THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 2.05 – INDIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Based on the *Master Card* ruling given by AAR, MC Singapore will establish PE in India. The candidate must discuss the nature of the PE includes Fixed Place PE in India (due to MIPs & Mastercard Network), Fixed Place PE in India (through the bank), Fixed Place, Subsidiary and Dependent Agent PE in India (of MC Singapore). Based on the transaction structure as explained in the question, candidate is required to evaluate the permanence of activity through use of technology or network as a factor of establishing permanent establishment. Further, utilization of equipment (though owned by customers) entirely controlled through technology provided by MCI & MC Singapore, would result in fixed place of PE. MCI having no activity in India as such, no PE is being established of MCI in India.

Part 2

Attribution of profits to the PE (depending on the nature of PE concluded) should be based on the functions performed, assets employed, and risks assumed by Indian entity on behalf of the MC Singapore. However, it will be important to highlight the factors on the basis of which such profits can be allocated such as:

1. MIPs being considered fixed place – Ownership, control and operations;
2. Subsidiary PE & Dependent Agent PE; and
3. MyCard Network – relevant of DEMPE function.

In this scenario, having concluded that there is fixed place PE, allocation of profits are required to be made on the basis of segregation of functional profile of MC Singapore and that of its fixed place PE (in the nature of MIP) or through use of MyCard network. Accordingly, arm's length standard of profits to be attributed has to be paid by the MC Singapore to MC India

The current remuneration structure between entities (i.e. MC Singapore to MC India) would not be considered arm's length based on the AAR Ruling in case of Master Card. Though it is not a settled position of law, in such factual pattern PE would be held to be in India. However, candidates may highlight that once arm's length price is established, additional attribution cannot be done merely on the basis of the fact that PE has been determined.

Part 3

Based on the provisions of section 9(1)(i) business connection can be established. Reliance can be placed on the position taken in the AAR Ruling in case of MasterCard, for establishing PE under the treaty and examining the nature of payment (in AAR Ruling, it was held to be royalty). However, having concluded there is a PE, taxability will not be restricted to royalty as computation of profit attributable to PE will have to be done and computation of income will have to be on the basis of provisions of ITA. Alternatively, if candidate evaluates chargeability as FTS, factor concerning human intervention being involved also needs to be considered. In absence of human intervention in the process of transaction processing directly, charges/fees cannot be held to be FTS.

Part 4

Section 9(1)(i), 9(1)(vi) & 9(1)(vii) will be examined. In case of fees payable to MC Singapore, final tax at the rate of 10% under section 115A could be applied. Business connection u/s 9(1)(i) could be established and accordingly, tax would be payable in India. However, question of attribution would not arise once tax is deducted on gross amount under special provisions of section 115A.

Question 2

Part 1

Amalgamation of foreign company into another foreign company is not covered under the section 47 exception except for section 47(vi), which is the not the case here. There is a potential capital gain issue at the company level (Nexus). However, one can argue, relying on the AAR decision in *Banca Sella* that there is no consideration (and hence the capital gains provisions will not work following *Srinivasa Shetty*). The revenue might argue on the basis of transfer pricing but this argument was also rejected by *Banca Sella* because there was no underlying capital gains tax liability in the first place. However there is a risk under section 56(2)(x).

Income characterised as 'other income' will likely not receive treaty protection under the India UK DTAA (Article 23(3)) and India will have a right to tax such income. But *Banca Sella* also stated that section 47 should in any case apply because of non-discrimination provisions in the treaty. However, *Banca Sella* decision was regarding the India-Italy DTAA. Both the DTAAs apply identical non-discrimination provisions to 'nationals' of the contracting states. The India-Italy DTAA defines nationals to include legal persons, whereas the India UK DTAA does not define nationals. The client should seek an AAR ruling if it wants some certainty for this transaction.

Part 2

For Vector, the same arguments apply: if anything the position is even more clear-there is no consideration received and therefore no capital gains issues.

Part 3

It is clear that both Frankie and Robert have received consideration and therefore there is a potential capital gains issue. U.K. India DTAA will not provide CGT relief. For Frankie, indirect transfer provisions will apply because Nexus shares would be considered as Indian sited property under section 9. Robert comes within the de minimus exception in section 9. The candidate must lay out precisely the structure and ambit of indirect tax provisions in the ITA.

Part 4

On sale, indirect transfer provisions will not apply because of the 50 percent rule in section 9(1) Explanation 6. The candidate must state the precise application of the 50 per cent rule to the facts, identifying the Indian asset portion of Vector's global assets.

Part 5

The redemption of Vector debentures (capital assets) is taxable in the hands of a non-resident (M) if the debentures have their situs in India. Vector shares and debentures are not situated in India because of the 50 per cent rule in section 9(1) Explanation 6. The redemption of Vector debentures will not result in the application of indirect tax provisions as it is not India situated property.

PART B

Question 3

Part 1

The candidate must lay out the scheme of India UK DTAA PE taxation and consider the provisions of Article 5 The question asks whether the activities performed by E Smart India for E Smart UK will have tax consequences. There is no PE risk for E Smart UK as the functions are performed by E Smart India, which is a separate corporate entity. Article 5(6) of the UK India DTAA states that a subsidiary cannot ipso facto become a PE.

Part 2

Per *Morgan Stanley*, there is a Service PE risk for E Smart UK (under Article 5(2)(K), a service PE requires only 30 days of presence annually if services are performed for associated enterprises) but attribution is limited to arms-length payments made to E Smart India. However E Smart UK can claim that the deputation relates to ancillary business activity and therefore no PE is formed, replying on *E Funds* case. If E Smart UK wants to pursue this, it can seek an AAR ruling but pragmatically, because of the limits to attribution, it won't be necessary.

Part 3

There are no Indian tax implications under section 9 (1)(v) for the interest payment from E Smart UK to UK bank. Withholding of 15% (under DTAA) on interest payment from ESmart India to ESmart UK No Indian tax implications on capital subscription issues as per the Bombay High Court decision in *Vodafone*. Section 56(vii)(b) will not apply because the subscriber is a non resident.

Part 4

There is no tax treaty with Jersey, so one has to look at section 9. The issue is whether the access fee is a fee for technical services. E Smart India can confidently take the position, based on case law, that an access fee is not technical services because the services are not customised for any particular client: what has been provided is a fully automated software facility.

Question 4

Part 1

As per Section 9(1)(i) of the ITA, the income of XPL from the contract can be said to be earned through a business connection in India and therefore, the income is deemed to accrue and arise in India. Accordingly, the income is chargeable to tax in India under the ITA.

Section 44BB contains a special regime for taxation of income derived by a non-resident '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' in India. Accordingly, income of non-resident taxpayer is liable to income tax at applicable rates on 10% of the gross receipts earned from such operations in India. Section 44BB(3) provides an option to the tax payer to claim lower profits (than 10% of gross receipts) provided books of accounts are maintained by the non-resident in India.

Part 2

XPL is a tax resident of Singapore and India DTAA with Singapore. Section 90(2) provides that where India has DTAA with any country, then the provisions of ITA shall apply only if they are beneficial to the taxpayer. The income of XPL from the contract would be considered as a business profit in the hands of XPL. Business profits (under Article 7) will be taxable in India only if such income is earned through a permanent establishment (PE) in India.

Article 5 provides for the cases in which it can be said that a non-resident has established a permanent base in India. Specifically, Article 5(5) of the DTAA provides that a resident of Singapore will create a PE in India if it provides services or facilities in India in connection with the exploration, exploitation or extraction of mineral oils in India for a period of more than 183 days in a fiscal year.

The drilling services provided by XPL to CIL under contract do not exceed 183 days in any fiscal year - the services were commenced in January 2018 and will continue only for 120 days in subsequent year. Therefore, the presence in India was for a total of 180 days spread over two fiscal years. XPL's operations in India did not exceed 183 days in any fiscal year, XPL did not create a PE in India in terms of Article 5.

Therefore, as per Article 7 r.w Article 5(5) of India-Singapore DTAA income of XPL from the contract with CIL is not chargeable to tax in India in the financial year 2018-19 and 2019-20 in absence of permanent establishment in India in both the years. Tax Residency certificate is essential.

Part 3

YPL is tax resident of Singapore and non-resident in India. YPL has no business activity in India. Section 195 provides that any person (whether resident or non-resident) responsible to paying to non-resident any sum chargeable to tax in India shall deduct tax at source on such sums as per the rate of taxes in force. However, section 195 is applicable only if the sums payable to non-resident are chargeable to tax in India.

XPL and YPL, both non-residents have entered into a charter party agreement for bareboat charter of the drilling rig YD in Singapore. Except for the contract with CIL, XPL does not have any other business activity in India. As XPL does not have any business connection or permanent establishment in India, provisions of ITA so far as deduction of tax at source are concerned shall not be applicable as the provisions of ITA extend only to India.

The income of YPL is neither received in India nor can be deemed to be received in India. The income also does not arise in India nor accrues to YPL in India. The income is received in Singapore and accrues and arises in Singapore. YPL has no presence or connection in India other than the fact that XPL had deployed its rig YD for the purpose of providing services under a contract in India with an Indian party.

YPL is providing its rig YD on bareboat charter to XPL for a period of 1 year with no specific condition on the deployment or the use of the rig. It establishes YPL does not have a business connection in India. Accordingly, the income cannot be deemed to be accruing or arising in India within the meaning of section 9(1)(i).

As per Explanation 2 to section 9(1)(v), which defines the term royalty, specifically excludes amounts referred to u/s 44BB from the meaning of royalty. The amounts would be amounts referred to u/s 44BB since they represent payments for the supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils in India. Therefore, the amounts would not be royalties deemed to accrue or arise in India.

In absence of business connection in India the income from the bareboat charter shall not be deemed to accrue and arise in India under section 9(1) and would therefore not be chargeable to tax in India. For XPL, since the sums being paid to YPL (non-resident) are not chargeable to tax in the hands of YPL, XPL would have no obligation to deduct tax at source u/s 195 of the ITA.

Part 4

In case the contract between XPL & YPL is for chartering of the rig with crew, the payment would be characterized as service and not rent. If the crew is operating on the rig in India in connection with service of drilling to be rendered by XPL, business connection could be established. Accordingly, under provisions of ITA, amounts payable by XPL to YPL will be chargeable to tax in India. As per DTAA between India & Singapore, if no PE is established, no tax would be deductible in India.

Part C

Question 5

Part 1

The answer depends on the residential status of GM (place of effective management). Under section 6(3) of the ITA read with the CBDT guidelines, GM will fail the active business test because more than 50% of employees and payroll are in India. The question therefore is where are the effective management decisions being made? From the facts, it looks likely that GM's residence would be in India and therefore its global profits would be taxed as an Indian resident company. The Article 4(3) tie breaker in the India Mauritius tax treaty rules will make GM resident in the county in which its place of effective management is situated (India).

Part 2

The question relates to the nature of the services performed by Vortex. Under Article 13(4), Vortex is performing consulting services. Vortex is protected under the 'make available' clause under in the India UK DTAA and it would be difficult for the revenue to argue that by advising GM on how to develop markets in the UK, Vortex is 'making available' its knowledge, experience and know how. Further, the commission paid to Vortex is for sales and not for the provision of technical services (although the type of consideration doesn't necessarily determine the nature of the service provided). Therefore, absent PE, one can take a position that Vortex will not be taxed in India. The candidate can refer to DIT v Welspun Corporation Ltd in this regard although that decision was on export services. If one wants to be cautious, a section 195(2) application can be submitted.

Part 3

The first issue is the characterisation of the severance payment. If the termination fee is interpreted as payment for giving up of a capital asset, it is possible that this would be a case of capital gain under section 9 as the contract (under which the right to receive payments arose) was signed and registered in India. Since there is no benefit of a tax treaty, the payment is taxable and will be subject to withholding under section 195. But under the *Srinivasa Shetty* principle, it will be difficult for the revenue to quantify the capital gain because of the problems in determining the cost basis in the severance payment. If termination payments are considered as business income under section 28, this income would not be taxable since there is no PE. An application under section 195(2) or an AAR ruling can be considered.

Question 6

Part 1

The candidate is expected to do a comprehensive review of the conditions necessary for the MLI amending the tax treaties and discuss ‘Covered Tax Agreements’, optional clauses and mandatory clauses.

Part 2

The candidate is expected to compare and contrast the Principal Purpose Test (the PPT rule) with the Indian GAAR, detailing the following:

- The conditions for the application of the PPT and the main features of the PPT rule;
- The practical difficulties in complying with both the PPT rule and the Indian GAAR; and
- Whether the ITA or the CBDT clarifications/guidelines have resolved the PPT/GAAR overlap issues.

Question 7

Part 1

The candidate is expected to evaluate section 96(1)(c) along with section 97(1)(c).

The transaction under consideration is that of an acquisition and holding company of the existing group is in Singapore. Accordingly, in order to acquire existing entity, it has commercial reasoning to setup new entity in same jurisdiction. Cross border amalgamation is restricted in several jurisdictions and is more time consuming. Hence local SPV setup helps in restructuring acquired entity as per local laws. Singapore is economically, politically and legally a stable jurisdiction and is not a tax haven.

Part 2

The candidate is expected to evaluate section 96(1)(c) along with 97(1)(b).

The declaration of dividend by the SPV to I Co out of such interest income is resulting in a tax benefit in India by utilizing underlying tax credit becoming available for the tax on foreign dividend paid by I Co under section 115BBD for the taxes paid in Singapore. Had it been directly lent by I Co to Holding Co., I Co would have paid taxes in India on such interest at the rate of 30% (plus applicable surcharge and cess) and therefore, the revenue may allege the SPV as an accommodating party to avail Indian-Singapore treaty benefit along with the special taxation regime available to domestic company under section 115BBD of the ITA. However, once the commercial substance for setting up SPV in Singapore is justified (in part 1), then it cannot be considered as accommodating party only for the reason that it provides flexibility in the capital structure for the operating entity. Even though the majority of funding by SPV to the operating company is in the form of debt it cannot be concluded that it is to avail benefit of zero withholding as per the domestic law of Austria. In case of acquisition of entity, there is much more commercial benefit than the tax.

Part 3

Hold Co was already existing in Singapore and SPV is also setup in same jurisdiction resulting into additional advantage of underlying tax credit based on transaction with an independent party at arm's length. Taxpayer has the right to arrange affairs in a manner which reduces the tax cost rather than maximizing it. Indian Apex court in case of *SA Builder* has held that revenue cannot sit on the judgement of a businessman. Further, in the case of a wholly owned subsidiary, funding by way of RPS only offers flexibility to repatriate capital as tax on dividend is uniform on all classes of share capital.

Question 8

Part 1

The conversion will not qualify for section 47 (xiii) exception (it will fail clause (d)-the partnership shareholding to continue for five years after conversion) but there won't be any capital gain since there is no consideration, hence there is no tax liability. The candidate can refer to *CIT Vs. Texspin Engg. & Mfg. Works* (2003) 263 ITR 345 and *CIT Vs. Umicore Finance Luxmeborg* (2017) 244 Taxman 43 (Bom).

Part 2

No, because Vestry will not qualify under section 47(xiii), and therefore would not be able to take advantage of section 72A(6).

Part 3

No, since the amalgamation will qualify under section 47. However there might be GAAR implications because Abakus UK is receiving shares in Vestry tax free whereas there would have been a tax payable if Abakus India had either sold Vestry shares to Abakus UK or distributed the Vestry shares to Abakus UK. On similar facts, the NCLT in *GABS* indicated there might be a GAAR issue (particularly misuse or abuse of the amalgamation provisions) and denied approval for an amalgamation. However the NCLT in the NIIT case, on similar facts, decided against the issue of tax avoidance (without discussing GAAR provisions). Abakus is advised to seek an AAR ruling if it decides to go through the amalgamation route.

Question 9

Part 1

For Indian tax purpose, KC LLC is a body corporate and it would be considered as a 'company' under the ITA. Under Section 2(22) of ITA, dividend is defined to include any distribution by a company of its accumulated profits. Therefore, in India, the receipt by Pardeep of his share of profits from KC LLC would be considered as a distribution of accumulated profits by KC LLC and accordingly, be regarded as dividend. 'Dividend' income is taxable under the head 'Income from other sources'.

As per India US treaty income from KC LLC being taxed both in the US (as business income) and in India (as dividend under domestic tax laws), it is necessary to examine the DTAA to determine the status of KC LLC and the treatment and taxability of income earned by KC LLC and received by Pardeep.

Since KC LLC has elected to be a 'disregarded' entity in US, it is not treated as a company. For the purposes of the DTAA the income from KC LLC would be considered as income in the hands of Pardeep (i.e. the owner/ partner) to the extent of his share (i.e. 75%). The technical explanation by the IRS to the DTAA between India and USA clarifies that under paragraph 1(b) of Article 4 of the DTAA, a partnership, estate or trust will be treated as a resident of a 'Contracting State' for purposes of the DTAA to the extent that the income derived by such person is subject to tax in that 'State' as the income of a resident, either in the hands of the person deriving the income or in the hands of its partners or beneficiaries.

Article 10 of the DTAA covers taxation of Dividends. The income from KC LLC would be treated as dividends for the purpose of the DTAA only if the income is treated as dividend under US tax laws. However, since under US tax laws, the income from KC LLC is not treated as dividends but as share of business income (profits) in the hands of Pardeep, it will not be treated as dividends under the DTAA. The entire amount would be considered as Business Profits under Article 7.
KC LLC would not be subject to tax on income either in India or in the US. Instead, the share of profits/ income from KC LLC will be taxed in the hands of Pardeep (and Sanjeev for his respective share) in the US as per rates applicable. The same income earned by Pardeep from KC LLC will be taxable in India as business profits (Article 7 of the DTAA). Credit of taxes paid in the US will be available to PA while paying taxes in India.

Part 2

Yes, TP Provisions will be applicable. TP provisions applies in case transaction is between associated enterprises, where, either or both are non-resident. Section 92A(2)(j) will apply on both the cases and accordingly, TP provisions will be applicable in respect of transactions between Pardeep & LLC.