. C India was taxed in India on its global income, in accordance with the provisions of the Income-tax Act, 1961 (Act). The Revenue contended that the income of AB USA should also have been taxed in India as they had PE in India in the form of C India, to which income from provision of IT and IT enabled services could be attributed.

Ruling of the Supreme Court - The Supreme Court held that support services performed by an Indian subsidiary, which enables the foreign company to render information technology and IT-enabled services to its client abroad, will not create a PE of the foreign company in India. The Indian subsidiary did not create a fixed place PE of its foreign company in India unless the premises of the subsidiary were at the disposal of the foreign company. The Apex Court also negated the possibility of service PE in India on the ground that none of the customers of the foreign company received any services in India. In relation to agency PE, the Apex Court held that it has never been the case of the revenue that an Indian subsidiary was authorised to or exercised any authority to conclude contracts on behalf of the foreign company. Even if the foreign company is held to have a PE in India, the transaction between the foreign company and its Indian subsidiary being at arm's length, no further profits can be attributed in India. Further, that the Mutual Agreement Procedures (MAP) agreement for an earlier year could not be considered as precedent for subsequent years.

Key Takeaways-The SC decision brings out certain guidelines for determination of existence or otherwise of the PE of a foreign company in India. The principal test, to ascertain whether an establishment has a fixed place of business or not, is that such physically located premises have to be "at the disposal" of the foreign company. No fixed place PE can be established if the main business and revenue earning activity of the foreign company are not carried on through a fixed place in India, which has been at the disposal of the foreign company. The mere fact that a 100% subsidiary may be carrying on business in India does not mean that the holding company would have a PE in India. If any customer were rendered services in India, whether resident or non-resident, a service PE would be established. If arm's-length conditions were satisfied, no further profit would be attributable, even if there exists a PE of a foreign company in India. The MAP resolution arrived for a year cannot be considered as a precedent for subsequent years.

9.30 Honda Siel Cars India Ltd v CIT [2017] 82 taxmann.com 212 (SC)- Fees for availing technical knowhow to bring a new business into existence in the form of a JV company treated as a capital expenditure

Understanding of facts - The taxpayer was an Indian company incorporated pursuant to a joint venture (JV) agreement between an Indian company and a foreign company. The foreign

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company was engaged in the business of development, manufacture and sale of automobiles and parts. The taxpayer entered into a technical collaboration agreement (TCA) with the foreign company for availing technical knowhow and technical information for a lump sum fee to be paid in five equal instalments commencing from the third year of commercial production along with a royalty of 4% on its sales. The taxpayer treated these payments as revenue expenditure. Simultaneously certain other agreements were entered between the taxpayer and the foreign company for providing technicians and engineers for necessary guidance for setting up of plant, supply of parts for manufacture of cars and supply of manufacturing facilities (the agreement inter-alia stipulated specifications for manufacturing facilities to be sold by the foreign company to the taxpayer). The taxpayer treated the payments made under these agreements as capital expenditure. The tax officer in the reassessment proceedings, treated the amount towards technical know-how and royalty payable under the TCA as capital expenditure and disallowed the claim of the taxpayer. The matter was carried by the taxpayer to the SC. Issue before the SC was whether the amount paid for availing technical know-how and technical information should have been treated as revenue expenditure or capital expenditure.

Ruling of the Supreme Court – The Supreme Court held that there is no single rule of thumb, principle or test which is paramount and each case needs to be probed in the light of circumstances of that particular case. The solution has to be derived from many aspects of the whole set of circumstances, some of which may point in one direction, some in the other. It is a common sense appreciation of all guiding features which must provide the ultimate answer. The distinction between capital and revenue expenditure with reference to acquisition of technical information and know-how has also been spelt out by the SC and HCs in many cases. Where there was transfer of ownership in the intellectual property rights or in licenses, it would clearly be capital expenditure. However, where no such rights had been transferred but an arrangement facilitates the grant of license to use those rights for a limited purpose, it would be in the nature of revenue expenditure as no enduring benefit was acquired thereby. Where the technical know-how availed was for improvising the existing business, the expenditure would be treated as revenue expenditure. This case, thus, indicates that if such technical know-how was for the purpose of setting up a new business, the position may be different. The very purpose of entering into the JV agreement was to set up a JV company with an aim and objective to establish a unit for manufacture of automobiles and part thereof. As a result of the JV agreement, the taxpayer was incorporated which entered into TCA in question for technical collaboration. This technical collaboration included not only transfer of technical information, but also complete assistance, actual, factual and on the spot, for establishment of plant, machinery etc. to create a manufacturing unit for the products. Thus, a new business was set up with the technical know-how provided by the foreign company. In case of termination of the TCA, the JV itself would end and there may not have been any further manufacturing using the technical know-how of the foreign collaborator. The TCA was crucial for setting up of the plant project in question for manufacturing of the goods. Thus, the question of improvising the existing technical know-how by borrowing the technical know-how from foreign company did not arise and accordingly, the expenditure in the form of fees paid

would be in the nature of capital expenditure and not revenue expenditure.

Key Takeaways- SC has reiterated the long standing position that the expenditure incurred on formation of a new business is capital in nature. However, as noted by the SC, whether a particular expenditure is capital or revenue in nature depends on specific circumstances and facts of the case, a detailed investigation needs to be undertaken to determine whether a particular expenditure of this nature has been incurred on capital field or revenue field .

9.31 Master Card Asia Pacific Pte. Ltd. Singapore 94 taxmann.com 195 (AAR - New Delhi) (A.A.R. No 1573 of 2014)

Understanding of facts- The Applicant, a Singapore based company and a leading global payment solution provider, used to charge banks [with whom it entered into Master License Agreements] processing fees relating to authorization, clearing and settlement of transactions. The Applicant provided the banks with a MasterCard Interface Processor (MIPs) that connected to the Mastercard Network and other processing centres. The MIPs were owned by the Indian subsidiary of the Applicant. The Applicant sought a ruling from AAR on the following issues i) Whether the digital equipment (MIP) created a PE (ii) Whether the MasterCard Network created a fixed place PE in India (iii) Whether agency relationship is created through Bank of India and its premises would constitute a fixed place PE (iv) Whether Applicant's subsidiary (MISPL) created a fixed place PE (v) Whether there was creation of a PE through the Applicant's visiting employees (vi) Whether there was a dependent agent PE created through MISPL

Ruling of AAR: On the first issue, the AAR accepted Revenue's stand that even an automatic equipment can create a PE and did not have to be fixed to the ground to constitute a fixed place PE. It held that since significant functions were performed by MIPs in facilitating authorization process and the MIPs were at the disposal of the Applicant, the MIPs constituted PE on account of the test of disposal and permanence being satisfied.

In case of the second issue, it noted that apart from MIP, transmission towers, leased lines, fiber optic cable, nodes and internet (owned by third party service provider) and application software which constituted the Mastercard Network were located in India as well as outside India. It also noted that the task performed by the MasterCard Network were significant activities in the context of overall functions of transaction processing rendered to third party and not preparatory or auxiliary. Further, noting that the Applicant owned part of the Network, the AAR held that the Network also constituted PE.

With respect to issue (iii), noting that the settlement activities happened through Bank of India who carried out the functions under the instructions of the Applicant, it accepted revenue's contention that the Bank of India premises where settlement activities happened through employees created a fixed place PE.

The AAR noted that MCI (of which Applicant was a wholly owned indirect subsidiary) had a liaison office ('LO') in India and for which the Applicant had disclosed income from transaction processing service rendered in India at full 100% attribution of global net profit rate. The

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Applicant had shut down LO and transferred the work and employees to MISPL. AAR held that once the Applicant in the case of LO had legally accepted a PE on account of 100% attribution of profit to India, now MISPL also created a PE of the Applicant.

The AAR, while examining whether the work carried out by the Applicant's employees visiting India was a part of transaction processing services, concluded that the work was an integral part of the Applicant's profession to provide new avenues of services to clients. Thus, it held that the employees visiting India were providing services to clients, and if they exceeded the threshold of 90 days in a year, a service PE could be created.

The AAR noted that the agreement concluded by the Applicant was routed through MISPL who brought the proposal though it was finalized by the Applicant. The above action of MISPL satisfied the requirement of securing order under Article 5(8) of DTAA and thus, MISPL constituted a dependent agent PE.

Key Takeaways-Setting up Indian subsidiaries and transacting on an arm's length basis with such entities has been a standard process for foreign MNEs looking to establish presence in India. The ruling will have an impact on such structures, and MNEs will need to evaluate the value attributed to their Indian entities vis-à-vis the functions performed.

9.32 Tiger Global International II Holdings [2020] 116 taxmann.com 878 (AAR – New Delhi)

Understanding of facts: The three applicants (i.e. Tiger Global International II Holdings, Tiger Global International III Holdings and Tiger Global International IV Holdings) are private companies, incorporated under the laws of Mauritius. They were set up with the primary objective of undertaking investment activities with the intention of earning long term capital appreciation and investment income.

The applicants had invested in shares of a Singapore Company ('S Co') which had in turn invested in multiple Indian companies and derived substantial value from assets located in India. Investment in shares of S Co was subsequently transferred to a Luxembourg company ('L Co'), an unrelated entity. Acquisition by L Co was as part of a broader transaction involving the majority acquisition of S Co group.

The applicants approached the tax department under section 197 of the Income Tax Act, 1961 ('the Act') for 'Nil' withholding certificate. However, Department held that Applicants are not eligible to avail benefit of India-Mauritius Treaty.

Applicants sought a ruling from AAR on a question i.e. whether the gains arising to the Applicants from the sale of shares held in S Co, to a company incorporated in Luxembourg, would be chargeable to tax in India under the Act read with the tax treaty between India and Mauritius?

Ruling of AAR: Firstly, AAR rejected the Department's argument that the application should be rejected as the issue was already decided by Department by way of proceedings u/s 197 of the Act. AAR distinguished the ruling in the case of ArevaNP SAS, France on the grounds that

in that case applicant had made concurrent application for tax withholding certificate as well as AAR application without making appropriate disclosure before the AAR.

AAR examined applicants' principal objective as per notes to financial statements and ownership structure and concluded that Applicants were set up for making investment in order to derive benefit under the tax treaty between Mauritius and India. AAR observed that the real management and control of the applicants was not with their respective Board of Directors but with Mr. X, the beneficial owner of the entire group structure. The applicant companies were only a "see-through entity" to avail the benefits of treaty. Key decisions were taken by the US based non-resident Director. The control and management of applicants does not mean the day-to-day affairs of their business but would mean the head and brain of the Companies and the authority to operate the principal bank account was with US-based director Mr. X, who was also signatory for parent company.

AAR observed that all the three applicants had not made any other investment other than in the shares of S Co. Thus, the real intention of the applicants was to avail the benefit of India-Mauritius treaty, whatever be the stated objective.

Against the contention raised by applicant that shares of the S Co derived their value substantially from assets located in India and, therefore, it was eligible to take benefit of tax treaty between India-Mauritius, AAR observed that even if the S Co derived its value from the assets located in India, the fact remain that what the applicants had transferred was shares of S Co and not that of an Indian company. The objective of India-Mauritius treaty is to allow exemption of capital gains on transfer of shares of Indian company only and any such exemption on transfer of shares of the company not resident in India, was never intended by the legislator.

9.33. PILCOM vs. CIT [2020] 116 taxmann.com 394 (SC)

Understanding of facts: The International Cricket Council ('ICC') a London based non-profit making organization controls and conducts the game of cricket in different countries of the world. For hosting of 1996 World Cup Tournament (Tournament), India, Pakistan and Sri Lanka were selected to jointly host the Tournament.

A joint management committee, named PILCOM ('Assessee') for the purpose of conducting the Tournament in these three countries was formed by the cricket boards of the these three countries and two bank accounts were opened in London, to which the receipts from sponsorship, T.V. rights etc., were deposited and expenses were met.

The accounts were to be operated jointly by the representatives of the Indian and the Pakistan Cricket Boards. The surplus amount remaining in the said Bank account was decided to be divided equally between the Cricket Boards of Pakistan and India after paying a lump-sum amount to Sri Lanka Board as per mutual agreements amongst the three Boards.

Tax Officer noticed that Assessee has made payment to ICC and cricket control boards of the different countries who took part in Tournament, without making TDS u/s 194E of the Act. The CIT(A) and ITAT upheld the Tax Officer's views and held that payments were taxable in India

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to the extent they were related to participation in matches played in India whereas the payments which were not related to participation in matches played in India were held to be not taxable in India.

Hon'ble High Court upheld the views of ITAT and observed that the provisions of the Act governing the taxability of guarantee fees to non-resident sports associations do not use the phrase "chargeable to tax". Therefore, the payer is responsible to withhold taxes @ 10% on the gross amount of payment. The obligation to make TDS is not affected by the tax treaty provisions as a deduction is neither a final payment of tax nor an assessment of tax. Further, payee can plead applicability of the provisions of the tax treaty by filing return of income in India but it is not open for the payer to do so at the time of making the payment to payee.

Ruling of Supreme Court: The Hon'ble Supreme Court held that the payments (guarantee money) made to the non-resident sports associations by the Assessee, represented income which is deemed to accrue or arise in India. Consequently, the Assessee was liable to deduct TDS on such payments to the extent attributable to matches played in India. Key observations of Supreme Court are as under:

The source of income, though described as guarantee money, was connected with the playing of the matches in India.

The special provisions for taxation of non-resident sports association clearly mandates that if the total income includes guarantee money, paid "in relation to" any game or sports played in India, the money is taxable @ 10% in India. The expression "in relation to" in section 115BBA, emphasizes the connection between the game or sport played in India and guarantee money to which such association is entitled to. Hence, as soon as the connection is established, the liability to tax and the corresponding withholding obligation arise.

The obligation to deduct TDS is not affected by the tax treaty. In case, the eligibility to tax is disputed by the payee on whose account the deduction of tax is made, the benefit of tax treaty can be considered by the payee and if found valid the taxes deducted can be claimed as a refund with interest. However, such a treatment does not absolve the payer from carrying out withholding obligations under the Act.

9.34 Union of India v. U.A.E. Exchange Centre [2020] 116 taxmann.com 379 (SC) (Civil Appeal No. 9775 of 2011)

Understanding of facts: The Taxpayer, a limited company incorporated in United Arab Emirates (UAE) was engaged in offering remittance services for transferring monies from UAE to various places in India.

The Taxpayer set up liaison Offices (LOs) in India after obtaining a license from the Reserve Bank of India (RBI), for undertaking the following activities: (i) responding to enquiries from correspondent banks; (ii) undertaking reconciliation of bank accounts held in India with correspondent banks; (iii) acting as a communication centre; (iv) printing drafts and dispatching the same to the customers; and (v) following up with the Indian correspondent banks.

The LO, under the approval, was not allowed to carry out any other activity of trading, commercial or industrial nature. No commission/income can be charged by LO for its activities. Entire expenses of LO shall be met out of funds received from abroad. LO cannot borrow/lend any money from/to any person in India without RBI approval etc. Further, the taxpayer could not and has not acquired any immovable property in India otherwise than by way of lease for operating the LO. The activities carried on by the LOs were in accordance with the RBI approval.

Taxpayer rendered remittance services to non-resident Indians (NRI) in UAE under contracts entered in UAE. Taxpayer would collect funds from NRI remitter in UAE and thereafter electronically remit the funds on behalf of the remitter by two modes i.e. (i) telegraphic transfer through bank channels or (ii) Sending instruments or cheques through its LOs to the beneficiaries designated by its customers.

In the second mode (which was the activity under dispute), the LO would download the particulars of remittances through electronic media and print the cheques/drafts drawn on the Indian banks which in turn are couriered to the beneficiaries, as per the instructions of NRI remitter. In doing such activities, the LO remained connected with its main server in UAE which could be accessed by the LO for the purpose of remittance of funds to the beneficiaries in India.

The Taxpayer had approached the AAR for determining its taxability with respect to the operations carried out by the LOs in India. The AAR ruled that: (i) The Taxpayer has a business connection in India because there was a real, continuous relationship between the business carried on by the Taxpayer and the activities of the LOs, which contributed directly or indirectly to the earning of income by the Taxpayer; (ii) The LOs carried out a part of the contract of remitting amounts, which constituted an essential activity in the performance of the Taxpayer's contractual obligations; (iii) The LOs in India constituted a PE within the meaning of the Treaty and income attributable to the LOs would be taxable in India even under the Treaty.

The High Court quashed the ruling of AAR and held that the Taxpayer was not liable to tax in India.

The High Court held that the commission for the remittance services offered by the Taxpayer was earned in UAE and the activities undertaken by the LOs in India were only supportive of the transaction carried on in UAE and, therefore, activities are to be considered as preparatory or auxiliary in nature.

Ruling of Supreme Court:

Hon'ble Supreme Court confirmed the findings of the High Court that the activities conducted by the liaison offices were 'preparatory and auxiliary' and hence excludable from the purview of PE. Supreme Court referred to the limited permission granted by the RBI to the Taxpayer regarding the activities to be conducted by its LO in India.

Hon'ble Court noted that as per the nature of activities allowed for under the RBI permission, the liaison offices were only allowed to provide service of and incidental to delivery of cheques / drafts drawn on bank in India. They were not allowed to perform business activities such as (i) entering into a contract with any party in India; (ii) rendering consultancy or any other service directly or indirectly with or without consideration to anyone in India; (iii) borrowing or lending any money from

or to any person in India without RBI's permission. Thus, it was amply clear that the liaison offices in India were not to undertake any other activity of trading (commercial or industrial) or enter into any business contracts in its own name in India.

On this basis, Hon'ble Court concluded that the nature of activities conducted by the LOs as circumscribed by the RBI constituted 'preparatory and auxiliary' in character, and hence outside the purview of PE.

Additionally, the Court noted that through the liaison offices, the Taxpayer was not carrying on any business activity in India, but only dispensing with the remittances by downloading the information from the UAE server and printing the cheques / drafts. The liaison offices could not even charge commission / fee for its services. Therefore, no income actually accrued to the liaison offices under the provisions of the Act.

Thus, Hon'ble Court concluded that the Taxpayer was not carrying on any business in India and hence the deeming provisions under sections 5 and 9 of the Act could not be invoked.

8.35 DIT vs. Samsung Heavy Industries Co Ltd (Civil Appeal no. 12183 of 2016) (Supreme Court)

Understanding of facts : The Taxpayer i.e. Samsung Heavy Industries Co. Ltd, a company incorporated in South Korea, along with another Indian company (I Co / Larsen & Toubro Limited), entered into a "turnkey contract" with Oil and Natural Gas Corporation (ONGC) in February 2006 (Project) for carrying out the work of surveys, design, engineering, procurement, fabrication, installation and modification at existing facilities, and startup and commissioning of entire facilities covered under the Project. An application was filed with the Reserve Bank of India (RBI) for setting up a PO in Mumbai, India for coordination and execution of the Project. The RBI approval was received in May 2006, which did not place any restrictions on the PO's activities. The PO had only two employees and it did not incur any expenditure in relation to execution of the contract in the relevant tax year.

The Taxpayer filed its tax return for AY 2007-08 on 21 August 2007, declaring a loss in respect of its India operations. Such loss was reduced in tax assessment on account of certain adjustments. In respect of its offshore operations, the Taxpayer claimed that it did not trigger any tax liability in India and, accordingly, no amount of income was offered to tax. However, the Tax Authority attributed 25% of gross profits related to offshore activities as income attributable to the PE in India, in accordance with directions of DRP.

Tribunal confirmed the order of the Tax Authority. On an appeal to the High Court (HC), the HC set aside the Tribunal's order and observed that there was no evidence or justification on record that 25% of the gross revenue of the Taxpayer outside India was attributable to the business carried out by the PO in India. Further, tax liability could not be fastened without establishing that the same is attributable to the tax identity or the PE of the enterprise situated in India.

Ruling of Supreme Court :

Relying upon its decisions in case of Hyundai Heavy Industries Co. Ltd. ((2007) 7 SCC 422), Morgan Stanley & Co. Inc. ((2007) 7 SCC 1), Ishikawajima-Harima Heavy Industries Ltd. ((2007) 3 SCC 481) and E-Funds IT Solution Inc. ((2018) 13 SCC 294), Supreme Court observed that said judgments make it clear that when it comes to “fixed place” permanent establishments under double taxation avoidance treaties, the condition precedent for applicability of Article 5(1) of the double taxation treaty and the ascertainment of a “permanent establishment” was that it should be an establishment “through which the business of an enterprise” was wholly or partly carried on.

Hon'ble Court further found that the profits of the foreign enterprise were taxable only where the said enterprise carries on its 'core business' through a permanent establishment. What was equally clear was that the maintenance of a fixed place of business which was of a preparatory or auxiliary character in the trade or business of the enterprise would not be considered to be a permanent establishment under Article 5. Also, it was only so much of the profits of the enterprise that may be taxed in the other State as was attributable to that permanent establishment. Further, the Board Resolution of the Taxpayer, application filed with RBI for opening of the PO indicate that the PO was established to coordinate and execute delivery documents in connection with the construction of offshore platform and modification of existing facilities for ONGC. It was not for the coordination and execution of the entire Project itself.

The PO was not carrying out any core activity for executing the Project. Accounts of the PO substantiate that no expenditure relating to the execution of the contract was incurred by the Taxpayer. Further, only two persons were working in the PO, neither of whom was qualified to perform any core activity. Accordingly, The PO cannot be said to be a fixed place of business from where core business activities are not carried on and it is solely an auxiliary office for liaising between the Taxpayer and ONGC. The PO is eligible for exclusion from PE since it is carrying out only auxiliary activities under Article 5(4)(e) of the DTAA.

8.36 Engineering Analysis Centre of Excellence (P.) Ltd .vs. CIT (2021) (25 taxmann.com 42) (Supreme Court)

Understanding of facts: The Taxpayer ('EAC') was a resident Indian end-user of shrink-wrapper computer software, directly imported from the United State of America (USA). The Tax Authority after applying article 12(3) of the Double Taxation Avoidance Agreement (DTAA), between India and USA, and upon applying section 9(1)(vi), found that what was in fact transferred in the transaction between the parties was copyright which attracted the payment of royalty and thus, it was required that tax be deducted at source by the Indian importer and end-user, EAC. Since this was not done for both the assessment years, EAC was held liable to pay the amount that it had not deducted as TDS, along with interest under section 201(1A). The appeal before the Commissioner (CIT) was dismissed. However, the appeal before the Income Tax Appellate Tribunal (ITAT) succeeded in which the ITAT followed its previous order dated 18-2-2005, passed in Samsung Electronics Co. Ltd. v. ITO [2005] 94

ITD 91 (Bang.).

The High Court of Karnataka, on an examination of the End-User Licence Agreement (EULA) involved in the transaction, found that what was sold by way of computer software included a right or interest in copyright, which thus gave rise to the payment of royalty and would be an income deemed to accrue in India under section 9(1)(vi), requiring the deduction of tax at source.

Ruling of Supreme Court:

The Supreme Court adjudicated on the appeal in the following four categories of software payments:

Category 1 – Sale of software directly to an end user by an NR

Category 2 – Sale of Software by an NR to Indian distributors for resale to end customers in India

Category 3 – Sale of software by an NR to a foreign distributor for resale to end customers in India

Category 4 – Software bundled with hardware and sold by foreign suppliers to Indian distributors or end users

The Supreme Court gave a common ruling for all the four categories of software payments, as below:

Whether software payments amount to use of copyright under the Copy Right Act, 1957

- Meaning of “copyright” in the definition of royalty should be understood as per the Copy Right Act, 1951, and not otherwise.
- A copyright means an exclusive right to do or to authorize to do certain acts in respect of a “work”, including an exclusive right, inter alia, to reproduce the copyright in the work in any material form and exploit the same by way of sale, transfer or license etc.
- A computer program (software) qualifies as a “literary work” for the purposes of the Copy Right Act, 1951. As per Section 30 of the Copy Right Act, 1951, the owner of copyright in a “literary work” is entitled to grant any interest in his rights by way of a license in return for a royalty payment.
- Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts. Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance. Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied.
- Terms of some sample agreements with the distributor and end users of the software are indicated as follows:
 - Distributors were granted a non-exclusive, non-transferable license to resell

computer software to end users.

- Distributors did not have a right to use the software
- The agreement specifically stated that the copyright in the software was not transferred, either to the distributor or to the ultimate end user.
- End users were allowed only to use the software and they were restricted from sub-licensing, transferring, reverse engineering, modifying, or reproducing the software.

The past judicial decisions rendered by the AAR²⁰ and the Delhi High Court²¹ held as follows:

- Parting with copyright entails parting with the right to do any of the specified acts conferred under the Copy Right Act, 1951 (such as reproduction, issue of copies, commercial exploitation etc).
- A non-exclusive, non-transferable license merely enabling the use of a copyrighted product, which is subject to restrictive conditions, cannot be construed as a license to enjoy all or any of rights of the copyright owner, or to create any interest in any such rights. Such license granted does not qualify as license of the nature specified in Section 30 of the Copy Right Act, 1951.

The use of the software is different from the right to reproduce granted under the Copy Right Act, 1951. Reliance in this regard was placed on the SC ruling in the case of State Bank of India (SBI) v. Collector of Customs, which held that mere use of software, subject to restrictions, does not result in parting of a copyright in the software.

- In case of license, the end user only gets a right to use computer software and not any of the rights conferred on the owner of a copyright under the Copy Right Act, 1951. There is a difference between the ownership of a physical item in which the software is embedded and ownership of the copyright. For e.g., in a case where a publisher sells books to an Indian distributor who then resells the same at a profit, it would not involve transfer of any rights to the Indian distributor. On the other hand, if the publisher sells the book to an Indian publisher, with the right to reproduce and make copies of the book, it would result in grant of copyrights to the Indian publisher and payment made by the Indian publisher would qualify as royalty.
- Making a copy or adaptation of a computer program in order to utilize it for the purpose for which it was supplied, making back-up copies as a protection against loss, does not result in infringement of copyright under the Copy Right Act, 1951. Even storage of computer program, per se, would not result in infringement.

The nomenclature of the agreement does not matter. What is relevant to be considered is the

²⁰ AAR ruling In Re., [(2010) 327 ITR 1 (AAR)]

²¹ Delhi High Court in case of Ericsson Radio Systems AB (ITA No. 504/2007, 507/2007, 508/2007, 511/2007 and 397/2007)

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real nature of the transaction, having regard to the overall terms of the agreement and surrounding circumstances.

- What is “licensed” by the foreign, NR supplier to the distributor and resold to the resident end user or directly supplied to the resident end user is, in fact, the sale of a physical object which contains an embedded computer program. This is sale of goods, which does not involve transfer of a copyright in the software. Reliance in this regard was placed on the decision of SC in the case of Tata Consultancy Services.
- As per the doctrine of first sale, once a copyrighted article is sold by the owner of the copyright, then the owner exhausts all rights to control that particular article/copy, although the copyright continues to vest with the owner
- The Copy Right Act, 1951 provides an exclusive right to the owner of a copyright to sell or rent a copy of software to the extent such copies are not copies already in circulation. Thus, it prevents a person other than an owner from reproducing the software and transferring them to a subsequent user. This suggests that the Copy Right Act, 1951 intends to apply the doctrine of first sale/principle of exhaustion.

The tax authority argued that the Copy Right Act, 1951 was amended in 1994 and 1999 and it no longer recognizes the principle of exhaustion. Accordingly, when distributors sell computer software or copyrighted software license to end users, there would be parting of a right or interest in the copyright itself, as per the Copy Right Act, 1951. Furthermore, reliance was placed on the decision of the US Court of Appeals in the case of Timothy S. Vernor v. Autodesk Inc.¹², to contend that the doctrine of first sale cannot be invoked by the distributor/licensee who are not the owner of copyright.

- The intent of the Copy Right Act, 1951 is not to prevent a distributor from selling the software which is licenced to be sold by the distributor, but to prevent reproduction of copies of software already sold and sale thereof. A distributor cannot use the software at all and it merely resells the product to end users. Thus, it is incorrect to suggest that distribution of software by the distributor constitutes grant of an interest in the copyright or infringement of the copyrights.

Royalty definition under the ITA v. DTAA

- The DTAA contains an exhaustive definition of the term “royalty”. It includes payment made for the use or right to use any copyright in a literary work. The royalty definition under the Act is different and wider as compared to the royalty definition under the DTAA. The Act refers to consideration paid for transfer of all or any rights, including by way of a license, in respect of any copyright.
- As the license granted to distributors and end users does not create any interest or right in the software, grant of such license would not amount to the “use of or right to use” of copyright and, hence, it would not qualify as royalty under the DTAA.
- The phrase “in respect of” used in the ITA means “in” or “attributable to”. Thus, in order to qualify as royalty even under the ITA, it is a sine qua non that there has to be transfer

of all or any rights in a copyright by way of license or otherwise. In a case where there is payment for grant of license, such payment would qualify as royalty only if such license results in transfer of rights in the copyright granted to the owner of a copyright under the Copy Right Act, 1951.

- Since the license granted to the distributors and end users did not involve granting of any interest in the rights of an owner of a copyright, payment made for such license does not qualify as royalty both under the Act, as subsisted till 2012, as well as the DTAA.
- The Copy Right Act, 1951 was amended in 2012 to provide that transfer of all or any rights includes transfer of all or any rights for use of a computer software. This amendment expands the royalty definition and may not be considered as clarificatory in nature. However, such payments would not qualify as royalty for the purposes of the DTAA.

Relevance of OECD Commentaries and India's positions on the OECD Commentary

- Definition of "royalty" under all the relevant DTAA's under consideration is identical or similar to the definition of royalty under the OECD MC. Hence, the OECD Commentary on the same becomes relevant.
- The OECD Commentary supports that making a copy or adaptation of a computer program to enable the use of the software for which it was supplied does not constitute royalty. This also supports that the payment made by distributors and end users does not qualify as royalty.
- Although India has stated its position on the above OECD Commentary that, in some cases, such use may also qualify as royalty, the positions are vague and do not alter the DTAA's provisions, unless it is actually amended by way of bilateral renegotiation.
- Also, India has not amended the DTAA's under consideration post expressing the positions on the OECD MC/Commentary to modify the definition therein. Moreover, even the DTAA's signed post expressing the positions on the OECD MC/ Commentary contain a similar definition as contained in DTAA's signed prior to expressing India's positions on the OECD MC/ Commentary. Hence, the guidance provided by the OECD would continue to have persuasive value for interpretation of the DTAA.
- For clarity and certainty, the DTAA provisions that are aligned to the OECD MC may be interpreted in light of the OECD Commentary.

Retrospective amendment and obligation to withhold taxes

- The definition of "royalty" under the Act was amended in 2012 by way of insertion of Explanation 4 (with retrospective effect from 1 June 1976), purportedly to clarify that the transfer of all or any rights in respect of any right, property or information includes right for use/to use a computer software (including the granting of a license), regardless of the medium through which such right is transferred (Explanation 4).
- Explanation 4 expands the royalty definition. A person who made a payment prior to 2012 cannot be expected to apply the expanded definition of royalty which was not in existence at the time of making payments to determine withholding obligations under Section 195. The substantive amendment to the Act does not compel a person to do the

impossible i.e., the law does not demand the impossible and impotentia excusat legem i.e., when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused).

Whether treaty benefits, if any, can be considered while determining withholding obligation under Section 195

- Section 195 of the Act confers a withholding obligation on the person paying any sum to an NR, which is chargeable to tax under the Act. Thus, the machinery provisions of Section 195 are interlinked with the charging provisions of the Act.
- Total income of an NR chargeable to tax in India includes income which accrues, arises or is deemed to accrue or arise in India. This, however, is subject to the provisions of a DTAA. In a case where an item of income is not chargeable to tax as per the DTAA, then such income would not be chargeable to tax even under the Act.
- A person referred to in Section 195 is required to withhold tax only if the amount is chargeable to tax under the Act as well as the DTAA.
- The tax authority's argument basis the date of entry into force article under the India-US DTAA was rejected on the ground that the distinction between withholding taxes and other taxes is made in the DTAA only to indicate different date of applicability of DTAA provisions and that does not affect the chargeability of income under the DTAA and, consequently, under the Act.
- In any case, acceptance of the tax authorities' contention would result in absurd results, where the taxes would be withheld even where the income is not chargeable to tax in India and withholding would be done at a rate much higher than the DTAA than the tax that is ultimately payable by the NR taxpayer.
- The SC decision in the case of PILCOM was concerned with a case of payments to NR sportspersons, which was governed by other provisions of the Act which were not linked with the chargeability under the ITA, unlike Section 195. Hence, the SC decision in the case of PILCOM is not applicable to cases where Section 195 applies

8.37 Concentrix Services Netherlands B.V. vs. ITO (2021) (127 taxmann.com 43) (Delhi High Court)

Understanding of facts: The Taxpayers, being resident of Netherlands, were contemplating to receive dividend income from its wholly-owned Indian subsidiaries

The Taxpayers made an application with the tax authority to grant a lower rate withholding certificate under the ITL, wherein the request was to permit remittance of dividend by Indian companies after withholding taxes at lower rate of 5% as per I-NL DTAA read with MFN clause and India's DTAA's with Slovenia/ Lithuania/ Columbia.

The tax authority issued a withholding tax certificate stating that the taxes will be required to be withheld at the rate of 10% as per I-NL DTAA when dividend income is remitted.

The Taxpayers contended that the benefit of MFN clause was automatic and triggered the moment India entered into a beneficial DTAA with a member of OECD and there was no

requirement to issue any specific notification to accord the beneficial rate of 5%. Aggrieved by the same, the Taxpayers filed writ petitions before the Delhi HC.

Ruling of High Court :

The High Court granted the benefit of 5% withholding tax rate on dividend income by virtue of MFN clause of I-NL DTAA and based on the below reasonings ruled that the 10% withholding certificates should be quashed and a fresh certificate indicating lower rate of 5% should be issued by the tax authority:

- The protocol of a DTAA forms an integral part of the DTAA and there is no requirement of issuing a separate notification in order to apply the provisions of the protocol. Reliance was placed on the Delhi HC decision in the case of Steria (India) Ltd. v. CIT [[2016] 386 ITR 390]
- The MFN clause, which forms part of the protocol, incorporates the principle of parity between I-NL DTAA and the DTAA's executed with the third states thereafter by India qua the rate of withholding tax or the scope of the DTAA in respect of items of income concerning dividends, interest, royalties, etc.
- As per the MFN clause, the principle of parity is applicable if the following conditions are satisfied:
 - The third state with whom India enters into a DTAA should be a member of the OECD.
 - The DTAA executed with the third state limits the rate of withholding tax imposed by India at a rate lower or a scope more restricted, than the rate or scope provided in the subject DTAA, i.e., I-NL in the present case.
- On satisfaction of the above conditions, the benefit of lower withholding tax or the restricted scope of DTAA with the third state should be applicable to I-NL DTAA from the date when the DTAA with the third country comes into force.
- Further, the contention of the tax authority that the benefit of MFN clause would be available only if the country with which India enters into a DTAA was an OECD member at the time of execution of the subject DTAA (i.e. I-NL in the present case) is misconceived and contrary to the plain language of I-NL DTAA. Rather, there could be a hiatus between the dates on which the DTAA is executed between India and the third state and the date when such third state becomes a member of OECD. The MFN clause can only apply when the third state fulfils the attribute of being a member of the OECD.
- On the contention of the tax authority that MFN clause of I-NL DTAA can be made applicable only in cases where the third state "is" a member of OECD on the date when the DTAA has been entered into with India, whereas the DTAA's with Slovenia/Lithuania/Columbia were entered into with India when these countries were not OECD members and became OECD members only on a later date, the HC has observed as below:
- The word "is" describes a state of affairs that should exist not necessarily at the time when I-NL DTAA was executed but when a request is made by the payer or deductee for issuance of a lower rate withholding tax certificate under the ITR.
- Assuming the DTAA language is susceptible to two readings, to glean the intent of the

India and Netherlands in framing MFN clause reliance can be placed on the decree issued by Netherlands, wherein Netherlands has provided the benefit of 5% withholding tax with reference to participation dividend paid by companies resident in Netherlands to a body resident in India from the date when Slovenia became a member of OECD.

- As per “common interpretation” rule, in order to allocate tax claims equally between the two contracting states, the courts of the contracting states are required to ensure that DTAAAs are applied efficiently and fairly so that there is consistency in the interpretation of the provisions by the tax authority and courts of the concerned states. However, the common interpretation rule should be applied with care and caution having regard to the fact that the view expressed could be unique and/or personal to the tax authority or a court. Hence, an attempt should be made to choose a view that finds general acceptance with courts and authorities.
- In the present case, Netherlands has interpreted the MFN clause in a particular way and, therefore, the principle of common interpretation should apply on all fours to ensure consistency and equal allocation of tax claims between the contracting states.
- While interpreting international treaties including DTAAAs the rules of interpretation that apply to domestic or municipal law need not be applied, as international treaties, conventions and DTAAAs are negotiated by diplomats and not necessarily by men instructed in the law.
- Therefore, interpretation of DTAAAs is liberated from the technical rules which govern the interpretation of domestic/municipal law. The core function of a DTAA should be seen to aid commercial relations and equitable distribution of tax revenues in respect of income which falls for taxation in both the contracting State Unit X

Unit X:	Triangular Cases
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10.1 Background

Countries enter into bilateral Double Tax Convention with the objective of eliminating or mitigating the impact of juridical double taxation. However, often situations arise where, despite the incorporation of article on methods of elimination of double taxation (i.e., Article 23A – exemption method or Article 23B – credit method or a combination of the two), the same income is taxed more than twice in certain specific kinds of cases.

The double taxation arises because a bilateral Double Tax Convention involves two tax jurisdictions and takes care of double taxation in those two tax jurisdictions whereas the cases that are being considered here involve triple taxation in three tax jurisdictions. In international tax parlance, such cases are known as triangular cases.

10.2 What is a Triangular Case?

A triangular case, as the name suggests, involves following three tax jurisdictions.

- State 'R' – the State in which the taxpayer is resident. The taxpayer is subject to tax in that State because of residence based taxation.
- State 'P' – the State in which the taxpayer is having a permanent establishment. The taxpayer is subject to tax in that State to the extent of income attributable to that permanent establishment because of source based taxation.
- State 'S' – the State from which the permanent establishment of the taxpayer earns income. The taxpayer is subject to tax on that income because of source based taxation.

Thus, while in case of two States, only one Double Tax Convention between State 'R' and State 'P' is involved, in case of a triangular case, with the involvement of three tax jurisdictions, three Double Tax Conventions are involved. These are: Double Tax Conventions between (i) State 'P' and State 'S', (ii) State 'R' and State 'P' and (iii) State 'R' and State 'S'.

10.3 Which sectors are generally affected?

Generally, triangular cases arise in all such sectors which are mainly service oriented and do not require permanent 'on-ground' presence. Accordingly, following sectors are generally affected.

- Banking
- Financial services
- Insurance services
- Regional headquarter operations
- Onsite technical support services (which are required to be provided urgently and therefore, are provided from a nearby location).

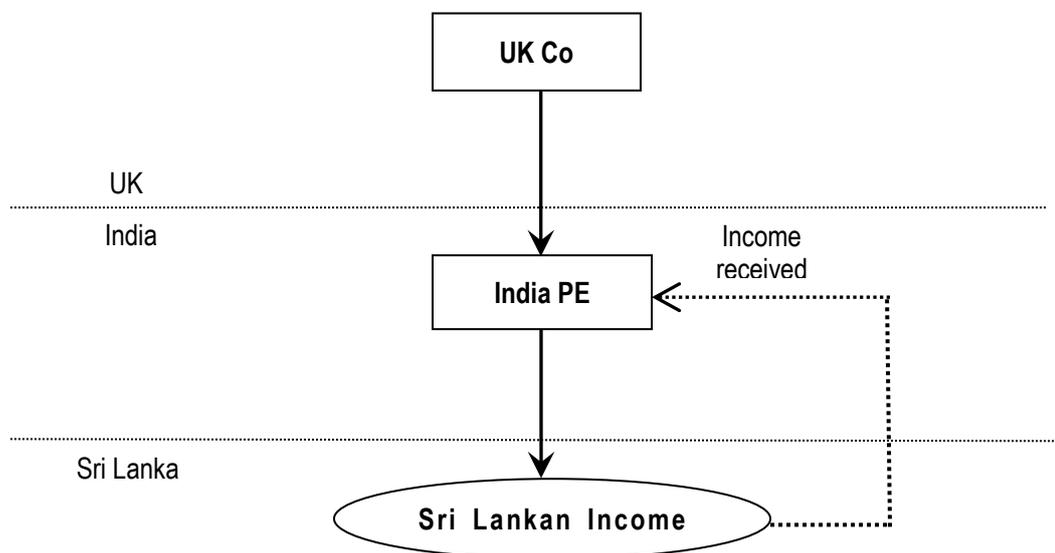
10.4 Case Study

The following case study will clarify how a triangular case develops and what issues arise from a triangular case involving three tax jurisdictions. The case study is based on certain assumptions. These assumptions do not reflect the actual tax rates or Double Tax Convention provisions.

Facts

- UK Co is a company incorporated in, and tax resident of, the UK.
- UK Co is engaged in time sensitive service based activity, which requires provision of services through deputation of personnel.
- UK Co has set up a branch in India for provision of time sensitive services. In terms of India-UK Double Tax Convention, the Indian branch of UK Co is a permanent establishment.
- The personnel of the Indian branch are based in India but for provision of services on emergency basis, they visit Sri Lanka from India.
- During the course of the year, the Indian branch personnel visited Sri Lanka for providing services. The branch earned income from Sri Lanka which was subject to tax in Sri Lanka and hence, the payer has withheld tax in Sri Lanka.

Following diagrammatic presentation will impart clarity to the aforementioned situation.



Assumptions

(a)	Income earned by Indian branch from Sri Lanka	1,000
(b)	Withholding tax rate in Sri Lanka	20%
(c)	Tax withheld in Sri Lanka	200
(d)	Income earned by Indian branch in India	2,000
(e)	Tax rate in India	30%
(f)	Tax liability in India on income earned in India	600
(g)	Tax liability in India on income earned in Sri Lanka but attributed to Indian branch	300
(h)	Total taxable income earned by Indian branch	3,000
(i)	Total tax liability in India	900
(j)	Total tax borne by Indian branch (Sri Lanka, 200 + India, 900)	1,100
(k)	Tax rate in UK	35%
(l)	Tax in UK on income earned in India (i.e., 2,000)	700
(m)	Tax in UK on income earned in Sri Lanka (i.e., 1,000)	350

Issues

- (a) India has entered into Double Tax Convention with Sri Lanka. The Indian branch of UK Co has earned income on which tax is chargeable in Sri Lanka.

Issue: *whether India-Sri Lanka Double Tax Convention can apply in such case?*

- (b) India has entered into Double Tax Convention with Sri Lanka. The income earned by the Indian branch of UK Co from Sri Lanka is subject to tax in India since it is attributable to the Indian permanent establishment.

Issue: *since the income earned by the Indian branch from Sri Lanka is attributable to the Indian branch, and since the Indian branch is subject to tax in India on such income, whether, under India-Sri Lanka Double Tax Convention, the Indian branch can claim credit for tax paid in Sri Lanka against tax payable by it in India on the income earned from Sri Lanka?*

- (c) The UK has entered into Double Tax Convention with Sri Lanka. the Indian branch of UK Co has earned income from Sri Lanka.

Issue: *whether UK Co can claim Double Tax relief under UK-Sri Lanka Double Tax Convention?*

- (d) The core underlying issues are as follows.

Issue: *as there are three Double Tax Conventions, which of these would apply – Source-PE or PE-Residence or Source-Residence?*

Issue: whether juridical triple taxation of the same income can be avoided or mitigated in any manner?

10.5 Issues

Having identified the issues, it would be interesting to discuss each issue separately

10.5.1 Will India-Sri Lanka Double Tax Convention apply?

Income earned by India branch from Sri Lanka is chargeable to tax in Sri Lanka as well as in India. A branch (or a permanent establishment) is not a legal person. Double Tax Conventions apply to 'persons' which are resident of one of the two States.

This proposition can be better understood by reference to certain provisions of the Income-Tax Act, 1961.

- Section 4 is the charging provision which charges tax on total income of every 'person'.
- Section 2(7) defines "assessee" primarily as a 'person'.
- Section 2(31) defines "person" to include several categories. One of the categories is 'a company'. However, definition of "person" does not include a 'branch' or a 'permanent establishment'.

Thus, for the purpose of the Income-Tax Act, 1961, UK Co being the 'person' is the 'assessee' and not its Indian branch. Since the Indian branch is not a 'person', it cannot be the 'resident' of the State in which it is situated (in this case, India). Therefore, the Indian branch cannot access India-Sri Lanka Double Tax Convention. Accordingly, India-Sri Lanka Double Tax Convention cannot apply in case of the Indian branch.

10.5.2 Will Indian Branch get Credit for Tax Withheld in Sri Lanka?

Credit for tax can be claimed only by applying the provisions of a Double Tax Convention. As discussed earlier, the Indian branch cannot access India-Sri Lanka Double Tax Convention. Therefore, the Indian branch cannot claim credit for tax withheld in Sri Lanka (i.e., 200 – see 3.3 in illustration).

However, since income from Sri Lanka is attributable to the Indian branch, it would be subject to tax in India. Accordingly, in addition to the tax payable on income earned by Indian branch in India, it will also be required to pay tax on the income earned in Sri Lanka (i.e., 300 – see 3.7 in illustration)

10.5.3 Can UK Co get credit under UK-Sri Lanka Double Tax Convention for Tax Withheld in Sri Lanka?

As discussed earlier, only a 'person' can access a Double Tax Convention. Since UK Co is a 'person', UK Co can access UK-Sri Lanka Double Tax Convention. Since the income earned in Sri Lanka will be subject to tax in UK, UK Co can claim credit for tax withheld in Sri Lanka (i.e., 200 – see 3.3 in illustration).

10.5.4 Which Double Tax Convention will apply?

As discussed earlier, only a 'person' can access a Double Tax Convention. Since UK Co is a 'person', UK Co can access UK-India Double Tax Convention. Also, UK Co can access UK-Sri Lanka Double Tax Convention. However, UK Co cannot access India-Sri Lanka Double Tax Convention. Since the income earned in India will be subject to tax in UK, UK Co can claim credit for tax withheld in India. Also, since the income earned in Sri Lanka will be subject to tax in UK, UK Co can claim credit for tax withheld in Sri Lanka.

However, in this case, the issue will be: *whether UK Co can claim credit in UK in respect of only the tax paid in India on the income earned in India (i.e., 600 – see 3.6 in illustration) or also the tax paid in India on the income that is earned in Sri Lanka and on which India has levied tax (i.e., 300 – see 3.7 in illustration)?*

10.5.5 Whether Triple Taxation can be mitigated?

Practically, income earned by the Indian branch from Sri Lanka has suffered tax thrice – firstly, in Sri Lanka, secondly, in India and thirdly, in the UK. A bilateral Double Tax Convention mitigates double taxation in two countries. As mentioned earlier, income from Sri Lanka is a case of triple taxation in three countries.

Normally, under a Double Tax Convention, the obligation on the Residence State is only to give credit for tax paid and only to the extent of tax payable in the Residence State. Hence, the credit that UK Co may get in UK cannot exceed 350 (see 3.13 in illustration).

Sri Lankan tax on income earned in Sri Lanka is 200. Indian tax on the same income is 300. Since India will not give credit for tax paid in Sri Lanka, the total tax paid on Sri Lankan income is 500. However, UK tax on the same income is 350.

In terms of Double Tax Convention between UK and Sri Lanka and between UK and India, UK will give credit to its resident (i.e., UK Co) to the extent of tax paid in Sri Lanka or India as the case may be. Further, such credit will be restricted to the extent of tax payable in the UK. In such case, practically, following three scenarios may emerge.

- The UK tax authority may hold that as the income was sourced in Sri Lanka and since Sri Lankan tax was 200, only 200 can be claimed by UK Co against its UK tax liability of 350 on the same income. Thus, UK Co may, effectively, pay aggregate tax of 650 (i.e., 200 in Sri Lanka + 300 in India + 150 in UK).
- The UK tax authority may hold that the higher of the tax paid in Sri Lanka or India will be allowed. In that case, the maximum credit that UK Co can get is 300.
- Even if UK tax authority were to adopt the most liberal approach, the credit cannot exceed the tax payable in the UK (i.e., 350) as granting any higher amount will amount to the UK giving refund of tax which was collected by a foreign government.

10.6 Conclusion

As will be seen from the foregoing discussion, triangular cases may not have a satisfactory solution under the bilateral Double Tax Conventions. The possible solution could be that the Residence State grants unilateral relief. However, even if the Residence State were to grant unilateral relief, full mitigation of triple taxation is not likely to happen as such relief would be limited to the tax payable in the Residence State.

Annexure

Relevant extract of the OECD's commentary on the Articles of the Model Tax Convention

COMMENTARY ON ARTICLE 1 - CONCERNING THE PERSONS COVERED BY THE CONVENTION

Application of the Convention to partnerships

2. Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships", the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.

3. As discussed in that report, a main source of difficulties is the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries adopt what may be referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners are taxed on their respective share of the partnership's income.

4. A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the Convention. Under Article 3, only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 1 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.

5. Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence (see paragraph 8.8 of the Commentary on Article 4).

6. The relationship between the partnership's entitlement to the benefits of a tax Convention and that of the partners raises other questions.

6.1 One issue is the effect that the application of the provisions of the Convention to a

partnership can have on the taxation of the partners. Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.

6.2 Another issue is that of the effect of the provisions of the Convention on a Contracting State's right to tax income arising on its territory where the entitlement to the benefits of one, or more than one, Conventions is different for the partners and the partnership. Where, for instance, the State of source treats a domestic partnership as fiscally transparent and therefore taxes the partners on their share of the income of the partnership, a partner that is resident of a State that taxes partnerships as companies would not be able to claim the benefits of the Convention between the two States with respect to the share of the partnership's income that the State of source taxes in his hands since that income, though allocated to the person claiming the benefits of the Convention under the laws of the State of source, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of that person.

6.3 The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

6.4 Where, as described in paragraph 6.2, income has "flowed through" a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as "paid" to the partners since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfy the condition, imposed in several Articles that the income concerned is "paid to a resident of the other Contracting State". Similarly the requirement, imposed by some other Articles, that income or gains are "derived by a resident of the other Contracting State" is met in the circumstances described above. This interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, can claim the benefits of the Convention with respect to that income. Following from the principle discussed

in paragraph 6.3, the conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.

6.5 Partnership cases involving three States pose difficult problems with respect to the determination of entitlement to benefits under Conventions. However, many problems may be solved through the application of the principles described in paragraphs 6.2 to 6.4. Where a partner is a resident of one State, the partnership is established in another State and the partner shares in partnership income arising in a third State then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his State of residence. If, in addition, the partnership is taxed as a resident of the State in which it is established then the partnership may itself claim the benefits of the Convention between the State in which it is established and the State of source. In such a case of "double benefits", the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention; therefore, where different rates are provided for in the two Conventions, the lower will be applied. However, Contracting States may wish to consider special provisions to deal with the administration of benefits under Conventions in situations such as these, so that the partnership may claim benefits but partners could not present concurrent claims. Such provisions could ensure appropriate and simplified administration of the giving of benefits. No benefits will be available under the Convention between the State in which the partnership is established and the State of source if the partnership is regarded as transparent for tax purposes by the State in which it is established. Similarly no benefits will be available under the Convention between the State of residence of the partner and the State of source if the income of the partnership is not allocated to the partner under the taxation law of the State of residence. If the partnership is regarded as transparent for tax purposes by the State in which it is established and the income of the partnership is not allocated to the partner under the taxation law of the State of residence of the partner, the State of source may tax partnership income allocable to the partner without restriction.

6.6 Differences in how countries apply the fiscally transparent approach may create other difficulties for the application of tax Conventions. Where a State considers that a partnership does not qualify as a resident of a Contracting State because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows through the partnership. Difficulties may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to a transaction. Some of these difficulties are discussed in paragraph 19.1 of the Commentary on Article 5 and paragraphs 6.1 and 6.2 of the Commentary on Article 15.

6.7 Finally, a number of other difficulties arise where different rules of the Convention are applied by the Contracting States to income derived by a partnership or its partners, depending on the domestic laws of these States or their interpretation of the provisions of the Convention or of the relevant facts. These difficulties relate to the broader issue of conflicts of qualification, which is dealt with in paragraphs 32.1 ff. and 56.1 ff. of the Commentary on Article 23.

COMMENTARY ON ARTICLE 4 - CONCERNING THE DEFINITION OF RESIDENT

8.8 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership “flows through” to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

India's position on the Commentary

India does not agree with the interpretation put forward in paragraphs 5 and 6 of the Commentary on Article 1 and the corresponding interpretation in paragraph 8.8 of the Commentary on Article 4 according to which if a partnership is denied the benefits of a tax convention, its members are entitled to the benefits of the tax conventions entered into by their State of residence.

It believes that this result is only possible, to a certain extent, if provisions to that effect are included in the convention entered into with the State where the partnership is situated.

COMMENTARY ON ARTICLE 5 - CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

19.1 In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

COMMENTARY ON ARTICLE 15 - CONCERNING THE TAXATION OF INCOME FROM EMPLOYMENT

6.1 The application of the second condition in the case of fiscally transparent partnerships

presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (see paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an “employer” (especially under the domestic law definitions of the term in some countries, e.g. where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.

6.2 The object and purpose of subparagraphs *b*) and *c*) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph *b*) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of “employer” and “resident”, as found in subparagraph *b*), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax conventions must be applied at the partners’ rather than at the partnership’s level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (*i.e.* the State in which the greatest part of the deduction will be claimed)

India’s position on the Commentary

India does not adhere to the interpretation set out in paragraph 6.2, because it does not recognise the concept of a partner being treated as an employer in the case of fiscally transparent partnership.

COMMENTARY ON ARTICLES 23 A AND 23 B - CONCERNING THE METHODS FOR ELIMINATION OF DOUBLE TAXATION**I. Preliminary remarks*****E. Conflicts of qualification***

32.3 Different situations need to be considered in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles

require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

32.4 This point may be illustrated by the following example. A business is carried on through a permanent establishment in State E by a partnership established in that State. A partner, resident in State R, alienates his interest in that partnership. State E treats the partnership as fiscally transparent whereas State R treats it as taxable entity. State E therefore considers that the alienation of the interest in the partnership is, for the purposes of its Convention with State R, an alienation by the partner of the underlying assets of the business carried on by the partnership, which may be taxed by that State in accordance with paragraph 1 or 2 of Article 13. State R, as it treats the partnership as a taxable entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which could not be taxed by State E by reason of paragraph 5 of Article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States and State E must be considered by State R to have taxed the gain from the alienation “in accordance with the provisions of the Convention” for purposes of the application of Article 23 A or Article 23 B. State R must therefore grant an exemption pursuant to Article 23 A or give a credit pursuant to Article 23 B irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if State E's qualification of the income were consistent with that of State R, State R would not have to give relief under Article 23 A or Article 23 B. No double taxation will therefore arise in such a case.

32.5 Article 23 A and Article 23 B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable. For instance, in the example above, if, for purposes of applying paragraph 2 of Article 13, State E considers that the partnership carried on business through a fixed place of business but State R considers that paragraph 5 applies because the partnership did not have a fixed place of business in State E, there is actually a dispute as to whether State E has taxed the income in accordance with the provisions of the Convention. The same may be said if State E, when applying paragraph 2 of Article 13, interprets the phrase “forming part of the business property” so as to include certain assets which would not fall within the meaning of that phrase according to the interpretation given to it by State R. Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law. In the former case, State R can argue that State E has not imposed its tax in accordance with the provisions of the Convention if it has applied its tax based on what State R considers to be a wrong interpretation of the facts or a wrong interpretation of the Convention. States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation.

32.6 The phrase “in accordance with the provisions of this Convention, may be taxed” must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

32.7 This situation may be illustrated by reference to a variation of the example described above. A business is carried on through a fixed place of business in State E by a partnership established in that State and a partner, resident in State R, alienates his interest in that partnership. Changing the facts of the example, however, it is now assumed that State E treats the partnership as a taxable entity whereas State R treats it as fiscally transparent; it is further assumed that State R is a State that applies the exemption method. State E, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which it cannot tax by reason of paragraph 5 of Article 13. State R, on the other hand, considers that the alienation of the interest in the partnership should have been taxable by State E as an alienation by the partner of the underlying assets of the business carried on by the partnership to which paragraph 1 or 2 of Article 13 would have been applicable. In determining whether it has the obligation to exempt the income under paragraph 1 of Article 23 A, State R should nonetheless consider that, given the way that the provisions of the Convention apply in conjunction with the domestic law of State E, that State may not tax the income in accordance with the provisions of the Convention. State R is thus under no obligation to exempt the income.

III. Commentary on the provisions of Article 23 B (Credit method)

69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State of source treats a partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of source may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realized and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence, however, will only tax the partner on his share of the partnership’s income when that income is realized by the partnership.

69.2 The first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership’s income, is obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows through the income of the partnership to the partner

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for the purpose of taxing him, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.

69.3 A second issue that arises in this case is the extent to which the State of residence must provide credit for the tax levied by the State of source on the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence, there is simply no tax in the State of residence against which to credit the tax levied by the State of source upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence should not be expected to credit the tax levied by the State of source upon the distribution against its own tax levied upon generation (see the first sentence of paragraph 64 above).

Glossary

Advance Pricing Agreement (APA)	Advance Pricing Agreement is a procedure to settle Transfer pricing issues by the taxpayer by negotiating with the competent revenue authorities for determination of 'arm length price' as per applicable transfer pricing methods before entering into a transaction(s).
Advance Ruling	To save the taxpayer from being saddled with uncertainty, an Authority for Advance Ruling has been set up which gives 'Advance Ruling' on Income Tax matters pertaining to an investment venture in India, in advance which are binding in nature.
Ambulatory Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time the treaty is being applied.
Base erosion and Profit Shifting (BEPS)	It refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to tax haven jurisdictions when there is no or insignificant economic activity to reduce corporate tax liabilities.
Capital Export Neutrality	The principle that investors should pay equivalent taxes on capital income, regardless of the country in which the income is earned.
Capital Import Neutrality	The principle that all investments within a country should face the same tax burden regardless of the residential status of the investor.
Consolidated Tax Regime	Consolidated Tax Regime is a system which treats a group of wholly owned or majority-owned companies and other entities (such as trusts and partnerships) as a single entity for tax purposes. Head entity of the group is responsible for all or most of the group's tax obligations.
Controlled Foreign Company (CFC)	A controlled foreign company is a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners.
Distributive rule	The basic purpose of Distributive clause in Tax Treaties is to lay down principles on which basis will be decided the right of the jurisdiction to levy tax.
Double Non Taxation	It is a situation where an income is not taxed in either of the contracting states to a treaty by virtue of the right to tax being given to one state and the income being exempt in that state.
Double Taxation	Double taxation is the levying of tax by two or more jurisdictions on the same income, asset, or financial transaction, as the case may be.

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Double Tax Avoidance Agreement (DTAA)	A Double Tax Avoidance Agreement (DTAA) is essentially a bilateral agreement entered into between two countries, whose basic objective is to promote and foster economic trade and investment between them by avoiding double taxation.
Dual Residence	It is possible to be resident for tax purposes in more than one country at the same time. This is known as dual residence.
Dualist view	Dualists view emphasizes the difference between national and international law, and require the translation of the latter into the former. DTAA becomes part of the National Legal system by specific incorporation / legislation in case of Dualistic View. Accordingly International law has to be national law as well, or it is no law at all.
Economic and Juridical Double Taxation	Double taxation is juridical when the same person is taxed twice on the same income by more than one state. Double taxation is economic if more than one person is taxed on the same item.
Entry into force	Entry into Force is the effective date from which the provisions of various bilateral Tax Treaties will come into force as per applicable OECD, UN or US Model Tax conventions.
Exemption with progression method	It means income earned in the source Country, though considered as exempt, is included in total income in the Country of residence for purpose of determining effective tax rate.
Fiscal Residency	Fiscal Residency, also known as Tax Residence is a test determining status of Residence of a person (including Companies) for the purpose of levy of tax in a state depending on domicile, place of management, close connection, etc. A person can be Fiscal Resident of two states at the same time wherein Tie-Breaker rules need to be applied.
Force of Attraction Rule	It implies that if a Foreign Enterprise sets up a Permanent Enterprise in Source state, all income derived by the foreign enterprise whether through PE or not will be taxable in source state.
Host Country	The country where source of income is situated is known as Host country.
Instrument of Ratification	Instrument of Ratification refers to a notification issued by a state to its counterpart state that it has made necessary changes in its local laws pursuant to the treaty.
International Offshore Financial Centres (IOFCs)	International Offshore Financial Centres are those tax jurisdictions where bulk of financial sector activities are of non residents. It is characterised by large number of financial institutions majority of whose ownership is with non-residents not opened to meet local needs but because of tax havens, secrecy and anonymity.

Last Better Offer Approach	It is the approach which is used in the Arbitration process to moderate the position of the negotiators so that the likelihood of its acceptance increases.
Monist View	Monists view accept that the internal and international legal systems form a unity. International Law and National Law are part of the same system of Law and thus DTAA overrides domestic law.
Most Favoured Nation (MFN)	MFN clause is usually found in Protocols and Exchange of Notes to DTCs. This clause helps in avoiding discrimination amongst residents of different countries. Once this clause is part of a treaty, the residents of contracting states get equal treatment as was earlier given to resident of other states.
Mutual Agreement Procedure (MAP)	The process of resolution of tax disputes arising between contracting States (of a tax treaty) by the competent authorities thereof.
Non Discrimination Clause	It is a clause found in many Tax Treaties whose aim is to ensure that there is no discrimination between the local assesseees and foreign assesseees as far as taxation is concerned.
Permanent Establishment (PE)	A permanent establishment is a fixed place of business which generally gives rise to income in a particular jurisdiction. The term is defined in many income tax treaties. It is a fixed place of business through which the business of an enterprise is wholly or partly carried on.
Protocol	A protocol in essence is a Treaty entered into between two countries at a later point of time, which nevertheless forms an essential part of the Tax Treaty and can be referred to while applying the earlier treaty entered into between the countries.
Ring Fencing	It means to financially separate a company from its parent company to make it immune from Financial ups and downs of parent company.
Round Tripping	Round tripping is where money is routed back into the country by local investors through tax havens. The income is sourced in the same country where the shareholder is resident but the income passes through a company resident in another country for tax reasons.
Specific Anti Avoidance Rules (SAAR)	Specific Anti Avoidance Rules are provisions that identify with precision the type of transactions to be dealt with and prescribe against the tax consequences of such treatment.
Safe harbor rules	Safe Harbor rules are those which when followed for certain international transactions, relieve the taxpayer of much complications as arm length price declared by him under transfer pricing will be accepted by tax authorities.

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Shell/ Conduit company	Conduit Company is a company which is set up in connection with a tax avoidance scheme. Whereby income is paid by a company to the conduit and then redistributed by that company to its shareholders as dividends, interest, royalties, etc.
Stateless person	A person who is not considered as a 'national' by any State under the operations of its law.
Static Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time of signing of treaty.
Switch over clause	It is a clause in a Tax Treaty to facilitate switching over by a taxpayer for foreign tax credit from exemption method to the credit method essentially to avoid Double Non Taxation.
Tax Equity	It implies that Each country whether being a country of Residence or a country of source must be entitled to its fair share of revenue. Also, taxpayers involved in cross border transactions must neither be saddled with additional levy of tax nor be given any undue concessions which results in discrimination.
Tax Information Exchange Agreement	Tax Information Exchange Agreement is a bilateral or multilateral agreement which gives legal authority to the contracting states to exchange tax related information by tax jurisdictions with the counterparts which was otherwise not possible.
Tax Inversion	Tax inversion means relocation of a company's legal domicile to a lower - tax nation, usually while retaining its material operations in its higher-tax country of origin.
Tax Residency Certificate (TRC)	It is a certificate issued by the government of a state to which a person belongs containing certain details concerning his or her residential status for claiming the benefit of any Tax Treaty in source state.
Tax Sparing Clause	Under the Tax sparing clause there is a provision where a country applies a tax credit against taxes owed on foreign income which is equivalent to the tax exemption provided by the foreign country.
Tax Terrorism	A situation where tax officials take undue advantage of powers conferred upon them for discharging their functions.
Tax Treaty	Government - to- Government agreement to prevent Double Taxation and Tax evasion by the resident of one country earning an income in the other.
Thin Capitalisation	A company is said to be thinly capitalised when its capital is made up of a much greater proportion of debt than equity, i.e. its gearing, or leverage, is too high. Also, the debt portion is financed by the parent co. and the purpose is to minimise tax expenses and nothing else.

Tie-Breaker Test	It is a test which is used to determine the predominance situation in cases where a person becomes fiscal resident in both the contracting states under a treaty.
Transfer Pricing (TP)	Transfer pricing refers to pricing the goods and services sold between associated and/ or controlled and/ or related legal entities within a group. It is the setting of the price for goods and services sold between controlled (or related) legal entities.
Treaty Shopping	The practice of structuring a multinational business to take advantage of more favourable tax treaties available in certain jurisdictions. For eg. a situation where a person, who is resident in one country (say the "home" country) and who earns income or capital gains from another country (say the "source" country), is able to benefit from a tax treaty between the source country and yet another country (say the "third" country).
Triangular Taxation	Triangular Taxation refers to a situation where tax incidence on a particular stream of income is typically triggered in three countries. Eg: A company resident of country A sets up a branch in country B which has some economic transactions generating income in country C.
Underlying Tax Credits	A method employed by a home country to provide fiscal incentives for outbound investments by home-based multi-national companies in which the total tax cost on foreign dividends is capped at the level of the home country's corporate tax rate.
Unilateral (Tax) relief	It refers to the relief scheme which can be provided to the tax payer by home country irrespective of whether it has any agreement with other countries or has otherwise provided for any relief at all in respect of double taxation. The purpose is to eliminate cascading effect of double Taxation.