

Roundup on International Tax and Transfer Pricing Developments in India

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- PE Avoidance – Key Concerns under BEPS Action 7
- BEPS Key Recommendations to address ‘PE Avoidance’
- Addressing ‘PE Avoidance’ – SEP test and expansion of ‘Business Connection’
- Recent Landmark cases on PE
- Profit Attribution – Global Formulary Approach vs. Arm’s Length Principle
- India’s MLI Position – Interplay of GAAR and PPT in countering treaty abuse
- Indirect Transfers – Some unaddressed issues on Valuation Principles & Intricacies of Offshore Reorganization
- Post BEPS World of Intangibles - India perspective on Intangibles & DEMPE functions
- Secondary Adjustment & Interest Cap

- **Commissionaire arrangement**

Such arrangements not recognized in India

- **Fragmentation of business activities/ Misuse of Treaty ‘Negative list’**

Fragmentation of cohesive business activities

- **Specific Activity Exemption/ Misuse of Treaty ‘Negative list’**

core, non-core activities and what constitutes ‘Preparatory and Auxiliary’ have been debated

- **Splitting contracts**

Most common form of Contract Structuring – besides risk of PE, profit attribution and bundling of services component with supplies for unbundled contracts

BEPS Key Recommendations to address 'PE Avoidance'

MLI Position

Commissionaire arrangement

- Targeted 'substance based' approach
- 'Agents habitually playing principle role leading to conclusion of routinely concluded contracts without material modifications' results in PE exposure
- Independent agent exemption inapplicable on activities undertaken for a single group

Specific activity exemption

- To check whether 'activity' represents a key part of business 'value chain'
- 'Anti-fragmentation rules' devised to check fragmentation of business activities for obtaining treaty benefit

Splitting up of contracts

- Principal purpose test (PPT) under BEPS Action Plan 6 recommended to diagnose treaty abuse
- Alternate provision to add connected activities (exceeding 30 days) undertaken by CRE for determining whether treaty threshold is met

India Position

Commissionaire arrangement

India notified para 1 and 2 of Article 12 of MLI for checking avoidance of Agency PE through Commissionaire arrangement. Article 12 of MLI prescribes 'broader DAPE rule'

Specified activity exemption

India has chosen Option A of Article 13 of MLI on 'Avoiding Fixed Place PE'. Option A (stringent provision) prescribes availability of treaty exemption only if overall activity undertaken is 'preparatory & auxiliary' in nature.

Splitting up of contracts

No notification or reservation by India on Article 14 relating to 'Avoidance of Construction PE'.

Addressing 'PE Avoidance' – SEP Test and Expansion of Business Connection (1)

- India widens the scope of source income to include expanded Dependent Agent PE and Significant Economic Presence
- Broader Dependent Agent PE defined

include any business activity carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the 'principal role leading to conclusion of contracts' by the non-resident and the contracts are:

- *In the name of the non-resident; or*
 - *For the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or*
 - *For the provision of services by the non-resident.*
- **Key concerns and risk areas:**
 - Exclusion clause narrowed. 'Purchase of goods and merchandise' removed
 - Aligned with India's MLI position of Article 12.
 - Applicable to non treaty jurisdictions till 'entry into effect' of MLI. Modified tax treaties shall contain expanded PE definition
 - 'Principal role' not yet defined

Addressing 'PE Avoidance' – SEP Test and Expansion of Business Connection (2)

- Significant Economic Presence test introduced

- *Transaction in respect of goods, services, or property carried out in India, including download of data/ software in India, if the aggregate payments for transactions exceeds the prescribed threshold; or*
- *Systematic and continuous soliciting of business activities or engaging in interaction with the prescribed number of users in India through digital means*

- Key Concerns & Risks:

- India signals Digital PE tax after Equalization levy 2016
- Thresholds not prescribed
- Attribution Principles – Will India await OECD BEPS Interim Report?
- Impact on non-treaty tax jurisdictions

Recent Landmark cases on PE (1)

Formula One World Championship Limited*

Facts:

- FIA, a non-profit organisation and principal regulatory body for major international motorsports events, owned all commercial rights of F1 Championship
- Commercial rights were transferred to FOWC's parent company FOAM
- Under Concorde agreement, amongst FIA, FOAM and FOWC, all commercial licences transferred to FOWC (taxpayer)
- F1 race teams signed agreements with taxpayer and FIA for participating in F1 championship
- FOWC entered into a Race promotion Contract ('RPC') with Jaypee, granting the right to host, stage and promote the F1 Grand Prix of India for a consideration of USD 40 million
- A separate Artworks License Agreement ('ALA') was also entered between the taxpayer and Jaypee for use of certain marks and intellectual property owned by the taxpayer



Recent Landmark cases on PE (2)

Formula One World Championship Limited

Key Findings of Supreme Court

Disposal Test

- Buddh International Circuit ('Circuit') belonging to Jaypee was at the disposal and control of taxpayer throughout the duration of race and a fortnight prior and week thereafter
- Mere construction of track by Jaypee is of no consequence
- 3 day access to a place sufficient to constitute Fixed PE since the entire 'control' was with taxpayer, including right of entry

Permanence Test

- Permanence in fixed place is in context to business activity
- Duration of RPC agreement was 5 years, with optional extension to extend. Accordingly, permanence test satisfied
- The physical control of the Circuit was with taxpayer from the inception, i.e. right from inclusion of the event in the F1 calendar till the conclusion of the event

Business Activity

- FOWC conducted its business as the commercial rights holder of the F1 Championship.
- The Circuit bore all three characteristics of a PE, i.e. stability, productivity and dependence.
- The Circuit a fixed place of business and a virtual projection of the foreign enterprise constituted on Indian soil.

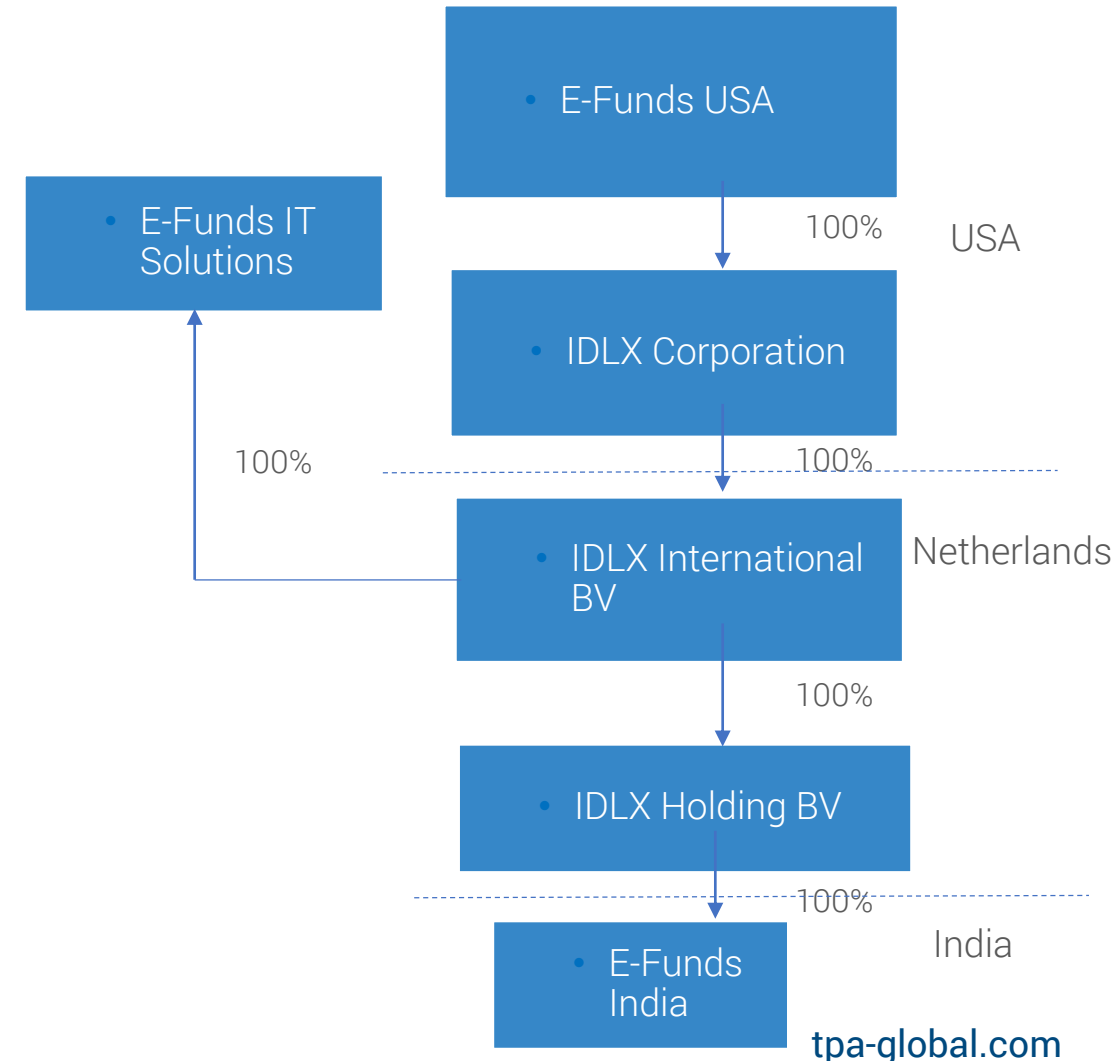
- Substance over form approach
- Short duration activities constitute PE. 6 month threshold in tax treaties not sacrosanct
- Independently operating entity may also lead to Dependent Agent PE if they work in accordance with pre-defined directions of non-residents

Recent Landmark cases on PE (3)

E-Funds IT Solution Inc.*

Facts:

- E-Funds Corporation (E-Funds USA) and its (indirect) subsidiary, E-Funds IT Solutions Group Inc. (E-Funds IT Solutions), entered into contracts with their customers outside India for providing services
- Some activities were outsourced to E-Funds International India Private Limited (E-Funds India), an indirect subsidiary of E-Funds USA in India
- Two employees of E-Funds USA were seconded to India
- Revenue held that foreign companies had Fixed Place PE, Service PE and Agency PE in India
- High Court decided in favour of taxpayer



Recent Landmark cases on PE (4)

E-Funds IT Solution Inc.

Fixed Place PE

- No premises at disposal, nor any control over use of E-Funds India's premises. 'Disposal test' not satisfied.
- 'Fundamentally erroneous' to say that merely by contracting with a 100% subsidiary, a PE would be created.
- E-Funds India rendered support services to its overseas clients on principal to principal basis abroad.

Service PE

- Nature of services of seconded employees and their reporting obligation are important deciding factors for establishing service PE.
- No customers of overseas subsidiary located in India, or receiving services in India.
- Primary condition is furnishing of services in India.
- E-Funds India undertook auxiliary operations that facilitated the provisioning of the main service. No Service PE in India.

Agency PE

- Agency PE could only be constituted if Article 5(4) of India US tax treaty met.

Profit Attribution – Global Formulary Approach v.s Arm’s Length Principle (1)

- No guidance on profit attribution in domestic tax law

- Law has restrictive meaning:

“in the case of a business of which all the operations are not carried out in India, income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India”

- Rule 10 prescribes 3 mechanisms to determine/ attribute income to business connection:

- *Percentage of turnover;*
- *Proportion to the total profits and gains of the business computed in accordance with domestic law, as the receipts so accruing or arising bear to the total receipts;*
- *Any other manner*

- Vast discretionary powers for determining profit attribution.

- Global Formulary Approach (GFA) (some similarities)

- Treats Multinational Enterprise (MNE) as one unit (unitary approach);
- Apportions income of MNE amongst its constituent entities (in different tax jurisdictions) based on a predetermined formula;
- Profit allocated based on economic indicators of AEs namely sales, payroll, assets deployed etc.

Profit Attribution – Global Formulary Approach v.s Arm’s Length Principle (2)

- **Arm’s Length Price (ALP)**
 - OECD recognized FAR analysis as Authorized OECD Approach (AOA)
 - Separate entity approach
 - Functional and comparability analysis;
 - ALP application difficult for valuing ‘intangibles’, due to:
 - complex nature;
 - Lack of availability of comparables;
 - Closely knit MNE functions with its AEs
- **OECD’s revised discussion does not contain guidance on profit attribution and transfer pricing except indicating that existing Article 7 is appropriate for determining profits**
- **India experience**
 - Mixed judicial experience – both FAR analysis* and GFA** are applied for profit determination, though application of ALP is predominant
 - Indian TP revisions apply to transactions between legal entities and not between two separate entities of same taxpayer (i.e. HO and its PE in the form of Liaison office in India)

* *Morgan Stanley & Co.; E-Funds (Supreme Court)*

** *Convergys Customer Management Group; ZTE Corporation (Delhi ITAT)*

India's MLI Position – Interplay of GAAR and PPT in countering treaty abuse

- BEPS Action Plan 6 prescribes PPT
- Treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of entering into an arrangement or transaction – ‘objective test’
- Indian GAAR uses ‘the main purpose’ whereas PPT uses ‘one of the principal purposes. Hence, PPT wider than GAAR
- Indian GAAR not applicable* where the ‘anti-abuse’ provisions (LOB or PPT) in a tax treaty sufficiently address ‘Treaty abuse’
- PPT has a carve out in terms of a ‘objective test’ where the treaty benefit is obtained in accordance with object and purpose of relevant treaty provisions, then PPT provisions do not apply. Accordingly, there is a scope of application of Indian GAAR in such situations

India's MLI position on treaty abuse:

- India has opted for PPT along with Simplified LOB (‘SLOB’)
- India's SLOB applicable only to those tax treaties where all treaty partners choose to apply SLOB
- India has not notified Article 7(4). Accordingly, no bilateral MAP benefit available for treaty abuse

**CBDT press Release dated January 27, 2017*

Indirect Transfers – Some unaddressed issues on Valuation Principles & Intricacies of Offshore Reorganizations



- Indirect transfer provisions create a deeming fiction to tax offshore transfers of share or interest deriving substantial value from assets located in India
- Substantial value is derived where the Fair Market Value of assets in India:
 - Exceeds INR 100 million; and
 - Represents at least 50 per cent of the value of all assets owned by company in India
- Liabilities not to be reduced while computing substantial value
- Holding should be 5 per cent or more
- Value of foreign assets of foreign investee company to be excluded
- Value of Indian entity to include all its assets and business operations
- Tax rate – LTCG: 10 per cent without indexation and exchange difference benefit
- STCG: 40 per cent (for foreign company)

Open issues:

- Clarity on availability of tax treaty benefit
- Withholding tax is mandatory where the transferee cannot decipher the overall asset base of transferor in a multi-tier shareholding structure*

* *Sanofi Pasteur Holding SA (2013, 354 ITR 316) (Andhra Pradesh High Court)*

Post BEPS World of Intangibles

India perspective on Intangibles & DEMPE functions (1)

- Excessive Advertisement, Marketing and Promotion ('AMP') expenses, applying Bright Line Test and a markup subjected to adjustment
- Special bench of Delhi Tribunal* decides it is an international transaction. Selling expenses not leading to brand promotion to be excluded from AMP base
- Post BEPS, 'Legal ownership' of intangibles not sole deciding factor (for returns) from intangibles. No concept of economic ownership.
- Delhi HC disallows use of 'Bright Line test'** as a method for benchmarking
- Delhi HC*** gives contradictory ruling for manufacturing taxpayers (distributors distinguished)
- Question of law - Whether AMP is an international transaction currently pending before Apex Court

Internationally, marketing intangibles were adjusted by using Bright Line Test in case of DHL Corporation (T.C. Memo. 1998-461, December 30, 1998)

** LG Electronics India Pvt. Ltd. (ITA No. 5140/ Del./ 2011)*

*** Sony Ericsson Mobile Communications Pvt. Ltd. (ITA No. 16/ 2014)*

****Maruti Suzuki India Limited vs Commissioner of Income Tax (ITA 110/2014; ITA 710/2014)*

Post BEPS World of Intangibles

India perspective on Intangibles & DEMPE functions (2)



- [Post BEPS reporting requirements for intangibles:](#)
 - Master File (Form 3CE-AA and AB) for purchase, sale, transfer of lease or use of intangible property exceeds INR 100 million.
 - Master file requirement:
 - List all MNE Group entities engaged in development and management of intangibles
 - Description of MNEs strategy (TP Policy) for development, ownership and exploitation of intangible

Secondary adjustment & Interest Cap

- Applicable where primary adjustment is made: Suo-moto, by Revenue and accepted, pursuant to APA, pursuant to Safe Harbour rules, arising out of MAP settlement
- If the adjustment amount is not repatriated, it is deemed as advance to AE and interest imputed

Questions?

Presenters:

For more information on this topic and to create a dispute resolution plan for your company, please contact:



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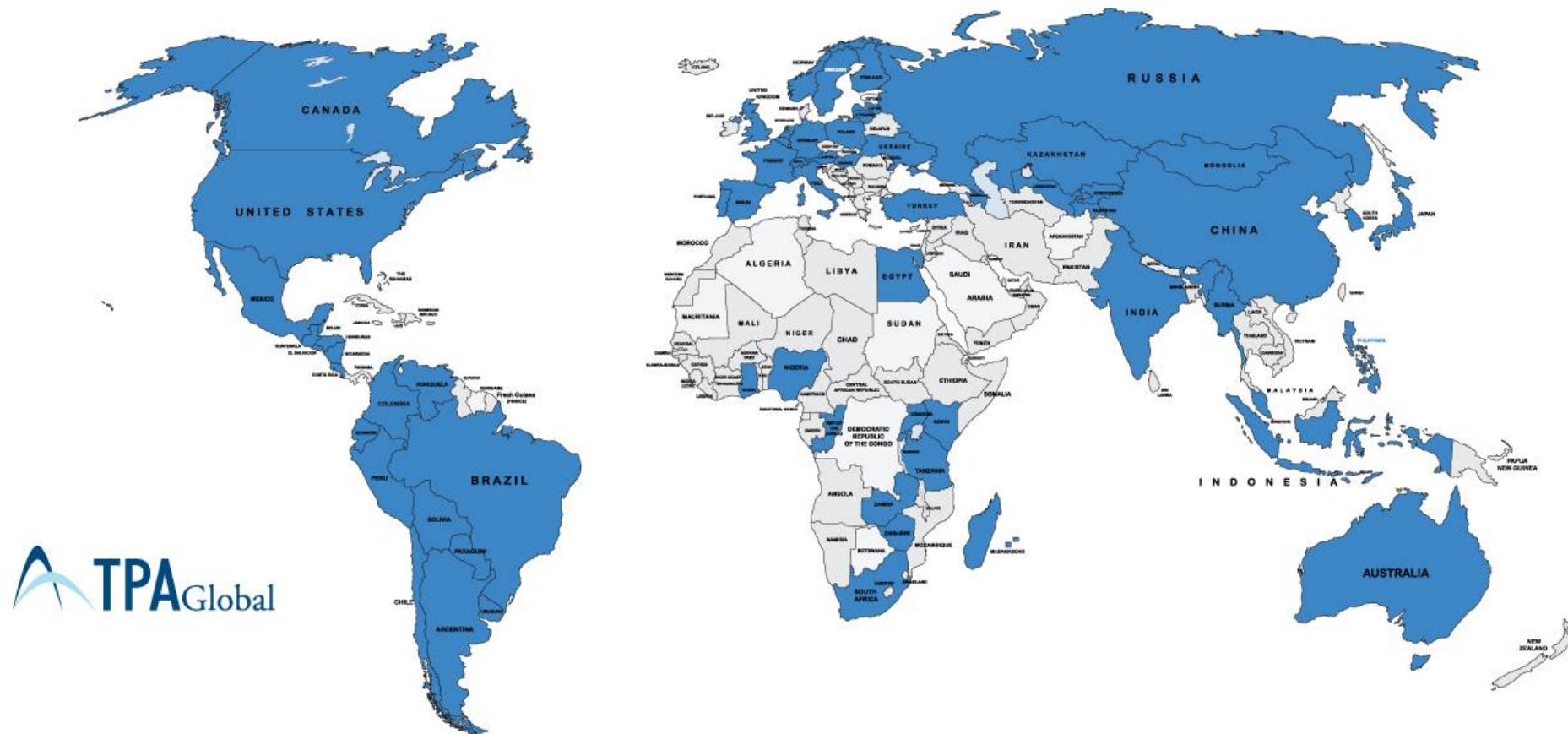


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