ADIT

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SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Prior to April 1, 2016

The residency status of Techeve HK would be determined under section 6(3) of the ITA. Prior to assessment year 17-18 (that is, in financial year 2016-17), the residency rule under s.6(3) classified a company as being resident in India if the control and management of its affairs were *wholly situated in India* during the relevant year. Indian courts interpreted the term to mean the central control and management of the company and not the carrying on of day to day business. Courts also consistently held that even if the slightest control and management were to be exercised from outside India, such a company would not fall within the ambit of s.6(3) (Narottam & Pereira Ltd. v. CIT, AIR 1954 Bom 67; Radha Rani Holdings (P) Ltd. v. ADIT, (2007) 110 TTJ Delhi 920).

Therefore, there should be no residency risk for Techeve HK prior to April 1, 2016, since the company had one non-Indian director from March 1, 2016 - March 31, 2016.

After April 1, 2016

With effect from April 1, 2016 (that is, in assessment year 2017-2018, financial year 2016-17), the residency rule under s.6(3) was modified, whereby a non-Indian company is resident in India if its "place of effective management" is in India. The explanation to s.6(3) now states that "place of effective management means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are in substance made".

The place of effective management is determined on the basis of the following factors, based on the December 2015 draft POEM guidelines.

The first requirement is the Active Business Income Test, which is triggered if 4 separate conditions are all satisfied on an average basis across the three previous accounting years (or period since incorporation if the company is existent for less than 3 years):

- Income: Less than 50% of the company's income is from royalty, dividend, capital gains, interest, rental income or purchase or sale of goods to associated enterprises
- Assets: Less than 50% assets in India
- Employees: Less than 50% employees in India
- Payroll: Less than 50% payroll in India

In the instant case, the primary assets of Techeve HK are the Techeve India shares. There are no employees in India and no payroll in India. Further, most of the income of Techeve HK is from HKB Finance and is likely to be in the nature of royalty under s.9(1)(vi) since it involves licence of algorithm for development of an internal software by HKB Finance. Therefore, it is likely that Techeve HK would satisfy the Active Business Income Test in AY 17-18

If the Active Business Income Test is satisfied, we then need to identify the persons who make key management and commercial decisions for the business and determine the place where the decisions are being made. In this case, the following factors would create a POEM risk for Techeve and would lead to Techeve being resident in India

- The board meetings are held in the Techeve India office
- There is one director in the US and two in India. All directors attend meetings remotely

- No director has an executive role at Techeve HK. Founder 1 has a casting vote on the board
- Founder 1 and Founder 2 are physically resident in India

Part 2

If Techeve HK is considered resident in India under s.6(3) of the ITA, it would be taxable in India on its worldwide income. As there is no tax treaty with Hong Kong, there would be no treaty tie breaker, and it may also be taxable in Hong Kong on its worldwide income, unless HK domestic law allows some relief.

The risk of Indian residency could be mitigated through the following five measures:

- Breaking the Active Business Income Test through an increased emphasis on offshore markets, operational business income or hiring of employees outside India
- Holding board meetings outside India
- Not allowing Founder 1 a casting vote
- Appointing senior managerial persons in Hong Kong
- Maintaining books of account outside India

Part 3

For the period prior to April 1, 2016

The payments made by HKB Finance to Techeve HK are for the licence of a proprietary algorithm, which HKC then uses to develop its own internal software. These payments will fall within the definition of royalty under s.9(1)(vi) of the ITA. (There is no tax treaty between India and Hong Kong).

Taxability would be evaluated under 9(1)(vi)(c) applicable to payments made from one non-resident to another. Under this test, royalty payments to Techeve HK would be taxable if they are made in respect of any IP used for the purposes of a business or profession carried on by HKB Finance in India or for making or earning income from any source in India. As we are aware, HKB Finance has no Indian branches, although it does have some Hong Kong resident Indian origin customers. Further, the IP is used only to improve internal HKB Finance processes. Therefore, the royalty should not be considered to have been paid for the purposes of business or profession carried on by HKB Finance in India or for HKB Finance to earn income from a source in India.

The payment received by Techeve HK should thus not be taxable in India.

For the period after April 1, 2016

If Techeve HK is considered resident in India under the POEM rule in s.6(3) of the ITA, it would be taxable in India on its worldwide income. As there is no tax treaty with Hong Kong, there would be no treaty tie breaker, and it may also be taxable in Hong Kong on its worldwide income, unless HK domestic law allows some relief

Question 2

Part 1

Discuss the potential characterisation issues regarding trading income and capital gains. As per a recent circular issued by the CBDT, the gain is likely to be characterised as capital gains. The circular safe harbour do not apply to transfers of share that result in a change of control but this is unlikely to be the case here as IB does not own a controlling interest in any of its portfolio companies. Because of the recent amendments to the India Mauritius treaty, the gains would be taxed at half the capital gains rate until 2019 and at the full rate thereafter. IB has to show substance in Mauritius and satisfy the LOB test. The candidate must discuss the complexities that arise vis-a-vis the grandfathering rules under the Mauritius treaty when converted equity shares are sold.

Part 2

The candidate must explain the MAT issue that might arise, point out the recent controversy about MAT imposition, delineate recent amendments to the ITA on the applicability of MAT and explain why these gains will not be subject to MAT.

Part 3

The candidate must discuss the wide impact of the indirect transfer provisions and point out how, in principle, NI and SE are subject to the indirect transfer provisions on dividend payments from IB. However, a CBDT circular has exempted such payments.

Part 4

The redemptions or the sales would be taxable as capital gains under the indirect transfer provisions, and the candidate must go through the triggering factors that provide for indirect transfer taxation.

Part 5

There are no relevant tax reporting obligations (pertinent to the facts) if the shares in the Indian companies are transferred by IB. However candidates will be accorded credit for noting the extensive reporting obligations imposed under Section 285A of the ITA read with the recently introduced Rule 114DB of the Income Tax Rules, 1962 if IB's shares are transferred.

Part 6

Consider the characterisation of the income. The revenue might characterise the consideration received for the transfer of the CCDs to fellow shareholders as interest income rather than capital gains. The candidate must consider the difference in tax consequences because of the potentially different characterisations. The candidate must then 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 B

Question 3

Part 1

First, consider whether the so called export commission is actually a payment for technical services. The payment should not be considered as a payment for technical services because of the 'make available' clause in the India UK tax treaty. Consider cases such as Delhi High Court decision in EON Technology in support of the position that an export commission is in the nature of business income and absent a business connection or a permanent establishment, there should not be any Indian tax consequences. However, refer to the AAR decisions in SKF Boilers and Rajiv Malhotra which have held that commission income is taxable Indian source income. There is some uncertainty about the classification of commission income. Rajiv Malhotra classified the commission income as 'income from other sources' under the tax treaty applicable in that case, and this would mean the permanent establishment exception would not be applicable to this income and that the income is potentially subject to Indian taxation under Article 23(3) of the India-UK Treaty. Consider whether a more cautious approach would be for TH India to apply for a section 195(2) determination.

Part 2

India and HK do not have a tax treaty, so the resolution of this issue will turn on an interpretation of section section 9 (1) (Vii) explanation 2. Consider such as UPS SCS Asia Limited Vs ADIT where on similar facts, it was held that the payment were not for technical services. Whether MH India should withhold depends on its comfort level with potential aggressive interpretations from the revenue. Revenue might argue that payment is still subject to withholding under s.195. Student must discuss impact of Transmission Corporation in this context. While MH India has a good case for non-withholding, a more cautious approach would be to apply for a 195(2) determination.

Part 3

MH India licensing technology to TPMs should result in Indian corporate income taxation as it is a payment from a non-resident to an Indian resident. TPMs receiving consideration from UK customers for the sale of the bats should not have any Indian tax consequences for MH India as this is a straight sale between TPMs and UK customers to which MH India is not a party. See Qualcomm for an explanation of similar tax issues.

Part 4

Discuss the taxation of dividends received by an Indian resident from a foreign company under the India UK tax treaty. UK will not tax the dividends paid but the dividends would be taxable in India. There is no underlying tax credit in India; therefore there will be no credit for taxes paid in the UK on income earned by JH UK. Discuss capital gains taxation under the UK-India tax treaty. Under the UK treaty, Indian capital gains rules would apply.

Question 4

Part 1

As the India-Ireland tax treaty does not have a “make available” provision in Article 12, we would need to examine whether the listing services are in the nature of managerial, technical or consultancy services. In *Ebay International*, it was argued by revenue authorities that listing fees should be characterized as fees for technical services on the basis that they involve providing access to and use of the Ebay technical platform. However, Mumbai tribunal held that there was no managerial or technical involved since the process was automatized and the fees commission based. Since Soukmagic’s listing arrangements are similarly structured, involve minimal supervision or involvement of Soukmagic and simply enable users to display their wares and pay a commission if the goods are sold, the listing fees should be treated as the business income of Soukmagic.

Under section 90 of the ITA, read with Article 5 and Article 7 of the India-Ireland treaty, Soukmagic would then only be taxable to the extent of income attributable to a permanent establishment (“PE”) of Soukmagic in India.

Under Article 5, Soukmagic would have a PE in India if it a) satisfies the conditions of a basic rule PE under 5(1) or b) has an agency PE under 5(6). The India-Ireland treaty does not contain a service PE provision. Under Article 5 (5) no PE shall be considered to exist merely because of maintenance of a fixed place for information collection, delivery of goods, or any other activity of a preparatory or auxiliary nature.

Since the activities of Souk India are limited to support functions, it should not result in a PE exposure for Soukmagic under Article 5 as the services would be preparatory and auxiliary in nature. Further, if Souk India is remunerated for services at an arm’s length and pays taxes on such services in India, nothing further should be attributable even if the presence of Souk India is considered to result in a PE.

As Soukmagic has no other presence in India, it would not satisfy the requirements of Article 5 read with Article 7 of the treaty and therefore should not be taxable in India on its listing fees.

Part 2

The payment received by Soukmagic in AY 2016-17 is for sale of advertisement space, which is defined as a “specified service” under s.164(i) of Chapter VIII of the Finance Act, 2016. It would therefore be subject to equalization tax under s.165 of Chapter VIII.

Such payments would then be subject to deduction of 6% of the consideration amount when payments are made to any non-resident by a person resident in India and carrying on a business or profession. Therefore, Indian users would be required to deduct equalization tax from payments made to Soukmagic, under s.165 read with s.166. The carveouts contained in s.165(2) would not be applicable in this case.

If the tax is not deducted, the payer is responsible as an assessee in default under s.166(3) and s.171. In such a situation, Chapter VIII does not prescribe any consequences for the recipient of payments for specified services.

Further, s.10(50) exempts any income from a specified service provided on or after the date on which Chapter VIII comes into force, which is 1 April 2016. Therefore, Soukmagic’s income from sale of advertisement space should be exempt under Indian tax laws and there should be no consequences for Soukmagic if Indian users fail to deduct equalization tax from payments made.

PART C

Question 5

Part 1

The residency status of the Singapore LLP in India would be determined under section 6(2) of the ITA. Under this provision, “a firm” is said to be resident in India unless the control and management of its affairs is situated wholly outside India. Section 2(23) of the ITA defines a “firm” to include LLPs incorporated under the Indian Limited Liability Partnership Act, 2008. Foreign LLPs are not specifically covered under the definition. However, foreign LLPs may be regarded as “firms” if their features are similar to firms under the ITA.

Since the Singapore LLP’s features are similar to those associated with an Indian limited liability partnership, it should be able to be considered as a firm under s.2(23). It should therefore be evaluated under the s.6(2) residency test and considered a non-resident in India, since Alpha & Beta take all decisions based out of Ploomeria.

Part 2

The India-Singapore treaty (Singapore Treaty), applies to persons who are residents of one or both of the Contracting States, as per Article 1.

The residency status of the Singapore LLP in Singapore would depend on Article 3 read with Article 4 of the Singapore Treaty. Under Article 4, the term “resident” refers to *“any person who is a resident of a Contracting State in accordance with the taxation laws of that State”*. Further under Article 3(j), the term *"person" includes an individual, a company, a body of persons and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States*”. Since Singapore counsel have confirmed that the Singapore LLP would be tax transparent in Singapore, it is likely that the Singapore LLP would not be considered a taxable unit in Singapore. It should therefore not be considered a “person” or a “resident” for the purposes of the Singapore Treaty and would not be eligible to Singapore Treaty benefits.

Part 3

Under s.90(4) of the ITA, the person claiming benefits should be a resident of the relevant state and have a tax residency certificate. Since the Singapore LLP is unlikely to be eligible to Singapore tax treaty benefits, its treatment would be under Indian domestic law.

Dividend income in the hands of the Singapore LLP would be exempt under s.10(34), as it is likely that the Indian company would have paid dividend distribution tax on the relevant income. Long term capital gains would be taxable at the rate of 0% and short term capital gains would be subject to a 10% as securities transaction tax was paid on the transfer.

Question 6

Part 1

Candidates should use the dependent agent article in the India-UK tax treaty to determine whether the circumstances result in tax consequences for the taxpayer in India.

Part 2

Candidates should examine the residency test contained in s.6 of the ITA to determine whether the periods of stay result in tax consequences for the taxpayer in India.

Question 7

Part 1

The marketing expenses are potentially subject to scrutiny from a transfer pricing perspective. A part of the marketing expenses could be considered as AMP expenses (advertising, marketing and promotion) for the associated party (Vector UK) and the revenue might make transfer pricing adjustments based on a markup on the AMP expenses. In the LG case, the markup was 13% of the AMP expenses incurred for the associated party.

Part 2

If there is no Indian tax obligation for Glango, Vector India does not have a withholding obligation as per the GE case. If the payment to Glango is characterised as business income, Glango will not have an Indian tax obligation under the India-UK DTAA as there is no PE. However, since Glango 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-UK DTAA can be taxed only by the UK unless the payment has an Indian source. It is likely that the revenue will argue that the payment has an Indian source as the payor is Indian and the sponsorship payments relate to an event in India. An application under section 195(2) can be considered.

Part 3

Consider the Indian tax implications under the UK- India Tax Treaty. Under Article 7 of the Treaty, Victor 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.

Question 8

Part 1

Discuss the lack of thin capitalisation rules in India but consider the potential impact of GAAR and transfer pricing legislation. Candidates will also be given credit for discussing the thin capitalisation rules introduced in the recent budget.

Part 2

Discuss the impact of the MFN clause, and the indirect application, through the MFN clause, of more favourable clauses in other Indian tax treaties that exclude management services from the definition of technical services and also have a 'make available' clause. The Delhi High court in the Steria case has taken the position that the MFN clause would result in exclusion of management services from the definition of technical services. Platinum France can take the position that its income will not be taxable as FTS income.

Question 9

Candidates should consider the original broadness of the McDowell standard, which was watered down by Azadi Bachao and subsequently expanded by Vodafone, although Vodafone still emphasized form over substance.

Candidates should then compare the judicial tax avoidance test with the more expanded enquiry mandated under the GAAR and consider whether the GAAR has now introduced a substance over form test through its various indicators.