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Arinjay Jain

From the Editor's Desk

As the season of filing tax return starts in India for Financial Year 2014-15 with the filing of individual tax returns, a lot of deliberation and discussion that took place over the last Financial Year has been now getting converted into action. Particularly, in the case of individuals, the disclosures relating to all active bank accounts and overseas assets is the key discussion point. At the same time, the IFA Congress at Basel, saw a large number of delegates and discussion on some of the most widely debated topics on International taxation.

In this Edition several aspects of BEPS, including specifically, the following have been covered:-

- BEPS Action 15 - Modifying Bilateral Tax Treaties through Multilateral Instrument
- US view on BEPS Projects
- OECD view on use of Hindsight for pricing of Hard-To-Value-Intangibles

From a Transfer Pricing perspective, the authors have delved into the following areas :-

- Losses/Low Profits & Transfer Pricing
- Extended Powers of TPO in Action

Given the increased aspect of investment by Indian companies/individuals outside India, in various Article, the authors have analysed the nuances of Managing Indian Tax and Transfer Pricing aspects of Outbound Investment as well as tax implications in USA, when an Indian investor purchases real estate in US.

Given the sophisticated tax planning adopted by MNE's, tax authorities in various Asia Pacific jurisdiction have been taking aggressive stands. The stands of these authorities and a comparison with the Indian situation are analysed in a detailed Article.

Additionally, the present issue covers whether Consideration for 'live broadcast' rights amounts to royalty, whether section 206AA overrules DTAA and whether voyage between Indian Ports would be covered as a part of International traffic and eligible for Treaty benefits.

The key tax developments in India and across the Globe, important developments in the US tax and insights into some recent developments in Transfer Pricing shall continue to provide useful insights on professional developments on that account.

Your suggestions and inputs are greatly welcome. You can contact the Editor at **arinjay.jain@taxmann.com** for any suggestion.

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A MONTHLY JOURNAL ON INTERNATIONAL TAXATION

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Mumbai	:	35, Bodke Building, Opposite Mulund Railway Station, M. G. Road, Mulund West, Mumbai - 400080 • Mobile : 9322247686, 9820326673
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Research & Development Division	:	21/35, West Punjabi Bagh, New Delhi-110026 (India) • Ph. : +91-11-45662200 • E-mail : editorial@taxmann.com
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SEPTEMBER 2015

Analysis of BEPS Action 15 – Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Pavan R. Kakade*

Mehul K. Jain**

1. Introduction

Globalisation has paved way for integration of Global Economies and so also the international tax environment. A number of countries had expressed a concern about how international standards on which bilateral tax treaties are based, allocate taxing rights between source and resident states. The concerns revolves around the fact that the interaction between existing domestic laws and treaty rules governing taxation of cross border transactions and multinational enterprises produce results that gives rise to Base Erosion and Profit Shifting ('BEPS') in several circumstances. Therefore, OECD member countries and G20 countries came together to develop an action to address BEPS issues in a coordinated and comprehensive manner. The BEPS project of OECD and G20 has broadly resulted into 15 Action Plans. BEPS Action Plans identifies treaty abuse as one of the most important sources of BEPS concerns. A wide range of specific issues have been identified which requires changes to the model tax conventions as well as the bilateral tax treaties which are based on those model tax conventions.

The concept of sovereign autonomy is a basic principle underpinning the international order and providing the foundation for negotiation of international treaties. The same applies to tax matters as well, which has resulted into governments globally being able to negotiate bilateral tax treaties.

The BEPS Action Plans were developed quickly, and enormous resources have been spent on the same. As the international tax order is based on the bilateral tax treaties negotiated between countries, even if changes are brought about in the model tax conventions based on the work done under OCED BEPS Project, its implementation would not take

* Pavan R. Kakade, Director, Tax & Regulatory Services PricewaterhouseCoopers Private Ltd.

** Mehul K. Jain, Assistant Manager, Tax & Regulatory Services, PricewaterhouseCoopers Private Ltd.

place until bilateral tax treaties are renegotiated in lines with the changes to the model tax conventions. The sheer number of bilateral tax treaties makes updates to the treaty network burdensome and time consuming which limits the efficiency of multilateral efforts. As can be seen from the gap between the current model conventions and the bilateral tax treaties existing between countries, it is evident that even decades after changes have been agreed and brought about in the model tax conventions, the implementation of the same by renegotiating bilateral tax treaties have not been brought about. *It's easier said than done.* However, if not implemented quickly, the purpose and the objective of the OECD BEPS Project would fail.

In this context, the need for change is urgent. This is where the Action 15 of the BEPS Project plays a vital role. Action 15 of the OECD BEPS Project states as under:

> "Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution."

The OECD in September 2014 issued a Report on Action 15 *i.e.* Developing a Multilateral Instrument to Modify Bilateral Tax Treaties. Further, as called for in the Report issued in September 2014, a Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS was issued by the OECD in early 2015. The Report and the Mandate issued by the OECD have been discussed below.

2. Objective

The Report outlines that the main objective of a multilateral instrument would be to modify the existing bilateral tax treaties in a synchronized and an efficient manner to implement the tax treaty measures developed during the BEPS Project, without the need to expend resources individually renegotiating each treaty bilaterally.

The multilateral instrument will implement agreed treaty measures over a reasonably short period and at the same time it would preserve the bilateral nature of tax treaties without violating the same, which would not be achieved in an attempt to unilaterally implementing measures to curtail BEPS.

The Mandate suggests that the negotiation of the multilateral instrument should include the implementation of the following tax treaty related measures:

- Action 2: provision on hybrid entities
- Action 6: prevention of treaty abuse
- Action 7: prevent artificial avoidance of PE
- Actions 8 to 10: transfer pricing
- Action 13: provide for country-by-country reporting
- Action 14: improve dispute resolution

3. Desirability of having a multilateral instrument to implement tax treaty related measures of addressing BEPS as per the Report

According to the Report, the current network of bilateral tax treaty network is complex and each bilateral tax treaties are independently distinct with no inter-relation. As a result of this, a lot of time and energy is spent interpreting each individual treaty, especially when treaties differ in small ways. This issue of interpreting several tax treaties will be aggravated if bilateral protocols are entered in order to implement tax treaty related BEPS Project measures. Also, countries will deviate from the changes suggested to the model tax conventions defeating the purpose of addressing BEPS issues in a comprehensive and coordinated manner. Therefore, a multilateral instrument is desirable to overcome these issues.

Further, normally, developed countries dominate the process of negotiating/renegotiating bilateral tax treaties. Therefore, the developing countries would encounter greater issues for addressing BEPS. Accordingly, multilateral instrument would be a best opportunity for the developing countries to come together, pool their expertise to be efficacious in the negotiating process and reap the benefits of multilateral efforts to tackle BEPS.

Tax administrations globally have expressed interest in developing a multilateral Mutual Agreement Procedure ('MAP') to resolve disputes involving tax incidence in multiple countries. However, most countries restrict having multilateral MAP in the absence of any hard law instrument authorizing the same. Therefore, a multilateral instrument could serve the purpose of Action 14, *i.e.* dispute resolution in a more efficient and comprehensive manner.

As mentioned earlier, according to the Report, a multilateral instrument to tackle BEPS would reduce the number of instrument (in the form of bilateral treaties and protocols thereto) to be interpreted and therefore grant consistency and continued reliability providing certainty to business. The Report also suggests to be accompanied by an interpretive guidance which would provide consistency to its implementation.

4. Feasibility of having a multilateral instrument to implement tax treaty related measures of addressing BEPS as per the Report

As per the Report, an analysis of precedents in the international law of amending bilateral treaties through multilateral instruments suggests that it is feasible. A multilateral instrument would coexist with the existing bilateral tax treaties. Provisions of existing bilateral tax treaties would stand appropriately modified and or new provisions would be introduced, as the case may be.

In this connection, the Report recommends that an international conference would be called upon to negotiate the content and actual text of the multilateral instrument based on the outcome of the BEPS Project. Once finalized, similar to execution of other bilateral treaties, the multilateral instrument shall be executed by each of the countries participating and then ratified as per the national laws of each of such country.

The Report also recognizes that providing flexibility to the countries would be a key to widespread acceptability of the multilateral instrument. Countries may not be ready to accept the same precise commitments *vis-à-vis* all other parties. Therefore, provision of flexibility to the multilateral instrument would make it feasible. However, the report also seeks to maintain consistency by ensuring minimum level of commitments.

The Report also annexes a work of an informal expert group formed to advice on the feasibility of the multilateral instrument to amend bilateral tax treaties. The outcome of the work done by the expert group shows that having such an instrument is feasible if following is taken care of:

- Terminology, 'Modification' is appropriate than 'Amendment': Under international law, the basic principle is that a subsequent treaty overrides the previously concluded treaty on the same subject matter. Accordingly, the term modification is better for this project as a formal amendment of the bilateral tax treaties is not required.

- Relationship between multilateral instrument and bilateral tax treaties: As per the international law of treaties, in case of inconsistency between the earlier provision and the later provision on the same subject matter, the latter of the provisions prevails. Therefore, on entry into force of multilateral instrument, the provisions of the bilateral tax treaties would continue to apply to the extent it is compatible with the multilateral instrument. However, in order to preserve the clarity and transparency, it would be important to explicitly define the relationship between the multilateral instrument and the bilateral tax treaties through inclusion of specific compatibility clauses.

5. Technical challenges arising from the interaction of multilateral instrument with the existing bilateral tax treaties

The Report recognizes that there could be variation in scope between the similar provisions of various existing bilateral tax treaties and the multilaterally agreed provisions covering the same subject matter. This variation may not only be limited to scope but also wordings of such similar provisions. The Report recommends that such challenges can be addressed by having a compatibility clause and/or superseding language in the multilateral instrument.

Some other small technical issues like numbering of several provisions, entry into force of multilateral instrument, language and translation can be addressed at a practicable level.

6. Conclusions

The Report concludes that a multilateral instrument to implement tax treaty related measures developed during the course of work on BEPS is desirable and feasible. Moreover, the report highlights that a multilateral instrument would be the most efficient manner of modifying the existing network of bilateral tax treaty.

7. Our thoughts

The Report has identified issues that will be faced in the course of developing a multilateral instrument to implement tax treaty related measures to address BEPS. The Report also addresses the issues identified but no concrete solutions have been provided for.

Also, the report recognizes that provision of flexibility to commit towards clauses of the multilateral instrument is a must, however, maintenance of consistency is also necessary to achieve its objective. However, no clear direction on how the objective of having a flexible but consistent instrument would be achieved.

Further, references have been made to the following precedents in the international law where multilateral instruments have been made for the modification of existing bilateral agreements.

- European Convention on Extradition (1957)
- European Convention on the Repatriation of Minors (1970)
- European Convention on the Suppression of Terrorism (1977)
- North American Free Trade Agreements (1994)
- International Convention for the Suppression of the Financing of Terrorism (1999)
- European Convention on Mutual Assistance in Criminal Matters (1959)
- United Nations Convention on the Law of the Sea (1982)
- International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families (1990)
- Convention for the Suppression of Unlawful Acts against Safety of Maritime Navigation (1998)

- Agreement on extradition between the European Union and the United States of America (2003)
- Vienna Convention on Consular Relations (1963)

As can be seen from the above, almost all the above agreements are on administrative cooperation. Some of them only cater to social issues. Most of the agreement is amongst the countries from the European Union whose economies are closely interconnected to each other. In other words, there is no precedent of a multilateral instrument catering to financial matters. This could be on account of the fact that negotiations on financial matters involve several factors which are specific to the two countries to a bilateral agreement and cannot be extended to other countries. Therefore, unanimous consensus on having a multilateral instrument relating financial matters is relatively difficult. For instance, India has made is clear that arbitration as method for dispute resolution under the multilateral instrument is not in accordance with the sovereign rights of the government. Similar concerns would be raised by several countries to the negotiation on multiple attributes of the multilateral instrument which will lead to difficulty in arriving at a consensus which is relatively easier in case of bilateral instrument.

One ray of hope on widespread acceptance of the multilateral instrument proposed under the Report and Mandate, is the Multilateral Convention on Mutual Administrative Assistance in Tax Matters to which India is a signatory. However, it should be noted that this instrument is also instrument dealing with administrative matters and not on financial policy.

Infact, it would not be out of context to refer to the Convention on International Civil Aviation (commonly referred to as the Chicago Convention, 1944) at this stage. The Chicago Convention was primarily meant for promotion of international civil aviation and cooperation between nations. During the Chicago Convention International Air Service Transit Agreement was executed multilaterally, by which non-traffic rights for scheduled services were exchanged. The policy and Guidance Material on the Economic Regulation of International Air Transport issued by the ICAO (a specialized agency of UN) states that under the Chicago Convention attempts were made to develop a multilateral agreement intended to exchange traffic rights and to address the regulation of capacity, tariffs and unfair practices. However, these efforts were unsuccessful and therefore a template agreement is provided and updated regularly on the basis of which countries enter into bilateral agreements for exchange of traffic, capacity and tariffs rights. This unsuccessful attempt to have a multilateral instrument in place to exchange traffic rights or agreement on capacity and tariffs shows that countries do not tend to multilaterally agree on exchange of rights beyond rights to exchange of information/administrative co-operation.

Accordingly, a multilateral instrument to implement tax treaty measures to address BEPS is promising, but difficult to achieve given the intricacies involved and varied interest of various economies. In other words, just like in the case of implementation of changes brought about in the model convention to bilateral tax treaties, in our view, for the multilateral instrument also; *It's easier said than done.*

Accordingly, it would rather be more practical to issue a guiding template agreement framed under the BEPS project which can be referred to by the countries during their bilateral negotiations for entering into agreement to address BEPS.

Cost Contribution Arrangements – Newer Dimensions!

Arun Sapripalli*

Sumin Mehta**

Anuja Talukder***

It's an acknowledged phenomenon that the domestic tax rules diverge on several counts with the international principles/laws across the globe. This divergence of tax rules often leads to double taxation/double non-taxation. While the Double Taxation Avoidance Agreements do attempt to harmonize the ambiguities to avoid such scenarios, however in the real world, double taxation/double non-taxation continues to be a reality. With increasing globalization and cross border trade, the issue of double taxation/double non-taxation has been a key focus for the taxpayers and tax authorities alike.

With this backdrop, Organisation for Economic Co-operation and Development ('OECD') coined the term "BEPS" or Base Erosion and Profit Shifting which refers to instances where there is shifting of profits from one jurisdiction to other due to the favourable tax regimes in the latter, thereby leading to effective double non-taxation. The precursor to the concept was the request made by the G20 Finance Ministers to the OECD to develop Action Plans to address BEPS issues in a coordinated and comprehensive manner. Specifically, the aim was to provide countries with domestic and international instruments that will better align rights to tax with economic activity being undertaken in the respective country.

OECD, as part of the BEPS project has identified 15 Action Plans on various subjects including Action Plan 8 which focuses on developing rules to prevent the occurrence of BEPS due to the movement of intangibles among group companies. The endeavour of Action Plan 8 is to:

- adopt a broad and clearly delineated definition of intangibles;
- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation;

* Arun Sapripalli, Director, Transfer Pricing, PriceWaterhouse Coopers & Co. LLP.

** Sumin Mehta, Associate, Transfer Pricing, PriceWaterhouse Coopers & Co. LLP.

*** Anuja Talukder, Assistant Manager, Tax & Relgulatory Services, PriceWaterhouse Coopers Private Limited.

- develop transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- updating the guidance on cost contribution arrangements ('CCAs')

As part of the above, the OECD had issued a discussion Draft ('Draft Guidelines') providing guidance on the CCAs which essentially updates the guidance on the subject currently detailed in the Chapter VIII of the OECD's Transfer Pricing Guidelines[1] ('Current Guidelines').

This article discusses the concept of the CCA as detailed in the Draft Guidelines, the key updates and some potential issues where further guidance is required in this regard.

CCA's - The prologue

Simply put, CCA's refer to the contractual arrangements wherein parties decide to jointly develop tangible/intangible asset/services by making contributions and sharing risks and rewards on an equitable basis. Thus, in a CCA, parties agree to share the costs, risks and the corresponding benefits (by pooling resources and skills) associated with developing, producing or acquiring assets, rights or services on the expectation of anticipated/future benefits. The contribution of each participant forms the basis in which the future benefits will be shared by them.

The outcome of the joint efforts may be the creation of a tangible/intangible asset(s) that might be legally owned by all or one of the participants. In the event where the tangible/intangible asset(s) is legally owned by one of the participants, the other get a right to use the same without making any further payments (such as rent or royalty).

The usual triggers for parties to enter into a CCA include (*a*) spreading of the anticipated risks among the parties thereby de-risking any single entity; (*b*) sharing of the funding costs associated with such projects; and (*c*) achieving economies of scale by streamlining the multiple/duplicative activities.

Guidance so far

The Current Guidelines on CCA recognize the concept of mutual benefit and risk sharing as being fundamental to a CCA and provide that risk-reward be shared on an arm's length basis. Given that a CCA usually involves an anticipated benefit not fully ascertainable at the time of entering into the arrangement, use of 'projections' as a basis of sharing the risks-reward was acknowledged by the Current Guidelines.

To afford flexibility to the arrangement, Guidelines recognize the concept of balancing payments to adjust the participants' proportionate share of contributions. Buy-in payments refer to the contributions required to be made by an entity to become a participant to an existing CCA. Buy-out payments refer to the payments required to be made by the surviving participants to the exiting participant(s) where the latter decides to exit the arrangement. Furthermore, the balancing payments refer to the payments that are required to be made to align the share of the contribution (of the participants) with the share of the anticipated benefit.

Also, the Current Guidelines provide that where the facts and circumstances indicate that the reality of CCA differs from the terms purportedly agreed by the participants, the tax administration may disregard part or all of the purported terms of a CCA.

The United Nations Transfer Pricing Manual[2] and United States Regulations[3] also provide the similar guidance on CCA's.

Updates from the Action Plan 8

Some of the key updates provided by the Draft Guidelines to the CCA (*vis-à-vis* that documented in the Current Guidelines) are listed below:

- *Definition*

The Draft Guidelines provides that the intangible, tangible assets or services in a CCA should result in a 'direct' benefit to the participants as against the 'direct/indirect benefit' envisaged in the Current Guidelines. This implies that in an event where one of the participants derives only an indirect benefit from participating in a CCA, it will not be considered as a participant to the CCA thereby such a participant is neither required to make contribution to the CCA nor will he be entitled to the benefits derived thereupon.

Rationale for the change seems to give recognition to the actual participants to a CCA rather than recognizing the nominee participants.

◆ *Benefit Allocation key*

The Current Guidelines provide that contributions made by the participants be measured at cost. However, the Draft Guidelines indicate that all contributions must be identified and assessed based on their value rather than their cost.

This is quite a significant shift and emphasizes the thinking of OECD to encourage the participants to measure the contributions using the arm's length concept. Under the Current Guidelines cost of the contributions form the basis of determining the share of the participant in the anticipated benefits of the CCA. Given the same, cost might not reflect the correct picture for a variety of reasons including –

(*a*) cost might be historical and may not depict the accurate value that would have been determined had the contribution been made by unrelated parties who would typically tend to adopt current value as the basis of valuation;

(*b*) typically in a third party scenario, transfer of goods/services will be undertaken on the basis of cost plus a mark-up and not merely on cost and therefore valuing the contributions at cost will represent a non-arm's length behaviour which is against the very basic premise of the Guidelines (Current as well as Draft); and

(*c*) also, adoption of cost as the basis could result in undervaluation of the contribution of one of the participants. To illustrate the point, say in a given CCA, two parties A and B contribute assets costing USD 100 and USD 200 respectively and thereby decide to share the anticipated benefit say USD 600 in the ratio of 1:2 (A's share being USD 200 and B's share being USD 400). However, the fair value (as on the date of entering into the CCA) of the assets contributed by A and B being USD 300 and USD 150 respectively. In this situation, the sharing ratio will be just reversed *vis-à-vis* that arrived by the cost method (*i.e.,* 2:1).

Given the above, probably one might tend to agree the approach of ascertaining the contribution at value being more close to third party scenarios and thereby depicting arm's length behaviour.

While prescribing the use of value rather than cost for valuing participants' contribution, the Draft Guidelines also recognizes practical cases (such as low value added services) where the difference between the costs and the value is relatively modest and provides that in such situations, the contributions be valued at cost.

◆ *Capability and authority to control risks*

Specific recognition of the capability and authority to control risks (arising out of the CCA) by the participants is yet another important update that's been provided by the Draft Guidelines. With sharing of risks being fundamental to a CCA, the Draft Guidelines provides that each of the participant (to the CCA) must have the capability to undertake decisions that result in risks and should be in a position to assess, monitor, decide and bear the risks arising out of a CCA. A participant not exhibiting this trait will generally not be considered as a participant to the CCA.

- *Mere funding not to entitle the participant to the benefits of CCA*

Another important aspect provided by the Draft Guidelines is that mere activity of funding the CCA will not entitle participant to enjoy the benefits arising out of the CCA *i.e.*, legal/economic ownership of the tangible/intangibles developed as part of the CCA. In such cases, the Guidelines provide that the participant would be entitled to a risk adjusted rate of anticipated return on its funding costs.

This is in line with the guidance provided in 'Action Plan 8 – Guidance on Transfer Pricing Aspects of Intangibles' which provides that mere funding activity undertaken by an entity will not entitle it to the ownership of the intangible asset developed thorough research and development activity undertaken by another entity. In such scenarios, having regard to the arm's length principles, the funding entity should ideally receive only a risk adjusted return for its funding costs and nothing more.

Open issues

- *Ascertaining the expected benefits*

As discussed above, generally the benefits of CCA are not readily ascertainable at the time of entering into the arrangement and the parties would generally use projections as the basis for sharing the benefits amongst the participants. A fundamental challenge is the inherent uncertainty associated with the projections and thereby the possibility of ambiguity in the expected benefits as envisaged at the inception of the CCA vis-à-vis the actual results.

The Draft Guidelines do realize this inherent challenge and provide that the tax authorities should assess the reasonableness of the underlying assumptions considered by the participants at the time of the inception of CCA and where they are found to be reasonable/aligned with the arm's length behaviour, the agreement should be respected despite material differences in the actual results vis-à-vis the expected benefits.

In the Indian context, the tax authorities undertake audit for each financial year where transactions are evaluated on stand-alone year basis without specific reference to past or future years. Use of projections for CCA purpose could give rise to dispute as the revenue authorities might expect revision of the projections every year (in the course of audit) having regard to the specific facts of the concerned year rather than regarding the overall context of the arrangement. To illustrate, say A and B enter into a CCA for the joint development of intangibles and ascertain the expected benefits by drawing up projections. Post the developments, the tax authorities could challenge the sharing basis by comparing the projections with the actual results. The situation would be more challenging if the tax authorities start making such a comparison on a year on year basis.

To avoid adoption of such approach by the tax administration, it is recommended for OECD to provide guidelines/examples on the parameters to be considered by the tax authority to challenge the projections (as well as the underlying basis) by both taxpayers as well as tax authorities to avoid/minimize potential dispute in this regard.

- *Economic ownership vs legal ownership*

In the Draft Guidelines, the concept of economic ownership has been advocated wherein one of the participants may become the legal owner of the tangible/intangible asset developed by CCA and the other participants would be considered as economic owners. The implication of economic ownership is that all such owners will have right to use the property without payment of any separate consideration to the legal owner. While this accurately captures the intent of CCA, being the joint sharing of risks and rewards, two aspects remain unanswered in the Draft Guidelines.

A. The term 'economic ownership' not being legally codified is susceptible to interpretation and therefore could lead to scenarios where the CCA benefits may be denied by the tax authorities. Hence, it is recommended that the OECD provides guidance on the key traits to establish the economic ownership (of the participants) of the tangible/intangible being developed through the CCA; and

B. Also, the other aspect is whether the legal owner needs to be compensated for any additional function undertaken in the capacity of a legal owner such as maintenance/protection of the intangible property. There could be two possible scenarios here:

- the costs associated with such additional functions have already been factored in the projections and the share of participants benefit was determined after consideration of the such future costs; or
- legal owner bears such costs separately and not as part of the CCA.

While in the latter case, it is appropriate for the other participants (economic owners) to proportionately compensate the legal owner for such cost, however in the former case, there's a possibility of potential double taxation as the revenue authority may require the legal owner to seek such payments from the other participants without being sensible of the fact that such payment was already factored into the overall arrangement. Therefore, in this regard, it will be quite useful for OECD to provide guidance on the treatment of such expenses to avoid any potential double taxation.

◆ *Balancing payments*

The Draft Guidelines provides for balancing payments required to be made at the time of entering/exiting/making true-up/true-down adjustments to appropriately reflect the participants share by the participants and allows netting off payments in this regard. While this is a welcome move as its simplifies the process of multitude of payment/receipts involved in intra-group transactions (in the CCA), however it is recommended that due cognizance be considered by the OECD of the country specific guidelines (such as the Indian Foreign Exchange Management Act) that might not allow for such netting off payments.

To tackle such scenarios, OECD should provide guidance/illustrations on the mechanism for making the balancing payments that can be adopted by the participants.

◆ *Transition*

As discussed above, there are few fundamental changes made by the Draft Guidelines vis-a-vis the Current Guidelines, however the Draft Guidelines do not discuss the vital aspect as to tax treatment as well as the transition of the existing CCAs to the new regime. Providing clarity on whether the new guidance will be prospective or retrospective will be quite helpful to avoid potential litigation between the taxpayers and tax authorities.

Conclusion

While the updates provided by the Draft Guidelines indicate the intention of the OECD to align the CCAs with the arm's length principles and thereby minimize the cases of BEPS, further clarifications (as discussed above) will go a long way in providing greater clarity to the taxpayers as well as the tax authorities and thereby will reduce the litigation on this count.

1. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators issued by the OECD
2. Practice Manual on Transfer Pricing for Developing Countries issued by United Nations
3. United States Treasury Regulations issued by Internal Revenue Service

Targeted US Attacks Challenge BEPS Projects

Robert Feinschreiber*

Margaret Kent**

Congressional tax leaders, Senate Finance Committee Chairman Orrin Hatch (R-Utah) and House Ways and Means Chairman Paul Ryan (R-Wis.), attacked specific targeted OECD BEPS Actions. The Congressional leaders served notice to Treasury Secretary Lew that they would seek to curtail four specific BEPS Actions: BEPS Action 13, which requires country-by-country reporting; BEPS Action 4, which limits interest deductions; BEPS Action 7, which would prevent the artificial avoidance of permanent establishment status; and BEPS Action 6, which would prevent artificial avoidance of the anti-abuse rules. In particular, the Congressional tax leaders sought to exempt private companies having annual revenues of 750 million Euro or more from the clutches of the BEPS regime. In contrast, the American Enterprise Institute scholar Aparna Mathur uses the Congressional tax leaders' targeted attack to further disparage the entire BEPS program.

Background

The OECD, together with a host of international tax-related organizations, held an International Tax Conference June 10-11, 2015 in Washington D.C. OECD leaders and Senior Treasury and Foreign Tax Policy officials were the speakers, addressing BEPS-related topics: U.S. tax reform and BEPS, transfer pricing – aligning returns with value creation, dispute resolution, interest deductibility and CFC rules, permanent establishments, treaty abuse, and steps the OECD should consider after completing the BEPS project.

Against that background, on June 9, 2015, the day immediately before the inception of OECD International Tax Conference, the Congressional

* Robert Feinschreiber, Esq., Transfer Pricing Consortium.com
** Margaret Kent, Esq., Transfer Pricing Consortium.com

tax leaders called upon Treasury Secretary Jack Lew to work with Congress to ensure that the international tax BEPS proposals the OECD is considering are "beneficial to American workers and job creators." This analysis addresses BEPS concepts challenged by two high-ranking Congressional tax leaders; further, this analysis addresses the American Enterprise Institute scholar Aparna Mathur's June 22, 2015 response to the Congressional tax leaders' letter sent to Secretary Lew.

Congressional Tax Challenge

At the outset, Senator Hatch and Congressman Ryan remind Senator Lew that the Committees are "tax-writing committees," asking the Treasury to "remain engaged with Congress as you and your colleagues negotiate and develop" OECD BEPS proposals. The Congressional l tax leaders caution that Congress and the Treasury need close co-ordination as to these BEPS proposals, and, quite specifically, that "U.S. tax policy will not be constrained by any concessions to any other nations in the BEPS project to which Congress has not agreed." In particular, the Congressional tax leaders challenge six specific OECD BEPS-related concepts.

1. ***BEPS Action 13 Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting – Part One***

The Congressional tax leaders praise Treasury staff for its OECD BEPS accomplishments, especially as to its defending and advocating long-standing tax principles, such as the arms-length transfer pricing standard. Despite the issuing of this praise, these Congressional tax leaders expressed their concern that Treasury would be agreeing to country-by-country reporting standards as part of this BEPS standard. These Congressional tax leaders argue that the application of this country-by-country standard would cause the U.S. company to reveal "sensitive information related to a U.S. multinational's group operations."

The OECD promulgated the BEPS 13 Action Plan on June 8, 2015, one day before the Congressional leaders reviewed and made negative comments that concern the OECD's country-by-country reporting. A fair-minded tax practitioner might challenge the Congressional tax leaders' assertions, because BEPS Action 13 does not require a company to disclose its technical or scientific information, or to provide the company to disclose its marketing plans or technology transfers. In fact, Action 13 provides a 750 million Euro exemption, nearly $1 billion at the stipulated January 2015 exchange rate. Public companies would furnish much of that required information through securities law compliance in that country. Private companies subject to the country-by-country purview are few in number, except for the largest high-tech, real estate, hotel, agribusiness, or similar enterprises.

The Congressional tax leaders challenge the concept that the Treasury has the authority under the Code to require country-by-country reporting for "certain (unnamed) U.S. companies." The Congressional leaders ask the Treasury to support any authority it has to request such documents which would give the IRS the authority to retain such country-by-country information.

2. ***Action 13 Guidance on the Implementation of the Transfer Pricing Documentation and Country-by-Country Documentation – Part Two***

The Congressional tax leaders expressed their concern that the Treasury has appeared to agree that foreign governments would be able to collect "master file" information from U.S. multinationals, and to obtain this master file information without any assurances of confidentiality, or evidence that the requested government needs that information. These Congressional tax leaders assert that the master file contains information that is "well beyond" what the government could obtain though public filings, and that the information disclosure is "even more sensitive for privately-held multinational companies."

Coming from the country by country report concept, the Congressional tax leaders attack on the lack of assurances of confidentiality appears specious. Model Legislation Article 6 addresses the use and confidentiality of the country-by-country report information. An annex to the agreement contains a confidentiality and data safeguards questionnaire, and that questionnaire specifies information security management, including the application of the ISO/IEC 27000 information security series – which is at least a beginning point toward assuring confidentiality.

The EU developed the Masterfile rules a decade ago with the goal of achieving co-ordination among taxing jurisdictions. The Congressional tax leaders are concerned that enforcement of the master file process might cause the multinational to disclose its pricing strategy and comparative data deception to high taxed countries. The master file process might reveal the company's shifting profits away from the high taxed jurisdiction to tax-favoured jurisdictions or tax havens such as the Cayman Islands, or to Luxemburg, a valued part of the scheme when taking into account Luxemburg's sourcing rules.

3. ***Action 4 Interest Deductibility Limitations and Transfer Pricing***

The Congressional tax leaders expressed their concern about the interest-deductibility limitation based on "questionable empirics and metrics," but these Congressional tax leaders failed to address what these empirics and metrics might be. The OECD issued the December 19, 2014 discussion draft indicating at the outset that debt structuring is perhaps "one of the most simple of the profit-shifting techniques available in international tax planning." U.S. legislation was the first country to respond to excessive interest deductions, enacting the earning stripping interest limitations more than a quarter century ago.[1]

The OECD has not finalized the BEPS Action 4 activities. The proposed BEPS guide addresses the manner in which the OECD could best design interest deductibility rules in general, linking interest deductibility to either (1) the relevant attributes of the group as whole, *i.e.*, the group's overall position, or (2) reliance on fixed interest ratios or attributes, *e.g.*, debt to equity, interest divided by EBITDA, or interest divided by assets. One wonders whether the Congressional tax leaders view such ratios as being such questionable empirics and metrics, a view that objective advisors can readily challenge.

4. ***BEPS Action 7 Preventing the Artificial Avoidance of Permanent Establishment Status***

The OECD issued BEPS Action 7 on May 15, 2015, reflecting the fact that certain multinationals are abusing the tax treaty regime placing limited functional activities in each tax treaty jurisdiction, thus avoiding permanent establishment status. Action 7 addresses the validity of a taxing jurisdiction to aggregate these activities, causing permanent establishment status to apply. The Congressional tax leaders expressed their concern that the OECD would be modifying these permanent establishment rules. The Congressional tax leaders fail to indicate the reasons why the Treasury should oppose the BEPS Action 7 provisions.

5. ***BEPS Action 6 Preventing the Artificial Avoidance of Anti-Abuse Rules***

The OECD issued BEPS Action 6 on May 15, 2015, addressing agency-commissionaire structures as a taxpayer device artificially avoiding permanent establishment status. The Congressional tax leaders fail to indicate the reasons why the Treasury should oppose the Action 6 provisions.

6. ***Catch-all BEPS Provisions***

The Congressional tax leaders profess their concern that the BEPS regime would be collecting even more sensitive data obtained from U.S. companies to analyze and measure base erosion and profit shifting. It is our view that this concern of the part of the

Congressional tax leaders is misplaced – the congressional tax leaders fail to demonstrate that the BEPS program would unfairly target this base erosion and profit shifting information from American taxpayers. As a note of caution, the Congressional tax leaders use an open-ended approach to their BEPS comments, "We also have significant concerns" – which the Congressional tax leaders fail to specify –"as to many of the provisions included in several other proposals of the BEPS project"– again, a project that the Congressional tax leaders fail to specify.

Nevertheless, despite the critical tone in their letter to Secretary Lew, the Congressional tax leaders appear to convey a more measured approach toward BEPS, stating in their penultimate conclusion that "Many of the OECD's BEPS project objectives are sound, and international co-operation – as well as competition – in tax policies is desirable." For its conclusion, the Congressional tax leaders return to their "questionable empirics and metrics" phraseology confined to the BEPA Action 4 interest-deductibility limitation proposals, stating that "we trust that you agree, however, that precipitous decisions to impose constraints on U.S. tax policy and added burdens on U.S. companies, especially on the basis of weak empirics and metrics, are not desirable."

AEI's Wholesale BEPS Attacks

Dr. Mathur expresses her concern about the BEPS program, that the Congressional tax leaders are "right to worry" about the potential impacts of BEPS proposals on American businesses and workers.

She argues that a "high corporate tax rate country like the U.S. whose current and future economic standing rests upon its status as a hotbed of innovation" and the U.S. is "very likely to lose out under the international order that the BEPS project appears to be striving for." It is our view that the United States would be better able to expand its status as a hotbed of innovation by expanding its H-1B visa program rather than conjuring up an ostensible tax solution. Dr. Mathur rightly addresses America as being in completion with its trading partners, but the fact remains that all taxing jurisdictions will benefit as a group if they successfully curtail base erosion and profit shifting.

1. ***Dr. Mathur Challenges the Magnitude of Tax Evasion***

Well-known economist Dr. Aparana Mathur asserts that "the evidence suggests that opportunities for tax avoidance or tax minimization for corporations are nowhere near as vast as people imagine," but she fails to demonstrate any assertions for her specious claim. In fact, OECD BEPS studies demonstrate both base erosion and profit shifting are much greater than these taxing jurisdictions perceived through the presence of an extensive number of tax schemes, ultra-complex tax-related structures, *plus* greedy taxpayers and their tax processionals competing with each other for a race to the bottom.

Dr. Mathur asserts that "empirical research shows that firms typically do locate real investment and jobs in low-tax countries compared to high tax countries." Looking beyond Dr. Mathur's bold assertion, the fact remains that investors compare taxing jurisdictions based on each jurisdiction's results - the extent to which each such jurisdiction improves the wherewithal of its populace. Some countries are successful in imposing high taxes, countries such as Germany in providing free education for all its citizens. Other countries impose high taxes to fund its leader's avarice, such 2010-2013 Ukraine.

2. ***Dr. Mathur's Overreliance on Other Academic Studies***

Dr. Mathur relies heavily on the April 1, 2013 Grubert-Altshuler study, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax" in her attack on BEPS. Harry Grubert and Rosanne Altshuler evaluated cross-border income proposals undertaken in response to the 2005 reparation tax holiday. The study itself includes full and partial inclusion measures of various types, and active business requirements. Most importantly, the Grubert-Altshuler study, focused on prior tax behaviour, took place before the OECD initiated the BEPS program, and before the OECD initiated Action 3, the CFC provisions. In short, Dr. Mathur is comparing apples with oranges – by comparing controlled foreign tax avoidance structures that no more than a dozen taxing jurisdictions currently apply, taken in contrast to the newer controlled foreign company tax regimes under BEPS Action 3.

Dr. Mathur also relies heavily upon Dr. Michael Mandel's diatribe against the BEPS project, "Obama's Corporate Tax Blunder" published by the New York Times on June 9 as an op-ed opinion. Dr. Mandel asserts the "United States lost, and lost big" because of the BEPS program, because BEPS will encourage American companies to quickly move high-paying jobs such as those of research scientists and software developers to Europe to take advantage of lower tax rates. Dr. Mandel specious "brain drain" hasn't been happening now, or in the future for that matter. Quite simply, Dr. Mandel uses the wrong set of assumptions, leading him to reach erroneous conclusions. In fact, Dr. Mandel confuses the OECD with its 34 members with the G20, lumping both together as the "the Group of 20 countries."

3. ***Formulary Apportionment Challenge***

Dr. Mathur is sharply critical of formulary apportionment, and argues that BEPS would cause countries to apply this formulary apportionment process. Unfortunately, Dr. Mathur, like Dr. Mandel, is not a lawyer nor a CPA, having neither a JD, an LLM in tax, or an MBA. Dr. Mathur confuses an aggregation of related-party transactions, an approach that the OECD approves, with aggregation of all transactions, an approach that the OECD rejects.[2]

4. ***Dr. Mathur used her Tried – but Untrue - Standard Rhetoric***

Dr. Aparna Mathur is on record asserting that in a free market, where capital is globally mobile, "rich corporations" don't pay taxes, workers do. Dr. Mathur explained in The American magazine, a publication of the American Enterprise Institute, "How Taxing the Rich Harms the Middle Class."[3] Regrettably, her analysis then reflected a compound accumulation of four erroneous assumptions, leading to her totally erroneous results:

a. Mobile Capital Flows

Dr. Mathur's first assumption is that in a free market, mobile capital flows from high tax jurisdictions to low tax jurisdictions. The reality is that rate of taxation is just one factor that impacts the mobile capital flow. A myriad of factors cause capital flows to move from one jurisdiction to another. The rational investor needs to consider factors other than taxation, including the costs, rewards, and risks, taking into account factors such as expropriation, natural resources, labour availability, and much more. Taxes are not the be-all and the end-all. Taxes are just one factor in an investor's decision-making process.

b. Investment in High Taxed Countries

Dr. Mathur's second assumption is that this outflow of capital investment out of a high-tax country, such as the United States, leads to lower domestic investment. The reality is that even if Dr. Mathur's second assumption were to apply, her assertion is contrary in fact; the United States has remedies to address these capital shortages. For example, it is our view that the United States could obtain capital by relying on public sector – private sector partnerships. The U.S. could use this technique regardless of the affiliation of the party in power, using its scarce capital resources to marshal our needs. Consider the following six examples:

1. Building the national park system under the administration of President Theodore Roosevelt, a Republican
2. Developing synthetic rubber under the administration of Franklin Delano Roosevelt, a Democrat
3. Undertaking the Manhattan project under the administration of Franklin Delano Roosevelt, a Democrat
4. Building the highway system under the administration of Dwight Eisenhower, a Republican
5. Exploration of space under the John Kennedy and Lyndon Johnson administrations, both Democrats, and
6. Restructuring the automobile industry under the great recession under the administration of Barrack Obama, a Democrat

c. American Productivity

Dr. Mathur's third assumption is that America's lower levels of investment affect the productivity of the American worker, asserting that such a worker may not have the best machines or enough machines to work with. The reality is that the United States has remedies for productivity shortfalls. America can retrain its resilient employees, import well-trained foreign workers, and take advantage of scalar economies though developing tax incentives.

d. Lower Investment, High Taxes, and Lower Wages

The penultimate of Dr. Mathur's assumption is that lower levels of investment leads to lower wages. The reality is that America has comparatively high income tax rates for 95 years, but America's wages have continued to rise during this almost all of this 95 year period. Dr. Mathur's concern is that America has a high tax rate that is leading to lower investment and then to lower wages. Her concern is misplaced as it is contrary to fact.

Major projects require vast sums of capital. Private industry in some circumstances cannot succeed alone because of its capital limitations. We need the Federal Government to risk the initial capital for these special mega-projects, and then step away from these huge capital projects in favour of private industry.

How Taxing Jurisdictions Respond to Aggressive Tax Planning

Until just a few short years ago, aggressive tax planners conjured up their clients' tax schemes far from the watchful eyes of the taxing jurisdictions. The first government to challenge the efficacy of these schemes in the broad sense was the Hong Kong government.[4] Hong Kong, being incensed by the CPA's tax scheme, sought to publicize the scheme to all as a warning, describing details of the technique in its then-new transfer pricing guide. The scheme turned out to be a roadmap for other perpetrators, forcing other taxing jurisdictions to act. OECD moved toward the development of the 15 Actions as part of this response.

Dr. Aparna Mathur claims that "the evidence suggests that the opportunities for tax avoidance or tax minimization for corporations are nowhere near as vast as people imagine." The fact remains that aggressive tax planners and their clients deliberately obfuscate overly-complex techniques to hide – in plain sight – a wide variety of tax evasive techniques, making the BEPS program essential for honest taxpayers and tax collectors alike. Consider three schemes that taxpayers have been using:

- A company, headquartered in Hong Kong, had engineers, designers, and top executives in that city, but the company's production took place in China. Where did the profits go? Not to Hong Kong, not to China, but to the British Virgin

Islands thanks to a scheme conjured up by certain advisors.

- A U.S. mortgage servicer, shifted much of operating staff to India, and shifted its intangibles to Altisource, the entity that Ocwen set up in the Luxembourg. Much of the profits go to the Cayman Islands or to Luxemburg, not to India or the United States. The principal corporate owner shifted his income from the United States to the U.S. Virgin Islands.
- One of banks was engaged in siphoning off ostensible U.S. manufacturing profits, ultimately destined for customers in high-taxed countries, though a tax haven, through reinvoicing. The U.S. government and the foreign customer's country receive little taxable income; most of the profits go to the tax haven enterprise. The bank receives an abnormally high fee for its "service."

Conclusion

The facts are clear that Dr. Mathur and Dr. Mandel, and Dr. Altshuler and Dr. Grubert for that matter, are relying on data that does not address sophisticated tax schemes that these three example indicate.

1. I.R.C. section 163(j); Omnibus Business Reconciliation Act, Pub. L. 101-239, 103 Stat. 2106 (1989); Feinschreiber, R., *An Earning Stripping Primer,* 17 Int'l Tax J. 59 (1990)
2. Feinschreiber, R. and Kent, M, Transfer Pricing Handbook: Guidance for the OECD Regulations (vol. 5), John Wiley & Sons, Inc., 2012, Chapter 6, pp. 57-68.
3. Feinschreiber, R. and Kent, M "How the American Enterprise Institute Distorts America's Tax Policy" CCH Corporate Business Taxation Monthly, February 2013, pp 29, 30-31
4. *Ngai Lik Electronics Company Limited v. The Hong Kong Commissioner of Internal Revenue, FACV No. 29, 2008.*

BEPS Action 8: OECD Recommends use of Hindsight for pricing of Hard-To-Value-Intangibles – Is the Recommendation Flawed?

Nilesh Patel*

1. Opening

Consider the case of an Indian Pharma Company 'I Ltd.' which is developing a drug to cure diabetes. Eight stages of Research and Development (R&D) have to be passed successfully to get from a pharma molecule to a marketable drug. Assume that first two stages of R&D are done in India. Then the molecule is transferred to 'S GmbH', a Swiss Subsidiary of 'I Ltd', for subsequent stages of R&D, because Switzerland is a better location for advance R&D. That is due to availability of qualified scientists, effective IP protections laws, and better R&D infrastructure, in Switzerland.

Say, 'S GmbH' successfully clears the remaining six stages of R&D in next 4 years, after the transfer of molecule by 'I Ltd'. Consequently a new drug for diabetes comes into being. 'S GmbH' becomes the legal owner of the Patent for the newly developed drug. Through licensing of the Patent to various manufacturing entities of the Group - including 'I Ltd.' - 'S GmbH' earns substantial royalties, from 5th year (from the year of transfer of molecule by 'I Ltd.') onwards.

On transfer of molecule by 'I Ltd.' to its Swiss Subsidiary ('S GmbH') the following primary Transfer Pricing issues arise:

i. How do we determine the Arm's Length Price of the molecule?

(*This determination is to be made in these peculiar circumstances*: an early stage intangible like the pharma molecule is a hard-to-value-intangible; the anticipated cash-flows from future exploitation of the pharma drug, if and when developed out of the molecule, are very uncertain; the final success or failure of the R&D is hard to predict at the time when the molecule is transferred.)

* Nilesh Patel, CPA (USA), IRS (Ex)Partner, TAXWIZE

ii. Because of uncertainty in valuation of early stage molecule at the time of its transfer can the Indian Tax Authorities use hindsight, by considering ex-post information of actual income realised by 'S GmbH' from 5th year onwards, to look back and make Transfer Pricing adjustments in case of 'I Ltd.' by disturbing the valuation made at the time of transfer of the molecule?

Last month (on 6th July, 2015) the OECD held Public Discussion on the **Discussion Draft on Hard-To-Value-Intangibles (HTVI)** – the Discussion Draft was released by the OECD on 4th June, 2015 under BEPS Action 8 (HTVI). This Article presents the key features and practical implications of the Discussion Draft, as well as improvements that could be made by the OECD. In course of the Article, answers to the questions posed above will also, hopefully, get unravelled.

2. Key Features of the OECD Discussion Draft on HTVI

Below are the key features of the OECD Discussion Draft on BEPS Action 8 (HTVI).

2.1 What is meant by Hard-To-Value-Intangibles (HTVI)?

The term HTVI covers intangibles - or rights in intangibles - for which, at the time of their transfer in a transaction between Associated Enterprises –

(*i*) no sufficiently reliable comparables exist, and

(*ii*) there is a lack of reliable projections of future cashflows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain[1].

Intangibles falling within the category of HTVI may exhibit one or more of the following features[2]:

- Intangibles that are only partially developed at the time of the transfer; or
- Intangibles that are not anticipated to be exploited commercially until several years following the transaction; or
- Intangibles that separately are not HTVI but which are connected with the development or enhancement of other intangibles which fall within the category of HTVI; or
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

2.2 Why special rules are needed for HTVI?

BEPS Concerns

There are valid BEPS concerns that MNCs are able to erode tax-bases by moving intangibles to low-tax territories. Often MNCs arbitrarily transfer intangibles under development (which subsequently generate a very substantial income stream) at an undervalued price to a Subsidiary domiciled in a low-tax jurisdiction, and then shift there substantial amount of the income derived from the intangibles. Such a wrongful practice has been pointed out as one of the root causes of Base Erosion and Profit Shifting (BEPS). Nations need to devise measures against abusive arrangements of this kind.

Information Asymmetry

Further, Transfer Price of intangibles is generally set on basis of valuation e.g. Discounted Cash Flow valuation.The Discussion Draft argues that it is difficult for a Tax Authority to evaluate the reliability of information used by a Taxpayer to price a HTVI given the information asymmetry between Tax Authorities and Taxpayers. Information asymmetry exists when (*i*) the Taxpayer has more information than is available to the Tax Authorities and (*ii*) the incremental information has an impact upon pricing.

2.3 Due to Information Asymmetry the Tax Authorities may use benefit of hindsight

To get over the difficulty posed by information asymmetry a Tax Authority may consider -in hindsight - ex post evidence about actual financial outcomes, to gauge the reasonableness of the ex-ante transfer price set by the Taxpayer.

The use of ex-post evidence in cases involving HTVIs may, however, only be made if the difference between ex-ante *projections* and ex-post *outcomes* is "significant," and where such difference is due to events that were foreseeable at the time of the transaction.

2.4 Tax Authorities may not use hindsight if the Taxpayer proves that variation in Ex Ante valuation and Ex-Post results is due to unforeseeable events

Tax Authorities cannot make hindsight adjustment where the Taxpayer[3] -

i. provides full details of its ex-ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the comprehensiveness of its consideration of reasonably foreseeable events and other risks; and

ii. provides satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events (occurring after the determination of the price) that could not have been anticipated at the time of the transaction.

2.5 Possible Transfer Pricing Adjustments

As for the determination of what independent enterprises might do, the Discussion Draft notes that independent enterprises may agree to account for highly uncertain valuation in a variety of ways, including:

- Adopting a shorter-term agreement;
- Including price adjustment clauses in the agreement;
- Adopting a payment structure with periodic milestone payments;
- Requiring payment of additional contingent amounts payable on achievement of milestones;
- Requiring additional payments when development targets are achieved;
- Setting a royalty rate to increase as sales of the licensee increase; or
- Renegotiation of the agreement.

On hindsight the Tax Authorities may re-characterise the transaction by including one of the above features in the Transfer Agreement.

After highlighting above the key features of the Discussion Draft, we now look below at the implications of the Discussion Draft.

3. Implications of the suggestions made in the OECD Discussion Draft on HTVI

The Discussion Draft departs from the Arm's Length Principle and introduces Commensurate-with-Income Principle, prescribed in the US TP Regulations for pricing of intangibles. Also, the definition of HTVI is too wide and will capture transfers of almost all intangibles. So there will be large scale adjustments by the Tax Authorities. And that will lead to uncertainty and double taxation.

Various implications are explained below through a Case Study.

3.1 Case Study on Implications

3.1.1 ***Facts***

Let us revisit the case of 'I Ltd.' cited in the Opening Para of this Article. After completing initial two stages of R&D 'I Ltd.' transfers the diabetes pharma molecule to 'S GmbH' (subsidiary of 'I Ltd.'). Assume that future income would be 0 (zero) if the molecule fails in subsequent stages of R&D and 100 if the molecule succeeds. Also assume that the probability of both failure and success is equal *i.e.* 50:50. So the transfer price of the molecule is set by the parties at 50, after valuation and negotiation.

3.1.2 ***Implications of the OECD Discussion Draft on HTVI***

The molecule will be categorized as HTVI, because it is an early stage intangible – even otherwise almost all intangibles will fall within the scope of HTVI because of the overly broad definition of HTVI.

Note also that there will certainly be significant divergence between the ex-ante valuation (50) and ex-post earnings (either '0' on failure or '100' on success).

A. Implications when the Molecule is successfully developed into a diabetes drug

- When the R&D succeeds the ex-post accrual is 100 while the ex-ante valuation was 50. In view of this significant difference the Transferor ('I Ltd.') has to demonstrate that all foreseeable events were duly considered while valuing the molecule at the time of its transfer.
- And 'I Ltd.' also has to prove that the difference between the ex-ante valuation and ex-post result is due to events unforeseeable at the time of transfer of molecule. But here the difference is not because of any unforeseeable event. Rather the difference is due to initial uncertainty about the success of the molecule at the time of its transfer.
- So how will 'I Ltd.' prove that the ex-ante and ex-post difference is due to an unforeseeable event? 'I Ltd.' will find it hard to do so. Will the Tax Authorities, therefore, make a Transfer Pricing adjustment?
- Because of the significant difference Tax Authorities may contend that the ex-ante valuation was not reliable – authorities may seek to recharacterize the transaction (of transfer of molecule) by imputing a price adjustment clause to the Transfer Agreement.
- The Tax Authorities clearly have the benefit of hindsight which shows that the molecule has been successful. Such benefit was not available to the Taxpayer who had to consider both future scenarios: failure as well as success of the molecule.
- To make Transfer Pricing adjustment the Authorities will have to reopen the assessment. For how many years - after the transfer of molecule and after its development into a successful drug - can the Authorities make ex-post evaluation of actual accruals? Is the time unbounded? No time limit has been prescribed under the current Discussion Draft.
- Will the Swiss Authorities allow co-relative adjustment (by increasing the purchase price in hands of 'S GmbH') to relieve double taxation? Not necessarily.
  - No mechanism is prescribed in the Discussion Draft for resolution of dispute between the two Jurisdictions on application of the HTVI rules.
  - So, there will be double taxation if one Jurisdiction applies the HTVI rules based on hindsight, while the other Jurisdiction decides that those rules do not apply – this risk is real because, *without amendment of Article 9 of Tax Treaties, all Jurisdictions may not agree to apply an ex-post Commensurate-with-Income principle which violates the Arm's Length Principle.*
  - Besides, the Swiss Authorities may contend that the difference of 50 is attributable to functions performed by 'S GmbH', related to the ongoing development, enhancement, maintenance, protection and exploitation of the intangible, subsequent to the transfer of molecule.
  - And so the Swiss Authorities may deny any co-relative adjustment to relieve double taxation.

- The uncertainty caused by taking into account ex-post results will lead to open tax positions for future years in case of 'I Ltd'. As a consequence 'I Ltd.' will find it hard to restructure its business in future even for genuine commercial reasons.

B. Implications when the Molecule fails to develop into a diabetes drug

When the R & D fails no downwards adjustments would be allowed if there are domestic laws similar to section 92(3) of the Indian Income-tax Act, 1961. The Discussion Draft does not explicitly recommend downward adjustment to the transfer price on basis of ex-post information.

4. What the OECD can do to improve its recommendation?[4]

More often than not 'independent parties' transfer HTVI between them based on imperfect future projections; yet the terms of such transfers cannot be revisited subsequently by one party or the other, even though the actual results obtained differ significantly from the original projections. So, generally it is not appropriate to use ex-post information to reconsider and reset ex-ante pricing decisions. But the OECD might still stick with the approach set forth in the Discussion Draft. In that case the Discussion Draft may incorporate the following improvements.

4.1 Provide appropriate Exemption from application of Ex Post hindsight

As the proposed approach is presented as part of the BEPS Project, its application should be restricted to transfers of HTVIs to low-tax jurisdictions. If the Taxpayer can offer rational explanations for deviation from original valuation assumptions, the transaction should not be subject to the ex-post Commensurate-to-Income principle, based on hindsight. This should particularly be the case where –

(*i*) neither of the parties to the arrangement are low functioning entities in low or zero tax jurisdictions; or

(*ii*) where there is an expected incremental pre-tax economic benefit to the Group as a result of the transaction; or

(*iii*) the anticipated *commercial benefits* from sale of the HTVI are significant in comparison to any *tax benefit* in the Transferor and Transferee jurisdiction; or

(*iv*) there are other commercial or non-tax justifications for the transfer.

Additionally, to help it arrive at an ex-ante price, if the Taxpayer uses valuation report prepared by an independent professional valuer – valuation that accords with generally recognised valuation standards such as those published by the International Valuation Standards Council - then that should be an exemption from the approach suggested in the Discussion Draft.

4.2 Tax Authorities should not revisit the Transaction when Profit Split Method is used

With respect to profit splits, the Guidance on Intangibles published in September of 2014 states that the Profit Split Method may be useful in pricing transfers of intangibles, particularly where it is not possible to identify a reliable CUP. See Paragraphs 6.142, 6.145, and 6.199 of the **Guidance on Transfer Pricing Aspects of Intangibles** (Action 8: 2014 Deliverable).

Similarly, the **Discussion Draft on Profit Splits published on December 16, 2014**, states that a *profit split may be reliable for pricing even HTVIs*. See Paragraphs 44 to 49 of the Discussion Draft on Profit Splits. Paragraph 45, in particular, says that a profit split might be a reliable way to address significant differences between ex-ante and ex-post results and that a profit split *"may provide an appropriate way to deal with unanticipated events where strategic risks are effectively shared between associated enterprises."*

Consistent with the above guidance, where a properly constructed profit split is appropriately applied, the Tax Authorities should not revisit the transaction.

4.3 Burden of Proof – Relieve the Taxpayers' Heavy Burden

The Tax Authorities - not the Taxpayers - should bear the burden of proving that price-influencing developments were foreseeable at the time of the transfer.Taxpayers should not be asked to prove that differences between projections and actual results are due to unforeseeable developments and events. Unless the Tax Authority is able to demonstrate that the assumptions or projections did not take into account important foreseeable developments and events, the projections should be respected.

When the Taxpayer provides details of its ex-ante projections, risk assessment, and its consideration of material reasonably foreseeable events and risks, or relies on an independent professional valuation, then the onus should be on the Tax Authority to demonstrate that Taxpayer's projections did not reflect the economic or commercial circumstances prevailing at the time of the transaction.

4.4 Suggest measures for avoidance of Double Taxation

If one Jurisdiction is making an upward adjustment under the BEPS HTVI provisions, then the Jurisdiction on the other side of the transaction must make a downward adjustment and *vice versa*. But the approach suggested in the Discussion Draft is a one-sided approach that does not take into consideration the symmetry of the taxation burden. *It may, therefore, lead to double taxation, as pointed out in Part I (Para 3.1.2.A - seventh Bullet Point).*

Hence it is absolutely critical to ensure a global consensus on offsetting adjustments in the other Jurisdiction. Safeguards must be provided to guarantee that the tax administration in the other State respects an adjustment made by the tax administration in the first State. Preferably, some form of binding conflict resolution – better than MAP - should be introduced.

4.5 Factor in the Developments subsequent to the Transfer

For HTVI *i.e.* intangibles that are transferred at an early stage of development, by definition, there is significant additional development that takes place after the transfer of the partially developed intangible. Subsequent developments carried out by the intangible-purchaser can give rise to deviations from ex-ante projections *vis-a-vis* ex-post results.Where an asset is subject to continuous development, it should be clear that any upside or downside that is due to post-sale development is entirely allocable to the purchasing entity.

So, it is necessary to ensure that at the time of assessing the differences in ex-ante and ex-post profit levels, Tax Authorities recognize the role of parties in developing, enhancing, maintaining, protecting and exploiting (DEMPE) the intangible. The value added by the Transferee, after the transfer of HTVIs, should be eliminated in measuring the difference.

Inconsistent application of these principles by Tax Authorities would lead to double-taxation where the same income is attributed to both the Pre-existing Intangibles (in hands of the Transferor) and to the subsequent DEMPE activities (in hands of the Transferee).

4.6 Lay down Time Limit for Ex Post evaluation and adjustment

The timeframe, within which retrospective adjustment can be possible, should be strictly limited and specified in the guidance. Under the current Discussion Draft the Tax Authorities can evaluate the ex-post results at any point in time after the transfer is undertaken. Leaving this evaluation unbounded by time (and unbounded in number) leaves Taxpayers open to unnecessary uncertainty regarding their tax obligations.

Tax Authorities should not have unlimited jurisdiction to re-evaluate intercompany transactions. Some sort of certainty would be achieved if there is a defined period – a short timeframe, say of 5 years from the date of transfer as per the US TP Regulations – after which no ex-post evidence could be applied by Tax Authorities. It should be recognised that the passage of time reduces the likelihood of a future event being reasonably predicted, and increases the likelihood of divergence between ex-ante projections and ex-post results.

Therefore, tax Authorities should only have a limited duration of time, after a transaction, to apply hindsight based on ex-post results. And if it is once determined that exemption is applicable, then exemption should apply for all points of time in future for the subject intangible.

4.7 Define 'Significant Difference'

In virtually every case ex-ante and ex-post returns will diverge because ex-post results reflect the *realization* of risk and other events rather than their mere *anticipation*. So, it is very important that the proposed guidance does not apply unless there are significant divergences between ex-ante and ex-post results. The OECD should adopt a standard that if the ex-post results are within a specified range of the ex-ante projections, then no adjustment will be made under the HTVI Rules.

The final guidance should, therefore, incorporate easy to apply principles to determine what constitutes a significant difference. The US TP Regulations, for example, lay down a 20 per cent (aggregate actual ex-post profits are less than 80 per cent or more than 120 per cent of the projected ex-ante profits) "significant difference" window. Accordingly, "significant difference" - between ex-ante projections and ex-post outcomes, for application of ex-post evidence – may be set at 20 per cent.

4.8 Prescribe broader category of Unforeseeable or Extraordinary Events

The Discussion Draft allows actual results to differ from projections, so long as those differences arise from unforeseeable events. Two such unforeseeable events (natural disaster and bankruptcy of a competitor) are identified in the Discussion Draft. More such events should be prescribed by the OECD for the benefit of both the Taxpayers and the Tax Authorities. Otherwise, there is concern that Tax Authorities might disagree with events the Taxpayer deems unforeseeable.

Further examples of unforeseeable events that may be prescribed: financial market crises, macroeconomic developments such as recessions and Government actions, greater efficiency or inefficiency of the Transferee, product failures, product recalls, uncertainty of the businesses environment such as unexpected technical innovation, and higher demand arising out of an unexpected popularity of the product.

4.9 Provide Guidance on how the price will be adjusted on hindsight

Ex-post financial data should be used as a pointer only, to assess the reasonableness of the projections and to trigger further enquiry, rather than to straightaway process a transfer pricing adjustment. On adjustment further guidance is needed on how the price will be adjusted; it is currently unclear how the Tax Authorities will determine what should be the alternative hypothetical pricing arrangement. Tax Authorities should not be allowed to easily replace a transaction, or include a contingent payment arrangement, based on the argument that third parties would have structured the transaction that way. Further, guidance is needed on the use of adjustment clauses (milestone payments etc.) recommending that such should be used only when it can be expected in third party situations.

The Discussion Draft indicates several options that might be considered by independent enterprises to deal with various levels of uncertainty. But there is little guidance when to apply which option. Some options (renegotiate, use short term contracts) do not involve contractual clauses to adjust pricing whereas other options (a price adjustment clause) do. When a price adjustment clause is to be applied there has to be guidance on what that clause should look like.

It must be noted that re-characterizing an HTVI transaction shifts the risk among the different participants to the transaction. Therefore, re-characterization should only be permitted when the initial allocation of risks would not have been agreed by parties at arm's length.

Finally, the guidance seems geared to situations where the transferred asset is more successful than anticipated. There needs to be some explicit reference in the guidelines to symmetry of treatment that ensures that *downward adjustments* are also possible where, for example, a product is less successful than anticipated.

5. What should the Taxpayers do?

The Taxpayers will have to maintain reliable evidence and documentation to demonstrate fair pricing of intra-group transfer of HTVIs. More specifically, the following documentation would be needed to meet the approach laid down in the Discussion Draft.

- Prepare at the outset a cash-flow forecast taking into account all material future scenarios and listing all relevant assumptions made. The assumptions should include economic, commercial and technical assumptions with a range of predicted outcomes. This may be used to prove what was reasonably foreseeable at the outset. Also spell out the underlying assumptions in relation to discount rates, growth rates, useful life of the intangible, material risk factors, and the tax effects of the transaction[5].
- Demonstrate that the pricing arrangements are set based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of the intangibles involved. Discard only very low probability events from projections, and that too after documenting why such events have been judged as having very low probability of occurrence in future.
- Independent Valuation, involving independent industry experts, should be done as per prevalent valuation standards. And the projections should be reviewed and approved by either the Executive Committee or Board of the entities involved in the transaction.
- Where subsequent developments are sufficiently predictable and, therefore, the projections of anticipated benefits are sufficiently reliable, the pricing for the transfer of intangible may be set at the outset on the basis of those projections.
- But where the pricing based on anticipated benefits alone does not provide adequate protection against the risks posed by the high uncertainty in valuing the intangible, Taxpayers may adopt shorter-term agreements, include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving periodic milestone payments, as protection against subsequent developments that might not be sufficiently predictable.
- Where possible, establish that the contractual arrangements are consistent with those that would be agreed between unrelated parties. And document that the transfer did not result in a significantly lower effective tax rate. Also maintain satisfactory evidence of the legal and commercial reasons for the transfer.

6. Closing

The guidance provided by the OECD in the Discussion Draft on HTVI released on 4th June, 2015 under the BEPS Action 8 (HTVI) is not yet final. Public comments on the

Discussion Draft have been submitted by various stakeholders. And a Public Discussion too was held on 6th July, 2015. Taking into account the inputs of stakeholders, the OECD is likely to modify the guidance. We can, however, expect modification only on the practical aspects of making the Discussion Draft easier to apply and implement. It means that the basic approach – use of hindsight based on ex-post results – is not likely to change. So the Taxpayers need to watch out for the final guidance. If the OECD makes the necessary changes and improves its guidance on HTVIs, the burden of both the Taxpayers as well as the Tax Authorities will be lightened to some extent.

1. Para 9 of OECD Discussion Draft on Hard-To-Value Intangibles
2. Para 10 of OECD Discussion Draft on Hard-To-Value Intangibles
3. Para 14 of OECD Discussion Draft on Hard-To-Value Intangibles
4. This write up is based on 'Public Comments' and 'Public Discussion' on the OECD Discussion Draft on HTVI, duly supplemented by Authors' own independent analysis.
5. Ref: **Paragraph 6.154 of the BEPS paper,** Guidance to Transfer Pricing Aspects of Intangibles 16 September, 2014

Losses/Low Profits - A Transfer Pricing Perspective

Ajit Jain*

I. Background

In the current business scenario, incurring losses or low profits in business are not said to be very abnormal if the losses are incurred for a limited period of time. There could be various commercial reasons behind any business losses. Losses or low profits are incurred by entities having control or related party transaction and also incurred by the independent parties. Therefore, on a macro level, if the losses or low profits are explainable, by no means, the losses indicate that the business behaviour of the taxpayer is conflicting with the arm's length principle.

The key objective of the arm's length principle is that the transaction between the taxpayer and its AE should be at arm's length price. Where the profit based methods (TNMM or PSM) are the most appropriate methods for computing the arm's length price, profitability earned by the taxpayer becomes key area of consideration while justifying the arm's length price of its related party transactions.

Losses/low profits incurred by taxpayers are a trigger for transfer pricing adjustments in India. Indian transfer pricing authorities are very much concerned about the erosion of tax base in India, the profit position of the taxpayer is the prime focus for them. The tax authorities expect profitability and tend to associate low profits/losses with inappropriate pricing of cross border transactions between the taxpayers and its Associated Enterprises ('AE's).

Defending such cases during assessment proceedings and establishing that the lower profits/losses are a result of extraneous business/ commercial factors and not non arm's length pricing of intra-group transactions poses challenges.

* Ajit Jain is a Chartered Accountant.

– All the views in the article are personal

In this article, I have dealt with the various economic factors that cause losses and the arm's length response to them. For the sake of clarity it should be noted that for the purpose of this document, the term ''losses'' shall include cases of low profits.

II. Arm's Length Principles and Losses

Indian transfer pricing regulations do not provide any specific guidance for determining the arm's length price in case of losses. We can draw guidance from the following Para of the OECD's transfer pricing guidelines:

> *"1.70 When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues.* ***Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons.*** *However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely.* ***An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole."***

Based on the above guidance, in an independent scenario, any entity cannot continue to incur losses for a longer period, it will eventually cease to exist. However, in a controlled situation, the AE may continue to incur losses comparatively for a longer period, if its business is beneficial to the group as a whole. Therefore, the key thing to evaluate is whether the AE incurs losses due to non-arm's length pricing of intra-group transactions or the losses are incurred due to certain business or commercial rationale (e.g. start-up costs, unfavourable economic conditions, inefficiency etc.) not influenced by the related party relationship. In case the losses are incurred due to certain commercial reasons and for a limited period of time, the same can be justified or defended from arm's length perspective.

Characterisation of entity also important while performing arm's length analysis for a loss making entity. Being an entrepreneur, if any entity incur losses, this may not be considered as unusual, since entrepreneurs are prone to the various risks of business and they are responsible for profit/losses in their businesses. Accordingly, it is very important to document the detailed FAR of entity which shows that the entity has performed functions and assumed risk being an entrepreneur.

III. Common Causes of Losses/low profits

As mentioned earlier, business may incur losses due to various commercial reasons. In many situations, it is not possible to identify the reasons for losses since losses are driven by external circumstances. However, following are the key commercial reasons due to which any entity may incur losses:

- Start-up losses ;
- Business strategies ;
- Economic downturn/recession ;
- Foreign exchange losses ;
- Other reasons

Start-up Losses

Any business in start-up phase need to incur heavy expenditure for the purpose of establishing in the market and this may results into operating losses.

The start-up losses can be justified from a transfer pricing perspective if the same are incurred for a limited period of time and if the cost of investment result into expected future revenue. The start-up losses are explained with the following example:

A Ltd. is a company based in USA engaged in manufacturing of consumer products. A Ltd. set up a subsidiary B. Ltd. in India. B Ltd. operates as a licensed manufacturer in India, it imports raw materials from A Ltd. and utilise the same for the purpose manufacturing the finished products for selling to the third-party customers in India. B Ltd. also pays royalty to A Ltd. for the use of technology owned by A Ltd. In the first two years of operations, as a part of its expansion strategies, B Ltd. invests heavy capital in India. Further, B Ltd. also incurs significant marketing expenses to reach out to the target customers in India. Due to all these reasons, B Ltd. incurs operating losses for the first two years of its operation.

The tax authorities may accept start-up losses for a limited period of time, provided the losses are genuinely supported by sufficient documentary evidences showing business rationale. Following documents can be useful for justifying the losses from business and commercial perspective:

- Budget/projections/forecast level/expected demand
- Report on market dynamics – size, demography and competitors
- Documenting a detailed functional description of taxpayer which clearly reflect its functions related to start-up phase
- Search for comparables in start-up phase
- Use an appropriate sales revenue filter
- Economic adjustments – capacity utilization adjustment, working capital adjustment, risk adjustment, etc.
- Any other document for supporting losses from business and commercial perspective

For defending start-up losses, it is utmost important to document the relevant data which supports the business & commercial rationale for start-up losses. Further, one should perform the comparability analysis by considering various factors which differentiate the FAR profiles of the taxpayer and the potential comparable companies. Based on the same, one can apply quantitative filters, perform economic or comparability adjustment to arrive at most reliable comparables.

Business Strategies

Business strategies involve- any new product development, diversification, marketing penetration strategies etc. Implementing such business strategies either require investment of capital or loss of income opportunity for a limited period. Loss due to business strategies is explained with the following example:

A manufacturing entity in USA (A Ltd.) has a distribution subsidiary in India (B Ltd.). B Ltd. imports finished products from its holding company and distributes in India. B Ltd. operates as a full-fledged distributor. It bears marketing risk related to its business in India and undertakes key decisions for its business in India. As a part of marketing penetration strategies, B Ltd. launches products in India comparatively at lower price to attract customers. Further, B Ltd. also incurs significant advertisement & marketing expenses. Due to discounted price of products and high advertisement & marketing expenses, B Ltd. incurs operating losses.

In this regard, we refer to the following para of OECD transfer pricing guidelines:

> *"**Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration**. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. **However, especially low prices should be expected for a limited period only, with the specific object of improving profits in the longer term.** If the pricing strategy continues beyond*

a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises."

In view of the above para, losses arising from market penetration strategies can be accepted for a limited period of time provided the losses are genuinely supported by sufficient documentary evidences showing business rationale.

The taxpayer should maintain all the relevant documents pertaining to the its business strategies and the profitability potential e.g. third party feasibility study reports, future profitability projections, market share of the product etc. The taxpayer should also consider economic adjustments while performing the comparability analysis.

Economic Downturn

Economic downturn or recession can be the external cause for low profitability or losses. Current economic downturn considered to be major one which resulted into decrease in sales, constrained profit margins, consolidated losses, closure of business units etc.

Following considerations may be useful if there are losses in the scenario of economic downturn:

- Use of multiple year data to consider the impact of business and economic cycle in which the comparable went through.
- Performing an in-depth industry analysis which reflect the actual position of taxpayer's industry, challenges faced by industry, future forecast etc. This could be very important to show that the adverse financial results are due to non-transfer pricing factors.
- Capacity utilization adjustments- Due to recession, if taxpayer has underutilized its manufacturing capacity it can perform capacity adjustments *vis-à-vis* the comparable companies.
- Re-location of plants, production lines, warehousing facilities to the AEs location, centralising certain functions etc. However, while considering these restructuring options, the taxpayers should be aware about the possible transfer pricing and tax treatment of business restructuring.
- In economic downturn, going for an Advance Pricing Agreement ('APA') can also be an important step by the taxpayer, since the scenario gives opportunity to the taxpayer to negotiate with APA authorities in more advantageous conditions.

Recession gives an appropriate time to consider whether the transfer pricing model/policy meets the need of MNE and accordingly respond to the changing global market conditions. Taxpayers can consider efficient business model in the era of economic downturn to achieve a most tax efficient answer.

As a part of implementing revised transfer pricing model/policy, the taxpayer may consider business restructuring (e.g. converting licensed manufacturer to a contract manufacturer), use of profit split method etc. Any change in transfer pricing model/policy must have economic substance and should be implemented only after performing in-depth analysis from tax, transfer pricing and other regulations perspective.

Other reasons

In addition to the above mentioned reasons, there may be certain other reasons behind business losses e.g. product specific losses, losses due to R&D failure, poor business management, quality issues, competition, foreign exchange etc.

Although the facts behind the above losses may be different, however the fundamental part of transfer pricing treatment is similar *i.e.* the taxpayer needs to maintain robust documents in order to co-relate the losses with the business realities in case the losses are incurred due to non-transfer pricing reasons.

IV. Other Considerations

Based on the facts of each case, the taxpayer may also consider following approaches while performing arm's length analysis of a loss making entity:

- Use of Comparable Uncontrolled Price ('CUP') Method- In case of losses, if there are reliable comparable data available, the taxpayer may choose to select CUP as the most appropriate method for benchmarking its international transaction. If CUP method is considered as most appropriate method, taxpayer's profitability at net level may not be challenged.
- Use of multiple year data – As mentioned earlier, the taxpayer may use multiple year data of the comparables to consider the impact of business and economic cycle in which the comparable went through.
- Differential Depreciation adjustments- If the taxpayer has charged depreciation at the rate higher than those prescribed under the Companies Act, depreciation adjustment can be allowed in computing the operating margin of the taxpayer.
- Cash profit/sales ratio- Cash profit is operating profit plus depreciation, amortization, non-cash expenses such as provisions. Using cash profit ratio enhances the comparability between the tested party and comparables by excluding non-cash expenses if these expenses cannot be adjusted for differences. Applying cash profit ratio can be appropriate in case of start-up companies having high depreciation cost.
- Foreign AE as the tested party- Where the taxpayer, being an entrepreneur, incurs losses and its AEs are operating as low risk entities, the AEs can be considered as the tested parties for determining the arm's length price of the transaction between the taxpayer and its AEs. In such scenario, taxpayer's operating losses may not be considered for the purpose of arm's length analysis.
- Identification of abnormal/non-operating cost- While computing the taxpayer's operating margin for the purpose of arm's length analysis, it is important to carefully identify abnormal and non-operating expenses. Such expenses should not form part of margin computation, since it may result into losses or lower profits. E.g. foreign exchange gain or loss may have significant impact on the profitability of the taxpayer based on its nature (operating or non-operating).

While performing arm's length analysis of the entity incurring the losses, it is very important to stick to the fundamentals of the transfer pricing principles. The taxpayer should maintain relevant documents to show that the losses are due to non-transfer pricing reasons. Further, if there are differences between the taxpayer and its comparable companies, the taxpayer should perform required comparability adjustments to arrive at the most reliable results.

V. Sharing of losses

In case where the losses are on account of non-arm's length pricing, the key question to be answered is – can the losses be shared between the taxpayer and its AEs, which are part of affiliated non-arm's length transaction.

In this scenario, it is important to evaluate the FAR profile of the taxpayer and its AEs for proper allocation of risks and returns. As per the OECD's draft publication on 'Transfer Pricing Risk Assessment', losses should be allocated based on the way risks and functions are allocated among participants to any given inter-company transaction. E.g. in a value chain, entity performing routine functions earning high profits and another entity performing critical functions, incurring losses.

Thus, the transfer pricing outcome should be in line with the value creations and any allocation of losses between the AEs should be made only after detailed evaluation of their functions and risks.

VI. Way Forward

Incurring losses are not per se any issue, but it requires explanations. The fundamental part is to evaluate the rationale for losses *i.e.* whether the losses are due to non-transfer pricing reasons or due to the pricing arrangement of the international transactions between the taxpayer and its AEs. While performing transfer pricing analysis under any of these scenarios, drafting detailed FAR analysis and maintaining the relevant documentations are the key things for the taxpayer. If the losses are incurred due to external commercial factors, the same should be reflected in the industry analysis performed for the purpose of transfer pricing documentation.

If there are continues losses, the taxpayer can re-look at the existing transfer pricing model/policy of its company or the group as a whole and can consider new model/policy consistent with the roles & responsibilities of the taxpayer and its AEs.

Extended Powers of the Transfer Pricing Officers - Exercised Judiciously or Exploited?

Amit Agarwal*

Ayush Rajani**

In the last few years the Government of India has taken many steps in order to strengthen the Indian transfer pricing regulations ("TP regulations"). A series of amendments have been introduced in order to enhance the ambit of tax base and consequent increase in the revenue. One such amendment pertains to the "Powers of Transfer Pricing Officers", whereby the scope of the Transfer Pricing Officers ("TPO's") powers have been extended from mere determination of arm's length price to conducting surveys or imposing penalties for non-compliance with transfer pricing provisions.

This article discusses some of the extended jurisdictional powers of the TPO as bestowed upon them under the Indian TP Regulations *vis-à-vis* the intricacies of the practical insights of powers actually exercised during TP audits and hardships faced by the taxpayers and their representatives.

Overview

Let's begin with a quick overview of what the Legislature has to offer as guidance on powers of the TPOs. As a brief, the powers of TPO can be divided into three parts, where the first Part deals with its powers to compute the arm's length price of an international transaction; Part 2 deals with powers to seek information, documents and records; the last part of the TPO powers involve ancillary powers like levy of penalty, passing rectification orders etc.

A transfer pricing audit normally involves an examination of books and records of the taxpayer, supplemented by a series of notices and personal hearings. TPOs generally request for copies of contracts and

* Amit Agarwal is a Partner in Nangia & Co.

** Ayush Rajani, Manager at Nangia & Co.

documentations maintained by the taxpayer including information on methods for determining cost and pricing of the international transactions.

Legislative support

Section 92CA, it all begins here, once a matter is referred to the TPO by the Assessing Officer ("AO") to determine the ALP of an international transaction or specified domestic transaction ("SDT") (hereinafter collectively referred to as "covered transactions") entered into by the taxpayer during the given financial year under review. Once the matter is referred to the TPO, he would then examine the facts and circumstances surrounding the covered transactions.

Finance Act, 2011 inserted section 92CA(2A) and 92CA(2B), which widened the powers of the TPO to adjudicate the covered transactions whether or not the same have been referred to by the AO and even if the taxpayer has not disclosed the same in its Accountant's Report *i.e*. Form 3CEB. Essentially, this amendment in TPO powers was made to nullify the decision of the Tribunal in the case of *Amadeus India (P.) Ltd*.[1] The powers of determining ALP of covered transactions was earlier limited to only those transactions referred to the TPO.

TPO may for the purposes of determining the ALP also exercise powers specified under section 131(1) of the Act. These powers are essentially for:

(*a*) Discovery and inspection;

(*b*) Enforcing attendance of any person and examine him on oath;

(*c*) Compelling the production of books of account and other documents; and

(*d*) Issuing commissions.

TPOs have also attempted to obtain secret comparable companies by gaining access to information by forwarding data requests to the third parties under the influence of powers conferred upon TPOs under section 133(6) of the Act.

Subsequently, the TPO can proceed to determine the ALP of the said transaction if on the basis of material or information so obtained by him, once he establishes that any of the provisions of section 92C(3) of the Act is attracted.

TPOs are also vested with powers under section 133A of the Act, which allows them to undertake survey and take possession of already existent information.

Having provided an overview of the TPO's powers, we have discussed below some practical insights on exercise of TPO powers, some of which can be termed as excessive and unreasonable.

Transfer Pricing Audit Process

Even after completion of almost a decade since the first audit cycle, practically, the scenario in tax offices (with respect to exercise of TPO's powers) is quite different from the laid down law and many practitioners and taxpayers could relate to this. We would like to highlight a few scenarios which occur more often than not and leaves the taxpayers and their representatives muddled as to whether the TPO is actually authorised to adopt the said course of action:

- Calling upon the taxpayers to furnish details of its overseas associated enterprises ("AEs"):

The never ending list of requirements of the TPO pertaining to financial and commercial information of the AEs *viz*. financial statements, agreements entered into by AEs with its customers, invoices raised by the AEs on their end customers, credit period extended by the AEs to their customers and *vice-a-versa* etc., is overwhelming for the taxpayers and their authorised representatives ("ARs"). Is the taxpayer under a legal obligation to obtain and furnish such information to the TPO, especially in situation where the taxpayer is not in possession of such information and neither has the ability to enforce such compliance upon the overseas AE? Quite often there are situations wherein the relationship exists due to a deeming provision and the AEs are either not bound or unwilling to share the requisite information with the taxpayer. Should such non-furnishing of information be a reason for an adversarial action against the taxpayer?

Any failure or inability of the taxpayer to furnish such information is often followed by stern notices being issued by the TPOs. Most of the times, it is genuinely difficult for the taxpayer and their ARs to convince the TPOs that they are not privy to such information specifically in view of the time pressing deadlines given by the TPOs. Resultant, *ad-hoc* adjustments and complete disregard of the hardship endured by the taxpayers.

- Transfer pricing study report ("TPSR") is "not reliable":

This phrase is a sign of the beginning of a never ending battle. Mere mention of these words in a show cause notice issued by the TPO and there goes the TPSR out of the window. Taxpayers are now left at the mercy of the TPOs. The mandatory requirement to reject the TPSR only after categorising the defect or insufficiency of the report under one of the four clauses under section 92C(3) of the Act are conveniently neglected.

It will not be out of place to mention the findings of the Hon'ble Bangalore Tribunal in one of its initial and landmark decision pertaining to TP regulations when the TP regime was in its nascent stages. The Tribunal in the case of ***Philips Software Centre (P.) Ltd.***[2] had observed that:

> *"The intention of section 92C(3)* ***has always been that scrutiny of the international transactions of an assessee can only be done if the Assessing Officer/TPO can prove that the circumstances enumerated in clauses (a) to (d) are satisfied.*** *Even where any infirmity is identified by the Assessing Officer/TPO, the action of the Assessing Officer/TPO would be restricted to taking remedial action commensurate with the infirmity identified by him, and not beyond…"*
>
> ***(Emphasis supplied)***

The aforesaid judgment has still not attained finality and is still under litigation.

In most cases, the TPOs proceed with altering/ rejecting the benchmarking analysis of the taxpayer or proceed to change the comparable set based on search sets available with the TPO, without adhering to the provisions of section 92C(3) of the Act read with section 92CA of the Act. Such action of the TPO is clearly not in accordance with provisions of section 92C(3) read with section 92CA of the Act. There are various jurisprudence on the subject enforcing the need to state reasons for rejection under section 92C(3) before proceeding with fresh analysis but are often ignored at field levels. Whilst, there are cases where both the courts and the tribunals have failed to find significant merit in this legal ground of the taxpayer and have often failed to conclusively adjudicate on the issue of beyond jurisdiction exercise of powers by TPO and consequent quashing of the TPO order on this ground alone.

These issues have been revolving around for quite some time now without any strong "single tracked" support from the judiciary.

- Application of fresh economic analysis:

Let us take a real-life situation for ease of understanding. A taxpayer (a provider of logistic services) has justified its international transaction using transaction net margin method, as the most appropriate method and by considering a comparable set of independent logistic service providers. During the course of transfer pricing audit, the TPO does not agree with the entity characterization and issues a notice to the taxpayer instructing to identify comparable companies undertaking business support services instead of logistic services. "Revenue authorities cannot step into the shoes of the taxpayer…" is now a well settled proposition, even upheld by the Hon'ble Delhi High Court in its recent decision[3].

At first, such a request by the TPO may looks legitimate. However, let us now evaluate the legitimacy of the TPO's request in light of the provisions of section 92CA of the Act read with section 92C(3) of the Act.

- The request of the TPO clearly does not fall within any of the limbs laid down in section 92C(3) of the Act as neither the documentation of the taxpayer was unreliable nor incorrect and is merely difference in opinion from the TPO's point of view;
- The same cannot be considered to fall under provisions of section 92CA(2), as the said sub-section provides for furnishing of information by the taxpayer, which the taxpayer may rely in support of his determination of the arm's length price. This section does not empower the TPO to seek additional analysis to satisfy himself about the arm's length pricing by re-characterising the covered transactions;
- Even the provisions of section 92CA(7) which bestow significant powers to the TPO, and allow him to exercise the powers referred in sections 131, 133 or Section 133A do not contemplate or empower seeking of additional economic analysis by the TPO. In this regard, attention is drawn to section 131 (Clauses (*a*) to (*d*)), which merely empower the TPO to seek information that is existent with the taxpayer and does not cause or empower him to seek any analytical data from the taxpayer. Similarly section 133(6) only empowers the TPO to seek any data statutorily or internally maintained by the taxpayer. Similarly, section 133A of the Act allows the TPO to undertake survey and take possession of already existent information. Thus, in view thereof, none of the above provisions empower the TPO to seek additional economic analysis from the taxpayer.

Be that as it may, one can reasonably conclude that the information request of the TPO is beyond his jurisdiction and the taxpayer cannot be forced upon to furnish such additional analysis, as it has already discharged its burden by preparing and furnishing a complete transfer pricing documentation under rule 10D of the Rules. Having said so, in most cases, the taxpayers or their ARs more often than not, furnish the requisite analysis on a *without prejudice* basis with a view to avoid further aggravating the TPO and dodge the wrath of the penal provisions, say for instance, invoking section 271G of the Act which ought to be triggered only where the taxpayer fails to furnish the TPSR maintained by the taxpayer under rule 10D of the Rules.

Conclusion

Every country wants to protect its revenue base and India is no different. Transfer Pricing has been an area that has seen significant tax litigation in India. After a decade of audit cycles, with numerous occasions where the taxpayers have suffered the brunt of aggressive positions adopted by the revenue authorities and various amendments to the TP regulations, there remains a thin line between "enforcing" powers and making an "inquiry" by the TPO.

One is alive of the fact that the extended powers conferred upon the TPOs is to make better informed risk assessments and to conduct better targeted transfer pricing audits, however, such powers should be exercised with due caution and care to ensure that the taxpayers do not foresee TP audits as a bane.

1. *CIT* v. *Amadeus India (P.) Ltd.* [2011] 203 Taxman 602/16 taxmann.com 43 (Delhi)
2. *Philips Software Centre (P.) Ltd.* v. *Asstt. CIT* [2008] 26 SOT 226 (Bang.)
3. *CIT* v. *Cotton Naturals (I) (P.) Ltd.* [2015] 231 Taxman 401/55 taxmann.com 523

Outbound Investment - Key considerations from the Indian Tax and Transfer Pricing perspective

Bhavin Shah*

Kunal Shah**

Introduction

India is increasingly being recognized as a superpower on the global map. The general perception is that the incumbent Government has been sending the right signals to the world that India is open to partnerships and shall introduce the necessary reforms that will benefit all the stakeholders.

The two way globalization process and integration of the Indian economy with the rest of the world has not only enabled substantial inflow of foreign investments into India but also enabled a significant increase in the investments made from India.

India has a vibrant private sector which is known for its entrepreneurial drive and Indian investors have been exploring foreign markets primarily with the following objectives:

- Penetration and access into new markets;
- Accessing improved technology and skills;
- Facilitating research and development activities for their business;
- Availability of finance at competitive rates

The data on overseas investments[1] for the month of July 2015 reveals the following trends:

- The total financial commitment by Indian investors with respect to outbound investments for the month of July 2015 stood at USD 1,235 Million (*i.e.* INR 8,000 crore approximately). Out of this total, the majority (*i.e.* about 57%) comprised of guarantees issued by Indian investors in favour of investee-companies outside India.

* Bhavin Shah, Associate Director, BDO India LLP

** Kunal Shah, Manager, BDO India LLP

\- The views expressed herein are personal.

- Majority of investments have been made in the Manufacturing Sector followed by the Financial, Insurance and Business Services sector. Cumulatively, these sectors constituted 72% of the total investment made.
- Singapore remains the top destination for outbound investments (27% of the total investments), followed by the Netherlands (16%), the United States of America (15%) and the United Kingdom (6%). Mauritius, which is the major source of foreign investments into India and had been the top destination for investments outside India earlier, witnessed outflows of 8% from India for the month of July 2015.

In view of the above, a logical inference that could be drawn is that Singapore, Netherlands and Mauritius remain the top investment routing destinations for investments made from India whereas the United States of America and the United Kingdom remain the top destinations where the ultimate investments are made.

There has been a steady growth in the number of outbound investments made by Indian entities over the years. However, owing to high leverage taken for making investment; adverse changes in the business cycle and global slowdown, some of the big ticket overseas acquisition in the recent past have, in fact, eroded shareholders' wealth. Nonetheless, the view amongst various quarters is that outbound investments are only going to grow from the current levels.

In ensuing paragraphs, an attempt has been made to discuss some of the key considerations from the perspective of the Indian income tax, including transfer pricing regulations, which the Indian investors have to factor in at the time of making outbound investments.

Selection of the overseas entity

The foremost consideration that an Indian investor has to bear in mind is to select the type of entity that needs to be formed for operations in the foreign country. Typically, one may set up a separate legal entity *i.e.* a company or a limited liability partnership firm or may set-up an office such as project office, branch office, or liaison office. Whilst the tax efficiency in an outbound structure is an important criterion, other factors such as legal indemnity, business considerations, ease of operations, etc. are equally relevant.

A related aspect hereto is the permanent establishment exposure which may get triggered in the foreign country for the Indian investor by selecting a particular type of entity. The analysis in respect of permanent establishment is a fact based exercise, and is dependent on several factors such as the type and nature of activities performed; manner of conducting business, etc. Generally, the act of setting up a subsidiary company by itself should not create a permanent establishment exposure for the Indian investor in the foreign country. On the other hand, setting up branch office or a project office in a foreign country is likely to trigger a permanent establishment exposure for the Indian investor in that country.

India levies tax on the worldwide income of an Indian resident. Thus, in a case where it is held that the Indian investor has a permanent establishment in the foreign country, the income attributable to such permanent establishment of the Indian investor in the foreign country would form a part of the Indian tax base and taxed normally. However, the Indian investor would be entitled to claim credit for taxes paid or borne by such permanent establishment in the foreign country.

Selection of Holding company jurisdiction

The use of intermediate holding companies has been a common practice worldwide amongst companies desirous of making investments in a foreign country. While it is commonly perceived that the use of intermediate holding companies is to minimize or mitigate tax liabilities, the use of such holding companies is in fact multi-fold, such as (on illustrative basis):

- Protect shareholder's interest in the investment and at the same time safeguard the ultimate parent from any legal risks
- Unlocking the value of foreign investments through stake sale, listing on foreign bourses, etc.
- Creating an investment hub for further expansion
- Managing certain central functions
- Leveraging the capital structure of the holding company by raising debt or equity, without diluting the equity of the flagship group company
- Enabling flexible movement of funds between group companies
- Minimizing tax incidence on income from investments and at the time of exiting such investments

The Indian investor could thus select the holding company jurisdiction and the preferable holding company structure therein, keeping in mind the aforesaid factors.

Funding the overseas entity

The other consideration that the Indian investor has to evaluate is the manner in which the investment is to be funded. The Foreign Exchange Management Act, 1999 ('FEMA') of India regulates the manner in which an Indian resident is permitted to make investment outside India. Under FEMA provisions[2], Indian companies are allowed to undertake financial commitments in relation to foreign investments (*i.e.* inclusive of equity, debt and corporate guarantees) upto four times of their net worth as per the last audited balance sheet. Furthermore, such Indian companies are required to satisfy the conditions prescribed individually for each type of instrument. On the other hand, Indian resident individuals are allowed to invest upto USD 250,000 annually in their individual capacity under the Liberalised Remittance Scheme under FEMA.

As per the provisions of the Income-tax Act, 1961 ('Act')[3], a concessional tax rate of 15% has been prescribed on dividend income received from a foreign company, where the Indian company holds at least 26% of the nominal value of the equity share capital of such foreign company. The said provision further prescribes that the Indian company cannot claim any deduction in relation to any expenditure or allowance incurred for earning the said dividend income.

Thus, while on one hand the Indian company pays tax on dividend received from the prescribed foreign companies at a concessional rate, it appears that the Indian company may not be able to claim the tax deduction on the related expenses, such as interest paid on loan borrowed to fund the investments in such foreign companies. However, the Indian company, subject to fulfilment of the prescribed conditions[4], may be able to pass on the dividend so received from the prescribed foreign companies to its shareholders without paying any dividend distribution tax.

Concept of Place of Effective Management

Upto March 2015, a foreign company was treated as a tax resident of India under the Act[5] if the control and management of its affairs was situated wholly in India. However, *vide* Finance Act, 2015, the above test of residency has been amended. Accordingly, with effect from April 1, 2015, if the place of effective management ('POEM') of a foreign company in a particular tax year is situated in India, the foreign company will be considered as a tax resident of India under the Act. Further, the term POEM has been explained as 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. Additionally, it has been clarified that a set of guiding principles to determine POEM of a company would be issued in due course.

The concept of POEM has been well accepted internationally and most of the Double Taxation Avoidance Agreements ('DTAAs') entered into by India incorporate the concept of POEM. Thus, a useful reference may be drawn from the commentary of the Organisation for Economic Co-operation and Development ('OECD') on Model Tax Convention on Income and Capital Gains, commentaries of eminent international authors and judicial precedence on the term POEM, as used in the provisions of the articles relating to residence, permanent establishment and shipping & aircraft under various tax treaties.

In view of the above amendment in the residency test, foreign companies whose POEM is situated in India in a particular tax year would be considered as a tax resident under the Act and accordingly such foreign companies shall be required to pay taxes on its global income in India. Additionally, foreign companies could also be subject to other provisions of the Act such as withholding compliances, tax liability based on the provisions of Minimum Alternate Tax, recently introduced Income Computation and Disclosure Standards, etc. Thus, Indian investors who are proposing to invest in a foreign company would need to keep in mind the above change in the residency test under the Act and its impact on their structure.

General Anti-Avoidance Rules

Apart from the above considerations, while making an outbound investment, Indian investors should also analyse the General Anti-Avoidance Rules ('GAAR'), which shall apply from tax year 2017-18 and onwards. The said provisions are in addition to the specific anti-avoidance rules under the Act and they empower the Indian Tax Authorities to declare any transaction as an impermissible avoidance arrangement and determine the tax consequences thereof in accordance with the relevant provisions of the Act. The consequences of a transaction being considered as an impermissible avoidance arrangement and thus subject to GAAR have been defined in an inclusive manner and amongst others include the following:

- Denial of tax benefits or benefits under a tax treaty
- Reallocating amongst parties any receipts or expenses
- Treating the residency at a place other than place of residence
- Treating the situs of asset or of a transaction at a place other than the location of asset or transaction
- Looking through any arrangement by disregarding any corporate structure

As can be seen from above, the consequences of an arrangement being classified as an impermissible avoidance agreement are wide, ambiguous and hence prone to litigation. There has been considerable debate amongst various stakeholders regarding practical applicability of the GAAR provisions. It is thus imperative to ascertain the impact that the GAAR provisions would have on the outbound structures.

Controlled Foreign Company

The provisions relating to Controlled Foreign Company ('CFC') are generally provided for under the tax laws of a country with an objective to taxing the income and avoid deferral of tax by residents of that country by use of intermediate entities or structures. Typically, the undistributed passive income of a foreign entity may be included in the tax base of the resident entity if the prescribed conditions in relation to treating such foreign entity as a CFC of a resident entity are satisfied.

India at present does not have CFC regulations under the Act. However, there has been a news report[6] suggesting that the Indian

Government may introduce CFC regulations under the Act.

It may be recalled that the Direct Tax Code Bill, 2013 ('DTC') had proposed introduction of CFC regulations. The DTC Bill had proposed the following conditions to treat a foreign entity as a CFC of an Indian entity:

- The foreign entity is a tax resident of a foreign country, where its actual amount of tax paid, under the law of that country or territory would be less than half of what it would have been subject to under the DTC, if it was a domestic company;
- Its shares are not traded on any stock exchange recognised by law of such territory;
- One or more persons, resident in India, individually or collectively exercise control over the foreign company;
- It is not engaged in any active trade or business;
- The specified income (*i.e.* passive income) of the foreign company exceeds twenty five lakh rupees.

Strengthening of CFC rules under the domestic tax laws is one of the identified areas for the purpose of tackling base erosion and profit shifting issue by the OECD, which has been discussed in subsequent paragraph. Thus, it remains to be seen as to how would the impact on outbound holding structures play out in case CFC regulations are introduced under the Act.

Indian Transfer Pricing Regulations

Under the Indian transfer pricing regulations, the term 'international transactions' has been defined in an inclusive manner and includes within its ambit transactions which are capital in nature. However, the Bombay High Court, in the case of *Vodafone India Services (P.) Ltd.*[7], has principally held that issue of shares by an Indian company to its overseas holding company cannot be subject to transfer pricing adjustments. The Hon'ble High Court held that issue of shares, being a capital transaction, does not give rise to any income in the hands of the Indian company and thus does not trigger the charging provisions of the Act. Subsequently, the Indian government issued a press release dated 28 January 2015, accepting the above order of the Hon'ble High Court and thereby refraining from filing a special leave petition before the Supreme Court of India. The press release further clarified that it shall also accept orders of other courts/appellate authorities in cases of other taxpayers where similar transfer pricing adjustments have been made and the issue has been decided in favour of the taxpayer.

Although the aforesaid decision was rendered in context of inbound investments, the ratio laid down by the Hon'ble High Court could be equally applicable in case of outbound investments, wherein there is no income that arises in the hands of the Indian investor at the time of making outbound investments.

In addition to the above issue, some of the typical intra-group transactions in relation to an outbound investment and the key challenges arising from an Indian transfer pricing perspective have been discussed in the following paragraphs.

Corporate Guarantee

As is evident from the data on overseas investments discussed above, the majority of financial commitment in relation to outbound investments has been undertaken by issuing guarantees in favour of the investee foreign entities. This is primarily due to the fact that the investee foreign entities may not be in a position to procure finance from global markets in the absence of established credibility.

In the Indian context, the transaction of giving guarantee and the benchmarking thereof has been a matter of considerable litigation. The primary issue arises as to whether the Indian entity should recover some fees from the investee entity in whose favour the guarantee has been given and if yes, what is the amount of fees that shall satisfy the arm's length test in this context. The Indian Tax Authorities insist that the Indian investor ought to have recovered a fee equivalent to the guarantee fees that an Indian bank would have charged to its customers for granting guarantee on its behalf, failing which there could be a transfer pricing adjustment to that effect. However, it needs to be appreciated that the circumstances prevailing and the terms and conditions under which the guarantee is given by the Indian bank to its customers may not be comparable to those in the case of guarantees given by a parent company on behalf of its subsidiaries.

Other intra-group transactions

Outbound investments are undertaken primarily with a view to expand the Indian investor's business in the foreign country. It is thus conventional for the Indian investor to support such entities till the time they are capable of operating as a fully functional unit in themselves. The support could be extended by providing its resources to the investee foreign companies for no cost in the growth stage so as to avert any financial burden on such companies, which if allowed, would affect the value of investments made by the Indian investor.

A case in point could be allowing the investee foreign company to use the well established trademark or brand name of the Indian investor for no additional consideration. While it is plausible for the Indian investor to argue that such use enhances the reputation of the trademark or brand name in the foreign country, the Indian Tax Authorities may insist that the Indian investor ought to have charged a fee equivalent to the arm's length price for allowing the investee company to use the trademark or brand name. Further, for the purpose of determining what constitutes arm's length, the information of comparable companies undertaking similar transactions would be difficult to obtain since, as a normal practice, companies do not allow third parties to use their trademarks or brand name for various reasons.

Another case in point could be a situation where the Indian investor extends interest-free advances to the investee foreign companies for the future work that the latter would undertake for the former. While the objective would be to facilitate the working capital requirements of the investee foreign company in the initial stages, the Indian Tax Authorities may insist the Indian investor to prove that similar assistance is granted to a third party as well. In absence thereof, the Indian Tax Authorities may propose an adjustment of interest for the period such interest free advance is granted to the investee foreign company.

It thus becomes obligatory for the Indian investor to maintain sufficient documentation and explanations in order to justify the basis and rationale behind undertaking such, which may have an element of benefit that is otherwise not available under third party dealings.

Base Erosion and Profit Shifting

The Governments of various countries have been heavily voicing their concerns over losing substantial tax revenues because of planning adopted by multi-national taxpayers which are aimed at shifting profits in a manner which will erode the taxable base of a country to an overseas country where such multi-nationals are subject to a more favourable tax treatment. In order to address the concerns so raised, the OECD has introduced the Base Erosion and Profit Shifting ('BEPS') project. Under the BEPS project, the OECD has identified fifteen action points to address the issue of base erosion and profit shifting and for which the guidelines shall be framed. Amongst other areas, strengthening of CFC rules; limiting base erosion *via* interest deductions and other financial payments; preventing tax treaty abuse and ensuring that transfer pricing outcomes are in line with value creation are the areas that have been identified. The recommendation that shall be made by the OECD along with the extent to which the concerned countries (including India) shall implement such recommendations is expected to have an impact on outbound investments going forward.

Concluding Thoughts

While Indian investors tread cautiously, it is anticipated that the volumes of outbound investments are going up at a gradual pace. Further, the general perception is that the recent reforms including the BEPS project have been aimed at targeting all holding structures. However, legitimate holding structures, which are not established primarily for tax avoidance or tax planning purposes, should withstand the test of time. It is thus indispensable for investors to be aware of all the relevant tax laws and other regulations that may have an impact on their structures so as to avoid being caught off-guard.

1. Published by the Reserve Bank of India at www.rbi.org.in.
2. Notification No. FEMA 120, as amended from time to time.
3. Refer section 115BBD of the Act.
4. Refer section 115-O of the Act.
5. Refer section 6(3) of the Act.
6. News article titled 'New rules soon to tackle offshore tax deferral' published on 20 May 2015 by the Financial Express at http://www.financial-express.com/article/economy/new-rules-soon-to-tackle-offshore-tax-deferral/74207/.
7. *Vodafone India Services (P.) Ltd.* v. *Union of India* [2014] 368 ITR 1/228 Taxman 25/50 taxmann.com 300.

Indian investors purchasing U.S. Real Estate – From a U.S. point of view

Kenneth Lobo*

Stanley C. Ruchelman**

The U.S. Federal income tax regime will apply to an Indian resident who purchases U.S. real property, whether the purchase is made for personal use or for investment. Indian tax advisors should be concerned about two principal tax problems that affect every real estate investment: The Foreign Investment Real Property Tax Act ("F.I.R.P.T.A.") and the U.S. estate tax. Consequently, it is helpful to address these two issues first before delving into the matter of strategy and structures.

U.S. Estate tax

This section addresses the U.S. estate tax consequences of owning U.S. real property by Indian residents.[1] However, other issues such as probate, incapacity, medical care, insurance coverage and income tax consequences should not be forgotten and may occasionally outweigh the importance of the U.S. estate tax.

U.S. Estate Tax Basics

The U.S. estate tax is imposed at rates up to 40% on the transfer of the estate of a deceased individual owning U.S. real property at the conclusion of life. The gross estate for a non-resident, non-citizen, such as an Indian resident who is not a U.S. citizen, is comprised solely of U.S. situs assets that are included in a U.S. taxable estate under general U.S. estate tax rules. Because there is no estate tax treaty between the two countries, the full breadth of U.S. estate tax jurisdiction will be applicable. The gross estate tax value is reduced by various deductions to arrive at a taxable estate and some deductions are allowed only on a percentage basis that reflects asset deployment within and outside the U.S.

* Kenneth Lobo is the Managing Attorney of Ruchelman PLLC, Toronto.

** Stanley C. Ruchelman is the Managing Partner of Ruchelman PLLC, Toronto.

1. This article assumes that the Indian resident is not a U.S. citizen.

U.S. tax law provides for a $60,000 exemption from the estate tax. Since the threshold is quite low, and the tax rates are steeply graduated, the U.S. estate tax will apply in nearly all cases where the property is directly owned by an Indian individual. The total tax on the first $1.0 million of a taxable estate is $345,000. Thereafter, all additional assets are taxed at 40% under current law. Moreover, if global assets are not reported for the purpose of determining the global expenses and claims attributable on a *pro rata* basis to the U.S. situs assets, the tax base will be the gross U.S. estate.

U.S. Situs Assets

Only assets deemed situated in the United States ("U.S. situs assets") are included in the Indian decedent's gross estate and are subject to the U.S estate tax. U.S. real estate is considered a U.S. situs asset. Other U.S. situs assets are shares of stock of U.S. corporations and debt securities and promissory notes issued by U.S. corporations, partnerships, and resident or citizen individuals. It should be noted that this includes shares of a U.S. company which holds real property.

Example: Raj, an Indian citizen who is not a U.S. person, purchases a condo in Miami, Florida as a vacation home in 2010. Title to the home is in Raj's name. Raj passes away in 2015 and the property is valued at $1.0 million. Raj will be subject to the U.S. estate tax on the Miami property as he owns U.S. situs assets upon his death. If no other facts exist, the tax will be approximately $345,000.

Example: The same example as above. Raj forms an Indian corporation, Ashoka Corp, who will in turn, purchase the property. Title to the home is in the name of Ashoka Corp. Raj passes away in 2015 but his estate will not be subject to the U.S. estate tax as he does not directly own any U.S. situs assets. No look-through rule generally exists if the Indian corporation is not a sham.

F.I.R.P.T.A.

F.I.R.P.T.A. can apply regardless of whether the property is being held for investment or for personal use. Under F.I.R.P.T.A., the gain or loss from a disposition of a U.S. real property interest ("U.S.R.P.I") by an Indian resident is treated as gain that is effectively connected with the conduct of a trade or business. This means the gain is subject to income tax. If the property is owned by an individual, the gain can qualify for reduced tax rates as a long-term capital gain. Thus, the tax rate will be 20%. In comparison, if the seller is a corporation, the tax rate is 34% or 35% depending on the total amount of the taxpayer's U.S. taxable gain and income.

Regardless of the final tax imposed on the gain, when the seller is not a U.S. individual or entity, the buyer is required to deduct and withhold 10% of the amount realized on the disposition, unless an exception applies. In most cases the amount realized is the sales price. This is often known as "F.I.R.P.T.A. Withholding." If the F.I.R.P.T.A. Withholding exceeds the ultimate tax liability, a refund may be claimed at the time a tax return is filed by the Indian resident. The amount realized is generally the sales price plus seller expenses assumed by the buyer.

The Indian resident is required to file U.S. tax returns to determine the amount of tax owed on the gain. An Indian seller is taxed in the same way and at the same rate as a U.S. seller, without regard to rules that may be applicable in India. To complete this process, the Indian vendor must obtain a tax identification number. Note that without a U.S. tax identification number, the I.R.S. will not be able to match the F.I.R.P.T.A. Withholding and the ultimate tax due.

What is a U.S.R.P.I?

A direct ownership interest of U.S. real property is considered a U.S.R.P.I. In addition, many other types of ownership interests could be considered to U.S.R.P.I.'s. These include options and leases to allow ownership or occupancy at below market prices and life estates. Shares of stock of a U.S. real property holding corporation ("U.S.R.P.H.C.") constitute a U.S.R.P.I. This includes both non U.S. and U.S. corporations that meet the standard to be considered a U.S.R.P.H.C. However, only a U.S. corporation that is a U.S.R.P.H.C. can be a U.S.R.P.I that generates taxable gain when sold by a non U.S. person.

Example: Raj, an Indian resident and citizen who is not a U.S. person, purchases an apartment in New York City for $1.0 million in 2011. Title is in Raj's name alone. He later sells the property for $2,000,000 in 2015. The buyer will be residing in the property full time. F.I.R.P.T.A. applies to the transaction and 10% of the purchase price must be withheld ($200,000) unless an exception applies.

When is a Domestic Corporation Considered to be a U.S.R.P.H.C?

A domestic corporation is a U.S.R.P.H.C. whenever it holds U.S.R.P.I's having an aggregate fair market value that equals or exceeds 50 percent of the fair market value of the following assets:

a. The corporation's U.S.R.P.I.'s,

b. The corporation's interests in real property located outside of the U.S., and

c. All other assets of the corporation that are used in a trade or business, wherever located.

Example: Corporation Longhorns Inc., incorporated in Texas, holds ownership interests of the following assets: 100% of a New York building valued at $2,500,000, 100% of a business located in India valued at $1,250,000, and a 100% interest of a building located in Dubai valued at $1,000,000. Raj, an Indian citizen and resident who is not a U.S. person is the sole shareholder of Longhorns. Because the fair market value of its U.S.R.P.I. is more than 50% of the total value of its holdings, Longhorns Inc. will be considered a U.S.R.P.H.C. Consequently, the sale of shares is subject to U.S. Federal income tax under F.I.R.P.T.A.

F.I.R.P.T.A. Withholding Exceptions

The withholding obligation imposed under U.S. tax law can be reduced in several ways. The most likely reduction involves a fact pattern in which the actual tax due in the tax return for the year, imposed on the net taxable gain at rates discussed above, is less than the F.I.R.P.T.A. Withholding of 10% of the amount realized. Where this occurs, F.I.R.P.T.A. Withholding can be reduced pursuant to an I.R.S. determination letter that is obtained by filing Form 8288-B, *Application for Withholding Certificate For Dispositions By Foreign Persons Of U.S. Real Property Interests* not later than the close of the date of the sale. Another reduction involves a disposition of shares of a U.S.R.P.H.C. in a tax-free share-for-share exchange in which the shares received by the taxpayer are shares of a domestic U.S.R.P.H.C. that is not a publicly traded corporation in which the client owns not more than 5% of the shares.

Property purchased for personal use

An Indian individual may decide to purchase a home in the U.S. for a number of reasons; temporary stays, short-term vacation homes, job postings or for children who are university students. The biggest, but not sole issue, that arises when purchasing property for personal use is the U.S. estate tax.

The following section will list several strategies for purchasing U.S. real property, and the relative advantages and disadvantages in using each structure.

Options for owning personal use property

Option 1: Individual Name Owning U.S. real property in an individual's name is a preferred option when that individual is not subject to the U.S. estate tax—as noted above, this is highly unlikely in the case of an Indian resident. The property owner may desire to purchase life insurance, the proceeds of which will be used to pay the U.S. estate tax liability. However, this leaves unresolved the issues of incapacity and probate and measures should be taken by the tax practitioner to address those issues. Probate can be time-consuming and expensive.

Option 1A: Individual Name—Beneficiary Deed/Enhanced Life Estate Deed: Holding title in the name of a beneficiary deed/ enhanced life estate deed is common in certain U.S. states. Generally, such deeds will avoid probate, but will not exclude the U.S. asset from the decedent's gross estate. There may be U.S. gift tax and when additional owners (i.e., children) are added to the title of the property after the property is already owned. Care must also be taken to plan for any Indian attribution issues upon the purchase of the property.

Option 2: Trust Ownership: A properly drafted irrevocable family trust will exclude the trust's assets from the U.S. estate tax, provided that the initial corpus of the trust consist of the proceeds of a wire transfer from the settlor. This allows the trust to acquire the property from an unrelated seller. The trust is typically set up for a spouse and descendants. If the spouse dies first, the surviving contributing spouse must pay fair market value rent to the trust if he or she continues to reside in the property as the contributing spouse is not a beneficiary of the trust and property must remain as investment property held by the trust. The trust will be subject to individual, not corporate rates, and the transfer of funds by wire is not subject to a gift tax, if properly structured. A foreign trust is not subject to net investment income tax.

Option 3: Corporate Ownership: If a non-U.S. corporation owns the U.S. real property, the Indian shareholder will not own U.S. situs assets, and consequently, there will be no U.S. estate tax owed when the shareholder dies (assuming that the non-U.S. corporation is not a sham). However, any income earned by the corporation is subject to the U.S. corporate tax (up to 35%) and possible state corporate tax as well. Capital gains of corporations are subject to the same rates as income, which are higher than U.S. capital gains tax rates applicable to individuals or trusts.

Option 4: Limited Partnership: Indian individuals who are limited partners of a limited partnership will be treated as if they directly own the partnership's U.S. income for income tax purposes. If the partnership is engaged in a U.S. trade or business such, for example, rental operations, the partnership will constitute a situs asset. Upon the death of a partner, the partnership interest will be included in a taxable estate. U.S. tax practitioners are divided as to whether a multi-tiered partnership formed in separate countries will exclude U.S. situs assets from a decedent's gross estate and consequently, caution must be used when using such structures.

Property purchased for Investment purposes

Generally, when advising Indian individuals who wish to purchase U.S. real property for investment purposes, the advisor should advise the client of the following (in addition to the U.S. estate tax and F.I.R.P.T.A.):

1. The U.S. tax treatment of rental income;
2. The financing of the purchase; and
3. The branch profits tax.

Rental Income

Generally, rental income is U.S. sourced if the property is located in the U.S. If rental operations do not rise to the level of a trade or business, because for example, the property is commercial property that is subject to a triple net lease calling for the tenant to bear all operating costs, income generated by the property is not considered "effectively connected" with a U.S. trade or business ("U.S.T.B.") Instead, it will be considered "Fixed, Determinable, Annual or Periodic" ("F.D.A.P.") from U.S. sources and will be subject to a 30% withholding tax except as provided below under the heading "Net Election." A withholding tax of 30% of rents will equate to a large percentage of net income because deductions such as interest expense on debt and depreciation are not take into account.

Conversely, if the Indian individual or corporation is engaged in a U.S.T.B, the income effectively connected with that business ("E.C.I.") is subject to U.S. income tax on a net basis that reflects graduated rates. A U.S. tax return must be filed annually. For a non-U.S. corporation or individual operating in the U.S. to be considered to be engaged in a U.S.T.B., activities conducted in the U.S. must be considered "considerable, continuous, and regular." For rental operations, the typical activity involves the acquisition of the property, leasing to tenants, and maintenance. Whether the activity is "considerable, continuous and regular" is a question of fact, and the I.R.S. may not reach the same conclusion as the non-U.S. owner. The specter of 30% withholding tax on rental payments is a significant risk in the absence of a heavily staffed U.S. office. Again, the net election discussed below is intended to eliminate that risk.

Net Election

When the Indian investor's activities are not considered a U.S.T.B., an option exists to treat the income as if it were E.C.I. This allows the investor the opportunity to deduct depreciation, real estate *ad valorem* taxes, interest expense, and other expenses in computing the tax base.

A non-U.S. corporation or individual is eligible for the net election if:

- Income is derived from ownership of or an interest in U.S. real property during the taxable year in which the election is made and
- The interest in or holding of that property is for the purpose of producing income.

Financing Considerations

Debt and Equity

When the acquisition of real estate is financed by debt, the investor may deduct all or a portion of the interest payment when computing the tax base. Where the parties are related, the I.R.S. examines debtor-creditor relationships to ensure that the loans are not equity disguised as debt.

To bolster the character of an advance as true debt, certain guidelines are generally followed. The loan obligation should be documented and the overall terms should be structured to meet an arm's length standard as to period, interest rate, and payment terms. The payment terms must be achievable so that constant revisions to terms are avoided. The terms should be enforceable and the lender must monitor and enforce the loan in a way that would be followed by an unrelated lender. The borrower should pay interest and a portion of the loan balance should be repaid at least annually.

Earnings Stripping – "Disqualified Interest"

The earnings stripping rules limits a corporation's deduction for interest on obligations held by related persons, if the corporation's debt-to-equity ratio exceeds 1.5 to 1, the corporation's interest expense exceeds 50 per cent of a modified taxable income figure, and the related recipients of the interest pay no U.S. withholding tax on the receipt of interest income. The provision also applies to interest on indebtedness from unrelated persons if the indebtedness is guaranteed by a related person that outside the U.S.

Earnings stripping rules limit the deduction for net interest expense to 50 per cent of "adjusted taxable income," which is the functional equivalent of E.B.I.T.D.A. with a limited number of adjustments. Excess interest is carried forward to future years.

Branch Profits Tax Considerations

The branch profits tax is imposed only if a U.S. branch repatriates U.S. earnings back to the Indian home office and generally applies when an Indian corporation directly owns the U.S. property. The treaty rate is 15%, which is to be paid in addition to any income tax liability due.

The tax may not adversely affect Indian investors if a non U.S. corporation directly owns U.S. real estate and that property does not produce income. A branch profits tax may apply when that property is eventually sold, unless all U.S. operations are terminated.

Generally, the branch profits tax is eliminated by having a U.S. corporation own the U.S. real property and to use excess funds to expand operations or pay down debt.

Structured Investment Options

This section will address planning options available to Indian individuals when they are considering purchasing U.S. real property for investment purposes.

Option 1 – Directly Owning Real Estate

As mentioned previously, if the Indian resident's ownership of U.S. real estate is considered a U.S.T.B, current net rental income will be taxed at ordinary income tax rates. If the Indian resident is not involved in a U.S.T.B. (and does not elect to be so treated), a withholding tax on the gross rental income will apply.

Potential U.S. estate tax liability is the main disadvantage when using this strategy, along with probate, incapacity and the lack of limited liability protection. Additionally, if the investor sells the U.S. real property, F.I.R.P.T.A. may apply. However, the Indian individual may be able to benefit from the preferential long term capital gains rate.

Option 2 – Owning U.S. Real Property Through Non-U.S. Corporation

Although the corporate level taxes on current income may be slightly lower than the maximum rates applicable to individuals, taxes on the sale of real estate and repatriation of funds may be higher for a corporation owning U.S. real property. In addition, current income and income from the disposition may be subject to an additional branch profits tax up to 15%. A deferrred branch profits tax can apply in a transaction where the sale proceeds are not kept out of the U.S. for three years.

However, owning U.S. real estate through a non-U.S. corporation also has its advantages. The sale of stock in the non-U.S. corporation will be tax-free to an Indian individual or non U.S. corporate holder, and, as mentioned previously, U.S. estate tax will not apply where the real property owner is a non U.S. corporation rather than an individual.

Option 3 – Owning U.S. Real Property Through U.S. Corporation

Although owning U.S. real estate through a U.S. corporation will eliminate the branch profits tax, the holding will incur tax on all other fronts and is ordinarily not recommended.

The sale of stock in a U.S. corporation owning exclusively U.S. real estate is taxable since it would constitute the sale of a F.I.R.P.T.A. asset. Distributions by the U.S. corporation may be subject to a 15-25% withholding tax as stipulated under the Treaty.

Shares of a domestic corporation are U.S.-situs property for U.S. estate tax purposes and consequently the U.S. estate tax will apply if owned directly by an Indian individual.

Option 4: Indian Individual Owns Non U.S. Corporation, Which Owns U.S. Corporation Holding Real Estate

A triple tiered investment (where an Indian individual owns stock in a non U.S. corporation that, in turn, owns a U.S. corporation holding real estate) is a commonly recommended structure, with significant tax advantages.

Branch profits tax will not be applicable, although withholding will apply on dividend distributions. However, the withholding tax may not be imposed if there are liquidating distributions after the sale of all U.S. real property interests by the U.S. corporation. In addition, neither the U.S. estate tax nor F.I.R.P.T.A. withholding will apply to this structure.

Option 5—Using a Foreign Trust To Own U.S. Real Estate

In this structure, a foreign trust is used to own U.S. real estate through a Delaware L.L.C. As mentioned previously, the trust must be drafted properly to avoid U.S. estate tax exposure. The advisor must weigh the advantages of the preferential individual tax rates and limited liability provided by the structure versus the regular maintenance costs incurred to operate the L.L.C.

Option 6A—Multiple Properties—U.S. Brother Sister Corporations Owned By Non U.S. Parent

The advantage of brother-sister corporations owned by separate non U.S. corporations is the ability to sell one property and distribute the proceeds free of further U.S. withholding tax. However, gains and losses from one U.S. property cannot be offset against gains and losses of another U.S. property.

Option 6B—Multiple Properties—U.S. Brother Sister Corporations Owned By U.S. Parent, Which In Turn is Owned by a Non U.S. Parent

The advantage of creating a U.S. consolidated group permits gains and losses of each property to offset each other, potentially saving tax dollars on a current basis. However, a distribution of sales proceeds may be subject to U.S. withholding tax if the group continues to own U.S. real property. Again, neither F.I.R.P.T.A. nor the U.S. estate tax will apply to this plan. However, the advisor will have to weigh the annual maintenance and compliance costs of running such a structure versus the annual cash flows derived from the property.

Option 7—Partnership Structure

As mentioned above in the section titled "Options for Owning Personal Use Property", the advantages of using a partnership structure must be weighed against the possible disadvantage of U.S. estate tax exposure. Maintenance fees will need to be considered when using any form of partnership structure, although they tend to be not as costly as when using a multiple tiered structure.

Conclusion

When advising their clients on the purchase of U.S. real property, the Indian tax practitioner should be aware of the many negative consequences that can arise from using the incorrect strategy or structure. When applying the correct strategy, the Indian resident may be able to limit their tax liability, however, if the wrong structure is utilized, the client could incur a bigger tax liability than the fair market value or incoming cash flow of the property.

India-US Inter-governmental Agreement on FATCA: Comprehensive reporting mandate

Aseem Chawla*

In the prior edition for the month of September, the author did share the news on the ongoing developments in India *vide* the article **"India - US inter-governmental agreement on FATCA"**, on the recent initiatives undertaken by the Indian authorities to effectively promote seamless exchange of information (**'EOI'**) and curb the practice of tax evasion followed by taxpayers around the world.

The author pointed the fact and highlighted that India, along with several other nations, like Switzerland, and sovereign *viz*. British Virgin Islands having signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters designed by the Organization for Economic Cooperation and Development ('OECD'), which going forward would facilitate automatic exchange of information.

Further, the Government in its drive for bringing back illegitimate money enacted a new legislation 'The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, (**'The Black Money Act'**) on May 27, 2015 and continued, as part of its larger efforts and in all its earnestness to curb the menace of tax evasion, almost at the same time executed Model 1 Inter Governmental Agreement (**'IGA'**) with USA on July 9, 2015 to implement Foreign Account Tax Compliance Act (**'FATCA'**) with the intention to enable effective exchange of information between the two nations.

Pursuant to the IGA signed, the foreign financial institutions, (**'FFIs'**) including *inter alia* banks, custodial institutions, depository institutions, specified insurance companies, mutual funds, hedge funds, venture capital funds, investment banks, private equity companies, other financial service providers and intermediaries, in India are required to report tax information about the US account holders to the Indian Government which subsequently would be passed on to the US Internal Revenue Service's (**'IRS'**).

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* Aseem Chawla, Partner, MPC Legal assisted by Ms. Priyanka Mongia, Associate

The provisions of FATCA essentially provide for 30% withholding tax on US source payments made to FFIs in case of non-compliance with reporting requirements.

In order to be governed/regulated by the IGA, one needs to ensure whether a person shall be classified as a Reporting Financial Institution (**'RFI'**) and thereunder would have any reporting obligations.

The Guidance Note issued by the Ministry of Finance, Government of India *vide* Circular [1] lays down the mechanism for determination of a RFI mentioned hereunder:

- The person is an entity;
- Is the entity a financial Institution;
- Is the Financial Institution in India;
- Is the Financial Institution a Non- Reporting Financial Institution;

In terms of the power enshrined *vide* section 295 of the Income-tax Act, 1961 (**'Act'**), rules[2] were enacted envisioning *inter alia* the due diligence requirements along with the information that would be required to be maintained and reported by financial institutions.

An overview of the rules has been succinctly provided hereunder:

Rule 114F 'Definitions', explains comprehensively the terms used in the IGA.

Rule 114G provides for the information that shall be maintained and reported. For instance, every Reporting Financial Institution (**'RFI'**) is expected to maintain and report with respect to each reportable account the name, address and taxpayer identification number. In addition to this, a RFI is also entitled to provide the names, address, and place of birth of each such controlling person, wherein an entity has one or more controlling persons as reportable persons.

Further details pertaining to account number, account balance or cash value at the end of the year would also be required to be specified. Also, a non-participating financial institution (**'NPFI'**) would be liable to maintain and report for the calendar years 2015 and 2016, the name of NPFI and the aggregate of such amounts.

The Rules also does provide for filing of a *Nil* statement in a scenario wherein no account is identified as a reportable account.

Rule 114H lays out the specific guidelines for conducting due diligence of reportable accounts *viz.* US reportable accounts and other reportable accounts. Reportable Account has been defined under Rule 114F(6) as a financial account, which has been identified, pursuant to the due diligence procedures and held by a reportable person, including *inter alia* one or more US citizens/residents in their individual capacity or as a US entity.

The said guidance note prescribes that other reportable accounts includes the accounts held by residents (for tax purposes) of countries / territories outside India, whether individually or as a specified entity.

Different rules have been spelled out for accounts held by individuals and entities as well as pre-existing and new accounts, reflecting the differing characteristics between the different types of accounts.

The instant Rules also leverage on existing processes such as those for Anti-Money Laundering purposes but not for any other process that may have been in place for identification of the account holders for any other purposes or under any Act, Regulations etc including the Income-tax Act, 1961.

The differentiation in rules for pre-existing and new accounts is essential, since persons opening the new accounts are required to provide additional information for FFIs to determine whether they satisfy the test of residency in a country/territory outside India.

The said Guidance Note specifies that for accounts (other reportable Accounts) opened prior to January 1, 2016 and in case of US Reportable accounts held prior to July 1, 2014, the financial institutions would be required to place reliance on information they hold on file.

Further, the pre-existing individual accounts have been classified into high value, low value and other accounts, explained hereunder:

High Value		Low Value		Other Accounts	
US Reportable	Other Reportable	US Reportable	Other Reportable	US Reportable	Other Reportable
More than USD 1 million as on June 30, 2014 or December 31, 2015	More than USD 1 million as on December 31, 2015 or December 31 of any subsequent year	More than USD 50,000 less than USD 1 million as on June 30, 2014	Less than USD 1 million as on December 31, 2015	Less than USD 50,000 as on June 30, 2014; Less than USD 250,000 for cash value contract or an annuity contract, as on June 30, 2014	Cash Value Insurance/Annuity contract, prevented from sale to an Indian Resident.

The rules as well as the guidance note stresses on the fact that no due diligence shall be required to be reviewed and identified in case of the Other Accounts, wherein an indicia test comprising of the following:

a. Identification of the account holder as a resident of any country or territory outside India for tax purposes or by place of birth in the US; or

b. Mailing address or current address in any country or territory outside India; or

c. One or more telephone numbers in a country or territory outside India and no telephone number in India; or

d. Standing instructions (other than with respect to a depository account) to transfer funds to an account maintained in a country or territory outside India; or

e. Currently effective power of attorney or signatory authority granted to a person with an address in a country or territory outside India; or

f. a 'hold mail' instruction or 'in care of' address in a country or territory outside India if the reporting financial institution does not have any other address on file for the account holder;

is undertaken to ensure that none of the above mentioned are discovered in an electronic search, until there is a change in circumstances, resulting in one or more indicia being associated with the account, or the account becomes a high value account.

However, an exception has been carved wherein if a 'hold mail instruction' or 'in care of' address is discovered in the electronic search and no other address and none of the other indicia listed in items a to e are identified for the account holder, the reporting financial institution shall apply the paper record search or seek to obtain from the account holder a self-certification or documentary evidence to establish the residence or residences for tax purposes of such account holder.

Additionally, high level due diligence has been prescribed in case of pre-existing entity account holders, resulting in review for every reportable person, information maintained for regulatory or customer relationships; passive non-financial entity owned by reportable persons, a self certification from the account holder along with information collected and maintained under the Prevention of Money Laundering Act, 2002 for controlling persons or a self certification with an account balance or value which exceeds an amount equivalent to USD one million; and for a non-participating financial institutions, self certification or whether the same has been defined under an IGA.

Taking into consideration that there's an eminent reporting deadline of September 10, 2015 for the calendar year 2014 to enable the Indian Government to meet the deadline for exchange of information with the US IRS, it is important that the Indian financial institutions start the implementation process to report the required information within the stipulated time period.

Furthermore, the Reserve Bank of India has also issued a notification[3] suggesting that implementation of provisions of FATCA as laid down in rules are in the nature of fulfilment of country's obligations under various international agreements and non-compliance can lead to huge penalties in addition to loss of reputation and it is incumbent upon the Chairperson/CEO of the Reporting Entity to form a 'High Level Monitoring Committee' to ensure that the reporting entities can comply within the deadline set, in order to not attract penalties specified under section 35A of the Banking Regulation Act, 1949 and section 45 of the Reserve Bank of India Act, 1934.

In view of the above, it won't be out of place to suggest that the Government has taken an unprecented step by introducing comprehensive and exhaustive reporting and it would be of utmost importance for the financial institutions and taxpayers to have an understanding of the compliances that would be required to be abided for every person/entity engaged in business with the US or in most likelihood is in the process of doing business with the US or in the US.

Though, the intention for complying with the US legislation is entirely motivated by India's stand for global tax transparency, the new FATCA rules/reporting have increased the legal and compliance costs for financial businesses manifold and only times ahead will tell whether purpose is viewed as utilitarian!!

1. Guidance Note on Implementation of Reporting Requirements Under Rules 114F to 114H of the Income Tax Rules, F.No. 500/137/2011-FTTR-II Dated September 31, 2015
2. Income Tax (11th Amendment) Rules, 2015
3. RBI/2015-16/165 DBR.AML.BC.NO.36/14.01.001/2015-16 dated September 28,2015.

Aggression of tax authorities – India, not a solo player in the Asia Pacific region!

Naveen Gupta*

I recently acted as a faculty at ASPAC tax conference organized by KPMG in Thailand. This was attended by various international tax experts from KPMG offices across the Asia Pacific region. It was an enriching experience and learning about tax environments of various countries in the Asia Pacific region in great details was nothing less than achieving 'Tax Nirvana'. This article attempts to scan through relative tax environments across the region and highlights that other tax authorities in the region are equally, if not more, aggressive than their counterparts!

Introduction

It is hard to imagine a period of time, when there has been so much focus on local and global tax policies. Since Asia Pacific has been a great beneficiary of FDI from the world over, it is not unusual to find tax dominating headlines in addition to growth, opportunities and risks in the region. Numerous tax laws of different countries do influence today's business environment, directly or indirectly. While the overall tax environments of some countries are seen as very simple and business friendly, some other countries are heavily criticized for being too aggressive and complex. Let us scan through some of the broad developments and trends for assessing how complex and aggressive are the tax regimes in Asia Pacific.

Tax rates – Hong Kong on the lowest side and Japan on the highest side

Tax rates are one of the key parameters for assessing the overall tax environment of various jurisdictions in the region. Among the

* Naveen Gupta is a Chartered Accountant and can be reached at ngupta1@kpmg.com

- Views expressed in the article are personal

Asia Pacific economies, Hong Kong and Singapore lead the race to the bottom with headline corporate tax rates of 16.5% and 17% respectively. Japan has had the highest effective rate of 41% earlier, which has now been brought down to 35.64% through successive cuts over last 4 years. Other jurisdictions like China, Indonesia, Malaysia and Vietnam have 25% as the headline tax rate. However, Singapore's effective tax rate is cited by many as the most competitive with the partial tax exemption scheme. For instance, a company with a chargeable income of S$ 300,000 will have an effective tax rate of 8.36% only.

Trend of lowering corporate tax rates across the region to compete for investment

It's interesting to note that all Asia-Pacific nations have participated in the general trend towards lowering corporate tax rates, by implementing phased reductions to woo investment. For instance, after Hong Kong lowered its rate to 16.5%, Singapore reduced its rate from 18% to 17% in 2010 by way of its sixth rate cut since 2000. Taiwan also decided to compete in this cluster of ultra-low corporate tax rates by cutting its statutory rate from 25% to 17% in 2010.

China and Indonesia also cut their rates to 25% from 33% and 30% respectively. Thailand is the newest member of the low-tax-rate club. While it maintained a comparatively high rate of 30% for several years, it announced a bold move and cut its statutory rate to 20% in 2013-14.

And now, India has also decided to join this club by announcing a rate cut in the Union Budget 2015 from 30% to 25% over next 5 years. Rationale mentioned by the Finance Minister in his speech was also in line with this overall trend as he announced *"We lose out on both counts,* i.e., *we are considered as having a high corporate tax regime but we do not get that tax due to excessive exemptions."* Besides this, the rate cut will be helpful to the top three FDI investors in India – Mauritius, Singapore and UK, with respective corporate tax rates of 15%, 17% and 20% as they are unable to fully use tax credits in their home countries for taxes paid by Indian subsidiaries.

Complexity of tax regimes – China, India and Indonesia are front runners!

While the headline corporate tax rates are on a general downtrend, it is not so good news when it comes to complexity as the tax regimes across Asia Pacific, from mature to developing markets, have become more complex over time. However, tax regimes of high growth markets like Mainland China, India and Indonesia scored way above over other tax regimes as these appeared to be most complex and least predictable in the region.

It's hard not to find mention of *Vodafone* case in the context of India changing its position on tax laws more rapidly than others. My co-faculty from Beijing office also echoed the sentiments that there are tax challenges in every jurisdiction but to the degree present in China and India, it is not there in other countries. For instance, frequent changes in legislations, reversals in the positions taken by tax authorities, subjectivity involved in interpretation of law, strong enforcement of contrary views by tax authorities are some of the factors, which contribute to the overall complexity in these jurisdictions.

Simplicity and consistency in tax regimes – Singapore, Hong Kong and New Zealand as clear winners!

When it comes to simplicity and consistency in tax regimes, Singapore, Hong Kong and New Zealand seemed to be the only jurisdictions in Asia-Pacific with the least complex and most consistent tax policy.

Apart from having the lowest tax rates of 16.5% and 17% in the entire region, both Hong Kong and Singapore follow a single-tier tax system and do not impose tax on dividends that are distributed to shareholders. There is no estate duty, inheritance tax or capital gains tax in Singapore or Hong Kong. Both the territories have an extensive tax treaty network, although Hong Kong does not have tax treaty in India at present. While foreign sourced income is taxed only if it is remitted in Singapore, Hong Kong imposes no tax on overseas income (regardless of whether it was remitted into Hong Kong). Singapore GST/ VAT is one of the lowest in the region at 7%, while Hong Kong has no VAT.

It's not surprising to note that Singapore, New Zealand and Hong Kong are also the three countries, which secured first, second and third ranking respectively in the World Bank's report of 2015 on Ease of Doing Business.

Leading Holding company jurisdiction in Asia – Singapore and Hong Kong

Location of a holding company is an important consideration in any international structure. While there is not just one optimal holding company jurisdiction to suit all investment profiles, competition to become a major hub has heated up in the Asia-Pacific region. Singapore and Hong Kong have held the paramount position for many years, and there is tough competition between them in attracting global business and capital with regional headquarters/treasury management incentives.

Except for investments into India, where Singapore scores over Hong Kong due to lack of treaty between India and Hong Kong, almost all other countries in the Asia Pacific region seem to prefer both Singapore and Hong Kong as the clear leading choice for holding company jurisdiction. However, some prefer Singapore more as it scores well not only in terms of the efficient tax regime rate but also in terms of political stability, strength of the local currency, free market concept, economic strength and infrastructural prowess. On the contrary, if we look at the World Bank statistics of FDI, Hong Kong received US$ 111 billion in total in 2014 as against US$ 81 billion received by Singapore in the same period.

Broadening of the tax base to increase tax collections

While Governments in the region have implemented cuts in headline corporate tax rates, they are also simultaneously broadening their tax base to keep up with the pressure on tax collections. Towards this end, one can see a rising trend of governments making legislative and administrative adjustments to cast a wider net over taxable income. This includes implementing stricter interpretations of existing law, enforcing new and existing economic substance rules, introducing and strictly enforcing transfer pricing rules, initiating tax information exchanges with countries, and stepping up audits on cross-border transactions. These measures are being used across the region by No. of countries like India, China, Indonesia, Japan, Australia, Philippines, etc. with very few exceptions. And these tactics are helping the Governments in improving tax collections, making up for the revenue lost to a rate cut.

Rigorousness of Tax audits by authorities – Generally high across region with few exception

It was a sort of consensus in the group that tax audits in the Asia Pacific region take place frequently and tend to be very rigorous. While India, China, Australia, Indonesia, Philippines and Japan are said to witness high level of audit activity by tax authorities, other countries like Korea, Hong Kong, Thailand and Singapore engage in moderate or low levels of audit activities. Across the region, there is a trend of seeing stricter tax audits, close tax compliance monitoring of large taxpayers, and regular performance evaluations of revenue examiners and officers.

For instance, China has tightened up enforcement on non-resident taxpayers and cross-border transactions, by codifying 'substance over form' doctrine through circulars since 2009. Similarly, India has been invoking GAAR using the judiciary approach and is bracing itself to operationalize a legislative GAAR in coming years.

Similarly, Philippines may have strict audits, but it is best known for Run After Tax Evaders (RATE) and Run After The Smugglers (RATS), two publicity campaigns that have produced many civil and criminal charges against suspected tax evaders, smugglers and corrupt tax officials. This is the type of media–related tax administration that has emerged as one of the initiatives by the Philippines Government.

According to the World Bank, Indonesia has one of the lowest tax intakes in the region, despite being the largest region of Southeast Asia. To tackle this problem, the Indonesian tax authorities are making conscious efforts to gather more detailed data, monitor their collections on a timely basis and follow an aggressive audit program focused on multinational companies. Transfer pricing audits and adjustments are increasing significantly every year and it has become a hot issue, especially over last five years. Accordingly, the Indonesian authorities are now amongst the most aggressive authorities in the region. Moreover, it is also very difficult to obtain refund of taxes from them as they do not grant refunds easily and require lot of documentation and efforts to be put in place.

Emphasis on information-sharing and joint audits by different tax authorities

Across the region, tax authorities are intensifying their tax collection drives and squeezing taxpayers harder in order to achieve their targets and keep their coffers filled. Joint audits conducted by two or more nations' tax administrations are the newest development. Governments are also intensifying cooperation by inking tax information exchange agreements (TIEAs) so that they can keep tabs on global investors' international activity. In Asia-Pacific, there has been an increase in the use of advance pricing agreements (APAs) so that companies and tax administrations can come to an agreement on a set of transfer prices. Both China and India have signed some APAs very recently.

Overall aggression of tax authorities – Japan, India and China authorities as most aggressive

As per a poll done by TPWeek with tax directors and tax advisers worldwide sometime back, Japan, India and China were rated as the most aggressive tax authorities for transfer pricing in the world. It quotes that the Japanese tax authorities are a nightmare to deal with as they request all sorts of information, which no other tax authority ever wants and which a business would not ordinarily keep.

This news report is equally brutal on Indian tax authorities as it mentions that the Indian authorities do not appreciate economic and commercial factors and internal revenue targets drive the conclusion to a transfer pricing audit. Similarly, for China, the report states that the various provinces in China follow their own timelines, where documentation is asked for at the notice of a day even before the due date of filing the tax return.

Expectation ahead in terms of BEPS Action Plan

Current global tax policy efforts around OECD's BEPS project (Base Erosion and Profit Shifting) is likely to cause even further complexity, confusion and change within Asia Pacific. The rationale for BEPS project is that globalization of the world economy has resulted in MNCs shifting from country-specific models to global models with integrated supply chains, centralization of service functions and location of activities that are distant from the physical location of customers.

In their engagement with the BEPS Action Plan, countries in ASPAC fall on a spectrum that runs from 100% participation and commitment to non-engagement. At one extreme, the OECD members in the region are highly engaged and likely to adopt the full slate of BEPS proposals in accordance with the OECD guidelines. Australia is perhaps most involved, given its presidency of the G20 for 2014. With a Japanese Ministry of Finance official currently in place as chair of the OECD Committee on Fiscal Affairs, Japan is also highly invested in the Action Plan's successful outcome.

Along the middle of the spectrum are G20 countries, such as China, India and Indonesia, which are engaging in the OECD discussions and will implement some aspects of the BEPS proposals that suit their domestic purposes. Other countries, like Singapore, are monitoring the debates and actively engaging with the OECD and will likely adjust certain aspects of their tax systems in response to any new international norms.

Even though it is still work in progress for BEPS Action Plan, many countries are already changing their tax legislation or administration in response and this is likely to cause even further complexity, confusion and change within Asia Pacific.

Summary

While tax authorities in high growth markets like China, India, Indonesia and Philippines are coming across as aggressive and complex, overall tax environment in New Zealand and investment hubs like Singapore and Hong Kong have generally been stable and fairly simple. In the middle of the spectrum, lies some mature jurisdictions like Australia, Japan and Korea.

There is competition in various economies not to be seen as a high tax jurisdiction and this is evident from reduction of steep tax rate cuts by No. of countries like 10% by Thailand, 8% by Japan, China and Taiwan, 5% by Indonesia and India (proposed).

However, Governments are also simultaneously broadening their tax base to keep up with the pressure on tax collections. Across the region, there is a trend of seeing stricter tax audits, close tax compliance monitoring of large taxpayers. Accordingly, MNCs are facing challenges on account of stricter interpretations of existing law, enforcement of new and existing economic substance rules and transfer pricing provisions and stepped up audits on cross-border transactions.

Parting thought

Asia Pacific is growing in importance and tax is an important consideration. Moving ahead, as the Asian economies continue to influence and be influenced by global forces, we know that tax regimes can only become more complex. However, the opportunity lies in being able to keep up-to-date with these changes and complexity. After all, prevention is better than cure!

Consideration for 'live broadcast' rights – Royalty? Neoteric trends in Royalty taxation

Mixed bag of settled and open issues

Sumeet Khurana*

Background

Broadcasters obtain media rights to live telecast various events and these sometimes include right to re-broadcast, use of footages, action replays, etc. The consideration paid for these rights faces challenging questions on its taxability as 'royalty'.

The issue first came up before the Mumbai Tribunal in the case of *Neo Sports Broadcast (P.) Ltd.*[1] It held that the cricket matches cannot be equated with either literary, dramatic, musical, artistic work or a sound recording. It added that the live telecasting could not be said as 'work' and therefore could not be considered as transfer of copyright. Payment for telecast of live matches was thus held as not in the nature of 'royalty'. Similar view has also been taken by the Delhi High Court in the case of *Delhi Race Club (1940) Ltd.*[2]

A royalty earned by a non-resident of India could be taxable in India under the source rule provisions embodied in section 9 of the Income-tax Act, 1961 ('the Act'). Further the payer may be obliged to withhold tax at source despite there being a tax treaty between the source country and resident country. The cases under which such consideration is clearly not royalty and when it can get taxed as royalty is deliberated in this article.

Royalty

Under section 9 of the Act, 'Royalty', *inter alia*, includes payment for *transfer of all or any rights in respect of* a copyright, literary, artistic or scientific work including films or video tapes. OECD Model Convention (OECD MC) has slightly varied language and the definition therein includes consideration for the *use of, or the right to use*, any copyright

* Sumeet Khurana is Director Direct Tax in Lakshmikumaran & Sridharan, Attorneys.

of literary, artistic or scientific work including cinematograph films. (Emphasis supplied for highlighting distinction).

Meaning of key expressions in the definition

The words used in the definition of 'royalty' in the Act are legally well recognized words and therefore a legal meaning as per respective law dealing with these should govern their meaning[3]. As regards treaty definition one may argue that the meaning under the laws of country applying the treaty should apply to the extent permitted thereunder on the lines of Article 3(2) of the OECD Model Convention.

Without much debate however the Federal Court of Australia reached a conclusion that while determining taxability in Australia on royalty earned by resident of Switzerland, the meaning under the Copyright law of Australia will apply[4].

Literary, artistic or scientific work

Delhi High Court had an occasion to adjudicate on the character of payment for right to live broadcast. The court did *not* feel it necessary to dwell with each and every aspect of the definition and found an easy route holding as under:

- *Copyright [in] literary work*

The definition talks about copyright along-with objects like literary work etc. in which the copyright exists. The intention behind specific mention of literary work etc. is to exclude other rights from the ambit of copyright. Accordingly the court held that the phrase should be read as consideration for transfer of all or any rights (including granting of license) in respect of any copyright in literary, artistic or scientific work including films or video tapes.

- *Live telecast is not a work wherein copyright can subsist*

The court held that section 13 of the Indian Copyright law does not contemplate '*broadcast*' as a work in which 'copyright' subsists. It added that section 14 thereof reveals that work should already by existing for being protected as copyright.

The court quoted with approval the decision of US Court of Appeal[5] on the aspect that *'sports event'* is a performance and not a work – it is not copyrightable.

Author feels that while examining as to whether the payment is for something in which copyright subsists, the Hon'ble High Court did not focus on the correct thing.

Very crudely, in the sequence of things the first thing is 'event' and second being 'signal' and third 'live telecast'.

⟶ Event ----➤ Capturing and providing signal ----➤ Live telecast of signal

The *subject matter* to be examined from the perspective of existence of copyright therein should *not* have been *live telecast itself*. *On the contrary* it should have been the matter which was telecasted i.e. *the signal* or the *event.*

What should have been examined is as to whether the signal given to broadcaster is a work wherein copyright can or does subsist.

Federal Court of Australia[6] had an occasion to examine as to whether the signal 'is something' or 'contains something' in which copyright exists. It undertook extensive analysis of Australian Copyright law and came to a conclusion that the signal does not contain visual images or audio sounds. Court held that signal contains only electromotive forces which can be converted into images and sounds at the end of recipient using television, and this amounts to *production* of images as against *re-production*, a precondition under domestic copyright law.

Federal court also examined the issue from the perspective of catch all phrase used in Article 12(3) of relevant tax treaty, *viz.*, 'other like property or right'. The court opined that sports event is not a pre-planned event as is the case of movies etc. hence the same does not satisfy the criterion of being 'like property'. This result is similar to the concurring view of Delhi High court regarding sports event not being a work.

As regards Indian legal position, the issue can still be treated to be open as the High Court decision in the case cited above does not provide enough comfort.

Should the answer differ if the broadcast is recorded for re-broadcast purpose?

Delhi High Court (*supra*) specifically noted that the revenue has not alleged existence of any right to re-broadcast. It thus proceeded on the fact that there is no recording of live telecast to be used later for re-broadcast. This fact was found existing in the case of *Seven Networks Ltd. (supra)*. Counsel for revenue asserted existence of a 'future copyright' on account of this fact. Federal court however observed that revenue counsel did not meaningfully articulate his ascertain and therefore it refrained from dealing with it at length.

This aspect therefore can be considered to be an open issue.

Is the payment for a scientific work?

Delhi High court examined this with respect to live telecast as against signal. Federal court did not have an occasion to deal with this aspect separately. As a result following questions remain open for deliberation:

- Can the task of digitizing the performance in the field and generating signal, be treated a 'scientific work'?
- Can copyright be said to subsist therein?
- Federal court held that signal does not contain visual image /sound itself hence copyright cannot subsist therein but does this conclusion hold good in Indian context?
- Can the right to record and rebroadcast coupled with possibility of the signal being a scientific work result in the consideration being treated royalty?

Conclusion

Despite there being favourable rulings, the issue of royalty with respect to live broadcast, is surrounded by many open questions that need to be addressed at the time of making any remittance of this nature. The entire gamut of facts need to be examined from a combined skill of a professional dealing with Intellectual Property (IP) laws and another professional dealing in tax because (*a*) rulings available so far are not a complete guide to the issue and (*b*) intricacies of IP laws may not get fully appreciated by those specializing in tax laws alone.

1. *Asstt. DIT (International Taxation)* v. *Neo Sports Broadcast (P.) Ltd.* [2011] 133 ITD 468/15 taxmann.com 175 (Mum.).
2. *CIT* v. *Delhi Race Club (1940) Ltd.* [2015] 228 Taxman 185/[2014] 51 taxmann.com 550 (Delhi).
3. *Vazir Sultan Tobacco Co. Ltd.* v. *CIT* [1981] 7 Taxman 28 (SC).
4. *Seven Networks Ltd.* v. *Commissioner of Taxation* [2014] FCA 1411.
5. *National Basket Ball Association and NBA Properties NIC* v. *Motorola Inc.* 105 F3rd 841 (1997)
6. *Seven Networks Ltd.'s case (supra).*

Does section 206AA overrides the DTAA?

Sanjiv Chaudhary*

Overview

Section 206AA of the Income-tax Act, 1961 ('the Act' in short) was introduced with an intent to monitor payments to persons who do not possess a Permanent Account Number ('PAN' in short), thereby unearthing under-reporting of income (if any) by the payee. The insertion of the provision has been surrounded by debates ever since this section is enacted. The language of the provision did not carve out any exception for any specific class of persons and concerns were raised about its applicability to non-residents. Subsequently a press release was issued clarifying that the rigors of section 206AA would equally apply to payment to non-residents. After having been clarified that the section would apply to non-residents, there was considerable ambiguity on whether higher withholding would be required even for payments to non-residents, who are entitled to be taxed at the beneficial rates applicable under the Tax Treaties.

The controversy surrounding the rate at which taxes should be withheld from payments made to the non-residents (when the non-resident payee does not furnish the PAN to the Indian payer) has left both the payer as well as the payee in a bewildered state. As we go along with this article, we will explore as to what are the different facets revolving around the aforesaid issue and also discuss some of the recent decisions that throw light on this vexed issue.

Genesis of provisions of section 206AA

Historically, there has always been controversy in respect of determination of taxability of cross border transaction and more specifically in relation to withholding tax provisions. The issue became even more critical

* Sanjiv Chaudhary is a member of the Institute of Chartered Accountants of India. He can be reached at schaudhary@bsraffiliates.com

after insertion of provisions of section 206AA in the Act. The controversy associated with applicability of provisions of section 206AA is manifold and is being discussed in the ensuing paragraphs of this section.

With an intent of strengthening the PAN mechanism, enhancing detection capabilities of the Revenue authorities and ensuring better compliances, provisions of section 206AA of the Act were inserted by Finance Act, 2009 w.e.f. 1st April 2010. The new provision mandated all recipients to furnish the PAN and at the same time with a view to discourage non-compliance, it required taxes to be withheld at rates higher than the normal rates. The provisions obligated the payer to deduct tax at higher of (*a*) rates prescribed in the Act, (*b*) rate in force or (*c*) 20 per cent in absence of valid PAN being furnished by the payee.

The obligation to obtain PAN is governed by provision of section 139A of the Act along with the relevant rules. As per the said rules, non-residents are not required to obtain PAN. However, post-insertion of section 206AA, this rule has not been amended. This particular issue was dealt by Bangalore Tribunal in the case of *Bosch Ltd.*[1], wherein it was held that provisions of section 206AA clearly overrides the other provisions of the Act and a non-resident, whose income is not chargeable to tax in India, is not required to obtain PAN. However, where the income is chargeable to tax irrespective of the residential status of the recipients, every assessee is required to obtain PAN and this provision is brought in to ensure that there is no evasion of tax by foreign entities.

The ambiguity in relation to applicability of provisions arose primarily because no specific reference was made to non-residents in the Memorandum to Finance Act, 2009. However, subsequently the Press Release issued by CBDT in January 2010, made it clear that rigors of section 206AA would equally apply to non-resident payee. Section 206AA uses the term 'persons' and the definition of person as provided in the Act is wide enough to cover the non-residents as well. The Author is also of the opinion that the provisions of section 206AA are applicable to non-residents only when income is chargeable to tax. The non-resident may either chose to obtain a PAN and be subject to the applicable rate or suffer a higher withholding in terms of the rates specified in the provisions of section 206AA.

Litigation on the rate of tax deduction, from payments made to the non-residents when the beneficial provisions of the Treaty were available, added further fume to the persisting controversy. However, the recent decision pronounced by the Pune Income Tax Appellate Tribunal ('ITAT/Tribunal') and Bangalore Tribunal have taken a view that provisions of section 206AA would not override the beneficial provisions of the DTAA.

Recent Judicial Precedence

I. Facts of the Serum Institute[2]**-** Assessee made payments to non-residents on account of interest, royalty and fees for technical services after deducting taxes in accordance with the rates provided in the respective DTAA's. Even in instances where PAN was not furnished, the assessee did not invoke the provisions of section 206AA and withheld tax at the rates provided in the relevant DTAA's. The first Appellate Authority held that section 206AA of the Act overrides other provisions of the Act but not section 90(2).

Issue before the Tribunal-Whether section 206AA would override the provisions of DTAA in a situation where non-resident taxpayer did not furnish PAN, thereby necessitating a minimum withholding tax rate of 20% irrespective of the rate provided in the DTAA?

Tribunal Ruling - The Tribunal observed that section 206AA is not a charging section but a part of procedural provisions dealing with collection and deduction of tax at source. Similarly, section 195 also casts a duty upon the assessee to withhold taxes from payments to a non-resident and therefore it cannot be understood to override the charging sections 4 and 5 of the Act. It was held that even the charging sections 4 and 5 are subordinate to the principle enshrined in section 90(2) and therefore it would be incorrect to hold that section 206AA overrides the provisions of DTAA. Where tax has been deducted on the strength of the beneficial provisions of DTAAs, the provision of section 206AA cannot be invoked to insist on the tax deduction at rate of 20%.

II. Facts of the Infosys BPO[3]- Assessee made payments to non-residents on account of royalty and fees for technical services during the year and deducted tax at rates provided in the DTAA. The Assessing Officer raised demands u/s 200A on account of non-compliance with the provisions of section 206AA. The first Appellate Authority held in favour of the assessee by holding that non-resident recipient is eligible for the benefit of the DTAA and therefore tax deducted cannot be more than the tax liability provided under the DTAA.

Issue before the Tribunal - Whether tax deduction cannot be at rate prescribed under section 206AA, which is higher than the rate at which income is chargeable to tax under Act or DTAA?

Tribunal's Observations & Ruling[4]-The Tribunal, on the facts of the case, observed that there is no dispute that the benefit of DTAA is available to the recipients and therefore tax liability could not be more than the rate prescribed under the DTAA or the Act whichever is lower. Reliance was placed on Pune Tribunal's decision in case of *Serum Institute* (*supra*), wherein it was held that section 206AA does not override the provisions of section 90(2) of the Act. Relying on the decision of Karnataka High Court in case of *Bharti Airtel*, the Tribunal held that the obligation of deducting tax at source arises only when there is a sum chargeable under the Act.

The Tribunal held that there is no scope of deduction of tax as per the provision of section 206AA when benefit of DTAA is available. Moreover, the provisions of TDS have to be read along with the machinery provisions of computing the tax liability on the sum in question.

Parting Thoughts

In view of the above rulings, it is evident that the recent judicial intent on this controversial issue appears to be inclined towards the view that section 206AA being a procedural section ought not to interfere with the operations of the DTAA. What one could summarize from the above-mentioned judgments is that two school of thoughts (SOT) exist on this contentious issue.

The first SOT firmly assails that section 206AA is a machinery provision which has to be read along with the charging provisions and computation mechanism as provided in the Act. Irrespective of the provision having a '*non-obstante*' clause, the same could not be read in severance of and independent of the charging and computation provisions.

The second SOT, on the other hand, assails that section 206AA is a machinery provision, which deals with deduction of tax at higher rates, in case of a recipient not furnishing the PAN. It only results in higher withholding and not higher taxation. The final tax liability of the non-resident is not in any way altered by reason of provisions of section 206AA being invoked. Section 206AA does not warrant application of any charging provisions. Both the sections are at complete variance to each other and therefore to hold that one provision overrides the other would not be appropriate. Both the provisions need to be applied independent of each other.

Another important aspect which needs consideration is that provisions of section 206AA stipulate that taxes shall be withheld at higher of the rates specified in the relevant section, rates in force or 20 per cent. A literal reading of the provisions of section 2(*37A*)(*iii*) of the Act indicates that 'rates in force' includes rates specified in the Agreement entered into by Central Government under section 90 of the Act (*i.e.* the tax treaty).

Though arguments for and against the principle have equal force, yet the author is of the belief that provisions of section 206AA can at best be viewed as a 'rate override' but not a 'tax treaty (charge) override'.

Both the SOTs may have their own challenges. Following the first SOT may lead to severe consequences for non-compliance in the form of disallowance of expenses u/s 40(*a*)(*i*), liability of interest u/s 201(1A) and penalty u/s 271C and other inconvenience that accompanies it. Following the second SOT, on the other hand, may lead to additional tax burden in case of net of tax arrangements, risk of denial of the credit for taxes deducted u/s 206AA in the home country, etc.

Thus, to put at rest the ambiguity which has persisted amongst the industry at large as to which SOT should be followed, there is a dire need that the Government clarifies the issue through a legislative amendment. Though the recent judgments do provide a ray of hope for the taxpayers involved in litigation on the same issue, however one needs to be cautious enough before relying the same.

1. *Bosch Ltd.* v. *ITO* [2012] 28 Taxman 228/[2013] 141 ITD 38.
2. *Dy. DIT* v. *Serum Institute of India Ltd.* [2015] 68 SOT 254/56 taxmann.com 1 (Pune – Trib.).
3. *Dy. CIT* v. *Infosys BPO Ltd.* [IT Appeal Nos. 1143 (Bang.) of 2013, dated,29-6-2015].
4. Please note that the Tribunal also delved into the scope of provision of section 200AA. We have restricted our discussion to the part of the ruling which deals with the aspect of section 206AA overriding the DTAA.

Place of Effective Management - What to expect?

Jatin Kanabar*

Manish S. Jain**

Indian MNCs are now grappling with a new provision under the Income-tax Act, *viz* Place of Effective Managment (PoEM). Under the amended provision with regards to tax residency of a company in India, a foreign company would be treated as tax resident of India, if its PoEM, in the year under consideration is in India. PoEM 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 a whole are, in substance made'.

PoEM as a concept was first introduced in the proposed Direct Tax Code (DTC). With DTC not seeing light of the day, it is not surprising to see the amendment in the ITA. Prior to the amendment to Finance Act, 2015, the term 'place of effective management' (PoEM) was also found in the tax-treaties mostly under Article 4 on Residence and Article 8 on Shipping and Airlines. In terms of Article 4 of the tax treaties, PoEM is used as tie breaker to determine residency of a company which is found to be dual resident. However, the term PoEM was not defined under the Income-tax Act, 1961 (ITA) nor under most of India's tax treaties.

The Explanatory Memorandum (EM) to Finance Bill 2015 clarified the need for this amendment. The concern was that the current requirement of 'whole' of control and management to be situated in India rendered it practically inapplicable as a company could easily avoid becoming a resident by simply holding a board meeting outside India. This facilitated creation of shell companies which are incorporated outside but controlled from India. It also states that PoEM is an internationally recognized concept for determination of residence of a company and modification in the condition of residence in respect of company by including the concept of effective management would align the provisions of the ITA with the tax treaties entered into by India with other countries and would also be in line with international standards.

The definition of the term 'PoEM' under the ITA is in line with the OECD Commentary. Therefore, the interpretation of the term PoEM may

* Jatin Kanabar, Director, Deloitte Haskins & Sells LLP.

** Manish S. Jain, Manager, Deloitte Haskins & Sells LLP.

be derived considering the OECD commentary. In relation to PoEM, the OECD Commentary further provides that,

- All relevant facts and circumstances must be examined to determine the place of effective management;
- An entity may have more than one place of management, but it can have only one place of effective management at any one time.

With respect to determining the PoEM of a company, OECD provides various factors to be considered:

- Place where meetings of the Board of Directors or equivalent body of the company are usually held;
- Place where the chief executive officer and other senior executives usually carry on their activities;
- Place where the senior day-to-day management of the person is carried on;
- Place where the person's headquarters are located;
- Place of which country's laws govern the legal status of the person;
- Place where its accounting records are kept.

Interestingly, India has provided its reservation to the OECD interpretation of PoEM. In its view the place where the 'main and substantial activity of the entity' is carried on is also to be taken into account while determining PoEM.

Similar to OECD, the United Nations (UN) Commentary also considered the PoEM as preferential criteria for determining the residential status of tax payers other than individuals. Though it does not define the term PoEM, UN Commentary provides the following factors to be considered in analyzing a PoEM in a particular jurisdiction:

- Where a company is actually managed and controlled;
- Where the decision-making at the highest level on the important policies essential for the management of the company takes place;
- The place that plays a leading part in the management of a company from an economic and functional point of view; and
- Where the most important accounting books are kept.

The Protocol to the India-Belarus tax treaty also considers the factors provided under the UN Commentary in interpreting the term PoEM. Therefore, one may also consider the above factors in determining the PoEM under the tax treaties entered by India with other countries.

The Explanatory Memorandum to the Finance Bill 2015 also states that a set of guiding principles would be issued which can be followed while determining the PoEM of a company in India. The PoEM guidelines would assist the assessees and the tax officials in interpretation and application of PoEM in determining the tax residence of a foreign company in India.

We hope the guidelines to be issued by the CBDT provides clarity on the following key aspects to avoid ambiguity and reduce uncertainties with regards to determination of PoEM

1. The words 'at any time' have been omitted from the originally proposed definition which shall have effect that a company shall be resident in India if its PoEM is in India in the financial year under consideration. Nevertheless, a question may still arise that for a foreign company to be resident in India, is it necessary that the PoEM should be situated in India throughout the financial year under consideration or at any time in the year or mainly in India. Currently, the provisions of the ITA do not provide any clarity on this. The guidelines could provide clarity on whether that the entire

year as a whole should be considered for determining the PoEM in India. The determination should look at where the key management and commercial decisions are regularly and predominantly made during the whole year.

2. The proposed guidelines should clearly define some of the key terms like 'Key', 'Effective', 'Key Management and Commercial Decisions' and 'Senior Management/Key Management Personnel's', in order to avoid any ambiguity with regards to their interpretation.

3. PoEM is a fact and circumstance specific concept and all relevant facts and circumstances must be examined on a case-by-case basis. The proposed guidelines should clearly provide the factors which should be considered to determine PoEM in India.

   Factors which could be considered for determination of PoEM can primarily include place of senior management and key management personnel's, place of meeting of Board of Directors of the Company and the extent of shareholders influence. If one is unable to determine the PoEM based on the above factors then, the place where the operational management may be considered as an ancillary factor.

   Similarly, the place of incorporation and the governing law and the place where the accounting records are kept should be of limited relevance. Further, the place of management advisory board or committee in India providing non-binding advice and the place from where the support services are provided can be considered as irrelevant to determine PoEM in India.

4. Safe harbor provisions may be prescribed to avoid unnecessary compliance burden with no corresponding tax collection in India. For instance, PoEM should not be considered to be in India in cases where the foreign company is incorporated in a jurisdiction with a minimum base tax rate, say 20%, as India will in any case be required to grant foreign tax credit.

5. PoEM provision should be resorted only in exceptional case. A process, similar to the process prescribed for General Anti-avoidance Rule should be prescribed for selecting cases for invoking PoEM.

6. If a foreign company is resident in India on account of PoEM in India then, it should be eligible to claim foreign tax credit in respect of taxes paid in foreign jurisdiction which is being doubly taxed on account of PoEM in India. The proposed guidelines should provide the mechanism for claiming foreign tax credit in India.

7. With regard to the transfer pricing regulations the following points should be considered:

   The transactions between the associated enterprise (PoEM in India) and the Indian company should not be considered to be within the ambit of Specified Domestic Transactions under Indian transfer pricing regulations.

   Transactions between the associated enterprise (PoEM in India) and its group companies outside India should also not be considered within the ambit of International Transactions under Indian transfer pricing regulations.

8. The tax compliances to be undertaken under the ITA should be applicable only once the foreign company is considered as having PoEM in India and the same is confirmed under the Mutual Agreement Procedures of the respective tax treaties.

While the guidelines cannot be exhaustive to cover all situations, providing clarity on the above aspects in line with international standards would go a long way in reducing uncertainties and litigation.

Voyage between Indian Ports as part of international voyage does not affect the status of 'International Traffic' for the purpose of India-Singapore Tax Treaty

An analysis of the order of the Income Tax Appellate Tribunal in the case of *ITO (International Taxation)* v. *Taurus Shipping Services* [2015] 59 taxmann.com 331 (Rajkot)

Alok Pareek*

1. Background

The Income-tax Appellate Tribunal, Rajkot Bench ('ITAT'/'Tribunal') has recently adjudicated on the issue whether a vessel which has operated within Indian Ports as part of larger international voyage would said to be operating in international traffic and get benefit of Article 8 of India-Singapore Double Taxation Avoidance Agreement ('tax treaty') OR would the voyage between the two Indian ports would be construed as a costal voyage/traffic.

The Tribunal while giving a reasoned order, has analysed the provisions under Article 8 of India-Singapore tax treaty and has also examined/ cited the key judicial precedents on the subject. An examination of the Tribunals order in the case before hand has been made below. In order to comprehend the issue in detail, an analysis of the important rulings of tax courts in India/abroad along with the position in tax commentaries has also been examined.

2. Relevant laws and regulations

Article 8 of India-Singapore DTAA – 'Shipping and Air Transport'

> *"1. Profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.*
>
> *2. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency engaged in the operation of ships or aircraft.*

* Alok Pareek , CA, CS, LLB.

3. Interest on funds connected with the operation of ships or aircraft in international traffic shall be regarded as profits derived from the operation of such ships or aircraft, and the provisions of Article 11 shall not apply in relation to such interest.

4. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic shall mean profits derived from the transportation by sea or air of passengers, mail, livestock or goods carried on by the owners or lessees or charterers of the ships or aircraft, including profits from:

(a) the sale of tickets for such transportation on behalf of other enterprises;

(b) the incidental lease of ships or aircraft used in such transportation;

(c) the use, maintenance or rental or containers (including trailers and related equipment for the transport of containers) in connection with such transportation; and

(d) any other activity directly connected with such transportation."

3. Facts

- The assessee-company *(Taurus Shipping being representative assessee of the non-resident shipping line)* is in the business of providing shipping services *inter alia* operating vessles in international waters;
- During the course of international voyage, certain vessels namely M.V. Nord Leader/M.V. Global Hope/M.V. Parnon had made costal journeys between Kandla and Vizag ports in India;
- The assessee was claiming benefit under Article 8 of the India-Singapore tax treaty and claimed income earned exempt from taxes in India.

In the backdrop of the above facts, the laws in force, below is an examination of the tax issues arising in the case.

4. The assessment stage – *Start of debate on 'Costal voyage vs International voyage'*

Allegations of the Assessing Officer

- The Assessing Officer had alleged that certain vessels had operated within Indian ports as part of larger international voyage for the following details:

S No.	Name of Vessel	Date	Port
1	M.V. Nord Leader	19-6-2012	Kandla
2	M.V. Global Hope	13-7-2012	Kandla
3	M.V. Parnon	1-11-2012	Kandla

- The vessels had evidently performed voyage between two ports in India and not in international traffic. Thus, the voyage is an Indian costal voyage.
- Although, the assessee is eligible to take benefit under Article 8 of the India-Singapore tax treaty, however, the voyage being Indian costal voyage, the benefit claimed under the tax treaty was not available to the assessee.

Assessees arguments

Against the allegation of the assessing officer that for the costal journey undertaken by a vessel during its larger part of international voyage, benefit under Article 8 of the India-Singapore tax treaty was not available, the assessee made the following arguments:

- As the ships had passed through Indian ports during the course of sailing in international waters, it was a case of ships operating in international traffic only.
- In order to prove the position, the assessee relied on the certificate issued by Assistant Commissioner of Customs Port Area Vishakhapatnam, certifying that vessel M.V. Global Hope reverted to foreign run and pleaded that it was conclusive proof of the ship operating in international traffic and not a costal voyage.

5. Commissioner of Income-tax (Appeals) ['CIT(A)']

The assessee aggrieved by the order of Assessing Officer, filed appeal before the first appellate authority, the CIT(A). To respite of the assessee, the appellate officer appreciated the argument of assessee that transportation of goods from one port in India to another port in India would constitute international voyage and not coastal voyage.

Consequently, in view of the benefit available to assessee under India-Singapore tax treaty, the CIT(A) deleted the addition made by assessing officer on account of income alleged to be arising out of operating ships in Indian coastal waters/Indian costal voyage.

As regards the reasoning on making distinction between international voyage and costal voyage, for the purpose of availing benefit under the tax treaty, the discussion made by the Tribunal has been elaborated below.

6. On the doors of the final fact finding authority

The revenue, aggrieved by the order of CIT (A), knocked on the doors of the second appellate authority/final fact finding authority, the ITAT.

The Tribunal considered the arguments made by the assessee as well as the revenues stand on the issue of Costal voyage v. International voyage and the requirements for taking benefit under Article 8 of the India-Singapore tax treaty.

The revenue had alleged that the vessels had operated in coastal traffic and the assessees plea was that the vessels had operated between Indian ports as part of the larger international voyage, hence said to be operating in International traffic.

Thus, the moot issue to be determined by the Tribunal was, whether the operation of ships between Indian ports, as part of larger international voyage is coastal Indian voyage or could it be categorised as operation of ships in international traffic, so as to avail benefit under Article 8 of the India-Singapore tax treaty.

A ship operating in 'International Traffic'

The Tribunal referred to the provision under Article 8 of the India-Singapore tax treaty in regard to income arising from business of shipping and proceeded to explain the scope of operation of ships in International Traffic as follows:

> *"A ship or aircraft if operated exclusively between places in foreign country, i.e. during a particular voyage, <u>if the place of departure and the place of arrival of ship or aircraft are both in a foreign country</u>, then the voyage would be termed as 'International Traffic' as used in Article 8 of Treaty."*

In view of the position under tax treaty, the Tribunal clarified that for the purpose of Article 8 of the India-Singapore tax treaty, in respect of India, a ship operated by a non-resident in India would be said to be operating in 'International Traffic' if the following conditions are satisfied:

Place of departure of ship for journey	A foreign country
Place of arrival of ship from journey	A foreign country

The ITAT then, referred to the order of Mumbai Tribunal in the case of *Essar Oil Ltd.* v. *Dy. CIT* [2006] 5 SOT 669 wherein:

- A Ship was sailing through international waters from Singapore to Arabian Gulf.
- During the course of voyage, the ship entered Indian waters and arrived at port of Chennai, loaded petroleum products and sailed to port of Hazira for unloading the goods.
- Thereafter, the ship continued its sailing to Arabian Gulf.

- The assessee remitted freight to foreign oil tanker without withholding tax under section 195 of the Income-tax Act, 1961.

In view of the above facts, the Mumbai Tribunal while adjudicating on the issue beforehand explained the difference between the concepts of 'international traffic' and 'coastal traffic':

- ***International traffic*** - A ship operated by a non-resident in India shall be considered to have been operated in international traffic even if it has operated between two places in India by chance or along with other voyages.

- ***Coastal voyage*** - A voyage becomes coastal traffic only if the foreign ship operated solely and exclusively between domestic ports in India.

ITAT's observation in the subject case

The ITAT relied on the above discussed judgment in the case of *Essar Oil Ltd. (supra)* and also on a successive judgment of Mumbai Tribunal in the case of *Dy. DIT* v. *Safmarine Container Lines NV* [ITA No. 3073 (Mum.) of 2010], and made the following important observations:

- The ship had never operated between the ports of Kandla and Vizag solely and exclusively;

- Rather, the ship had operated in international waters.

In terms of Article 8 of the India-Singapore tax treaty, the ship had operated in international traffic even while carrying goods from Kandla to Vizag and hence it could be fairly construed that there was no liability on assessee to pay tax in India.

The enunciating rule of law

As discussed above, the ITAT after examining the judicial precedents on the similar issues, upheld the decision of CIT(A) and concluded that, the voyage of a ship between two Indian ports as part of the international voyage, cannot be termed as Indian coastal voyage so as to tax the receipts in India. Thus, the assessee was entitled to seek benefit under Article 8 of the India-Singapore tax treaty.

7. Conclusion

In the case before hand, the Tribunal was posed with settling the debate between the revenue and the assessee on 'Costal voyage v. International voyage'. The determination of question is important in view of the fact that for a non-resident, benefit under Article 8 of the India-Singapore tax treaty is available only in case of operation of ships in international traffic. Thus, the non-resident is liable to pay taxes in India out of income earned from Indian coastal voyage.

As per India-Singapore tax treaty, the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, ***except when the ship or aircraft is operated solely between places in the other Contracting State***.

Thus in Indian context, the term 'solely' implies that the entire voyage must begin, take place and end within India itself. As already discussed by the ITAT, the Order of Mumbai Tribunal in the case of *Essar Oil Ltd. (supra)* is a landmark ruling on the issue of determination of coastal voyage vs international voyage.

The Tribunal seems to have missed to mention its ruling on a similar issue in the case of *ITO* v. *Tristar Logistics India (P.) Ltd.* 2011-ITAT-Rajkot-INTL. Wherein, the tribunal while explaining the scope of international traffic had made an important observation that it is unnecessary for a border to be crossed after every take-off of sailing. Even if places within one State are stoppage points one after the other, such transportation would continue to fall within the scope of operating ships or aircraft in international traffic, unless the ship or aircraft had to remain in that State for good.

The noteworthy commentaries on convention on double taxation

In order to understand as to when a voyage would be considered one to be in international traffic and as to when it would be construed as a coastal traffic, it would be pertinent to refer to the explanation offered in ***'Klaus Vogel on Double Taxation Conventions'***:

> "Unless the context otherwise requires the term 'international traffic' means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a contracting State, except when the ship or aircraft is operated solely between places in the other contracting State."

The **UN/OECD Commentary on Article 3** of the model convention provides that the definition of the term "international traffic" is broader than the term is normally understood. The State where the enterprise is located has the right to tax domestic traffic as well as international traffic between third States and the other Contracting States can tax traffic solely within their borders.

A glimpse of key foreign court rulings

A quick reference to the key foreign court rulings on similar issues would be of wide import.

The **Australian Taxation Office** has delved on the issue of international traffic in the case **ATO TR 2008/8**. The ATO while providing meaning of the term 'international traffic', observed as follows:

"However, consistent with the OECD Model's approach, the term international traffic includes transport between places in the other Contracting State where the journey between places in that State (the internal leg) forms part of a longer voyage involving a place of departure and a place of arrival which is outside that State (a broader international voyage)."

As per ***IBFD*** **case no. K 8084/97 (Tax Court, Berlin)**, the court had adjudicated on the issue of operation of aircraft after unification of East and West Germany. The tax court had in substance held that when an aircraft is operated solely within Germany, it could not be said to be operating in international traffic.

Thus, it would not be farfetched to say that the tax position on international voyage and coastal voyage is similarly adjudicated in India and abroad.

In view of the order of the Rajkot Tribunal and the above mentioned tax commentaries, Indian and foreign court rulings, the following position could be fairly construed on the issue of international voyage v. coastal voyage:

- When a foreign ship during the course of its voyage in international traffic operates between two ports in India, such operation does not cease the voyage to be in international traffic. As the transport between two ports in India forms part of the larger voyage, wherein, the place of departure and final place of arrival both are outside India; AND
- For a voyage to be construed as coastal voyage, the place of departure and the final place of arrival of the ship must be in India.

In view of the above emanating position, the Rajkot Tribunal seems to have revalidated the test of determination of coastal voyage and international voyage for the purpose of determining 'international traffic' under Article 8 of the India-Singapore tax treaty. The position being in line with the other tax rulings in India and abroad and the interpretation made in the tax commentaries, it would be interesting to see as to what would be the stand of revenue on further litigating the issue. In case, the revenue so opts for, the outcome would possibly prove to provide a landmark judgment and rule of law on the issue.

Recent U.S. Tax Developments

Charles W. Cope*

This monthly column provides an overview of recent significant developments in U.S. income tax law that may be of interest to tax advisors in India who have clients with U.S. interests and tax directors of companies in India with U.S. interests.[1] The column is intended to cover many aspects of U.S. tax law including legislation, Treasury regulations, Internal Revenue Service ("IRS") rulings, judicial decisions and income tax treaties.

IRS Issues Guidance on Discretionary Grant of Benefits under Income Tax Treaties

In Rev. Proc. 2015-40, issued September 13, 2015, the IRS provides guidance to taxpayer, including residents of other countries, requesting competent authority assistance under U.S. income tax treaties. The revenue procedure includes guidance on the circumstances in which the U.S. competent authority will consider granting discretionary relief under the limitation on benefits article of a U.S. income tax treaty. The guidance, is consistent with recently announced proposed amendments to the 2006 U.S. Model Income Tax Treaty. Significantly, the guidance also introduces a "purpose test"which is a new, and relatively undefined, concept for U.S. income tax treaties.

Background

In order to qualify for the benefits of a U.S. income tax treaty, a tax resident of a country with which the United States has an income tax treaty must generally[2] qualify under one of the tests in the Limitation on Benefits ("LOB") article of the treaty. Although these tests vary by treaty, recent U.S. income tax treaties generally include (i) an active

* Charles W. Cope is a U.S. tax attorney who focuses on U.S. cross-border tax planning and tax controversies. He can be reached through his website: www.copetax.com.

trade or business test, (ii) an ownership-base erosion test, (iii) a derivative benefits test, and (iv) a test for publicly traded companies and their subsidiaries. Also, certain residents qualify without regard to satisfying one of these tests, *e.g.*, individuals, pension funds and certain tax exempt entities.

When a resident of a treaty country cannot satisfy at least one of these tests, the LOB article provides a resident (the "applicant") may approach the U.S. competent authority and request a ruling that, in the discretion of the competent authority, the applicant qualifies for the benefits of the treaty. Prior guidance, provided in Rev. Proc. 2006-54, offered virtually no guidance as to the circumstances in which the United States would grant benefits.[3] Moreover, when relief was granted, the IRS did not disclose the facts or the government's rationale for providing relief.

Rev. Proc. 2015-40

Discretion is absolute

Rev. Proc. 2015-40 offers significant insights as to when the U.S. competent authority will exercise its discretion in favour of an applicant. It also makes clear that, in the government's view, the competent authority's decision is not subject to appeal or review. The revenue procedure states that "a decision by the U.S. competent authority not to grant discretionary benefits is final and not subject to administrative review." It further states that "an applicant that does not qualify for the requested benefits under the relevant LOB provisions of the applicable U.S. tax treaty may not claim those benefits, either at source or through a refund claim, unless it has received a favourable determination from the U.S. competent authority exercising its discretion to grant benefits." With this, the IRS is saying that should a request for relief be denied, the applicant may not, nevertheless, claim treaty benefits by arguing that the IRS abused its discretion in denying it such benefits. This position also would appear to foreclose bringing suit in court to compel the IRS to grant benefits. (Although a court may well decide to take jurisdiction of such a case, notwithstanding the IRS's position).

Substantial non-tax nexus

Consistent with current policy, the applicant must first demonstrate that it does not qualify for benefits under the relevant LOB provisions of the applicable U.S. income tax treaty. This typically will entail discussing the relevant facts and demonstrating that under each of the tests the applicant fails to qualify.

Once this is done, the next step is to present the applicant's reasoning as to why relief should be granted. The IRS expects the resident to demonstrate certain facts. First, the applicant must have a "substantial non-tax nexus to its country of residence." This includes a discussion of the resident's trade or business activities in its country of residence. There must also be a discussion of the resident's trade or business activities in the United States.

The following factors are considered as to both U.S. and resident country activities: customer base, capital assets, employees, income and sources of supply. As all facts and circumstances are considered in making the determination, weaknesses in some metrics likely can be overcome by strengths in others. Moreover, the revenue procedure uses the term "trade or business" and not 'active trade or business' which implies a lower threshold of activity than is found in an LOB article's active trade or business test. It therefore should include consideration of the activities of agents and service providers. Thus, a purchasing office, a logistics center, a quality control function or a marketing office may create sufficient nexus in the applicant's country to support relief. The revenue procedure states that taking advantage of favourable domestic law or the resident country's network of income tax treaties will not establish the required nexus.

Purposes test

The revenue procedure introduces a concept new to U.S. income tax treaties – a purposes test. The applicant must demonstrate that, if relief is granted, neither the resident nor its direct or indirect owners will use the treaty "in a manner inconsistent with its purposes." The revenue procedure does not define the critical term "purposes."

The revenue procedure does offer some guidance of the factors that will be considered in applying the purposes test. These include the country of residence of the applicant's owners, any changes in the ownership structure of the applicant and its U.S. operations, and the history of the applicant's trade or business activities in its country of residence and the United States.[4] Thus, the competent authority may consider direct or indirect owners resident in a non-treaty country as a negative factor and as well as changes to U.S. operations or its U.S. corporate structure (*e.g.,* an inversion) that reduces the U.S. tax base.

As the purposes of income tax treaties are generally understood to be to avoid double taxation (and double non-taxation) and prevent fiscal evasion, the revenue procedure may be expanding the purposes of income tax treaties beyond those purposes commonly understood by treaty negotiators. Perhaps future treaties will explain the term further. In the author's view, the competent authority would have a stronger position if it does not seek to read into a treaty a purpose that is not negotiated and well understood. Such a position facilitates an abuse of discretion lawsuit by a rejected applicant.

Circumstances in which relief typically will not be granted

The revenue procedure also provides three fact patterns that typically will not qualify for relief:

- The applicant or any of its affiliates is subject to a "special tax regime"[5] in its country of residence with respect to the item of income for which relief is sought.
- The applicant bases its request solely on the fact that it is the direct or indirect subsidiary of a publically traded company and the relevant withholding rate provided by the treaty between the United States and the applicant's country of residence is not lower than the rate under the treaty between the United States and the country of residence of the parent company or any intermediate owner.
- No or minimal tax would be imposed on the item of income in the applicant's country of residence and the country of source taking into account both domestic law and the relevant income tax treaty.

Likely cases for relief

There is anecdotal evidence that the U.S. competent authority has been willing to grant relief in at least two types of cases. First, when a business structure is established for non-tax reasons, the structure qualifies for treaty benefits and later ceases to qualify because the business is sold to new owners. In some cases the new owners have been granted relief. The second case occurs when an applicant fails to qualify under one of the objective tests in the LOB by a small margin. The IRS has been willing to relax the rules in some cases and grant benefits. This case is more compelling if the failure to qualify is due to a business driven constraint rather than a tax imperative.

Treasury Tightens Rules on Transfers to Partnerships with Related Foreign Partners

Notice 2015-54, issued on September 6, 2015, describes regulations that the Treasury and IRS will issue under section 721(c), section 482 and section 6662 addressing certain transfers of property, in practice principally intellectual property, to partnerships with related foreign partners that the Treasury and the IRS view unfavourably. The regulations will complement and coordinate with tighter cost sharing regulations issued in 2011.

The regulations to be issued under section 721(c) are effective for transfers occurring on or after September 6, 2015 and for entity classification elections (*i.e.*, elections to on an entity be treated as a partnership) that are filed on or after September 6, 2015 and that are effective on or before September 6, 2015. The other regulations will be prospective, applying to transfers or controlled transactions occurring on or after the date of publication of the regulations.

Background

Taxation of partnerships and partners

Partnerships are transparent entities for U.S. federal income tax purposes.The partners in a partnership report their distributive share of income, gain, loss and deductions of the partnership for its taxable year on their tax returns annually. Subject to various limitations in the partnership regulations, partnerships allow the flexible allocation of items of income and deductions among the partners to satisfy business goals.

Generally, a person transferring property to a partnership in exchange for a partnership interest does not recognize gain or loss on the transfer. The partner's basis in its partnership interest is equal to the partner's basis in the contributed property. Each year a partner's tax basis in its partnership interest is increased by its share of income and capital contributions and reduced by its share of loses and distributions. Specials rules apply to determine the effect of liabilities of the partnership on a partner's basis in its partnership interest.

When a partner contributes appreciated property (*i.e.*, high-value, low-basis property) to a partnership, such contributed property creates a disparity between the "book" or fair market value of a partner's partnership interest and its lower tax basis. The rules of section 704(c) apply to ensure that the contributing partner is taxed on the property's pre-contribution gain, i.e., such gain is not allocated to other partners who may be taxed more favourably on such built-in gain.[6] This is particularly as issue with built-in gain property that is a depreciating asset as it may not be sold for its value on the date of contribution.

Regulations issued under section 704(c) require the partnership to use a reasonable method to eliminate the book-tax disparity. Three methods are provided: the "traditional method," the traditional method with "curative allocations," and the "remedial method." Under the current regulations, taxpayers may choose which method to apply, subject to certain limitations.

The traditional method requires the contributing partner to be allocated gain recognized on the sale of the appreciated property that it contributed. In addition, if the appreciated property is subject to amortization or depreciation, then deductions attributable to the property are allocated to the partnership's non-contributing partners in an amount equal to those partners' share of book depreciation of the asset.It may be the case that a partnership does not produce sufficient deductions for tax purposes to totally eliminate the book-tax disparity created by the built-in gain property.[7]This situation is known as the "ceiling rule." Finally, any depreciation deductions that are not allocated to the other partners are allocated to the partner who contributed the built-in gain property. If the property is disposed of, any remaining built-in gain or loss allocable to the contributing partner is the difference between the tax and book bases for the property on the date of disposition. Thus, under the traditional method, a partner contributing appreciated property is allocated more taxable income than it otherwise would if the traditional method were not applied.

One approach provided in the regulations to address the ceiling rule is the remedial method. Under the remedial method, the traditional method is followed until the ceiling rule applies. The partnership then creates a remedial item of deduction to allocate to the non-contributing partners and an offsetting remedial item of income to allocate to the contributing partner. The total amount equals the amount of the excess of the book value of the asset over the asset's tax basis. Such remedial items are wholly fictional, but they must have the same character as the item limited by the ceiling rule.

Taxation of transfers of intellectual property

Due to the relatively high U.S. corporate tax rate, U.S. multinationals have engaged in a variety of strategies to cause intellectual property to be owned outside the United States. With proper planning, the U.S. tax on the income generated by this property can be deferred until the income is repatriated to the U.S. parent. Deferral is desirable when the foreign tax on such income is less than the U.S. tax.

Generally, an outright transfer of intangible property to a foreign subsidiary is unattractive from a tax perspective because, under section 367(*d*), the transfer is recast as a sale for a contingent payment over a number of years and the payment may be subject to adjustment by the IRS based on hindsight. For many years, a more popular strategy was to enter into a cost sharing arrangement to allow the cost of developing new intellectual property to be shared between a U.S. member of the group and a foreign member with the foreign member owning the non-U.S rights to the developed property. In 2011, the IRS issued revised cost sharing regulations intended to make such arrangements less attractive to taxpayers. U.S. companies then increasingly turned to a partnership between a U.S. member of the group and a foreign member as an avenue to deferring U.S. tax on income from intellectual property. The flexibility of such arrangements allowed appreciation in the value of such property to accrue for the benefit of the foreign partner and permitted deferral of the U.S. tax on the built-in gain on the contributed property.

Section 721(c) and section 367(d)(3) give the Treasury regulatory authority to address transfers of property to partnerships with foreign partners. The provisions were added to the Code in 1997, but regulations were not issued. The IRS been working on revisions to the regulations under section 367(d) for quite some time. No project under section 721(c) was ever announced, however, so the notice was unexpected.

Regulations to be issued under section 721(c)

The notice states that the IRS is concerned with transactions in which a U.S. taxpayer contributes appreciated property to a partnership with related foreign partners that are not subject to U.S. tax and those foreign partners are improperly allocated income or gain from the contributed property. Taxpayers, according to the notice, also are using valuation techniques that are inconsistent with the arm's-length standard.

Although there is authority in section 367(d)(3) to address transfers of intangibles to partnerships,[8] the Treasury Department and the IRS decided to issue regulations under 721(c) "because the transactions at issue are not limited to transfers of intangible property." The IRS also may have taken this approach because of the relatively narrow definition of intangible property in the Code and regulations under section 367(d). The Obama administration has sought legislation to expand the definition of intangible property; however, Congress and the administration have been unable to agree to tax legislation due to long standing differences.

The regulations to be issued will apply when property (other than cash, securities and tangible property with a *de minimis* amount of built-in gain) defined in the notice as "Section 721(c) Property is transferred to a partnership if, after the transaction, a related foreign person is a "Direct or Indirect Partner"[9] in the partnership and the U.S. person transferring the property and one or more related persons own more than 50 per cent of the interest in the partnership capital, profits, deductions or losses. Such a partnership is known as a "Section 721(c) Partnership."

The regulations will provide that when section 721(c) Property is transferred to a section 721(c) Partnership, the U.S. transfer must recognize gain on the transfer unless the "Gain Deferral Method" is applied by the partnership. The Gain Deferral Method requires that (*i*) the partnership adopt the remedial method with respect to the section 721(c) Property, (*ii*) for any taxable year during which there is remaining built-in gain with respect to section 721(c) Property the partnership must allocate all items of income, gain, loss and deduction with respect to that property in the same proportion, (*iii*) certain reporting requirements are satisfied, (*iv*) the U.S. transferor recognizes built-in gain with respect to any item of section 721(c) Property upon the occurrence of an "Acceleration Event,"[10] and (*v*) the Gain Deferral Method is adopted for all subsequent contributions of section 721(c) Property until the earlier of (*a*) the date that no built-in gain remains with respect to any section 721(c) Property or (*b*) 60 months after the date of the initial contribution of section 721(c) Property to which the Gain Deferral Method applied.[11]

Regulations to be issued under section 482

The notice also announces that, on a prospective basis, the IRS will issue regulations under section 482 to address transfer pricing issues raised by the transfer of section 721(c) Property to a section 721(c) Partnership. These regulations will extend the specified methods in the cost-sharing regulations, *e.g.*, the income method, to such transactions. (The preamble to the final cost-sharing regulations had limited the use of such methods to transactions involving cost-sharing arrangements.) The regulations also will provide a "commensurate with income" rule intended to allow upward adjustments of income allocated to the contributing partner when the contributed intangible is more profitable than expected at the time of contribution. This rule will be similar to the periodic adjustment rule found in the cost-sharing regulations.

Application of current law to section 721(c) Partnerships and section 721(c) Property

The final section of the notice describes how the IRS will apply existing law to the aforementioned transactions. These measures include:

- Applying section 482 to make adjustments to partnership allocations, including allocations under section 704(c).
- Utilizing one of the specified methods in the cost-sharing regulations as an "unspecified method" that is the most reliable measure of an arm's-length result.
- Applying an aggregate analysis when affiliates contribute property or services to the section 721(c) Partnership.
- Making a periodic adjustment based on Reg. § 1.482-4(*f*)(2) with respect to a section 936(h)(3)(B) intangible contributed to a partnership.

Observations

The regulations described in the notice are a clever regulatory solution, at least in part, to an issue that the Obama administration has not been able to address by legislation because of a poor working relationship with the Congress, *i.e.*, expanding the scope of section 367(d) which currently has a narrow definition of intangible property.

The recourse to section 721(c) is not without its issues, however. Section 721(c) provides for the recognition of gain on the transfer property to a partnership "if such gain, *when recognized*, will be includible in the gross income of a person other than a United States person." It is not clear that all contributions of the section 721(c) Property to a section 721(c) Partnership necessarily result in built-in gain being included in the income of a foreign person when recognized.

For example, one can imagine circumstances where the traditional method or curative allocations can avoid the problem that section 721(c) addresses. In those cases, the notice would appear to be overly broad and the regulations seem susceptible to challenge in the courts. In such cases, the regulations also may be subject to challenge as violating the non-discrimination provision of a U.S. income tax treaty. The government therefore may ultimately find that a more nuanced approach than the Gain Deferral Method is appropriate to address its concerns.

1. The information contained herein is of a general nature, is based on authorities that are subject to change, and does not constitute legal advice. Applicability of information to specific situations should be determined through consultation with your tax adviser.
2. A few treaties do not contain a limitation on benefits article, *e.g.*, the U.S. income tax treaties with Hungary and Poland. The Treasury is negotiating new treaties with those countries; however, they have not yet entered into force.
3. Section 3.08 provided: "[C]ertain treaties provide that the competent authority may, as a matter of discretion, determine the availability of treaty benefits where the prescribed requirements are not met. Requests for assistance in such cases should comply with this revenue procedure and any other specific procedures that may be issued from time to time. A request may be with respect to an initial discretionary determination, a renewal or a redetermination. The request should take the form of a letter as described in section 4.04 of this revenue procedure, except that if the requester does not file federal tax returns and cannot identify a person authorized to sign such returns, the letter may be dated and signed by any authorized representative or officer of the requester."
4. These facts may also be relevant in establishing a substantial nexus.
5. For a discussion of special tax regimes, see the Treasury's proposed amendments to the 2006 U.S. Model Income Tax Treaty, available at http://www.treasury.gov/press-center/press-releases/Pages/jl10057.aspx.
6. Section 704(c)(1)(A) provides: "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."
7. For example, consider the case of a partnership owning a single depreciable asset with a tax basis that is less than it's built in gain.
8. That sub-section provides: "The Secretary may provide by regulations that the rules of paragraph (2) also apply to the transfer of intangible property by a United States person to a partnership in circumstances consistent with the purposes of this sub-section."
9. A partner who owns an interest in a partnership directly, or indirectly through another partnership.
10. An "Acceleration Event" is a transaction that would either reduce or defer the amount of built-in gain that a U.S. transfer or would recognize under the Gain Deferral Method. Also, an Acceleration Event is deemed to occur for any taxable year in which the partnership fails to comply with all the requirements of the Gain Deferral Method. The regulations also will provide rules to govern the transfer of a partnership interest to a domestic Corporation and transfers of section 721(c) Property by partnership to a corporation in a section 351 transaction.
11. Regulations to be issued prospectively and one additional requirement to the Gain Deferral Method. Taxpayers will be required to agree to extend the limitation period for the assessment of tax on all items related to section 721(c) Property through the close of the taxable year following the taxable year of the contribution.

Key Indian International Tax Developments

Every month there are several rulings that are delivered in various areas of International Taxation. This section summarizes the key rulings and their impact on various stakeholders. For the ease of reference, we have summarised the Rulings in various areas according to their nature

1. Transfer Pricing

Comparables

- **Addition made by TPO to assessee's ALP for rendering software development services to its AE was to be set aside, since some comparables selected by TPO were functionally different, as the companies were developing their own software or were outsourcing their work and thus did not satisfy 25% cost filter** – *LSI Technologies India (P.) Ltd.* v. *ITO* [2015] 59 taxmann.com 434 (Bangalore – Trib.).
- **Addition made by TPO to assessee's ALP in respect of rendering software development services to its AE was to be set aside, in view of the fact that the authorities failed to apply RPT filter of 15% of total revenue while selecting comparables; comparables were inappropriate on account of their huge turnover** – *Multitech Software Systems India (P.) Ltd.* v. *Asstt. CIT* [2015] 59 taxmann.com 432 (Bangalore – Trib.).
- **Addition made by TPO to assessee's ALP in respect of software development services had to be excluded in view of the fact that comparables selected by TPO were found to be functionally different and there was absence of segmental details, etc.** – *Sonus Networks India (P.) Ltd.* v. *Asstt. CIT* [2015] 59 taxmann.com 474 (Bangalore – Trib.).
- **Where one of the comparables selected by TPO earned super normal profits, and extraordinary events in form of IPO took place in its case, adjustment made by TPO to assessee's ALP in respect of rendering Information Technology Enabled Services (ITES) to its AE was to be set aside -** *Unisys India (P.) Ltd.* v. Dy. CIT [2015] 60 taxmann.com 26 (Bangalore – Trib.).

- **Addition made by TPO to assessee's ALP for rendering software development services deserved to be set aside, since comparable selected by TPO was a giant company in area of software development assuming all market risks leading to its higher profit** – *Unisys India (P.) Ltd.* v. *Dy. CIT* [2015] 60 taxmann.com 26 (Bangalore – Trib.).
- **Impugned addition made by TPO to assessee's ALP, engaged in the business of rendering non-voice based BPO services to its AE, was to be set aside in view of the fact that among the comparables selected by TPO one was rendering voice based BPO services whereas another was rendering software development services** – *Acclaris Business Solutions (P.) Ltd.* v. *ITO* [2015] 59 taxmann.com 332 (Kolkata – Trib.).
- **Where one of the comparables selected by TPO had related party transactions in excess of 25%, impugned addition made by TPO to assessee's ALP in respect of rendering software development services deserved to be set aside** – *Dy. CIT* v. *BMC Software India (P.) Ltd.* [2015] 59 taxmann.com 267 (Pune – Trib.).
- **Addition made by TPO to assessee's ALP in respect of rendering software development services was to be set aside in view of the fact that one of the comparables was rendering the said services by using its own IPRS in form of patents of software whereas assessee did not own any IPRS** – *Global Logic India (P.) Ltd.* v. *Dy. CIT* [2015] 59 taxmann.com 433 (Delhi – Tribunal).
- **In transfer pricing study companies selected as comparables should be functionally comparables not identical** – *CIT* v. *DSM Anti-Infectives India Ltd.*[2015] 60 taxmann.com 209 (Punjab & Haryana).
- **Company involved in providing diagnostic services cannot be compared with a company rendering research and development services –** *Albany Molecular Research Hyderabad Research Centre (P.) Ltd.* v. *Asstt. CIT* [2015] 60 taxmann.com 257 (Hyderabad – Trib.).
- **Company providing portfolio management services cannot be compared to a company providing investment research and advisory services on a non-exclusive and non-binding basis** – *Bain Capital Advisors (India) (P.) Ltd.* v. *Dy. CIT* [2015] 60 taxmann.com 204 (Mumbai – Trib.).

ARM'S Length Pricing

- **CUP method followed by assessee engaged in the business of manufacturing of jewellery, for determining ALP, could not be discarded, in preference over transactional net margin method, unless Revenue authorities were able to demonstrate fallacies in application of such method** – *Kailash Jewels (P.) Ltd.* v. *ITO* [2015] 59 taxmann.com 473 (Delhi – Trib.).
- **Addition made by TPO to assessee's ALP, engaged in the business of import & export of polished diamonds, was to be deleted since ALP can be considered on value of international transactions alone & not on entire turnover of assessee** – *CIT* v. *Firestone International (P.) Ltd.* [2015] 60 taxmann.com 235 (Bombay).
- **Adjustment in relation to notional interest on outstanding receivables from AEs could not be made while determining ALP, as there was uniformity in assessee's approach in not charging interest, both from AE and non-AE in case of delay in realization of outstanding amount –** *Bausch & Lomb Eyecare (India) (P.) Ltd.* v. *Addl. CIT* [2015] 60 taxmann.com 141 (Delhi – Trib.).
- **LIBOR rate of interest had to be applied for determining ALP in respect**

of loan granted by assessee to its AE located abroad – *Indegene Lifesystems (P.) Ltd.* v. Asstt. CIT [2015] 60 taxmann.com 28 (Bangalore – Trib.).

- **Amount received by assessee from its AE as reimbursement of expenses in respect of expat tax paid on behalf of employees deputed by parent company was to be excluded from revenues and costs for comparability analysis under TNMM, as there was no element of service in such reimbursement** – *Tesco Hindustan Service Centre (P.) Ltd.* v. *Dy. CIT* [2015] 60 taxmann.com 51 (Bangalore – Tribunal).
- **Abnormal costs incurred on account of start up of business on salary, rent and depreciation, etc., have to excluded while computing operating cost in course of transfer pricing proceedings** – *HCL Technologies BPO services Ltd.* v. *Asstt. CIT* [2015] 60 taxmann.com 186 (Delhi – Trib.).

2. Fees for Technical Services

- **Amount received by assessee, a non-resident company, from VSNL, an Indian company, as fixed annual charge for arranging standby maintenance work which was required whenever some repair work in undersea cable or terrestrial cable was actually to be performed or rendered, would not be chargeable as Fees for Technical Services (FTS)** – *Flag Telecom Group Ltd.* v. *Dy. DIT* [2015] 59 taxmann.com 411 (Mumbai – Trib.).
- **Payment made by assessee, engaged in wet leasing of aircrafts to foreign companies on international routes only, for carrying out repairs to aircrafts could not be taxed in India as it was covered under exclusionary clause of section 9(1)(vii)** – *DIT* v. *Lufthansa Cargo India* [2015] 60 taxmann.com 187 (Delhi)..

3. Royalty

- **TPO could not disallow the royalty payment made by assessee, engaged in the business of manufacturing of two-wheelers, to its AE in respect of export, holding that assessee was a contract manufacturer and benefit of producing components was reaped by AE** – *Honda Motorcycle & Scooter India (P.) Ltd.* v. *Dy. CIT* [2015] 60 taxmann.com 298 (Delhi – Trib.).

Section 40(a)(i) of Income-tax Act, 1961

- **Section 40(*a*)(*i*) could not be invoked for disallowance of depreciation on amount capitalized, where assessee had made payment to a non-resident for purchase of software and amount had been capitalized, even though TDS had not been deducted on such payment by assessee** – *Kawasaki Microelectronics Inc.* v. *Dy. DIT* [2015] 60 taxmann.com 256 (Bangalore – Trib.).

Applicability of DTAA

- **Services related to human resource matters, cost control, fund management, quality and design review, etc., cannot be classified as technical or consultancy services as per amendment to Indo-UK DTAA, effective from 11 February, 1994** – *Measurement Technology Ltd., United Kingdom,* In re [2015] 60 taxmann.com 1 (AAR – New Delhi).

Transfer Pricing Developments

Dr. Hasnain Shroff*

Introduction

Recently, the Ahmedabad Tribunal in the case of Soma Textile & Industries Limited, upheld interest adjustment on the loan advanced by the taxpayer to its associated enterprise (AE). The Tribunal observed that the comparable uncontrolled price of quasi capital loan cannot be '*nil*', unless it is only for a transitory period and the *de facto* reward for the value of money advanced is the opportunity for capital investment or such other benefit.

In another Tribunal ruling, in the case of *Austin Medical Solutions (P.) Ltd.*, the Bangalore Tribunal held that deduction under section 10A of the Income-tax Act, 1961 (the Act) (for export of software services) should be allowed in cases where the taxpayer has carried out a *suo moto* TP adjustment in the income tax return.

With the Advance Pricing Agreement (APA) program gaining momentum in India, the Central Board of Direct Taxes of India (CBDT) signed a unilateral rollback APA in a case where an APA rollback application was filed in March 2015. Further, pursuant to the instructions of Central Information Commission of India (CIC), the CBDT disclosed information in relation to the estimated amount of transactions pertaining to APAs signed in India and the functional currency involved in these APAs.

(1) Interest adjustment on advances made to associated enterprise upheld and the meaning of quasi capital elucidated

The taxpayer was engaged in the business of manufacturing of textile cotton fabrics. During the assessment proceedings, it was noticed that the taxpayer had invested INR 21.71 lakhs in the share capital of its wholly owned subsidiary (WOS) in the United Arab Emirates (UAE)

* Dr. Hasnain Shroff, a Practicing Chartered Accountant

and had also advanced INR 16.75 crore to its WOS. The taxpayer contended that the entire amount of INR 16.75 crore advanced to the WOS was out of the proceeds of taxpayer's Global Depository Receipts (GDRs) issue and that the advance was in nature of 'contribution towards quasi capital of the said company'. The taxpayer argued on the basis of commercial expediency of an interest free loan. The Transfer Pricing Officer (TPO) argued that commercial expediency of the transaction was not relevant while ascertaining the arm's length price (ALP) and the test should be made on the price at which such transactions would have been entered into by independent parties. TPO proceeded to treat LIBOR *plus* 2 per cent as the ALP and made an adjustment. The Commissioner of Income-tax (Appeals) [CIT(A)] confirmed the actions of the Assessing Officer (AO).

Tribunal ruling

- While determining the ALP, the transaction in the nature of 'quasi capital' has to be reviewed as a borrowing transaction between the AEs.
- Loan/commercial borrowing transactions are benchmarked on the basis of interest rate applicable on loan transactions, which under transfer pricing (TP) regulations, cannot be compared with a transaction which is something materially different than a loan transaction. Loans, which are in the nature of quasi capital, are treated differently than the normal loan transactions.
- The expression 'quasi capital' loan or advance was not a routine loan transaction and the substantive reward for such advance would not be 'interest' but opportunity to own capital. Therefore, the comparison of quasi capital loans should not be done with commercial borrowings but with loans or advances which are given in same or similar situations.
- The Tribunal pointed out that in all the other Tribunal decisions, where references have been made to advances in the nature of quasi capital, following situations were referred:
  - Advances were made as capital which could not be subscribed due to regulatory issues and the advancing of loans was only for the period till the same could be converted into equity, and
  - Advances were made for subscribing to the capital but the issuance of shares were delayed.
- The comparable uncontrolled price of quasi capital loan cannot be *nil*, unless such loan is only for a transitory period and the reward for the value of money advanced is the opportunity for capital investment or such other benefit.
- The relevance of quasi capital for ALP determination, should be from the comparability perspective of the borrowing transaction between AEs and source of funds shall be immaterial.
- Based on the above, the Tribunal upheld the decision of CIT(A) and confirmed the adjustment.

The Tribunal has set out clear parameters regarding the concept of 'quasi capital'. It lays down important factors which shall be given due consideration while determining whether any funds advanced between AEs would be considered as loan or quasi equity and whether the same would be subjected to arm's length interest charge or not. The ruling provides guidance on the characterisation and the determination of ALP for the 'quasi capital' transactions.

***Soma Textile & Industries Ltd.* v. *Asstt. CIT* [IT Appeal No. 262 (Ahd.) of 2012]**

(2) Deduction under section 10A (for export of software services) is allowable in

respect of a suo moto transfer pricing adjustment carried out by the taxpayer in the income tax return

The taxpayer is engaged in the export of software and Information Technology enabled Services (ITeS). For the year under consideration, the taxpayer filed its Return of Income (RoI) declaring *nil* income. In the RoI, the taxpayer claimed a deduction under section 10A of the Act, in respect of the entire business income including the amount of *suo moto* TP adjustment and arrived at *nil* total income. The AO, for the purpose of computing the deduction under section 10A, disallowed the *suo moto* TP adjustment carried out by the taxpayer. The taxpayer placed reliance on the decision of Bangalore Tribunal in the case of *iGate Global Solutions Ltd.*[1] However, the AO referred to the provisions of the second proviso to section 92C(4) of the Act and held that the taxpayer's claim defeated the purpose for which section 92C of the Act was legislated.

The CIT(A) upheld the action of the AO and relied upon the Hon'ble Karnataka High Court ruling in the case of *Yokogawa India Ltd.*[2] and distinguished the decision of the coordinate bench in the case of *iGate Global Solutions Ltd. (supra)*, holding that the methodology of computation of deduction under section 10A of the Act was not brought to the notice of the Tribunal in the case of *iGate Global Solutions Ltd.*

Tribunal ruling

- The Tribunal referred to the ruling of the coordinate bench in the case of *iGate Global Solutions Ltd.(supra)*, wherein the bench had allowed the deduction under section 10A of the Act in respect of suo moto TP adjustment carried out by the taxpayer.
- The Tribunal also referred to the Hon'ble Karnataka High Court ruling in the same case of iGate Global Solutions where the High Court upheld the judgment of the coordinate bench and ruled that the AO erred in relying upon section 92C(4) to a case where ALP determined by the taxpayer itself, whereas the said provision applies to a case where ALP was determined by the AO.
- Following the above referred judgment, the Tribunal held that the taxpayer be allowed a deduction under section 10A of the Act, in respect of the *suo moto* TP adjustment carried out in the RoI.
- The Tribunal also held that judgment of the Hon'ble Karnataka High Court in the case of *Yokogawa India Ltd.(supra)* relied upon by the CIT(A) does not apply to the present case.

The Tribunal has correctly distinguished the judgments in the cases of *iGate Global Solutions (supra)* and *Yokogawa India Ltd.(supra)* with respect to the aforesaid issue and provided due relief to the taxpayer. This decision is expected to reinforce the fact that a *suo moto* TP adjustment is a *bona fide* action of the taxpayer to meet the ALP requirements.

***Austin Medical Solutions Pvt. Ltd.* v. *ITO* [I.T.(TP)A. No. 542/Bang/2012]**

(3) India signs its first rollback agreement

The APA rollback rules were notified by the CBDT on 14 March, 2015. Rollback rules provide for extension of the APA terms on the pricing of international transactions for prior four years (rollback years) preceding the first year from which APA is to be applicable.

In one of the cases where an APA rollback application was filed after notification of rollback rules in March 2015, the CBDT has signed a unilateral rollback APA. As per press report[3], the APA pertains to a U.S. multinational company and has been signed for a period of nine years, thus including protection from litigation for the past four years and future five years.

(4) CBDT discloses only limited information on APAs – Identity of taxpayers cannot be disclosed

In May 2014, an application was filed under the Right to Information Act, 2005 (RTI Act) by an RTI activist (the appellant) seeking information from the Central Public Information Officer (CPIO), Ministry of Finance (the respondent), on 10 issues relating to APAs signed by the Government. In reply to this application, the CPIO denied the required information to the appellant by taking a plea under section 8(1)(*d*) of the RTI Act which provides for non-disclosure of information which could harm the competitive position of a third party, unless the competent authority is satisfied that larger public interest warrants the disclosure of such information. The first Appellate Authority upheld the decision of the CPIO and therefore, the appellant filed a second appeal.

Central Information Commission (CIC) order

In the second appeal before the CIC, it observed that out of the 10 issues on which information was sought, 3 issues or information points were not covered under section 8(1)(d) of the RTI Act. Accordingly, it directed the CBDT to provide complete and categorical information against the following 3 points to the appellant.

(*i*) The estimated amount of transactions pertaining to APAs signed in India;

(*ii*) The functional currency that is recognised for the proposed transactions under these APAs and

(*iii*) The annual tax revenue likely to be earned by CBDT as a result of entering into these APAs.

Information provided by CBDT pursuant to the CIC order

In response to the aforesaid CIC order, the CBDT provided the following information in April 2015:

(*i*) The estimated total amount of transactions of the five APAs signed (as on date of receipt of RTI application in May 2014) as INR 21,075 crores.

(*ii*) The financial currency recognised is Euro and Indian Rupee for one APA each, U.S. dollar for two APAs and two currencies *viz*. U.S. dollar and Euro for the fifth APA case.

(*iii*) Regarding the annual tax revenue likely to be earned from each APA, the CBDT replied that the likely tax revenue cannot be forecasted by determining the profit margin of a particular transaction. The CBDT observed that determination of a profit margin in certain transaction will not give any foresight of the total profits of the company, as other transactions will also impact the nature of profit/loss of a company.

1. *iGate Global Solutions Ltd.* v. *Asstt. CIT* [2008] 24 SOT 3 (Bang.).
2. *CIT* v. *Yokogawa India Ltd.* [2012] 341 ITR 385/21 taxmann.com 154 (Kar.).
3. An article in *The Economic Times*, dated 4 September, 2015

Global Updates

ALGERIA

Certain payments to be made only through the banking system

Extending the existing anti-money laundering provisions, Algeria has announced that certain payments (discussed below) shall be required to be made only through the banking system, and non-compliance thereof could result in sanctions against certain companies.

Payments to be made are as under : -

- U.S. $50,000 approx. for real estate purchases; or
- U.S. $10,000 approximately towards purchases of goods and services.

CHILE

Reporting indirect sale of assets of Chile Enterprise

Under a newly provided Form 1921, Chilean foreign investors are required to report indirect sale of assets located in Chile, which are subject to taxation under Chilean income tax law. Filing is required to be carried out for transactions between January 1, 2013 and September 5, 2015.

JAPAN

Delaware Limited Partnerships are to be treated as Corporations

In a recent decision the Japanese Supreme Court has concluded that a Delaware based limited partnership is to be treated as a corporation, for Japanese tax purposes.

ITALY

FATCA Guidelines

Italy has issued guidelines for covered financial institutions on transmitting data to comply with reporting requirements under FATCA.

ICELAND

FATCA Due Diligence

Iceland has issued guidelines relating to the implementation of FATCA alongwith detailed requirements for due diligence.

LUXEMBOURG

Tax Residency certificate

Recent circular issued by tax authorities in Luxembourg provides guidelines and rules for issuing tax residency certificate, for treaty cases, and where Treaty cases are not applicable based on the domestic laws of Luxembourg.

AUSTRALIA

TP - Proposed country-by-country reporting

Australian Government has released exposure drafts for : -

- Introduction of OECD country-by-country (CbC) reporting requirements
- Adoption of OECD revised standards on transfer pricing documentation
- Penalties for MNE entering into tax avoidance or profit shift schemes.

US

APA programme guidelines

The US IRS has issued two revenue procedures which provide guidelines regarding US APA programme, and offer guidance for the process to request U.S. Competent Authority assistance under Tax treaties.

KOREA

Implementing BEPS related transfer pricing requirements

South Korea has released drafted legislation to amend existing law to implement certain OECD BEPS initiatives for transfer pricing documentation by requiring taxpayers to submit Master file and a local file containing information on related-party transactions.

FEMA Updates

Reporting under FDI scheme on e-biz platform

In order to increase, ease of reporting FDI transactions, RBI has, **Vide A.P. (DIR SERIES 2015-16) CIRCULAR NO.9**, **DATED 21-8-2015**, now enabled online filing of, Foreign Currency Transfer of Shares (FCTRS) returns, which are required for reporting transfer of shares, convertible debentures, partly paid shares and warrants, both in case of transfer from:-

- Person resident in India to a person resident outside India; or
- Person resident outside India to a person resident in India.

This is an additional facility to Indian residents to undertake FCTRS reporting and the manual system of reporting shall continue for present.

The customer can login to the eBiz portal, download FCTRS form and upload it after completing it,using their digitally signed certificates. The AD banks shall thereafter download and verify forms and upload them for RBI to process, post-calling for additional information (if any). AD bank shall also allot the Unique Identification Number (UIN).