Chartered
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Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 2.05 – INDIA OPTION

Suggested Solutions

PART A

Question 1

Part 1

Under Indian tax law, profits of a non-resident are taxable if they accrue in India under section 5 ITA or are deemed to accrue under section 9. Since Alchemy UK is a UK resident, the UK- India Tax Treaty would apply. Under Article 7 of the Treaty, Alchemy UK's profits would be subject to Indian tax only if it were to carry on business in India though a permanent establishment in India. Consider the question of PE under fixed place PE and service PE. Consider if the exceptions to PE status apply. Consider the impact of the Morgan Stanley case as well as the E-Funds Corporation case, and the comments in these cases on subsidiaries as permanent establishments. Alchemy UK can be confident in taking the position that Alchemy India is not a fixed place of business through which the business of Alchemy UK is carried out in India. The persons performing research functions are employed by Alchemy India, not Alchemy UK.

Part 2

Since there is no profit element, there should not be any taxation. Consider the analysis in the AP Moeller case. In any case, it would be difficult to classify the payment as either royalty or technical services income under the India-UK tax treaty. Alchemy UK's business income would not be taxable in India in the absence of a PE.

Part 3

Lassnet does not have the protection of the India-UK tax treaty under which technical services have to be 'made available' which has been interpreted by the judiciary to mean that they must result in a transfer of enduring technical expertise to the customer. The relevant provision is section 9 (vii) of the Income Tax Act. There is a risk that the services provided would be considered as technical services within the ambit of section 9, pursuant to a retrospective amendment that clarifies that customer use of technical services is not relevant to the definition and that the service provider need not render technical services in India in order to come within the tax net. If payments made to Lassnet are taxable in India, then there is an obligation to withhold under section 195.

It is possible for Alchemy UK to claim that the payments made to Lassnet are not subject to Indian taxation as Lassnet's services are not used by Alchemy UK in any business in India or to generate income from an Indian source. This might be disputed by Indian revenue. There is no time limit for recovering taxes under section 195 when it comes to non-residents. Alchemy can decide not to withhold after receiving an indemnification from Lassnet.

Part 4

This is an issue about agency PE. The relevant discussion is under section 9 (1)(i) Explanation 2, as Alchemy HK is not covered by a tax treaty. Consider if SRK is an independent or a dependent agent, based on both a legal test and an economic test. It appears from the facts that SRK fails both the economic (acts exclusively or almost exclusively for Alchemy HK) and the legal test (Alchemy HK controls the activities of SRK) and therefore SRK would be considered as a PE of Alchemy HK. The agency issue would have to be revisited once again if the client profile of SRK changes over a period of time.

Part 5

The ultimate control of Alchemy India has not changed hands. The candidate must analyse the conditions mentioned in section 79 of the ITA and discuss conflicting judgments on the point in AMCO (Karnataka HC) and Yum Restaurants (Delhi HC).

Question 2

Part 1

The candidate must present an analysis of the MAT controversy, including the relevant sections of the ITA as well as the Indian companies legislation. The CBDT has clarified that retrospective application of MAT provisions will not be undertaken. Since PV UK did not have a place of business or a PE in India, it does not have to pay MAT. The custodian and the bank would be considered as independent agents.

Part 2

The capital subscription has been challenged by the revenue (see *Shell* and *Verizon*) under the transfer-pricing regime. The student must first set out the scope for transfer pricing in India, describe the relevant statutory provisions and then point out the relevant consequences in the light of the Bombay High Court judgment in the *Vodafone* case and the subsequent revenue decision not to appeal. In 2012, section 56, ITA has been amended to make taxable any amount received by the issuing company in a subscription that exceeds the fair market value of the issued shares. However this amendment only applies if the subscriber is an Indian resident.

Part 3

UK partnerships are covered by the UK India DTAA. According to Linklaters and Clifford Chance, the characterisation of the income earned by the partnerships would be business income. The candidate must discuss the taxation of business income under the UK India tax treaty. Symphony has no PE in India as the partners and associates have together spent fewer than 90 days in India. Work undertaken in London is not taxable because it is not attributable to PE (Clifford Chance). PV UK can take the position that it does not have any withholding obligations with respect to Symphony's work.

Part 4

PV UK is advised to hold the Indian entity through a Mauritius (or other favourable tax jurisdiction) subsidiary and affect the transfer through a sale of the shares of the Mauritius entity. But the transfer of the Indian shares to a Mauritius entity, the holding period and the operations of the Mauritius entity must be genuine in order to pass both judicial anti avoidance tests as well as GAAR tests that will be operational from 2017. The student must discuss these judicial tests (paying special attention to *ABA* and *Vodafone* decisions) and point out the trigger factors in GAAR.

PART B

Question 3

In the first part of the answer, the candidate must provide a detailed analysis, with examples, of the indirect transfer related amendments, comparing the tax positions before and after the amendments. The amended section 9 clarifies the ‘substantially’ requirement in section 9(1) Explanation 5. The amendment reads as follows: The share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets,-(a) exceeds the amount of ten crore rupees; and (b) represents at least fifty per cent of the value of all the assets owned by the company or entity. The candidate must point out issues that can potentially arise with respect to the valuation of assets, the rules on which are yet to be promulgated by the CBDT. The candidates can also comment on the applicability or non-applicability of the amended provisions to allied issues relating to indirect transfers such as the potential exceptions for foreign mergers and amalgamations, shares traded on the stock markets abroad, and P-Notes.

In the second part, the answer expects the candidate to provide a brief analysis of BEPS provisions and include their comments on how these provisions would modify Indian tax law, if applied. The candidate must in particular focus on how the BEPS initiative looks at permanent establishments for businesses driven by digital technology, and consider initiatives such as the equalisation levy. The candidate must consider the impact of Country by Country reporting on transfer pricing structures in India. Finally, the candidate must point out India's traditional reluctance to allow mandatory arbitration for tax disputes and query if mandatory arbitration would conflict with traditional assertions of tax sovereignty.

Question 4

Part 1

The candidates are expected to analyse whether Indian cases have gone beyond Ramsay. A good answer must discuss the implications of McDowell and how Chinnappa Reddy's statements were read down in the ABA and Vodafone judgments.

Part 2

The candidate must lay out the technical anti avoidance tests mentioned in GAAR and analyse the level of discretion allowed to the tax authorities in applying these tests. The answer must indicate the potentially vague language inherent in each of the tests (for example, 'obligations not ordinarily created', 'misuse or abuse' of legislative provisions, lacks 'commercial substance', carried out in a manner 'not ordinarily employed for bona fide purposes'). The answer must also note the restraints on revenue discretion built into the GAAR rules including stating detailed reasons for a GAAR action, reference to the Commissioner of Income Tax and the GAAR panel, and time limits on the revenue for taking action under GAAR.

Part 3

The candidate must analyse the potential problems created when domestic tax law provisions relating to GAAR purports to override double tax treaty provisions. The answer must begin with an analysis of the impact of section 90(2A) of the ITA (GAAR override of tax treaties) on tax treaties signed before the introduction of this provision. The answer must also explore problems that arise when the relevant tax already contains anti-tax avoidance provisions such as LOB (Limitation of Benefits) provisions.

PART C

Question 5

Part 1

To the extent that interest payable by NIFTY UK is attributable to its own operations in India, the interest will have an Indian source and be subject to withholding tax: Section 9(1)(v) ITA. No withholding is applicable in relation to monies on lent to NIFTY India since that business is not carried on by NIFTY UK. Finally, interest paid by NIFTY India to NIFTY UK will be subject to Indian withholding tax at 20%, or 15% if claimed under the India UK tax treaty.

Part 2

Discuss the possibility that consideration received for any subsequent transfer of the CCDs to fellow shareholders might be characterised as interest income rather than capital gains and the different tax consequences thereupon. Address the discussion on this point in the Zaheer Mauritius case. The Zaheer Mauritius decision supports the proposition that the transfer of CCDs would result in capital gains treatment, but a more careful analysis of the CCD documentation is required.

Part 3

Re FSN: vulnerable to Indian tax because of the amendments to section 9(vi) that added explanations 5 and 6 . NIFTY UK has a withholding obligation, despite being a non-resident. There is no tax treaty protection for HK residents. Re: Crossbeam: Under India-Singapore treaty, Crossbeam can take the position that it is not royalty income or technical services income and therefore no tax due to a lack of permanent establishment in India. The tax withholding issue is something to be negotiated between the two parties and NIFTY UK might consider insisting on a special indemnity clause, if it does not withhold.

Question 6

Part 1

The AAR rules have been amended to allow queries on GAAR. The AAR's rulings are specific to the transaction before it and does not bind the revenue regarding similar transactions by the same company.

Part 2

The candidate must set out the particulars of tax appeals as well as the provisions of section 226, and then discuss the conditions mentioned in case law including the Bombay High court judgment in *Vodafone* regarding the maintainability of writ petitions.

Part 3

Yes, but only for one year. After that, the assessing officer is free to begin recovery proceedings. The candidate must discuss the implications of section 254 (2A). The answer must refer to the recent decision of the Delhi HC in *Pepsi Foods Pvt.* Ltd declaring the restriction on granting stay as unconstitutional. But note the Karnataka HC decision in *Ecom Gill,* which upheld the restriction.

Question 7

Part 1

The sale of business software is the nature of business income and therefore not taxable under the India-UK tax treaty unless there is a permanent establishment. There is no permanent establishment here and online business income would not be taxed (*Right Florists*). However there is a small risk here that this would be considered as royalty income which would be taxable and therefore withholding would be required. Normally, since the copyright in the software is not being transferred, there is no risk of royalty characterisation but section 9 has been amended to include sale of software without regard to whether the customer can exploit the copyright in the software. However the more favourable provisions of the applicable DTAA should apply according to a recent Delhi High court ruling in infra soft. The finance director might want to consider an application under section 195(2), if Agrigator wants to proceed cautiously.

Part 2

The issue is whether the receipt of the subsidy is a capital receipt. Before the Finance Act 2015, the issue was decided by the purpose test laid down by the Supreme Court in *Ponni Sugars & Chemicals Ltd,* according to which the receipt of the subsidy would be a capital receipt if the purpose of the subsidy is to assist in the acquisition of a capital asset. The Finance Act 2015 characterised all subsidies as resulting in income treatment (under section 2(24)xviii) but consider the exception carved out for depreciable assets in section 43(1) read with Explanation 10.

Part 3

This depends on the characterisation of the payment. If the payment is such that it accrues or is deemed to accrue in India under section 9, ITA, Agrigator has an obligation to withhold after the retrospective amendment to section 195, even though Agrigator is a non- resident. If there is no Indian tax obligation for Quark, there is no withholding obligation on Agrigator (*GE*). There are two candidates in terms of characterisation: business income, in which case Quark will not have an Indian tax obligation per India-Mauritius DTAA as there is no PE (see for example *Hero MotoCorp*). However, since Quark does not have any trading activity (the only thing it does is hold and transfer media rights), the payment received for transferring media rights is likely to be ‘income from other sources ‘ which under the India-Mauritius DTAA can be taxed only by Mauritius. Therefore there should ordinarily be no withholding obligation for Agrigator. However, to safeguard its position, Agrigator can insist on a tax indemnity from Quark regarding non-taxability in India.

Question 8

Part 1

Sigma can rely on the *Zaheer Mauritius* decision to argue for capital gains treatment but that decision was confined to a transfer of CCDs to a joint venture partner. There is a risk that the revenue will argue for interest income characterisation. A reference to the AAR can be considered.

Part 2

Yes, the buyback would come under the purview of section 115QA which imposes a tax of 20% on the consideration paid by Sigma India on the buy-back of shares as reduced by the amount which was received by Sigma India for the issue of such shares. Since the dividend distribution tax is 15%, Sigma India would probably prefer the dividend route rather than the buyback route, absent any other tax considerations. Sigma UK will not be subject to taxation for the buy back as it is exempted under section 10(34A).

Part 3

There is no tax credit available to Victor UK for the dividend distribution tax since the tax has been paid by Victor India and not Victor UK. However, there is a possibility of receiving a tax credit for the tax paid by Victor India on its distributable profits. The candidate must discuss the underlying tax credit procedure under the India UK tax treaty.

Question 9

The candidate must point out the recent change in law relating to corporate residence and set out the main elements of the 'Place of Effective Management' test. The candidate must then discuss the ambiguities inherent in the draft guidelines issued by the revenue including the risk of Indian residence classification arising out of the following factors:

- The differences between active and passive income companies.
- The substance over form approach in the draft guidelines.
- The concept of a head office and its relation to a company’s residence.
- De facto and de jure delegation of authority by the management of a company.