THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 2.05 – INDIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Under Article 5(5) of the India-France DTA, a principal is deemed to have an Agency PE if the agent [other than of an independent status, which is not the case in hand since I Co. is acting exclusively on behalf of its related enterprise, viz. F Co.- Article 5(6)] acting on its behalf has and habitually exercises an authority to conclude contracts in a Contracting State.

In the case at hand, I Co. negotiates price and other key terms and conditions (being substantial activities) of the contract on behalf of F Co. in India, there is a possibility of I Co. constituting an Agency PE as per the DTA. Signing of the contract outside India may not be of any consequence as for Agency PE, provision in the DTA relating to 'authority to conclude contracts' needs to be seen.

Moreover, the amended definition of "business connection" as provided under Explanation 2 to Section 9(1)(i) of the Act as well relevant paragraph(s) under the DTA as modified vide the MLI inter alia provides that a person, other than agent of independent status, would constitute an Agency PE of the non-resident enterprise in contracting state if it plays a principal role leading to conclusion of contract, that is routinely concluded, without material modification by that non-resident enterprise for transfer/provision of good or services by that non-resident enterprise.

Part 2

F Co.'s products are customised products, and each product is designed and tailor-made for particular customer. The role of I. Co. extends from understanding a customers' requirement to providing suggestions on product design, agreeing to delivery schedules as also negotiating the price and other terms and conditions with F Co's customers in India. Negotiated prices/ terms and conditions are duly honoured by F Co. without any material modifications.

Given the substantive activities carried out by the I Co. surrounding customer contracts, the proposition, that I Co. follows standard operational guidelines provided by F Co. and hence cannot give rise to an Agency PE, may not be tenable. In other words, if an agent performs "principal role" leading to conclusion of contract(s) without any material modifications by the enterprise, I Co. would still constitute an Agency PE.

Part 3

The Supreme Court in Morgan Stanley has upheld the view that where a PE has been remunerated at arms' length, no further attribution should happen. This judgement was rendered in the context of a Service PE. In the context of Agency PE, the Mumbai High Court in the case of SET Satellite has also upheld the same proposition – Revenue's appeal in the case of SET Satellite is pending before the Supreme Court.

In the case at hand, the TP analysis and consequential arm's length determination has been made vis-à-vis the agreement/ marketing support services undertaken by the I Co. The aforesaid TP analysis, however, does not factor in substantial activities of negotiation of prices and contract terms with the customers that may warrant additional attribution of profits to the Agency PE in the instant case.

Question 2

Part 1

The total income of a non-resident includes all income from whatever source derived which (a) is received or is deemed to be received in India and (b) which accrues or arises or is deemed to accrue/ arise in India.

In terms of Explanation 2(v) to section 9(1)(vi) of the Act, royalty includes “the transfer of all or any rights (including the granting of a licence) in respect of any copyright”. Further, as per Explanation 4 to section 9(1)(vi) of the Act, the royalty, inter-alia, includes the payment of consideration (including a lump sum consideration) in regard to the transfer of all or any rights in respect of any right, property or information including the right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred. Based on this, software payments could be taxed as royalty since the use of a computer software is specifically covered under the definition of royalty as per the Act and may attract withholding tax.

However, the meaning of the term royalty as per Article 12 of the India-USA DTA is restrictive when compared to the Act. The term is generally applicable if it is for the use of, or right to use inter-alia any copyright, secret formula or process.

It becomes essential to understand what is meaning of the term “use or right to use” and “copyright”. It also needs to be understood whether there is distinction between a “copyright” and a “copyrighted article”. Transfer of copyright is completed when any of the rights mentioned in the Copyright Act, 1957 (“ICA”) is transferred to the buyer and in contrast copyrighted article means no such right is transferred and a product/ license is provided for limited use of such product.

Recently, the Supreme Court of India in the case of Engineering Analysis Centre of Excellence Private Limited v CIT (Civil Appeal Nos. 8733-8734 of 2018) along with multiple clubbed appeals held that a copyrighted article being computer software is not taxable as royalty under the DTA definition and accordingly no tax withholding is warranted under section 195 of the Act.

Key principles from the judgement of the Supreme Court are as follows:

- Meaning of “copyright” in the definition of royalty should be understood as per the ICA and not otherwise

- Copyright is an exclusive right, which is negative in nature and restricts others from doing certain acts

- Ownership of copyright in a work is different from the ownership of the physical material which is a copyrighted article

- A non-exclusive, non-transferable licence, merely enabling the use of a copyrighted product and which is subject to restrictive conditions, cannot be construed as a licence to enjoy all or any of rights of the copyright owner or to create any interest in any such rights

- OECD Commentary supports that making a copy or adaptation of a computer programme to enable the use of the software for which it was supplied does not constitute royalty – accordingly, OECD commentary can be utilized as aid to interpret international tax concepts

- For applicability of section 195 of the Act, for withholding tax purposes, there should be an “income chargeable” in the hands of the recipient non-resident

In the current set of facts, once the code is accepted in the downloaded software, ABC India can make multiple copies of the software for its internal use in manufacturing. ABC India cannot sell or otherwise distribute the software.

Since ABC India cannot sell or otherwise distribute the software, it is understood that what ABC India receives is a copyrighted article for internal consumption and not a copyright per se. Accordingly, within the restrictive meaning under the DTA, said amount cannot be construed as royalty and hence the same should not be taxable in the hands of XYZ.

Part 2

Section 195 of the Act provides that, any person responsible for making payment to a non-resident, any interest or any other sum chargeable to tax shall, at the time of credit of such income or at the time of payment thereof, whichever is earlier, deduct income-tax at the rates in force.

The Supreme Court in the aforementioned decision of Engineering Analysis had an occasion to review whether beneficial provisions of DTA can be considered by payers while deciding on tax withholding obligation while making payment to non-residents,

The Court relying on the earlier judgement in the case of GE India Technology Centre (P) Ltd v CIT [2010] 193 Taxman 234 (SC) held that requirement to withhold taxes do not trigger unless there is an income which is chargeable to tax in the case of the non-residents.

Accordingly, in the instant case, since the amount is not taxable as royalty under the DTA, ABC India can make the payment of the same to XYZ without withholding any taxes. ABC India should ensure obtaining tax residency certificate, Form 10F if required, and a no-PE declaration from XYZ.

The Supreme Court also distinguished the case of PILCOM v CIT.

If one carefully analyses the difference between section 195 of the Act vs 194E of the Act (as was relevant in the decision of PILCOM v CIT), one can note that section 194E of the Act requires withholding of taxes at flat rate of 20% whereas section 195 of the Act requires only when the sum paid is chargeable to tax in India. In section 194E of the Act, there is no reference to sum being chargeable to tax.

Additionally, rate of withholding tax as provided in section 195 refers to “rates in force” which is defined under section 2(37) of the Act which itself refers to DTAA entered into by India under section 90 of the Act.

ABC India and XYZ can take any of the following steps for ensuring Nil withholding:

- ABC India or XYZ can approach the Income Tax Department under section 195(2) or 195(3) of the Act to make a determination of the correct tax liability and requirement of withholding taxes.

- ABC India or XYZ can apply for an advance ruling as well to determine the taxability of the sums being received by XYZ and consequent withholding tax requirement.

Part 3

Under Action Plan 1 of the OECD’s Base Erosion and Profit Shifting (BEPS) Project, the OECD had considered an equalization levy (i.e. a tax to equalize the tax burden on remote and domestic suppliers of similar goods and services) as one option to tax digital transactions. While the Action Plan 1 did not recommend introducing such a levy as an internationally agreed standard at that stage, it did state that countries could introduce one in their domestic laws as an additional safeguard against BEPS, provided they respect existing treaty obligations, or include them in their bilateral tax treaties.

In India, the Finance Act, 2016 introduced EL with effect from 1 June 2016 which was restricted to gross consideration received by non-residents for online advertisement and related services from specified persons.

At the enactment stage of Finance Act, 2020, India introduced an amendment to Finance Act, 2016 to expand the scope of EL to cover gross consideration received by non-resident e-commerce operators. This EL will apply at the rate of 2% on the gross consideration received or receivable by the non-resident e-commerce operator from specified transaction where such receipts exceed INR 20 million during the relevant FY.

Further, the Finance Act, 2020 has extended the source rule by amending section 9 under the ITA to cover certain digital transactions, viz. related to significant economic presence which may overlap with the EL provisions. But the same would not override DTA PE concept.

The details of the newly introduced EL and relevance to current facts is as follows:

<u>Trigger of EL in India</u>

- Non-resident e-commerce operator who owns, operates or manages digital or electronic facility or platform in connection with India operations

- Non-resident who sells advertisement to another non-resident which targets an Indian resident customer or a customer who accesses the advertisement through internet protocol (IP) address located in India

- Non-resident who sells data, collected from an India resident person or from a person who uses IP address located in India

In the current set of facts, XYZ is the 'non-resident e-commerce operator' who supplies digital product being the software. owns, operates or manages digital or electronic facility or platform

<u>Specified services/ transactions on which EL is applicable</u>

- Online sale of goods owned by the non-resident e-commerce operator

- Online provision of services provided by the non-resident e-commerce operator

- Online sale of goods or provision of services or both, facilitated by the non-resident e-commerce operator

- Any combination of activities listed above

In the current context, it is important to understand that for EL to be applicable in the current transaction there should be "online sale of goods" or "online provision of services". Additionally, the e-commerce operator shall "own, operate or manage digital or electronic facility or platform".

In the current fact pattern, the Purchase Order is placed over email by ABC India. Further, the e-commerce operator (i.e. XYZ) supplies the code for license over telephone. While both email and telephone may fall within the meaning of "digital platform or facility" because of the wide meaning, the same may not be owned/ operated/ managed by XYZ. Accordingly, the sale of licenses of computer software program in the instant case may not be covered by EL.

Candidates may also outline an alternative view whereby a telephone may not be considered as "digital platform/ facility". However, as the code is ultimately downloaded through XYZ's website, the EL provisions may get triggered.

Amendments made/ proposed by Finance Act, 2021 have been ignore for the aforementioned analysis.

<u>Applicability on DTA</u>

Currently, arguments exist in relation to both the propositions that EL is and is not a tax similar to income-tax.

The action of the Indian Government to keep the levy outside of the ITA and introduce the same via Finance Act, 2016 would suggest that the intent of the Government to implement the EL as a levy which is not tax on income but tax on gross consideration such that levy remains outside the scope of DTA.

Accordingly, there is no clear answer on the issue, but the action and intent of the Government would suggest that EL is not a tax covered by the DTA and hence benefit of India-USA DTA may not be available to XYZ.

PART B

Question 3

Part 1

In terms of section 9(1)(i) of the Act, all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

However, India has enacted section 90(2) of the Act wherein the non-resident entity is eligible for DTA benefits. Under the DTA, current transaction may be taxable in India only if a business income arises out of a PE or the same is taxable as Royalty or FTS.

Article 5 of the DTA, provides various instances of constitution of a "permanent establishment" for a foreign enterprise in India which inter alia include (a) Fixed Place PE, (b) Agency PE, and (c) Service PE. In the current fact pattern, Fixed Place PE and Service PE would be relevant.

Fixed Place PE

A PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Further, fixed place PE exists if the following conditions are satisfied cumulatively:

- There is a "place of business" which will be used for carrying on the business of the enterprise
- Place of business is at the disposal of the enterprise
- Place of business should be fixed
- Business activity is wholly or partly through this fixed place of business

Accordingly, it is essential to understand whether all the activities would stand cumulatively satisfied in the current set of facts.

The OECD Commentary states that a permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. The 'core business' of the foreign enterprise should be conducted through the place of business. Such place of business should be at 'disposal' of the enterprise.

Disposal test is generally fulfilled where the enterprise has a formal legal right (as an owner or as a tenant) over the premises - however, such formal right is not a prerequisite to meet the disposal test.

In case of employees working from home, following could lead to creation of fixed place PE:

- Home office used on a continuous basis for carrying on business activities
- Rent and other similar expense being borne by the overseas entity. Even if the overseas entity does not pay rent for the premises, if no other premises is provided for the employee to work this could lead to an inference that there is a PE
- Long duration presence of employees
- Conduct of core business activities indicates effective use of premises

In a recent Danish decision [Case SKM2017.213.SR], Court adopted a liberal approach to hold that PE was created in a house of sales manager since he carried out core business of employer (German company) from his home. PE was seen to be held even though neither employer required the sales manager to work from his home, nor did it reimbursed for furnishing or setting up a home office.

In the current case, however there are following facts are in favour of non-creation of a fixed place PE:

- The employer of Madhu does not have any control over his house. Yes the house is from where services are provided but it is not at disposal of the overseas entity

- The reason for working from home is only due to pandemic and then visa issues. It is not that the overseas entity requires the employee to work from home in India

It may also be noted that the OECD released guidance in 2020. The guidance clarifies that use of home office by employees who are stranded in source country due to COVID-19 would not result in creation of home office PE as long as work from home does not become the new norm. Similarly, a number of countries have also released similar guidance.

While this guidance should aid taxpayers in defending a no PE position, but India has not released any such guidance. Nevertheless, the OECD guidance does have persuasive value in interpreting international tax rules as held in various judicial precedents including by Supreme Court in Engineering Analysis Centre of Excellence Private Limited v CIT (Civil Appeal Nos. 8733-8734 of 2018).

In the current case, one fact may go against U Ltd. While Madhu was stuck in India due to COVID-19, he/s he is unable to go back due to Visa issues. Accordingly, the Indian tax authorities would likely argue that Fixed Place PE is triggered and the reason for the same is not only due to COVID-19 but visa issues.

Additionally, Fixed place of business which is of preparatory or auxiliary character in the trade or business of the enterprise is not a PE under Article 5. In the current set of facts, Madhu is an engineer and is working on a specific software development project for clients located in the USA. Accordingly, it is arguable that preparatory or auxiliary exemption will not be available in the current case.

<u>Part 2</u>

<u>Service PE</u>

PE includes the furnishing of services, other than included services, 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 aggregating more than 90 days within any twelve-month period (1 day in case of related party).

Based on various judicial precedents, the expression 'furnish' means to provide or render. The expression furnishing of services includes doing activities or operations which are integral or contributory to the provision of services.

In the current set of facts, Madhu furnishes services of software development for clients and the activity is carried out for more than 90 days. The activities are furnished from within India and hence the same would likely trigger Service PE as well. The fact that Madhu provides services to clients outside India and in India does not change the determination of Service PE as the same is being provided from within India.

The OECD COVID-19 Guidance while provides guidance for various sorts of PE but does not provide any specific guidance for Service PE.

Question 4

Part 1

The tax deductibility of ESOP expenses in the hands of an employer has been a subject matter to controversy. The Revenue authorities alleges the expense to be 'capital' and/or 'notional' in nature that cannot be claimed under the provisions of Section 37 of the Act.

The issue was recently dealt in by Karnataka High Court in the case of M/s Biocon Ltd. While affirming the decision of Special Bench of the Tax Tribunal, the High Court observed that there is no requirement of pay out of expenditure under Section 37 of the Act, nor does it envisage incurrence of expenditure in cash.

The High Court, relying on Supreme Court decisions in case of Bharat Earth Movers and Rotork Controls India P. Ltd, held that discount on issue of ESOPs is not a contingent liability but is an ascertained liability. Karnataka High Court also held that, the expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount, where the assessee-employer absorbs the difference between the price at which it is issued and the market value of shares, would also be an expenditure incurred for the purposes of business and allowable under Section 37(1) of the IT Act. Similar views have been expressed by Madras High Court in PVP Ventures and Delhi High Court in Lemon Tree Hotels Ltd.

I Co. may rely on the aforesaid judicial precedent(s) along with the following line-of-arguments to justify its claim of ESOP expenses under Section 37 of the Act:

- ESOP plan is in the nature of a promise to compensate an eligible employee at a future date by making a valuable asset (viz. Equity Share of F Co.) available to her/him at a pre-determined discounted price (referred to as 'exercise price'), provided certain service/ performance conditions are fulfilled before the promise is honored.

- It incentivizes the employee to work hard towards the growth of the company during the term of ESOP plan, while at the same time promotes employee participation in equity capital of the parent company thereby accentuating a sense of ownership and belongingness to the Group at large.

- Benefits under ESOP scheme form integral part of employee compensation. Earnings under ESOPs accrue to eligible employees by virtue of their employment relationship with the Company. It forms part of their taxable salary and is fully subject to tax in his/her personal hands under the head 'Salaries.'

- Since I Co. is the direct and exclusive beneficiary of services rendered by the eligible employees, it is placed under a contractual obligation to fund the difference between the fair market value of the underlying shares and (pre-agreed) exercise price/ ESOP expense. In other words, the cross-charge represents the consideration paid by the Company to discharge its obligations towards the employee in terms of the employment contract. It can be likened to the Company making rental payments to a landlord to fulfil its contractual obligation on account of providing rent-free-accommodation to an employee. Or, it is similar to funding the cost of utilities, personal insurance, personal travel, etc. availed by an employee.

Part 2

The cross-charge, entered into between two associated enterprises, viz. F Co. and I Co., one of which is a non-resident, viz. F Co., qualifies international transaction as per Section 92B of the Act and accordingly needs to reported by I Co. in its Transfer Pricing documentation under

Section 92D of the Act and Accountant's Report in Form No. 3CEB under Section 92E of the Act.

Section 92(2A) of the Act requires the allowance for any expenditure (cross-charge/ESOP expense in the instant case) to be computed having regard to the arm's length price (ALP). ALP is in turn defined under Section 92F(ii) of the Act as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled transactions.

Section 92C of the Act lays down the prescribed methods for computation of ALP. In the instant case, I Co. can justify arm's length compliance of the cross-charge by employing "Other Method" prescribed under Section 92C(1)(f) of the Act read along with Rule 10AB of the Income Tax Rules, 1962 ("the Rules"). Other Method comprises any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. In the instant case, the cross-charge can be said to be arm's length compliant using "Other Method" since:

- It is based on valuation report issued by an independent valuer of international repute. The report employs 'Black-Scholes' model for valuation of ESOPs which is inter alia based on open-market variables, including real-time stock price of underlying shares as being traded on NASDAQ, and a widely accepted financial model across fiscal jurisdictions/ authorities.

- No mark-up is applied on the cross-charge by F Co. Not only the expense is charged on a cost-to-cost basis, but it is also vis-à-vis (third-party) employees of I Co.

PART C

Question 5

Part 1

In terms of section 9(1)(i) of the Act, all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

Under the provisions of the Act, a Project Office (PO) established in India could constitute a 'capital asset' or a 'source of income' or a 'property' situated in India and hence the transfer of assets of the PO in India may be subject to tax in the hands of A Ltd.

Taxability in the hands of A Ltd

Exemption in case of demerger is covered by sections 47(vib) and 47(vic) of the Act. However, both the sections in the current case are inapplicable as the former is only in relation to Indian demerger and latter covers foreign demerger but is in relation only of transfer of shares held in Indian company. Accordingly, no exemption is currently available in the current context and the same becomes taxable.

One can argue that the process of France demerger is tax neutral for the demerged company whose demerged unit goes out of existence without receiving or becoming entitled to receive any consideration for the transfer. Since no consideration flows to A Ltd there may be no taxability.

The DTA also does not provide any respite as the transaction is covered by Article 14(2) and India gets the taxation right in the present case.

Taxation in the hands of B Ltd

Since B Ltd is receiving assets, no capital gains tax can be levied in its hand. There may be a risk of applicability of section 56(2)(x) of the Act; however, the same is applicable only on specific “assets” (such as shares, jewellery, etc) and may not apply in the present case.

Taxation in the hands of minority shareholders of A Ltd

The minority shareholders of A Ltd receive shares in B Ltd in exchange for shares held by them in A Ltd under the demerger process. Exchange of shares is covered within “transfer” under section 2(47) of the Act. Further, India introduced “indirect transfer” provisions under section 9(1)(i) of the Act which may have to be analysed in the present case.

Candidates may discuss applicability of indirect transfer rules. In absence of specific information, and owing to the fact that Indian assets do not appear huge as compared to global assets, it may be presumed that the conditions for indirect transfer are not satisfied and hence the same may not be taxable in India.

Additionally, in terms of Article 14(6), the shares in a French company is transferred (and is resident in France), there is no taxation rights granted to India in terms of India France DTA. In other words, ‘indirect transfer’ of shares is not taxable in India as per the India France DTA.

Provisions of GAAR and MLI would have to be satisfied for taking DTA benefits.

Part 2

Under the provisions of the Act, interest in a Limited Liability Partnership (LLP) in India could constitute a 'capital asset' or a 'source of income' or a 'property' situated in India and hence the transfer of interest in LLP may be subject to tax in the hands of A Ltd. Same arguments as discussed earlier would apply on receipt of no consideration.

Further, the transaction would not be taxable under the DTA in terms of Article 14(6) as taxation of residuary capital gains is only in the State of Residence.

Question 6

Part 1

Section 92B of the Act defines 'international transaction' to include transactions of capital financing, which further includes any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.

Though the Act has included capital financing transactions within the ambit of 'international transaction', it does not provide any specific guidance with respect to how a capital financing transaction should be characterized for a TP analysis nor is there any guidance on determining the arm's length price for such transactions. Accordingly, one can place reliance on the principles emanating from OECD Transfer Pricing Guidelines ("OECD TPG") and UN Transfer Pricing manual to determine the appropriate characterization of an advance as 'debt' or 'equity'.

The SC in the case of Engineering Analysis Centre of Excellence Private Limited v CIT (Civil Appeal Nos. 8733-8734 of 2018) has held that the OECD Commentary can be relied upon in the context of international tax treaties. Similarly, the OECD TPG as a useful aid for interpreting Indian TP rules – this has been held in various cases such as Sony Ericsson Mobile Communications India (P.) Ltd v. CIT [2015] 55 taxmann.com 240 (Delhi HC), etc.

OECD TPG contains guidance on applying the arm's length principle and states that the application of arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in such an analysis – (a) Accurate delineation of controlled transaction and (b) Comparison of accurately delineated transaction with independent enterprises.

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between transaction can be broadly categorised as the contractual terms of the transaction, the functions performed by each of the parties taking into account assets used and risks assumed, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. The circumstances surrounding the transaction and industry practices are also important.

Upon accurate delineation of the controlled transaction under, next step entails analysis of options realistically available and analysis of "arm's length behaviour", i.e. whether independent third parties would enter into such transactions. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option.

In the context of inter-company financing transactions, the options realistically available concept would thus require a careful consideration of the financing needs of the borrowing entity, the purpose for which the loan is obtained, its financial forecasts, or debt service capacity, the impact of the loan and related interest payments on its financials and creditworthiness, the terms and conditions that would be agreed upon and, ultimately, how all these items would translate into an arm's length return for the inter-company financing.

Therefore, upon application of the aforementioned analysis, it is likely that a financial transaction as accurately delineated may take the form of debt, equity or a combination of both.

In the current case, the following facts are relevant:

- V Ltd had acquired Robert group as a strategic investment purpose. The sum advanced accordingly was towards acquisition of the Group

- When V Ltd provided loans to SPVs, the agreement did not specify any interest to be charged

- The agreement also did not specify any repayment schedule

- Further, no dispute resolution mechanism and no clause to enforce payments were present

The aforementioned facts would show that the financial instrument has more characteristic of an equity (no assured return, no repayment clause, etc.) than debt. Accordingly, it can be argued that the current transaction in the case of V Ltd of lending money to acquire Robert group may be delineated as an equity transaction.

Having said this, there is limited judicial precedence on the said issue and there is an alternate argument available to treat the transaction as debt as the same was a loan and arm's length price needs to be determined accordingly.

<u>Part 2</u>

An Advance Pricing Agreement (APA) is an agreement between a taxpayer and tax authority determining the transfer pricing methodology for pricing the taxpayer's international transactions. The same can be for future years and can also cover roll back period.

Section 92CC of the Act provides power to the Central Board of Direct Taxes, with the approval of the Central Government, to enter into APA with any person, determining the (a) arm's length price or specifying the manner in which the arm's length price is to be determined, in relation to an international transaction to be entered into by that person; (b) income referred to in clause (i) of sub-section (1) of section 9, or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident (ie related to business connection).

The APA entered into shall be binding on such taxpayer and in respect of the transaction in relation to which, the agreement has been entered into, and the concerned tax authorities in respect of the said person and the said transaction. APA shall not be binding if there is a change in law or facts having bearing on the agreement so entered.

In India, APA can be applied for 5 years with a roll back period of 4 years.

In the current set of facts, V Ltd can apply for an APA as the financing transaction between it and the SPVs is an international transaction subject to transfer pricing principles. It is interesting to note that the current APA process may not involve much field visit given the fact that determination will be only in relation to delineation of the transaction and consequent benchmarking of interest, if any.

Question 7

Part 1

In this case passive income is 30% of the total income of Happy Co. The passive income consists of (i) 25% income from the transaction where both purchase and sale is from/to associated enterprises; and (ii) 5% income from interest.

Happy Co. satisfies the first requirement of the test of active business outside India. Since no assets or employees of Happy Co. are in India the other requirements of the test are also satisfied.

Therefore, Happy Co. can be said to be engaged in active business outside India.

Part 2

The first limb of active business test is satisfied by Happy Co. as only 30% of its total income is passive in nature. Further, more than 50% of the employees and all the assets are also situated outside India.

The payroll expenditure in respect of the MD, Finance Controller and Head of Sales and Marketing, being employees resident in India, exceeds 50% of the total payroll expenditure.

Therefore, Happy Co. cannot be said to be engaged in active business outside India.

Part 3

Happy Co. is engaged in active business outside India as the facts indicated in (1) establish. The majority (4 out of 6) of board meetings have been held outside India.

Therefore, the POEM of Happy Co. shall be presumed to be outside India.

Part 4

While Happy Co satisfies the conditions of active business outside India, POEM provisions depends on substance over form. While equal number of meetings have happened in India and outside India, all the key decisions such as acquisition of new company in France, expansion of warehouses relating to Happy Co are taken in India. The board meetings outside India has only considered and decided upon routine matters.

Therefore, POEM of Happy Co shall be presumed to be in India.

Part 5

While Texas Inc satisfies active business test, the facts suggest that the effective management of Texas Inc has been usurped by its parent company Sunny Limited. Therefore, POEM of Texas Inc. may in such cases be not presumed to be outside India even though Texas Inc is engaged in active business outside India and majority of board meeting are held outside India.

Question 8

Part 1

In terms of section 9(1)(i) of the Act, all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

However, India has enacted section 90(2) of the ITA wherein the non-resident entity is eligible for DTAA benefits. Under the DTAA, current transaction may be taxable in India only if a business income arises out of a PE or the same is taxable as Royalty or FTS.

Article 5 of the DTAA, provides various instances of constitution of a "permanent establishment" for a foreign enterprise in India which inter alia include (a) Fixed Place PE, (b) Agency PE, and (c) Service PE. In the current fact pattern, Fixed Place PE would be more relevant.

A PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Further, fixed place PE exists if the following conditions are satisfied cumulatively:

- There is a "place of business" which will be used for carrying on the business of the enterprise
- Place of business is at the disposal of the enterprise
- Place of business should be fixed
- Business activity is wholly or partly through this fixed place of business

Accordingly, it is essential to understand whether all the activities would stand cumulatively satisfied in the current set of facts.

In the current set of facts as well, it can be argued that the Project Office (PO) cannot be said to be a fixed place of business from where "core business" activities are carried on. Since it is solely carrying out "communication activity" which is an auxiliary activity, the same cannot be construed as a PE for FastTrain plc. While a PO is a fixed place and satisfied the permanence test as well but it does not satisfy the business activity test in the facts of the current case.

Additionally, the PO in the present case cannot be considered as a PE in terms of Article 5(3) wherein the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information or for scientific research, being activities solely of a preparatory or auxiliary character in the trade of business of the enterprise is deemed not to be a PE.

The above position is also supported by the Supreme Court ruling in the case of DIT (Intl Tax) v Samsung Heavy Industries Co Ltd (Civil Appeal No. 12183 of 2016). The SC in this case relied on the following principles:

- Profits of foreign establishments are taxable only when it carries on its "core business" activities through a PE
- Fixed place of business which is of preparatory or auxiliary character in the trade or business of the enterprise is not a PE under Article 5
- Profit attributable to PE alone can be taxed in the other state

- Documents indicate that the PO was established to coordinate and execute delivery of documents. 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

In coming to the conclusion, the SC also relied on its earlier judgements in the case of Hyundai Heavy Industries Co. Ltd. ((2007) 7 SCC 422), Morgan Stanley & Co. Inc. ((2007) 7 SCC 1), Ishikawajma-Harima Heavy Industries Ltd. ((2007) 3 SCC 481), and E-Funds IT Solution Inc. ((2018) 13 SCC 294).

In the current set of facts as well, it is clear that the "core business" of FastTrain plc is happening offshore (i.e. outside India). The PO is not performing these activities and hence can be argued that no income is taxable in India.

Part 2

The fact that Mr Harry, an employee of FastTrain plc, was also appointed as the authorized signatory of the Project Office is not significant, given that the PO is only carrying out preparatory and auxiliary activities.

India and UK are signatory to MLI and India-UK DTAA is a Covered Tax Agreement for the purposes of MLI. MLI has brought in a key test for denial of tax treaty benefit, viz. Principal Purpose Test ("PPT"). The PPT denies treaty benefits when, having regard to all relevant facts and circumstances, obtaining that benefit is one of the principal purposes for entering into a specific transaction or arrangement that resulted directly or indirectly in that benefit, unless if granting that benefit is not contrary to the object and purpose of the relevant provisions of the Covered Tax Agreement.

In the current set of facts, India-UK DTAA provides that the Project Office is not a PE due to various reasons and PO is acting as only a communication channel. Given this, it does not appear that this would be affected by PPT.

Question 9

Part 1

“Fee for Technical services” has a narrow scope as per definition provided under Article 13(4) India-UK DTA as compared to Section 9(1)(vii) of the Act. Accordingly, the provisions of DTA, being more beneficial to the taxpayer shall prevail in the instant case (Section 90 of the Act) and need to be analysed for applicability in the instant case.

Discussion on article 13(4) of the India-UK DTA.

In this case, Health Limited has, through the seconded employees, provided “technical” services to Health India., especially since the expression FTS expressly includes the provision of the services of personnel. The seconded employees, who work, for Health India are provided by Health Limited and the work conducted by them, i.e., assistance in conducting the business of Health India of quality control and management is through Health Limited.

The nature of the services can be said to be within the hold of “technical or consultancy”. These services envisage the provision of quality service by vendors to the overseas entities, which Health India, and the secondees, are to oversee. This requires the secondees to draw from their technical knowledge, and falls within the scope of the term. This reading of “technical" services does not limit itself only to technological services, but rather, extends to know how, techniques and technical knowledge. This is supported by clause 4 of Article 13 itself, that lists these various sub-categories.

Health Limited requires the Indian subsidiary, Health India. to ensure quality control and management of their vendors of outsourced activity. For this activity to be carried out, Health India required personnel with the necessary technical knowledge and expertise in the field, and thus, the secondment agreement was signed since Health India. – as a newly formed company – did not have the necessary human resource. The secondees are not only providing services to Health India, but rather tiding Health India through the initial period, and ensuring that going forward, the skill set of Health India’s other employees is built and these services may be continued by them without assistance. In essence, the secondees are imparting their technical expertise and know-how onto the other regular employees of Health India.

The activity of the secondees is thus to transfer their technical ability to ensure quality control vis-à-vis the Indian vendors, or in other words, “make available" their know-how of the field to Health India for future consumption.

Considering the above, it can be said that services rendered by secondees to Health India does constitute Fee for Technical Services (FTS) in terms with India-UK DTA and thus taxable in the hands of Health Limited.

The above position is also supported by the ruling of Delhi High Court in the case of M/s Centrica India vs. CIT.

Part 2

Though the control and supervision of secondees rest with Health India which also bears all risks in relation to their work; there is no purported relationship between Health India and the secondees.

The secondees are entitled to participate in the overseas (Health Limited’s) retirement and social security plans and other benefits.

There is no obligation clearly spelt out that Health India needs to bear the salary cost of the secondees. In other words, the secondees could not sue Health India for any defaults in payment of their salaries.

Further, no powers are vested with Health India to terminate the ultimate contract between Health Limited and the secondees.

Whilst Health India may have had operational control over these persons in terms of their daily work and may have been responsible for their failures (in terms of the agreement), these limited and sparse factors could not displace the larger and established context of employment abroad.

In the light of the above undisputable facts and placing reliance on the Supreme Court decision in the case of Morgan Stanley, the real employer of the seconded employees continued to be F Co. considering which a PE of F Co. is likely to get established because of secondees' services rendered in India under the proposed secondment arrangement/agreement.