IFA News Letter India Branch - Western Chapter

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Chairman Speaks

REDEFINING INDIA – The dawn of a new era

Dear Mr. Modi, There is excitement (& hope) in the air. The mood, expectation & question in peoples minds is whether India is taking a decisive turn – for the better – from which it will never look back. Is this the time of reckoning from which India begins, slowly but surely, the unstoppable process of rediscovering itself – of rebuilding a resurgent, confident India. Will the future remember this, as the defining moment in the history of this glorious country – a new beginning? It has been often repeated that India is a country with boundless potential – but time (& patience) is running out. As Swami Vivekananda said "No power in the Universe can withhold from anyone anything he really deserves." Do the people of India deserve better? Are they justified in dreaming a new Indian dream? Will generations to come refer to this as the moment the sleeping giant did indeed finally "Awake, Arise ….." Or will this turn out to be yet another case of an unfulfilled unrealistic hope & frittered opportunity.

You Mr Modi deserve the credit for reigniting this hope & self-belief. The aspiring eyes, enterprising minds & rearing-to-go attitude of a billion plus, hungry to succeed Indians, is now upon you. The world is watching in anticipation. Will this be the liberating moment for the elephant in chains – will India deliver. Over to you, Mr Modi. With my Best Wishes. Sincerely …..

On a separate note I wish to thank you all for the overwhelming response so far to the upcoming IFA 2014 Mumbai Congress – the super early bird registrations have surpassed our most optimistic expectations. We look forward to making the event a very special one for IFA, for India and for each one of you!

Editor Speaks

Dear Readers,

I am happy to present yet another issue of News Letter of IFA for the second quarter of 2014.

This is a very special edition.

The general elections in India have been concluded and the elected party is scheduled to form the new Government. This will also bring about many changes. Many important issues which require the attention of the Parliament have been rescheduled. The tax administration is not expected to undergo much change.

This issue contains the welcome clarification from the Central Board of Direct Taxes for deduction of tax in the case of a Non resident. It has been held by the judiciary that any retrospective amendment cannot enjoin the obligation to deduct tax at source where the payment is made on the basis of law then prevailing. A decision of Income –tax Appellate Tribunal in India in respect of guarantee commission is decided in favour of the assessee although the Guarantee Commission is expressly subject to Transfer Pricing. The Belgian Court has held grossing up of partial foreign tax credit in the case of insufficient income to be unconstitutional on the facts of the case.

Now comes the time to attend the 68th Congress of the IFA in Mumbai, rejoice and network from 12th to 16th October 2014. I request you all to Participate. There are good technical subjects being discussed and cultural programmes being show cased for the delegates who will be attending from all over the world and from within India. Please do register early to avoid disappointment.

Cheers!
Tara.

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Courts Speak

I. Indian Rulings

Sagar Wagh
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1. *M/S Bharti Airtel Limited*[1]

In absence of cost to the taxpayer, the transaction of provision of corporate guarantee does not falls under purview of transfer pricing

The Taxpayer, an Indian company, provided a guarantee to a third party bank on behalf of its foreign subsidiary for which the Taxpayer did not charge a fee. Further, the Taxpayer had also made a contribution to the share capital of its foreign subsidiaries.

During audit proceedings, the Transfer Pricing Officer (TPO) imputed an arm's length guarantee fee by applying the Comparable Uncontrolled Price (CUP) method and considered the commission charged by independent banks as a benchmark. Further, the TPO noted that there was a significant delay in allotment of shares to the Taxpayer. Hence, the TPO treated the contributions as interest free loans for the period between the dates of payment and the date on which shares were actually allotted and imputed interest on such loans at the rate of 17.26%.

The Tribunal, on facts, held that the corporate guarantee provided by the Taxpayer, which does not involve cost to the Taxpayer, does not have a bearing on profits, incomes, losses or assets of the Taxpayer and hence the transaction does not fall within the definition of "international transaction" as provided in the Indian Tax Law. Further, with regard to the capital contribution made by the Taxpayer to its AEs, the Tribunal rejected the TPO's approach of determining the arm's length interest rate by treating these payments partly as that of an interest free loan. The Tribunal ruled that an arm's length price adjustment based on that hypothesis was no legally sustainable on merits as the TPO has not brought on record anything to show that an unrelated share applicant was to be paid any interest for the period between making the share application payment and allotment of shares.

2. *Maersk Global Centres (India) Private Limited*[2]

ITeS services cannot be further bifurcated into BPO and KPO activities and comparable companies cannot be rejected solely on the reason of earning abnormally high profit margins

The Taxpayer is a provider of information technology enabled services (ITeS) such as transaction processing, data entry and information technology (IT) services such as process support/ optimization and technical support services to its Associated Enterprises (AEs). The Taxpayer's transfer pricing (TP) documentation supported that its international transactions were at arm's length using the Transactional Net Margin Method (TNMM). The TPO rejected the TP documentation and made an adjustment by treating the activities of the Taxpayer to be in the nature of Knowledge Process Outsourcing (KPO) services instead of Business Process Outsourcing (BPO) services.

The Special Bench (SB), while approving TNMM as the most appropriate method, and considering the gamut of services provided by companies in the ITeS sector, ruled that there is no requirement to further segregate ITeS into BPO and KPO activities. The SB also ruled that comparables having abnormally high profits need not be eliminated at the threshold, but should trigger further investigation to ascertain whether such trends reflect normal business conditions or not. Where a high profit margin making entity does not satisfy comparability criteria or the same does not reflect normal business conditions, then such entity needs to be excluded from the comparability analysis.

3. *JC Bamford Excavators Ltd*[3]

As assignees retained lien over their former employment and did not enter into employment agreement with Indian subsidiary, they constituted service PE of former employer

The Taxpayer had granted right to use intellectual Property IP (along with technical documents containing IPRs) to its wholly owned subsidiary in India and also sent 8 of its employees (assignees) on deputation to such subsidiary for purpose of providing technical assistance for effective utilization of IP. The assignees were also engaged in managing overall operations of Indian subsidiary. Apart from the assignees, certain other employees occasionally visited the premises of Indian subsidiary (occasional visitors) for testing and inspection of licensed products manufactured by Indian subsidiary company.

The revenue authorities contended that assignees constituted service permanent establishment (Service PE) of the taxpayer. The other transactions in relation to royalty receipt (which included payment for testing and inspection) were effectively connected to service PE and thus taxable as business income under Article 7 of India – UK DTAA

On question of service PE, Tribunal held as under:

The assignees even after secondment remained employees of taxpayer and not of Indian company. Though Indian company had control over these assignees and could give directions to the assignees, the assignees did not enter into any employment agreement with Indian company. The assignees retained lien on their employment with Taxpayer, such that after completion of three years of secondment, the employees would resume

[1] TS-76-ITAT-2014 –Del –TP

[2] TS –74-ITAT-2014-Mum-TP

[3] TS-161-ITAT-2014-DEL

employment with taxpayer at level no less favourable than that they left prior to deputation.

Hence, the Tribunal held that, the assignees-constituted Service PE of the taxpayer.

On the question of effectively connected to PE, Tribunal held as under:

The income in relation to provision of services by assignees is effectively connected to PE and hence will be taxable under Article 7 of DTAA. Royalty income (which included income for testing and inspection services by occasional visitors) is not effectively connected to PE as "assignees" (service PE) had no role in granting, creating or making available IP to Indian subsidiary company and hence such income is taxable under Article 13 only.

4. *Tilda Riceland Pvt Ltd*[4]

Customs data compiled by private entity can be used for purpose of applying CUP method and in absence of substantial impact of brand on price; generic goods do not cease to be comparables

The Taxpayer was in business of exporting different varieties of rice to AEs situated in European Union (EU), United States (US) and Middle East Countries (ME). The Taxpayer had accepted CUP method as the most appropriate method. The Taxpayer had applied CUP method to prove the arm's length nature of its international transactions by comparing prices charged by the Taxpayer and rates prevailing in the international market as reported in "Daily Export Port Data - April 2007 to March 2008" with respect to export of rice to EU,US and ME compiled by TIPS Software Services Pvt Ltd, Mumbai. The Taxpayer adopted averaging for both controlled as well as uncontrolled transactions.

During the course of transfer pricing proceedings the TPO rejected the CUP method adopted by the Taxpayer on the basis that customs data published by TIPS Software Services Pvt Ltd. which is a private company cannot be considered as data available in public domain and thus such quotes are not covered within the provisions of Rule 10D(3). Further, the TPO observed that, brand is one of the important factor for price comparison and any adjustments carried out by Taxpayer to the price of uncontrolled transaction cannot quantify the price which Tilda brand would command in EU, US and ME compared to any other brand reported by TIPS data. Therefore, TPO rejected CUP method and applied TNMM.

The Tribunal held that, Rule 10D(3) is only illustrative in nature and merely describes the information required to be maintained by the Taxpayer under section 92D The logic employed by the TPO that since databases compiled by private entities is not included in rule 10D (3), such databases cannot be relied upon by the Taxpayer is clearly fallacious. The data compiled by TIPS software is public data maintained by the customs department at various ports. The product comparability does not require the comparables to be exactly the same. For the purpose of comparability under CUP method, the product categorization has been done on the basis of reasonable generic description, and the product being generic in nature, such categorization in reasonable and sufficient. Generic goods, even under different brand names, do not cease to be comparable with each other- unless the impact of brand or other intangibles is so substantial that it distorts the comparison altogether. As per Rule 10B, it is not open to the Taxpayer to compare the average price in his transactions with AEs with average price in uncontrolled transactions.

5. *DCIT v Virola International*[5]

Retrospective amendment in law cannot change the withholding tax liability of the deductor

On question whether withholding tax obligation under section 195 depends on law prevailing on date of payment and is not affected by retrospective amendment, the Tribunal held as under:

In accordance with the law laid down in Ishikawajma-Harima Heavy Industries, which was good law at the time of the remittance, unless the services are rendered in India, the same cannot be brought to tax as 'fees for technical services' u/s 9. Though the law was amended retrospectively, so far as tax withholding liability is concerned, it depends on the law as it existed at the point of time when payments, from which taxes ought to have been withheld, were made. The tax deductor cannot be expected to have clairvoyance of knowing how the law will change in future. A retrospective amendment in law does change the tax liability in respect of an income, with retrospective effect, but it cannot change the tax withholding liability, with retrospective effect. As there is no material whatsoever to establish that the design and development services were rendered in India, the assessee did not have any liability under s. 195 r.w.s. 9(1)(vii) to deduct tax at source from these payments. As a corollary thereto, no disallowance can be made in respect of these payments u/s 40(a)(i).

6. *Antwerp Diamond Bank N.V*[6]

Amended definition of royalty does not impact the definition in DTAA

The Taxpayer is a bank and a tax resident of Belgium, operating in India through a branch office (BO). The Taxpayer acquired banking application software. The software was installed on server in Belgium and was used by head office (HO) all over the world. The Indian BO was allowed to make use of the software by accessing the server located in Belgium. Since the Indian BO was using the information technology resources situated in Belgium which was paid for at HO level, the Indian BO reimbursed HO the cost of data processing on pro-rata basis.

The tax authority disallowed the above payment on the basis that payment constitutes 'royalty' on which no taxes were withheld at source.

The Tribunal held that, the amended definition of royalty in Indian tax laws does not impact the definition in Double Taxation

[4] TS-47-ITAT-Del-TP

[5] ITA.No. 256/Agr/2013

[6] I.T.A. No.7347/Mum/2007

Avoidance Agreement (DTAA). Thus definition of 'royalty' under India-Belgium DTAA should be looked into. The Tribunal held that, reimbursement by BO towards cost of data processing, by accessing HO's software is not royalty as BO does not have independent right to use or control over such software. Accordingly, there is no withholding tax obligation for BO for such payments. Further, as reimbursement was specific to BO, such expenditure cannot be termed as general HO expenditure and thus, such data processing cost are fully deductible as business expenditure of the BO.

II. Overseas Rulings

Harshal Bhuta
CA, ADIT

1. Name withheld (Spanish Central Economic-Administrative Court) [7]

Court allows re-characterization of part of the consideration under general anti-abuse law. It disallows the use of "secret comparables" as a valid valuation method under applicable transfer pricing rules.

The Spanish taxpayer had entered into separate contracts with two non-resident unrelated entities (one located in US and other in Switzerland). Under the first contract, the taxpayer had undertaken to prepare the beverages using ingredients which could only be acquired from the non-resident unrelated entities, and to subsequently package and distribute them in the Spanish market whereas under the second contract, the foreign unrelated entity allowed the taxpayer to use its brands, labels, designs, packages and other intangible assets in the distribution and sales process of the taxpayer without any consideration.

The Spanish tax authorities challenged that it was a complex and mixed-purpose contract wherein the part of the price paid by taxpayer to each of the non-resident entities under the first contract related to remuneration for the use of trademark and therefore should be characterized as a royalty payment, subjecting that part to Spanish withholding tax.

Further, to quantify such deemed royalty payments (ie to determine percentage of the price that should be considered as royalty income), the Spanish tax authorities used a set of comparables without disclosing data from the companies used to the taxpayer.

Despite the fact that the contracts explicitly established that the taxpayer had to compensate the non-resident entities only for the acquisition of the ingredients and not for the use of the brand itself, the Court concluded that payments made under the contract should be partially re-characterized as royalty income based on the reasoning that regardless of the independent economic value of the ingredients, the sale of the beverages under a certain well-named brand had a very significant value-add for the taxpayer which increased its turnover.

The Court further disallowed the use of secret comparables for quantification of that portion of the consideration which qualified as royalty, stating that the lack of disclosure to the taxpayer would lead to a situation where the taxpayer would be unable to properly defend its position.

2. Nyrstar Belgium SA (Belgian Constitutional Court) [8]

Grossing up of part of Foreign Tax Credit which cannot be imputed in case of insufficient taxable basis is unconstitutional.

Belgian companies receiving foreign-source interest income are entitled to a foreign tax credit in Belgium that is fully creditable vis-à-vis the corporate tax due. When calculating the corporate income tax liability, the foreign tax credit is technically added to the corporate tax base as a disallowed expense (i.e. grossing up) which can then be credited against the corporate tax due on the taxable base.

Based on the applicable tax treaty, the taxpayer with current-year losses was entitled to a tax credit for the Australian withholding tax on Australian sourced interest, in accordance with the relevant Belgian domestic law provisions and rate. Accordingly, the taxpayer added the amount of the tax credit to the disallowed items as required by law, but claimed the carry-forward of the unused credit.

The Tax Court of Antwerp subsequently made two requests to the Belgian Constitutional Court for preliminary ruling on the compatibility of the Belgian foreign tax credit rules with the principle of non-discrimination under Belgian constitution. First request for ruling related to a situation where companies with a sufficient tax base can effectively impute the foreign tax credit, whereas loss-making companies cannot carry forward the credit nor get a refund for the excess part. The second request for ruling pertained to the fact that both profitable companies (that can effectively impute the tax credit on their profits) and loss-making companies have to gross-up their taxable bases.

The Constitutional Court answered the first question in favour of the tax authority by holding that the impossibility to get a refund for or a carry-forward of the excess foreign tax credit does not constitute an infringement of the non-discrimination principle as such principle does not impose a general prohibition of double taxation. With regard to the second question, it concluded that there was a violation of the non-discrimination principle, however, insofar as relating to the foreign tax credit which could not be effectively imputed but which still had to be added to the taxable base in its entirety. Therefore, only the amount of the foreign tax credit that had effectively been credited against the corporate income tax could be added to the taxable base.

[7] Decision dated 3rd October 2013

[8] Decision No. 14/2014 of 29 January 2014

3. Name withheld (Dutch Supreme Court) [9]

Redeemable Preference Shares are shares for purposes of participation exemption. Conversion of erstwhile loan into such shares is not abuse of law.

Dutch corporate tax law provides for participation exemption for income derived from equity investments in a subsidiary in case a shareholder owns at least 5 percent of the nominal paid-in share capital in the subsidiary provided the shares are not held as a portfolio investment.

A Dutch corporate taxpayer had an indirect 16 percent interest in an Australian company to which it had granted shareholder loans. After a restructuring in 2004, the Dutch taxpayer received newly issued redeemable preference shares (RPS) in the Australian company and the shareholders loans were repaid. The characteristics of the RPS were that (1) they would annually pay cumulative preferred dividend of 8 percent increasing to 12 percent of the amount contributed on the RPS; (2) they would have basically no voting rights; (3) they would be redeemed within ten years; and (4) they would rank in priority over ordinary shares.

Where previously the Dutch taxpayer was taxed on the interest received on the shareholder loans, after the restructuring, the participation exemption applied on the income derived from the RPS. As a consequence, although the payments on the RPS were still deductible under Australian tax law, they were no longer taxed at the level of the Dutch taxpayer under the Dutch participation exemption rules.

Dutch Supreme Court ruled that the corporate law qualification of an instrument between a parent company and a subsidiary is in principle decisive when classifying such an instrument for purposes of the Dutch participation exemption. If an instrument is considered share capital for corporate law purposes, then this characterization is in principle also leading for tax purposes. This also held true for the RPS, regardless of the fact that (i) the RPS had an agreed term of 10 years, (ii) an annual, cumulative dividend was paid, (iii) from an accountancy perspective, the RPS were similar to a subordinated debt, and (iv) the contributed capital was considered debt under Australian and Dutch GAAP. According to the Dutch Supreme Court, cumulative preference shares with limited voting rights could be issued by Dutch companies under similar conditions, while still being considered “shares” within the meaning of the participation exemption. Furthermore, the fact that the dividend was deductible for Australian tax purposes did not prohibit the application of the Dutch participation exemption.

[9] Case number 12/03540 dated 7th February 2014

International Tax Updates - India and Global

Isha Sekhri, Pratikshit Misra
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I. India

1. Foreign Portfolio Investors (FPI) equated with Foreign Institutional Investor (FII)

Following from the notifications of SEBI for investments by FPI in Indian capital markets, the Central Board of Direct Taxes (CBDT) has notified that FPI will enjoy the same Indian income tax treatment as currently accorded to FII.

Source: Notification No. 9/2014/ F.No.173/10/2014-(ITA.I) dated 22nd January 2014

2. CBDT provides clarity with regard to tax withholding on payments to non-residents

The CBDT has clarified that the tax withholding on payments to non-residents should be restricted to the portion of payment which is chargeable to tax in India and not the entire payment to the non-resident per se.

Source: Instruction No. 2/2014/ dated 26th February 2014

3. India enters into DTAA with Republic of Albania

The Government of India (GOI) has entered into a DTAA with Republic of Albania, the salient features of which include the following:

- Lower withholding tax of 10% for taxation of dividend, interest, royalty and fees for technical services in the source country;
- Seemingly stringent Article on Limitation of Benefits;
- Provisions enabling Exchange of Information and Mutual Assistance in Collection of Taxes.

Source: Notification No. 2/2014/ F.No.501/1/2003-FTD-I) dated 7th January 2014

4. India's Tax Information Exchange Agreement (TIEA) with Belize notified

The GOI has entered into TIEA with Belize on 18th September 2013. The GOI has notified that it shall give effect to the provisions of the TIEA with effect from 25th November 2013.

Source: Notification No. 3/2014/ F.No.503/4/2012-FTD-I) dated 7th January 2014

5. India's DTAA with Socialist Republic of Sri Lanka effective from 1st April 2014

The GOI has entered into a DTAA with Socialist Republic of Sri Lanka. The GOI has notified that it shall give effect to the provisions of the DTAA with effect from 1st April 2014. The salient features of the DTAA include the following:

- Lower withholding tax of 10% for taxation of interest, royalty and fees for technical services in the source country;
- Lower withholding tax of 7.5% for taxation of dividend in the source country;
- Seemingly stringent Article on Limitation of Benefits;
- Provisions enabling Exchange of Information and Mutual Assistance in Collection of Taxes.

Source: Notification No. 23/2014/ F.No.503/8/2005-FTD-II) dated 28th March 2014

6. India's DTAA with Republic of Latvia effective from 1st April 2014

The GOI has entered into a DTAA with Republic of Latvia. The GOI has notified that it shall give effect to the provisions of the DTAA with effect from 1st April 2014. The salient features of the DTAA include the following:

- Lower withholding tax of 10% for taxation of dividend, interest, royalty and fees for technical services in the source country;
- Article on Limitation of Benefits;
- Provisions enabling Exchange of Information and Mutual Assistance in Collection of Taxes.

Source: Notification No. 12/2014/ F.No.503/2/1997-FTD-I) dated 5th March 2014

7. India's DTAA with Romania effective from 16th December 2013

The GOI has entered into a DTAA with Romania. The GOI has notified that it shall give effect to the provisions of the DTAA with effect from

16th December 2013. The salient features of the DTAA include the following:

- Lower withholding tax of 10% for taxation of dividend, interest, royalty and fees for technical services in the source country;
- Seemingly stringent Article on Limitation of Benefits;
- Provisions enabling Exchange of Information and Mutual Assistance in Collection of Taxes.

Source: Notification No. 13/2014/ F.No.501/10/1995-FTD-I) dated 5th March 2014

8. India's Protocol to DTAA with Government of United Kingdom effective from 27th December 2013

The GOI has entered into a Protocol amending its DTAA with Government of United Kingdom on 30th October 2012. The GOI has notified that it shall give effect to the provisions of the Protocol with effect from 27th December 2013.

Source: Notification No. 10/2014/ F.No.505/3/1986-FTD-I) dated 10th February 2014

II. Global

1. Greece establishes Advance Pricing Agreement procedures

On 31 December 2013, the General Secretary of Public Revenues of Greece decreed, the procedures for the conclusion, amendment, revocation and annulment of an Advance Pricing Arrangement (APA). The decree refers to the procedures of both unilateral and bilateral APAs. Applications for an APA, can be made in relation to cross-border intercompany transactions that take place in financial years starting 1 January 2014 onward and an APA is valid for financial years that have not elapsed by the time the APA request is filed.

2. New Dutch Decree on substance requirements for inter-company financing and/or licensing companies

As on 1 January 2014, as per a new Decree entered into force, Dutch companies, engaged in inter-company financing and/or licencing activities that claim the benefits of a tax treaty or EU Directive, should now declare in their annual Dutch corporate income tax return whether or not the tax payer meets a defined set of substance requirements. In case one or more of these requirements are not met and the company has claimed the benefits of a tax treaty, the Dutch tax authorities will notify the foreign tax authorities. It is up to the foreign tax authorities to decide what to do with this notification.

3. Italy issues new laws with important transfer pricing and VAT implications

On 23 December 2013, the Italian Parliament passed the budget law for 2014 (2014 Stability Law), effective 1 January 2014, which contains amendments which may impact the business of Digital Economy companies with respect to transfer pricing and VAT. It also includes changes regarding transfer pricing rules applied for the computation of the Regional Tax on Productive Activities.

4. Colombia issues regulations on taxation of permanent establishments and effective place of management for companies and foreign entities

Colombia's Ministry of Finance and Public Credit issued Decree 3026 (27 December 2013), regulating the taxation of permanent establishments (PE) and branches of foreign entities in Colombia and effective place of management for companies and foreign entities.

PE

The major changes comprise amending the definition of Permanent Establishment to include foreign individuals who develop any business or activity in Colombia, changes in the definition of fixed place of business, and changes in withholding tax and documentation obligations to PE.

Effective place of management

The decree establishes that, when a company has its effective place of management in Colombia, it will be considered as a national and will be treated as similar to a Colombian entity. The same tax rate applicable to a Colombian entity will apply and the company will be subject to the same tax obligations. This is an important change in the Colombian tax system, which traditionally followed the concept of incorporation of the company or legal entity in Colombia to determine the tax consequences in the country.

5. New French transfer pricing package entails a second, contemporaneous, documentation requirement

As part of the surge in government initiatives to address Base Erosion and Profit Shifting (BEPS) concerns, the French authorities recently released a

broad package of measures with far-reaching consequences with regard to transfer pricing and international taxation. The French Constitutional Council validated a new contemporaneous transfer pricing documentation "light" requirement included in the Fight Against Tax Evasion and Financial Criminality Bill adopted by French Parliament on 5 November 2013, which was officially published on 7 December 2013. "Light" refers to the fact that the transfer pricing documentation that will need to be lodged at the latest within six months of filing the tax return is "reduced" transfer pricing documentation as it will, notably, not include the obligation to disclose comparable studies.

Source: French Constitutional Council, decision no. 2013-685 DC, 2014 Finance Bill; French Constitutional Council, decision no. 2013-679 DC, Fight Against Tax Evasion and Financial Criminality Bill.

6. Vietnam releases circular on treaty benefit application and detailed guidance on APA process

Circular on treaty benefit application

Vietnam issued Circular 205 providing rules on the applicability of tax treaty benefits and general anti-abusive provisions (GAAR) and will be effective 6 February 2014. The most salient changes are the introduction of GAAR and the assertion and expansion of the beneficial ownership provisions. Generally, a tax treaty benefit will be denied if the main purpose of a transaction or arrangement is tax abusive and/or if a treaty benefit claimant is not a true beneficial owner. The Circular also provides various examples to clarify applicability of the tax treaty benefit, such as the determination of PE; the determination of profits attributable to the PE; and capital gains tax arising from a share transfer of a Vietnamese entity whose assets are primarily consisting of immovable property.

APA Process

A new Circular has been issued, effective 5 February 2014, on the detailed APA process. The material changes in this Circular are deletion of application fee clause and reduction of General Department of Taxation's timeline for evaluation of APA application dossier from six months to three months.

7. IRS releases transfer pricing roadmap

On 14 February 2014, the Internal Revenue Service (IRS) issued the Transfer Pricing Audit Roadmap (Roadmap), which provides best practices and helpful reference materials for LB&I employees regarding the administration of transfer pricing audits. The Roadmap, organized around a basic 24-month audit timeline, breaks down a transfer pricing audit into three phases: planning, execution and resolution, under the rubric of the IRS's Quality Examination Process.

8. Canada's federal budget introduces new international tax measures

Canada's federal budget tabled on 11 February 2014 includes a number of measures targeting certain specific elements of Canada's international tax system including insurance, offshore regulated banks, back-to-back loans and immigration trusts.

9. US Ways and Means Committee Chairman reformulates international tax reform proposals

On 26 February 2014, US House Ways and Means Committee Chairman Dave Camp released a long-awaited comprehensive tax reform discussion draft (Camp Proposal or Proposal). The Tax Reform Act of 2014 would reform all areas of the Internal Revenue Code, including reducing the top corporate tax rate to 25%, reducing or restricting many corporate tax deductions and preferences, and substantially reforming the international tax provisions.

10. IRS issues Guidance on taxation of "convertible" virtual currencies such as Bitcoin

On 25 March 2014, the IRS released Notice 2014-21, which provides guidance on the taxation of transactions involving certain virtual currencies. Rather than addressing broad tax policy issues raised by virtual currencies, the Notice provides guidance on a number of practical tax issues in a "question and answer" format specifically with respect to what it calls "convertible" virtual currencies, such as bitcoin.

11. New Profits Tax Regime for Foreign Organizations Tax Resident in Russia

The Tax Code of Russia has never based the tax treatment of companies on their place of residence. A draft federal law submitted for approval by the State Duma on 18 March 2014 provides for foreign organizations which are tax resident in Russia to be equated with Russian organizations for the purposes of the profits tax chapter.
Source:http://www.minfin.ru/common/upload/library/2014/03/main/KIK_2014-03-18.docx

12. Chile modifies foreign tax credit system

On 31 January 2014, Law N° 20.727, which amends tax provisions related to the Chilean foreign tax credit system and invoice issuance, was published in the Chilean Official Gazette. These amendments shall be applied to operations performed from calendar year 2014 onwards.

13. OECD Updates

OECD provides an update on BEPS Action Plan

On 23 January 2014, the OECD hosted a webcast on the ongoing project to address BEPS: BEPS Action Plan: Update on 2014 Deliverables. A replay of the webcast can be found on the OECD website. The webcast provided an overview of the OECD's activity with respect to its July 2013 Action Plan on Base Erosion and Profit Shifting. The discussion focused in particular on those Actions with a September 2014 delivery date.

OECD releases Common Reporting Standard - A global FATCA-like regime

On 13 February 2014, the OECD, at the request of the G8 and the G20, released a model Competent Authority Agreement (CAA) and Common Reporting Standard (CRS) designed to create a global standard for the automatic exchange of financial account information.

OECD updates schedule for stakeholder input in BEPS project

On 20 February 2014, the OECD released an updated timetable for its work on the areas of the Action Plan on BEPS where outputs are expected by September 2014. The new timetable includes specific dates for publication of discussion drafts, deadlines for comment, and public consultation sessions.

OECD releases discussion draft on preventing treaty abuse under BEPS Action 6

On 14 March 2014, the OECD released a Discussion Draft in connection with Action 6 on treaty abuse under its Action Plan on BEPS. The document titled BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances contains proposed tax treaty provisions and related commentary together with proposed domestic law provisions to address treaty shopping and other potential treaty abuse.

14. Foreign Account Tax Compliance Act (FATCA) Updates

IRS and Treasury issue proposed and temporary regulations under FATCA, as well as "conforming regulations" under chapters 3 and 61

On 20 February 2014, the IRS and Treasury released proposed and temporary regulations providing further guidance under the FTACA and "conforming" the requirements in chapters 3 and 61 of the Internal Revenue Code (i.e., the Section 1441 rules applicable to withholding and reporting on payments made to nonresident aliens and the Form 1099 reporting and backup withholding requirements imposed on payments to US persons) with the requirements of FATCA, which is also known as "chapter 4". The release of these regulations is significant for virtually all US withholding agents, including financial institutions, insurance companies, and asset management companies, as well as any non-financial businesses with an accounts payable department. In many cases, US withholding agents will need to obtain new withholding documentation from previously undocumented payees to avoid unnecessary withholding tax under these new rules.

FATCA Agreements signed

5 February 2014 - Canada and the US sign intergovernmental agreement to implement FATCA.

10 January 2014 - Italy signs FATCA intergovernmental agreement with the US.

Information in Courts Speak and Tax Updates sections are intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice.

Experts Speak

Can local subsidiaries constitute PE risks in the context of outsourcing?

Shreyas Shah, Senior Tax Professional

Background:

For the purposes of taxing profits arising from overseas business, the expression of Permanent Establishment (PE) is used in tax treaties to distribute taxing rights between the resident state and the source state. Recently, High Court of Delhi has issued its decision in the case of *CIT v. E Funds IT Solution Inc. and E Funds Corporation (ITA 735&736/Del/2011)* in respect of a Subsidiary Permanent Establishment (PE). An expression 'Permanent Establishment' is based upon functional and quantitative threshold criterion laid down under the Article 5 of the OECD Model Tax Convention on Income and Capital (hereinafter referred to as 'OECD Model'). Functional criteria would include, *inter-alia*, the nature of business activities carried on through a PE, regularity in business, etc. Quantitative criterion would include, *inter-alia*, physical presence, permanency to a place of business, etc. Once the functional and quantitative criterion exceeds the specified threshold, a PE is considered to be constituted and the source state will have the taxing rights to tax the profits attributable to that PE. In respect of a Subsidiary PE, Article 5(7) of the OECD Model[10] is quite explicit that a subsidiary by itself would not constitute a PE for its holding company unless it is covered by other clauses of Article 5.

Subsidiary has a distinct and independent legal identity from its Holding company. The business of Subsidiary cannot be considered as the business of holding company unless the corporate veil of the Subsidiary is lifted/pierced[11]. For income-tax purposes, tax authorities can contend PE in accordance with Article 5 *supra* without having to pierce the corporate veil[12]. This write-up will touch upon the latter concept of the Subsidiary PE.

High Court's Decision

Facts: Taxpayers (E Funds Corporation and E Funds IT Solution Inc.) are companies incorporated under the laws of and are a tax residents of the United States (US). It had entered into contracts with their clients for providing certain IT Enabled Services (ITES). The Taxpayers have entered into international transaction with its Indian subsidiary, namely, E Funds International India Private Limited (E Funds India) and for which, E Funds India is remunerated at arm's length. E Funds India performed the following services: (a) call center service; (b) financial shared services and data entries; and (c) software development services. The activities performed by E Funds India on behalf of the taxpayers were in the nature of back office operations and data entry operations.

The tax authorities and Income Tax Appellate Tribunal (ITAT) in the case of eFunds Corporation v. ADIT (42 SOT 165) held in favor of the revenue department that taxpayers carried on business in India through E Funds India and hence, constituted a Subsidiary PE as per Article 5 of the India-US Tax Treaty (Tax Treaty). The decision of the Tribunal was mainly based on the fact that the execution of the main contract was sub-contracted to E Funds India. And based on Functions performed, Assets used and Risks assumed (FAR) analysis, E Funds India did not have the adequate capability, requisite software and database needed for providing ITES independently and did not bear any significant risk to carry out business activities in India. The requisite software was made available by taxpayers to E Funds India free of any charges. Further, it noted that the sales team of the Taxpayers undertook marketing efforts for its group companies including that of E Fund India. The aggrieved Taxpayers went in appeal before the HC. Accordingly, taxpayer's income was liable to be taxed in India in respect of operations performed through Subsidiary PE.

Issue: The issue before the High Court was whether outsourcing of services to E Funds India resulted in constitution of a Subsidiary PE by way of fixed place

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[10] The Article 5(7) of the OECD Model provides for an exclusion for a Holding-Subsidiary relationship or Joint Venture relationship from the above concept by stating that *"The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other"*.

[11] Piercing of the Corporate Veil could be in a situation where the Subsidiary is used as a mere façade for the Holding company with no or little resources for carrying on the contract. The Holding company would make available resources on hire (employees, machinery, know-how, financial capital).

[12] Dun and Bradstreet Espana S.A., In re [2005] (272 ITR 99) (AAR)

PE/agency PE/service PE of the taxpayers in India under the India-US Tax Treaty?

Decision: The High Court of Delhi held in favor of the taxpayers that Subsidiary would not in itself constitute a Subsidiary PE unless the opposite is proved by applying other clauses of Article 5 of the Tax Treaty. It made the following notable observations:

- *Fixed Place PE:* It noted that taxpayers did not have the 'right to use' or 'disposal right' with respect to the premises of E Funds India. Reliance was placed in the Supreme Court's decision in case of DIT v. Morgan Stanley & Co. Inc. (292 ITR 416).
- *Negative clause:* Non-applicability of the negative clause (preparatory and auxiliary activities) would not imply constitution of a PE.
- *Service PE:* Employees of E Funds India cannot be regarded as 'other personnel' of taxpayers. The employees of E Funds India were de facto and de jure employed by it.
- *Agency PE:* E Funds India by itself should not be considered to be dependent agent PE (DAPE) of taxpayers unless the tests specified in Article 5(4) of the tax treaty are satisfied. The conditions and requirements of Article 5(4)(a) to (c) are not satisfied.
- *Mutual Agreement Procedure:* MAP agreed upon in earlier years between the Competent Authorities of two countries is not determinative and primary basis to decide existence of a PE. The said MAP specified a formula to tax profits arising from business in US and in India. It had also stated that the same is not binding on subsequent years. The determination of existence of a PE is a matter of law and facts that should be decided on merits.
- *Others:* Following factors were irrelevant for determination of a PE such as: (a) close connection between taxpayers and E Funds India; (b) provision of services by E Funds India to taxpayers and its dependence on the taxpayers for its earnings; (c) non-bearing of sufficient risk by E Funds India; (d) remuneration for back office operations at cost plus mark up; (e) assignment/sub-contracting services to India with the intent and purpose to save costs and to increase profitability; (f) supply of intangible software free of any charges; (g) manner and mode of the payment of royalty or associated transactions; and (h) E Funds India provided necessary inputs to taxpayers to enable them to enter into contracts which were later assigned to E Funds India, to the extent the same is not regarded as negotiating contracts on behalf of taxpayers.

Conclusion: This decision is relevant for the outsourcing industry. It also discusses factors that are not relevant for determination of a PE such as a mere shareholding or business relationship between subsidiary and holding company or outsourcing of business processes or dependence of subsidiary on holding company such as financial or technological advances, etc. Further, holding company should take caution when employees are seconded to local subsidiary or when it uses premises of subsidiary or when employees of subsidiary functions under the direction of the holding company ('other personnel').

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