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Navigating Key Tax Issues in India

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The transition of India from an insular economy in the early nineties to a global economy is indeed remarkable. It has thus become crucial that the tax environment of the country keeps pace with the global tax regime.

Till recently, the tax environment in India was viewed as a complex system with multiplicity of taxes, burgeoning litigation and lack of certainty. This image is now set to change with recent initiatives of Indian Government promising certainty and Tax Administration issuing clarificatory circulars on complex and recurring controversies.

This booklet contains essays on key income tax issues that surround the business environment in India dealing with the concept and how to cope-up with these issues.

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1

Tax issues surrounding human capital movement

1 TAX ISSUES SURROUNDING HUMAN CAPITAL MOVEMENT

Globalisation has led Multinational Companies (MNCs) to increase cross border secondment of technical, managerial and other employees to their subsidiaries located in low cost jurisdictions such as India. The rationale behind seconding such employees is sometimes to help the subsidiaries avail the benefit of skill and expertise of the seconded employees in respective fields and sometimes to exercise control. Such secondments on one hand facilitate efficient business functioning and may, at times, trigger tax liability for overseas MNC's as well as for Indian subsidiary. The MNC's therefore, need to be aware of such areas [infra] and accordingly carefully structure such assignments. The present write-up highlights tax issues that generally crop up whenever any employee is seconded to India.

Permanent Establishment ('PE')

Transfer pricing law of the home country would generally warrant a cross charge of the salary to be received by the entity seconding its employees. Tax scrutiny triggers on payment of such cross charge by the Indian subsidiary. On various occasions, Indian courts have held a permanent establishment of a foreign enterprise to have resulted because of presence of its employees in India. Presence of PE can result in applicability of tax @40% on the income attributable to the PE, the quantification of which is again a subjective exercise.

Service PE: In the context of Indian tax treaties containing Service PE clause, the secondment of employees for assisting

the Indian group entity have been held to constitute Service PE especially where the employees have contractual right of claiming remuneration from home country entity and also maintain lien on their employment with that entity.[1] The exception is where the services rendered constitute 'technical services' (*infra*) which itself may be taxable in India as source country both under its domestic law and treaty.

Direct payment of employment compensation by Indian entity disentitles the employee from potential claim of 'short stay exemption' with respect to Indian Income tax and hence, balancing the employee personal taxation with the corporate tax exposure becomes a sensitive issue.

Fixed Place PE: Many Indian treaties do not contain Service PE clause and in such cases the PE exposure can only arise if the stay of employees is prolonged and other tests of a fixed place PE are satisfied. With respect to tests of a Fixed Place PE (viz. Disposal Test, Functionality Test and Permanence Test) due care needs to be deployed while structuring the arrangement as in some cases the courts have held Disposal test to have been met where employees of foreign enterprise have unrestricted access to premises of subsidiary[2] while in other cases the court found as a matter of fact that employees of foreign entity did not have a right of disposal but were merely permitted to be present at discretion of Indian entity[3].

Fees for technical services (FTS)

Indian domestic law provides for source based taxation on consideration for services which are in the nature of managerial, technical or consultancy. Some of the Indian treaties also replicate this provision. It is pertinent to note that FTS is taxable in India on gross basis at the rate of 25%[4] or at the rate provided in relevant Double Tax Conventions ('DTC')[5], whichever is lower. Such services are excluded from the purview of Service PE. Some treaties, however, provide for a narrow definition of FTS and in such cases the consideration may not attract tax either as PE profit or as FTS.

[1] *Centrica India Offshore Pvt. Ltd.*, - WP (C) No. 6807/2012 dated 25.04.2014; *DIT (International Taxation) v. Morgan Stanley & Co. Inc.* - Appeal (civil) 2914 of 2007 dated 9th July, 2007.
[2] *Motorola Inc. v. Dy. CIT* - [2005] 147 Taxman 181 (AAR); *Western Union Financial Services Inc. v. Asstt. DIT* - [2007] 104 ITD 34 (ITAT Delhi).
[3] *Rolls Royce Plc. v. Dy. DIT* - [2008] 19 SOT 42 (ITAT Delhi) affirmed by Delhi High Court [2011] 339 ITR 147; *Seagate Singapore International Headquarters Pvt. Ltd.* - [2010] 322 ITR 650 (AAR).
[4] Section 115A of the Income Tax Act, 1961.
[5] 0% to 25%.

Transfer Pricing Implications

The Indian Transfer Pricing Regulations are largely at par with the international practices and require every company transacting with related enterprise ('Associated Enterprises' or 'AEs') situated in a foreign jurisdiction to offer for tax so much of profits as would have been earned if it were dealing with unrelated parties. If the Indian entity bears the remuneration of seconded employees, then tax authorities need to be satisfied that nature of services performed by them is not in the nature of shareholder activities or duplicative activities. While these expressions have not been used in Indian domestic law the focal point is that payment by Indian entity should be commensurate with the benefit it has received on account of services rendered by seconded employees.

CONCLUSION

Multiple aspects need to be taken care of, ranging from personnel tax, via PE exposure for foreign enterprise to TP implications on Indian entity. MNC's, therefore have to be vigilant in structuring the transaction so that tax cost is optimised without exposing itself to controversies.

2

Engineering, Procurement and Construction (EPC) contracts in India

2. ENGINEERING, PROCUREMENT AND CONSTRUCTION (EPC) CONTRACTS IN INDIA

The economic growth that India witnessed in last two decades has attracted Multinational Enterprises ('MNEs') to increase manifold their business presence in India. Many MNEs have won projects involving Engineering, Procurement and Construction ('EPC') to be undertaken on turnkey basis. An EPC contract generally involves supply of goods and services, both offshore and onshore. Such contracts may, either be a composite contract i.e. without any breakup of consideration towards goods and services, or on the other hand provide split up of the consideration. The present write up aims at highlighting income tax issues that generally arise in relation to such projects.

India follows a blend of residence based and source based taxation. The treaty framework restricts taxability of MNEs with respect to profits from their unincorporated Indian ventures only to those cases where a Permanent Establishment is created in India or where the income is in the nature of 'fees for technical services'.

Existence of permanent establishment ('PE')

Presence of PE can attract tax on the income attributable to the PE at the rate of 40% as against regular corporate tax rate of 30%.

Generally the MNEs maintain *project office* in India in order to efficiently execute the EPC contract. Indian courts have in some cases held a permanent establishment of a foreign enterprise to have resulted because of the project office in India observing that the activities of installation, etc., were routed through such office.[6]

Generally time threshold of 6 months is required to invoke Installation/Supervisory PE and time threshold for each project is taken individually. Unless properly structured, the tax authorities may find that multiple projects are interconnected and apply an aggregate approach for determining whether PE threshold is met.

Many Indian treaties have specific clauses for *installation and supervisory* PE. Depending on the treaty language and facts of a particular case, mere performance of supervision without undertaking installation, construction, etc., can in some cases create a PE.

Some of the Indian treaties recognize furnishing of services (beyond a specific threshold) also as a PE creating activity. The tax authorities tend to invoke Service PE clause where they are not able to justify existence of Installation/Supervisory PE. They allege that the visit of technical personnel for rendering onshore services in respect of the EPC contract gives rise to Service PE. The exception is where the services rendered constitute 'technical services' (*infra*) which itself may be taxable in India as source country both under its domestic law and treaty.

[6] *Samsung Heavy Industries Co. Ltd. v. ADIT* - ITA No. 5237/Del/2010 (ITAT Delhi).

Commencement of PE

The point of time at which the PE is said to have been set-up is also an aspect that requires due attention. In certain cases, attempt has been made by the tax authorities to justify that PE comes into existence from the time when first activity was undertaken by the foreign enterprise even though at that point of time the activity may only have been preparatory or auxiliary in nature. Maintenance of robust documentation corroborating the real nature of activities is extremely essential to mitigate such exposure.

Offshore supply

Supplies made offshore, conceptually should not give rise to tax implication in India.[7] The contracts at times indicate that the supply is complete and title over goods pass only after satisfaction of certain conditions in India. In such cases, tax authorities have at times endeavoured to tax the offshore supply. This happens especially when there is a composite price[8] for the contract. In exceptional cases tax authorities have observed that consideration towards non-taxable offshore supplies is inflated so as to reduce the tax impact on taxable onshore activities[9]. A justification of price break-up (on the lines of a transfer pricing study) is imperative in such cases.

Offshore services such as design, drawings, documentation etc. constitute inextricable part of offshore supply and usually entitled for similar treatment. A detailed examination of the facts and documents in some cases has revealed that what is ostensibly a payment for assignment of design is in law a payment in the nature of fees for technical services and taxable under source rule.

[7] *Ishikawajima-harima Heavy Industries Ltd.* reported at [2007] 288 ITR 408 (Supreme Court); *CIT v. Hyundai Heavy Industries Co. Limited* - [2007] 291 ITR 482 (Supreme Court); *DIT v. LG Cable Ltd.* - 237 CTR 438 (Delhi High Court); *DIT v. Nokia Networks Oy* - [2012] 253 CTR 417 (Delhi High Court); *Joint Stock Company Foreign Economic Association 'Technopromexport'*, In re, 322 ITR 40 (Authority for Advance Rulings); *Hyosung Corporation*, In re, 314 ITR 343 (Authority for Advance Rulings); *DCIT v. Roxon Oy.* - 291 ITR (T) 275 (ITAT Mumbai); *Toshiba Plant Systems & Services Corp., Japan*, In re, 332 ITR 456 (Authority for Advance Rulings).

[8] *Linde AG*, In re, [2012] 349 ITR 172 (Authority for Advance Rulings); *Alstom Transport SA* - [2012] 349 ITR 292 (Authority for Advance Rulings); *Roxar Maximum Reservoir Performance WLL*, In re, [2012] 349 ITR 189 (Authority for Advance Rulings).

[9] *Ansaldo Energia SPA.*

Offshore services – Fees for technical services (FTS)?

Indian domestic law provides for source based taxation on consideration for services which are in the nature of managerial, technical or consultancy. Some of the Indian treaties also contain similar provision. It is pertinent to note that FTS is taxable in India on gross basis at the rate of 25%[10] or at the rate provided in relevant Double Tax Conventions ('DTC')[11], whichever is lower. Such services are usually excluded from the purview of Service PE but can be taxed as PE profits if the contract generating FTS is effectively connected with the PE. Some treaties, however, provide for a narrow definition of FTS and in such cases the consideration may not attract tax either as PE profit or as FTS.

CONCLUSION

As EPC projects involve huge amount of investment, MNEs need to be cautious in respect of the tax exposure and take necessary safeguards to optimize the tax cost.Careful drafting of the contracts, meticulous planning and diligent conformity of the conduct with the contract are key factors for keeping taxmen at bay.

[10] Section 115A of the Income Tax Act, 1961.
[11] 0% to 25%.

3

Doing business in India through Liaison Office

3. DOING BUSINESS IN INDIA THROUGH LIAISON OFFICE

The way Indian economy withstood global economic slowdown has made India a very alluring destination for foreign investments. For testing Indian waters, many Multinational Companies ('MNCs' or 'HO' or 'Non-resident') prefer opening a Liaison Office ('LO') in India. LO can be set up in India only after obtaining permission from Indian central bank i.e., Reserve Bank of India ('RBI'). LO can carry out only restricted activities viz.,

- Representing parent company/group companies in India;
- Promoting export/import from/to India;
- Promoting technical/financial collaborations between parent company/group companies and companies in India
- Acting as a channel of communication between the MNC and the potential customers in India

In a nutshell, LO is not permitted to undertake any business activity in India and thus, cannot earn any income in India. Further, expenses of LO are to be met fully through permitted channels from HO outside India.

MNCs are liable to Income tax in India as per Income Tax Act, 1961 ('the Act') if interalia there exists a business connection with India. The Double Taxation Avoidance Agreements ('DTAA') with other Countries however supersede the Act and the Act applies only to the extent it is more beneficial to the Non-resident. As per the DTAA, business profits of a Non-resident can be taxed in India only if the Non-resident carries on its business in India through a permanent establishment (PE).

In recent past, Indian Revenue Authorities have found that some MNCs carried on commercial operations in India under the guise of an LO and sought tax on it as if it was a PE. There has been extensive litigation surrounding the issue as to when does an LO cross the boundaries and become a PE.

The present write-up is an outcome of an extensive analysis of judicial precedents on the subject and seeks to summarise key points emerging there-from.

Functions of LO that were viewed as taxable presence in India

- Identifying new customers, pursuits and follow-ups with customers, price negotiation and finalization, securing orders, payments for material and post-sale support[12];
- Conducting substantial activities such as designing of apparel with material to the taste of the customers and after adequate research, supervision of the manufacturing process etc.[13];
- Payment of salaries and managing pay rolls of corporate audit staff[14];
- Vendor development, developing garment designs jointly with the vendors and overseas clients, sample preparation/approval, price negotiation, order tracking, production/process control, supply chain management etc.[15];
- Procuring purchase orders, identifying the buyers, negotiating with the buyers, agreeing to the price and thereafter requesting them to place a purchase order[16];

[12] [2012] 206 Taxman 7 (Karnataka High Court).
[13] *Columbia Sportswear Co.* - [2011] 337 ITR 407 (Authority for Advance Rulings (AAR)).
[14] *General Electric International Operations Co. Inc.* - [2014] 44 taxmann.com 436 (ITAT Delhi).
[15] *Linmark International (Hong Kong) Ltd.* - [2011] 57 DTR 340 (ITAT Delhi).
[16] *Jebon Corporation India* - 2011-TII-15-HC-KAR-INTL

Functions viewed as not creating a taxable presence

- Holding seminars, directing trade enquiries received to HO, advertising the technology used by the group[17];
- Communicating the decision of the HO to the customers in India[18];
- Activity of downloading information from servers, printing and forwarding to beneficiaries in India[19];
- Enabling Indian manufactures to manufacture goods of particular specification as required by HO[20];
- Providing training, conducting refresher course for agents about standards of service and security, accounting procedures, telecommunication systems and configurations, merchandising standards etc.[21];

Filing of annual statement by MNC for their LO

In addition to the requirement of ascertaining the taxable presence, the Act requires MNCs to comply with reporting requirement for an LO in India. MNCs are required to file an annual statement with the jurisdictional income-tax officer within 60 days from the end of the financial year containing information about regulatory approval for setting up the LO, its address, tax registration of HO, details of salary to staff in LO, etc. There have been many cases of failure to make due compliance regarding taxability of employees of LO including non-compliance of tax withholding provisions in that regard. It is therefore imperative to take stock of affairs and compliance with respect to LO. The said annual statement is to be filed in electronic form along with digital signature.

[17] *K. T. Corpn.* - [2009] 181 Taxman 94 (AAR).
[18] *Mitsui & Co. Ltd.* - [1991] 39 ITD 59 (ITAT Delhi-Special Bench).
[19] *UAE Exchange Centre Ltd.* - [2009] 313 ITR 94 (Delhi High Court).
[20] *Nike Inc.* - [2013] 217 Taxman 1 (Karnataka High Court).
[21] *Western Union Financial Services Inc.* - [2007] 104 ITD 34 (ITAT Delhi).

CONCLUSION

Ensuring proper tax and regulatory compliance in relation to the LO is extremely important and requires meticulous planning with careful execution. The extent to which an LO is duly compliant is to be carefully analyzed in light of the activities carried out by each LOs and judicial interpretations. MNC's, therefore have to be vigilant in structuring the format of LO so that it is not exposed to tax liability or penalties by the regulator.

4

Transfer Pricing and location savings - An Indian perspective

4. TRANSFER PRICING AND LOCATION SAVINGS – AN INDIAN PERSPECTIVE

Relocation of business from one country to another, where the labor and other costs are comparatively cheaper, results in cost saving to the Multi National Enterprise ('MNE') groups. The net cost so saved is Location Savings ('LS') as explained by the Organization for Economic Co-operation and Development ('OECD')[22].The United Nations further expands the scope of LS to include certain advantages specific to a state, like huge customer base, advantage of infrastructure, etc, and terms LS as Location Specific Advantages ('LSA')[23].

LSAs have encouraged MNEs operating in high cost jurisdictions like USA and Europe to divert their capital to countries like India and China. While a portion of the cost saved by the MNE group is retained in the low cost state, significant sums are usually pulled back by the holding companies. Indian tax authorities have recently taken recourse to local Transfer Pricing Regulations to tax such extracted profits.

[22] OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, July 2013July 2010
[23] Para 5.3.2.41 of United Nation Practical Manual on Transfer Pricing for Developing Countries, 2013

Transfer Pricing on LSA – International practice

The OECD and UN have acknowledged LSA as a premium enjoyed by low cost jurisdictions. OECD is of the view that where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required[24]. The UN, though vouching the practice, has added that, the first entrant in the low cost jurisdiction should be entitled to a premium[25]. The UN refers to the premium as 'Arm's Length Surplus'.

USA's regulations and Courts[26] seem to have acknowledged the view of UN that location saving if any, would exist only till comparable service providers emerge in the low cost market. Enough guidelines are however not available on how to treat the LSA that accrued to a first entrant. Recent amendment to the German Foreign Tax Act has created a rebuttable presumption that location saving must be allocated between the parent and the subsidiary[27]. The Finnish Administrative Court[28] has also acknowledged adjustment for LSA if the very same functions earlier performed in Finland were moved to a low cost jurisdiction. China, which also provides significant cost saving to manufacturing groups, more specifically automobiles, has put in place a specific rule to measure and allocate location saving.[29]

Location Saving and India

India extends a variety of cost saving to MNEs operating in developed countries. Such LSAs include human resource at discounted costs, huge customer base, easy physical access to whole of Asia, etc.

India does not have a specific regulation to identify or allocate LSA. In the Country Practice chapter of UN Practical Manual, the possibility of application of Profit Split Method (PSM) has been

[24] Para 9.149 of OECD Transfer Pricing Guidelines for Multi National Enterprises and Tax Administrations, July 2010, further elaborated in Para D.6.1 on Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, July 2013.
[25] Para 5.3.2.44 of United Nation Practical Manual on Transfer Pricing for Developing Countries, 2013.
[26] *Baush and Lomb Inc v Commissioner*
[27] Transfer Pricing and Arm's Length Principle in International Tax Law, Kluwer Law International BV, 2010.
[28] KHO 2013:36
[29] Paras 10.3.3.4 – 10.3.3.10 of United Nations Practical Manual on Transfer Pricing for Developing Countries, 2013.

explored, as a means to allocate the location benefits derived by MNEs[30]. In the context of Indian Research &Development Centers of MNEs, the Central Board of Direct Taxes (CBDT) expressed a view that an upward adjustment shall be made to the Transfer Price for LSA[31]. This Circular was however later withdrawn[32] due to significant protest from stakeholders.

Even in the absence of specific regulations and the Government still 'exploring' an appropriate method, the Revenue Authorities ('RA') during audit have been making upward adjustment for LSA derived by MNEs. Courts in India have so far been adopting a liberal approach towards it. The Income Tax Tribunal in the case of *GAP International*[33] observed that LSA would generally be passed on to end customer, and even if it is not, ALP determined based on appropriate comparables will ensure that LSA is adequately compensated. The Delhi High Court in *Li and Fung India*[34] rejected the claim for adjustment for LSA in the absence of specific finding on the existence and quantum of LSA.

What should be India's revenue policy?

India has been showcasing its LSA to attract[35] foreign investment into India. Eyeing investment by MNEs, India has also extended investment linked tax benefits to new investments in identified zones[36] and in specified sectors[37], carefully balancing its limitations on account of commitment under General Agreement on Trade and Tariff. As a result of these measures, India is now amongst the top five investment destinations. Having invited MNEs to invest in India by showcasing the LSAs it can offer, it would not be appropriate for India to impose a tax on the LSA itself.

Secondly, LSA being enjoyed by India is no more unique. There is significant competition within India, and as a result, there will usually be enough comparables for ALP determination. In this scenario, even as per the recommendations of UN, no adjustment on account of LSA is desirable.

[30] Para 10.4.7.3 United Nations Practical Manual on Transfer Pricing for Developing Countries, 2013.
[31] Circular 2 of 2013 dated 26.03.2013
[32] Circular 5 of 2013 dated 29.06.2013
[33] *GAP International Sourcing (India) (P.) Ltd. v ACIT* - [2012] 149 TTJ 437 (Delhi).
[34] *Li and Fung India (P.) Ltd. v CIT* - [2014] 361 ITR 85 (Delhi).
[35] http://www.investindia.gov.in/InvestIndia_Brochure_web.pdf
[36] Income Tax, Customs and Excise exemption provided for new undertakings established in Free Trade Zones, Special Economic Zones etc.
[37] Income Tax, Customs and Excise exemption provided for investment in developing infrastructure, generation of power, providing telecommunication services etc.

5

Marketing Intangibles in India

5. MARKETING INTANGIBLES IN INDIA

Assets like Trade Marks, Trade Names, Brand Names, Logos etc., individually indentified as Intangible Assets, when promoted in a systematic manner to create a value in an identifiable geographical area, are collectively referred to as 'Marketing Intangibles'. This phrase has got special attention in the field of Indian transfer pricing in the recent past. Transfer pricing authorities have started enquiring into the amount of expenses incurred by an Indian subsidiary of an MNC on account of Advertisement, Marketing and Promotion (AMP) of a brand vis-a-vis the benefit derived there-from by the Indian subsidiary and other Associated Enterprises (AEs) situated abroad.

The perception that the Indian subsidiaries use the brand-name of the parent company for exploitation of the local market, over a period of time, has shifted to the Indian subsidiary being used as a vehicle to promote the foreign brand itself in India.

Beginning 2008, the Indian Revenue Authorities started focusing on such arrangements. Maruti Udyog Limited ('Maruti') was to be the first reported case. Maruti, established in 1983, grew to be the biggest carmaker in India. Maruti entered into a technology usage agreement with Suzuki Motor Corporation, Japan ('Suzuki') that also provided for the use of the latter's brand in India that was hitherto unknown in India. The Revenue Authorities argued that Maruti promoted the foreign brand "Suzuki" by including the logo of Suzuki in Maruti's products and advertisements. Promotion of an unknown brand in India was an international transaction by itself requiring an arm's length compensation, accordingly to the Revenue Authorities.

On a reference to the Delhi High Court[38] against the order of the Revenue Authority, the High Court made the following observation:

> "If the domestic entity which is an Associate Enterprise of the foreign entity within the meaning of Section 92A of the Income Tax Act is mandatorily required to use the foreign trademark and/or logo on its products and/or their containers, packaging, etc., appropriate payment in this regard should be made by the foreign entity to the domestic entity, on account of the benefit it derives in the form of marketing intangibles, obtained by it from such mandatory use of its trademark and/or logo."

The Delhi High Court thus laid emphasis on the fact that an obligation has been cast on the Indian entity to use the brand to establish that a benefit has accrued to the foreign entity. The issue was then remanded for quantification of the Arm's Length Price ('ALP') for the transaction.

In a later decision, the Special Bench of the Delhi Tribunal in *LG Electronics India (P) Ltd. v. ACIT*[39] held that the activity of using the brand owned by an MNC in advertisements in India would *per se* be an international transaction.

Quantification of compensation

The High Court in *Maruti Suzuki* (supra) observed that the ALP for such transactions would be the excess of expenditure incurred by an AE over and above the expenses incurred by an independent entity under similar circumstances, generally referred to as Bright Line Test ("BLT"). On an appeal, the Hon'ble Supreme Court[40] directed the Revenue Authority not to be influenced by the directions of the High Court and to proceed with the examination.

The Tribunal in *LG Electronics* (supra) has given much broader guideline for estimating the quantum of AMP expenses that would be regarded as being required for the business carried out in India.

[38] [2010] 328 ITR 210 (Del).
[39] [2013] 140 ITD 41 (Del).
[40] *Maruti Suzuki India Ltd. v. ACIT* - [2011] 335 ITR 121 (SC)

The guidelines cover the examination of the following:

a. Whether the goods sold by the Indian entity contain the brand of AE alone or a joint logo of the AE and the Indian entity?

b. Whether the foreign brand is an established brand in India or a new entrant?

c. Whether the Indian entity is paying any royalty to the AE and if yes, is it at ALP?

d. Whether the Indian entity is a manufacturer or distributer?

e. Whether the AE is compensating the Indian entity for brand promotion in any form, like subsidy on the goods sold?

f. If such subsidy is granted, is it commensurate with the expenses incurred for brand promotion?

g. Whether any new product has been launched during the subject period or is it a continuation of business of same products?

h. How would the brand be dealt with after termination of agreement with AE?

Scope of Marketing Expenses

A company incurs various selling and marketing expenses over and above what may be regarded as brand development expenses. Any Transfer Pricing adjustment on account of AMP expenses should ideally be restricted only to advertisement and branding expenses and not to extend to expenses that do not promote the brand of the foreign entity. In *GlaxoSmithkline*[41], *Canon India*[42] and many other rulings, it has been held that expenses on account of Selling Commission, Cash Discount, Volume Rebate, Trade Discount etc., shall not be considered for TP adjustment.

[41] *GlaxoSmithkline Consumer Healthcare Ltd.* - 2013-TII-71-ITAT-CHD-TP
[42] *Canon India Ltd v. DCIT* - 2013-TII-96-ITAT-DEL-TP

However, in order to avail the full benefit of the above cited rulings and to avoid litigation, Indian entities should follow standardized accounting practices for sales related expenses and also maintain adequate documentation distinguishing expenses that promote the brand of the foreign entities and other promotion expenses.

Other possible means to deal with the issue

Indian Tax Authorities and Courts have so far stuck to method of benchmarking AMP expenses of Indian taxpayer with comparable companies for determination of ALP. However, there can be other plausible variations as followed by Revenue Authorities of other jurisdictions. A few such variants are discussed below.

First, long-term exclusive agreement to exploit the Trade Mark in India can be imputed. This would give the subsidiary a right to use the Trade Mark for a period over and above the term specified in the license agreement.

Second, in cases where the promotion activities are significantly high and where the value of the brand is significantly derived from India, the Revenue Authority can treat the brand to be located in India and bring to tax a part of the licence fee received abroad.

Third, one can examine the AMP expenses for a block of five years to determine whether the expenses are excessive.
The BLT approach adopted so far in India is getting slowly refined. The Revenue Authorities are likely to revisit their stance in this regard. The apex tax administration body, Central Board of Direct Taxes (CBDT), has recently become very active regarding issuing clarifications on major tax disputes. CBDT is also likely to step forward and issue guidelines for the clarity of the stakeholders.

CONCLUSION

Mere comparison of marketing expenses of an Indian entity with another is too crude a method of determining ALP of AMP expenses. Using such a method in arriving at the tax liability of the taxpayer is unlikely to be accepted by the higher judicial forums. The jurisprudence in this regard is still evolving in India. Indian courts are expected to add new dimensions to the whole issue in the years to come. It is, therefore, imperative to take a cautious approach and take informed decisions after taking into account the current practices in their entirety.

6

Shareholder's activity – India's stand

6. SHAREHOLDER'S ACTIVITY – INDIA'S STAND

Subsidiaries of Multi National Enterprises ('MNEs') generally avail the services of their group companies for routine business operation and management. When such intra group services are paid for, questions often arise as to whether the services received are essential for business operations of the subsidiary, or are the services carried out by the MNE group with a view to secure their investment in the subsidiary, the latter being generally referred to as 'share holder activity'. Income tax regulations of many jurisdictions provide for tax deduction only for the first class of services received.

OECD's approach

The 1979 Organization for Economic Co-operation and Development ('OECD') report suggested a 'justification of benefit test' to identify shareholder activities. However, in 1995, the OECD revisited the position and observed that intra-group service will be regarded as rendered when *'the activity provides a respective group member with economic or commercial value to enhance its commercial position'*[43]. The 1995 Guidelines modified the definition of 'shareholder activity'[44] as the activities *'that a group member performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder'*. There was, thus, a noticeable deviation in the 1995 model from the 1979 model.

[43] Para 7.6 of 1995 Guidelines
[44] Para 7.9 of 1995 Guidelines

The US approach

In 1977, the United States Regulations[45] clarified that the expenses incurred on overseeing the activities of a subsidiary shall be regarded as 'stewardship activities' and shall be attributable to dividend received. US Courts have interpreted these regulations to mean the activities that related to securing investments in foreign subsidiaries. In Columbian Rope Co's case[46], the Tax Court held that rendition of services to a 'fully staffed' subsidiary would be regarded as shareholder's services and not a service for the purpose of the subsidiary.

On the other hand, provision of services essential for the 'day to day' operations of the subsidiary have been held to not to be in the nature of shareholder's activities in *Eli Lilly and Co*[47]. In relation to services that benefit both the parent and the subsidiary, the Technical Advice Memorandum[48] issued by Internal Revenue Service of the USA provides that an examination has to be done as to which of the entities have derived *'direct and proximate benefit'* from the service[49]. The services would be regarded to have benefited the entity which has obtained direct benefit than the entity that has derived an indirect benefit[50].

Thus, over the years, the Courts in USA adopted a broad standard for identification of share holder activities. However, in 2009, a narrower concept of 'shareholder activity' was introduced in the regulations[51], which its meaning to those activities which have '*the sole effect of protecting the capital investment of the service provider or to facilitate compliance with reporting or legal or regulatory requirements for the MNC group*[52]'. Thus, both OECD and the US moved to the 'sole beneficiary' test for determination of shareholder activity.

[45] § 861 regulations.
[46] *Columbian Rope Company v Commissioner* – [1964] 42 TC 800.
[47] *Eli Lilly and Co v Commissioner* – [1985] 84 TC 996
[48] TAM 8806002
[49] Similar observation can be found in the Circular issued by Italian Tax Authorities.
[50] Similar observations are made by the New Zeeland Revenue Authorities also.
[51] § 1.482-9(l)
[52] § 1.482-9(l)

European Union's Approach

In Europe, Tax deduction of expenses is governed only by the general law on deductibility and the Transfer Pricing regulations cover the determination of quantum of expense to be allowed[53]. However, Revenue Authorities of a few States have issued internal guidelines on deductibility of share holder costs. German Revenue Authorities seem to suggest that no charge may be made for the administration, management, control, advisory or similar functions insofar as they arise from shareholding relationships or from other connections establishing a relationship of the parties. The Austrian Administrative Court[54] held that 'group charges and allocation fee' paid to the holding company, without any verifiable evidence would be considered as distribution of hidden profits and not as allowable business expense. The Spanish High Administrative Court[55] held that costs incurred to adopt the requirement of parent were in relation to shareholder activities. The Dutch Ministry of Finance has clarified that if the group company is not able to independently, without a guarantee from an AE, raise a loan, the guarantee will be provided in a shareholder's capacity.

India's approach

India does not have specific guidelines for identification or treatment of consideration paid for shareholder activity. A specific observation has however been made by India in the UN Practical Manual on Transfer Pricing for Developing Countries that share holder services will not be regarded as services at all[56]. India has, however, agreed that identification of shareholder services would need a great deal of analysis.

The issue of categorizing certain services as shareholder services has been raised by the taxpayer[57] as well as by the Revenue Authorities[58] before juridical forums in India. However, the judgments did not give a conclusive ruling. Contrary views exist on the question of whether issuance of corporate guarantee to a subsidiary is a transaction entitled to a separate consideration[59].

[53] Para 3.1.1 of Final Report on Shareholder Costs of the EU Joint Transfer Pricing Forum.
[54] VwGH 14.12.2000, 95/15/0129
[55] Resolución del Tribunal Económico-Administrativo Central of 25 July 2007.
[56] Para 10.4.9.4
[57] Ground No. 13 in *Bharti Airtel Ltd v ACIT* - [2014] 161 TTJ 428 (Del); Para 21 in *Four Soft (P.) Ltd v. DCIT* - [2014] 44 taxmann.com 479 (Hyderabad - Trib.)
[58] Para 11 in *Invensys Systems Inc.*, In re [2009] 317 ITR 438 (AAR); Para 3.2 in *DCIT v Lear Automotive India (P.) Ltd* - [2014] 41 taxmann.com 307 (Delhi - Trib).

To sum up, the activities performed by the parent company, which a subsidiary would not have hired an unrelated company to perform, would be regarded as shareholder services[60]. The responsibility of establishing that the services paid for is not shareholder service is on the Taxpayer. In the absence of proper documentation, the Revenue Authorities have been considering Arm's Length Price of any payment to be 'nil', though the Courts have held against such determination[61].

To defend a claim for deductibility of intra-group services, the taxpayer as well as the service provider should maintain adequate documentation. The documentation could illustratively be:

a. Detailed description of the service ideally captured in an agreement
b. Resolution from the subsidiary for the need of such services
c. Proposal and quote from the services provider for the services
d. Details of persons who would render/have rendered such services, their qualification, their roles and responsibility in the share holder entity
e. Document capturing the fact of rendition of the service, e.g. minutes of teleconference/videoconference, copies of presentations received, e-mails, details of visits etc.
f. Control exercised by the taxpayer on the service provider which renders such services
g. Satisfaction report from the subsidiary after completion of the rendition of services.

This issue, though is in nascent stage in India, has been prevalent in other jurisdiction since 1960s. It would only be appropriate for the Central Board of Direct Taxes to consider the precedence and issue a Circular to guide the taxpayers, Revenue Authorities and Appellate Authorities. Sans such circular, taxpayers should formulate transparent policies for rendition of services and maintain documentation on the basis of the practices of other jurisdictions.

[59] *Everest Kanto Cylinder Ltd. v DCIT* – ITA No 542/Mum/2012 holding that Corporate Guarantee to a subsidiary would entail a consideration and *Bharati Airtel Ltd v ACIT* – ITA No 5816/Del/2012 holding otherwise.
[60] *Merck and Co v United States* – [1991] 24 Cl Ct 73.
[61] *CIT v. EKL Appliances Ltd.* – [2012] 345 ITR 241 (Del)

7

Transfer Pricing and Contract Research Centres in India

7. TRANSFER PRICING AND CONTRACT RESEARCH CENTRES IN INDIA

Globalization coupled with high skill at low cost feature of India has prompted many Multinational Enterprises ('MNEs') to outsource their business segments to India. With the passage of time, dimensions of outsourcing have extended to niche areas like Research and Development ('R&D') as well. MNEs in developed countries that are shifting their R&D functions to India, wholly or partially, need to be cautious about their taxation, especially Transfer Pricing (TP).

Conceptual background from a Permanent Establishment perspective

Indian Supreme Court in 1953[62] had held that a systematic and habitual activity having special skill and competency in executing the task assigned is sufficient to create a taxing nexus, referred to as 'business connection'. The term 'business connection', though much broader than the definition of a PE, falls on the same concept of a nexus between the business of the foreign enterprise and activities carried out within a taxing jurisdiction.

OECD commentary on Model Tax Convention has maintained a position, since 1963, that research activities are preliminary and auxiliary to the actual realisation of profits by an enterprise and that no profit can be attributed to such research activity. Similar is the position of maintaining a place for mere purchase function.

Skaar[63] also supports OECD view *de lege lata* however comments that the same is not persuasive *de lege ferenda*.

[62] *Anglo French Textile Co. Ltd. V. CIT* - 23 ITR 101 (SC) (4 Judge Bench).
[63] Arvid Skaar, *Permanent Establishment, Erosion of Tax Treaty Principle*

It appears that in harmony with the view of Supreme Court, Indian tax administration has given its observations on OECD commentary that it does not agree with the interpretation given [regarding research activities and] it would not include scientific research in the list of examples of activities indicative of preparatory or auxiliary nature.

Transfusion of the concept into Transfer Pricing (TP) regulations

In the Practical Manual on TP for developing countries released by United Nations, a separate chapter is devoted to country specific practices. Indian tax administration expressed therein that R&D efforts in India require a proper compensation, which could be by way of imputing royalties for use of know-how developed in India. The practice of MNEs providing a low cost plus mark up on the ground that they control all the risk and their Associate Enterprise (AE) operating in India are risk free or limited risk bearing entities was also condemned in that chapter.

On similar lines Bangalore Bench of the Income-tax Appellate Tribunal ('ITAT'), in the case of *GE India Technology Centre*[64] held that the ability of the foreign AE to exercise control over risks remotely from the place where the core R&D functions (carried on by Indian taxpayer) are not located is very limited.

The Central Board of Direct Taxes[65] (CBDT issued two circulars in the year 2013 viz. Circular 2/2013 and Circular 3/2013. Circular 3/2013 laid down five conditions to be cumulatively satisfied so as to demonstrate that the Indian entity providing R&D services is a risks mitigated entity. Circular 2/2013 stated that Profit Split Method would be the best method for determining Arm's Length Price (ALP) of remuneration of the Indian entity engaged in R&D activities, in case any of the condition mentioned in Circular 3/2013 is not satisfied.

[64] *GE India Technology Centre (P) Ltd. v. DDIT* - [2013] 141 ITD 245 (Bangalore).
[65] Apex authority for Indian direct tax administration.

Current scheme of TP regulations for R&D centres

The above circulars were later withdrawn and replaced by Circular 6 of 2013. The latest circular states that R&D centres in India can be classified into (a) entrepreneurial in nature, (b) cost-sharing arrangements; and (c) contract R&D.

The new circular lays down following guidelines for determining whether the Indian entity is engaged in contract R&D activities and assumes insignificant risks.

a) Foreign AE performs most of the economically significant functions like conceptualization, design, providing strategic direction and framework, involved in research while the Indian R&D Centre carries out the work assigned to it;

b) Foreign AE provide funds and significant assets required for the research;

c) The R&D Centre works under the direct supervision of the foreign AE;

d) The R&D Centre does not assume or has no economically significant realized risks, both in substance and in form;

e) An AE located in low or no tax jurisdiction will be presumed to be bearing no risks. The presumption can however be rebutted with evidence.

f) The R&D Centre has no ownership right (legal or economic) on the outcome of the research, both in substance and in form.

These guidelines are largely in line with the OECD recommendations as flow from revised discussion draft on Transfer Pricing Aspects of Intangibles dated July 30, 2013.

Experience of Indian administration has been that even those entities who claim to have met these conditions fail to corroborate their claims with sufficient documentary evidence. Maintaining a robust documentation is therefore crucial for sustainability of the position adopted.

Managing the risk

The change in the approach of tax administration is definitely welcome. Further, the tax policy framework offers options like (a) safe harbour rules and (b) advance pricing agreements that can be used to reduce the risk of any divergent view being taken by tax officers leading to unwanted litigation.

A. SAFE HARBOUR

CBDT in September, 2013 announced the Safe Harbour Rules providing that the transfer price declared by the taxpayer engaged in rendering contract R&D services in the light of circular 6 above would be accepted if its operating profit / operating expenses is not less than 29%[66] / 30%[67].

B. ADVANCE PRICING AGREEMENT (APA)

The Indian APA scheme was introduced by the Finance Act 2012, with effect from July 1, 2012. Corresponding rules for effective implementation were announced on August 30, 2013. The scheme has been quite popular amongst the taxpayers.
The scheme provides for pre-filing consultation, a preliminary processing of the application, across the table discussions, site visits by tax officers, post APA compliance and reduced scope of audit by tax officers. Regime envisages unilateral, bilateral as well as multilateral APAs. Recently in Fiscal Budget 2014 the scheme has been further expanded to cover roll back upto four past years in addition to five subsequent years.

[66] For contract R&D services (wholly or partly) relating to generic pharmaceutical drugs.
[67] For contract R&D services (wholly or partly) relating to software development.

CONCLUDING REMARKS

Keeping pace with industrial development and business dynamics, the role of R&D in profit generating process has been realised to be significant enough to warrant profit attribution and deserving ALP consideration in PE and subsidiary scenarios respectively.

Considering the fact that determining the nature of R&D activities is a fact based exercise and there can be subjectivity in evaluating the functional profile of a captive R&D centre, proper documentation should be maintained to demonstrate compliance with conditions mentioned in Circular 6/2013.

Taxpayers should also consider opting for an APA which, with roll back provisions can provide certainty for good nine years.

notes...

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Should you have any query based on the contents of this booklet, please get in touch with

V. Lakshmikumaran at vlakshmi@lakshmisri.com or
S. Seetharaman at seetharaman@lakshmisri.com or
Sumeet Khurana at sumeet.khurana@lakshmisri.com

For more information, visit us at
www.Lakshmisri.com

Lakshmikumaran & Sridharan attorneys

An ISO 9001:2008 and ISO 27001:2005 certified law firm

NEW DELHI
5 Link Road, Jangpura Extension,
New Delhi 110014

B-6/10, Safdarjung Enclave
New Delhi - 110 029
Phone : +91-11-4129 9811
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd Floor, CNERGY IT Park, Old Standard Mill,
Appa Saheb Marathe Marg, Prabhadevi,
Mumbai - 400 025
Phone : +91-22-2439 2500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
World Trade Center,
No. 404-406, 4th Floor, South Wing,
Brigade Gateway Campus,
No. 26/1 Dr. Rajkumar Road,
Malleswaram West,
Bengaluru - 560 055
Phone : +91-80-49331800
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church, Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail : lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII,
Nehru Bridge Corner, Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

EUROPE
Lakshmikumaran & Sridharan SARL
Avenue Giuseppe-Motta 35-37
1202 Geneva
Phone: +41 22 919 04 30
Fax: +41 22 919 04 31
E-mail: lsgeneva@lakshmisri.com

PUNE
607-609, Nucleus
1 Church Road, Camp
Pune - 411 001
Phone : +91-20-66801900
E-mail : lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building
41, Chowringhee Road
Kolkata - 700071
Phone: +91-33-40055570
E-mail :lskolkata@lakshmisri.com

CHANDIGARH
SCO No. 59, 1st Floor,
Sector 26, Madhya Marg,
Chandigarh – 160 026.
Phone: +91-172-4921700
E-mail: lschd@lakshmisri.com

designed@iwoodapple.com