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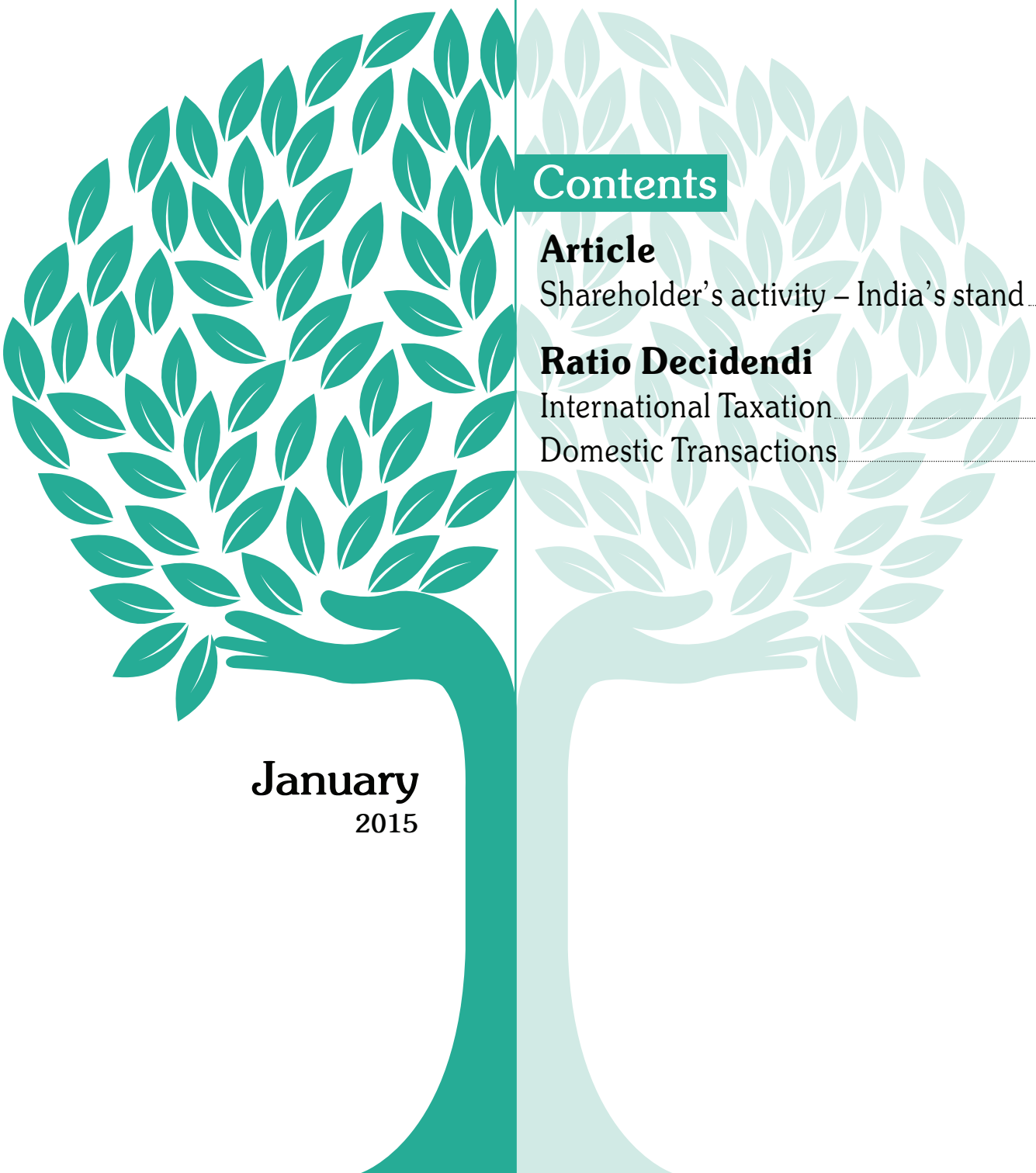

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Shareholder's activity – India's stand

By **S. Sriram**

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'*[1]. The 1995 Guidelines modified the definition of 'shareholder activity'[2] 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.

The US approach

In 1977, the United States Regulations[3] 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[4], 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*[5]. In relation to services that benefit both the parent and the subsidiary, the Technical Advice Memorandum[6] 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[7]. The services would be regarded to

1 Para 7.6 of 1995 Guidelines

2 Para 7.9 of 1995 Guidelines

3 § 861 regulations

4 *Columbian Rope Company* v *Commissioner* [1964] 42 TC 800

5 *Eli Lilly and Co* v *Commissioner* [1985] 84 TC 996

6 TAM 8806002

7 Similar observation can be found in the Circular issued by Italian Tax Authorities

have benefited the entity which has obtained direct benefit than the entity that has derived an indirect benefit[8].

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[9], 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[10]'*. Thus, both OECD and the US moved to the 'sole beneficiary' test for determination of shareholder activity.

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[11].

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[12] 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[13] 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[14]. 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[15] as well as by the Revenue Authorities[16] before juridical forums in India.

[8] Similar observations are made by the New Zeeland Revenue Authorities also

[9] §1.482-9(l)

[10] §1.482-9(l)

[11] Para 3.1.1 of Final Report on Shareholder Costs of the EU Joint Transfer Pricing Forum

[12] VwGH 14.12.2000, 95/15/0129

[13] Resolución del Tribunal Económico-Administrativo Central of 25 July 2007

[14] Para 10.4.9.4

[15] 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.)

[16] 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)

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[17].

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[18]. 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[19].

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 form the services provider for the services
d. Details of persons who would render/ have rendered such services, their qualification, their rolls 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 rendition of 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.

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[17] *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.

[18] *Merck and Co v United States* [1991] 24 Cl Ct 73

[19] *CIT* v. *EKL Appliances Ltd.* [2012] 345 ITR 241 (Del)

Ratio decidendi

International Taxation

Central purchasing entity is not the beneficial owner for the purpose of DTAA benefit

Group company of the taxpayer in India was a tax resident of Denmark. The Danish company obtained licenses from Microsoft and sub-licensed to its various group entities. The Indian entity relied on DTAA between India and Denmark as governing the taxability of payments made. The ITAT held that Denmark entity is only an intermediary and Microsoft US is the beneficial owner hence India Denmark DTAA is inapplicable. [*ITO* v. *F.L. Smidth*, I.T.A.No.1410/Mds/2007]

Payment for interconnect usage is in the nature of royalty after amendment of Section 9

The taxpayer had made payments to non-resident telecom operators for interconnectivity in respect of calls originating or terminating in the country of service provider. The Revenue Authorities (RA) alleged that the amounts paid were royalty for use of process. ITAT held that Indian courts were earlier interpreting the 'process' related royalty in a manner contradictory to the intention of Indian Govt. when it entered into DTAA and the insertion of explanations 5 & 6 are to clarify the stance and hence retrospective in operation. In the light of these explanations the payment is royalty both under the Act and DTAA. [*Vodafone South Limited*, TS-789-ITAT-2014(Bang)]

Amount received for international sales promotion held to be royalty considering substance over form

The taxpayer being a US tax resident had received reimbursement of expenses towards brand promotion from Indian hotels in pursuance of International Sales and Marketing Agreement. The group company of the taxpayer received royalty towards licensing of said brands. The Revenue Authorities (RA) alleged that the amounts received towards reimbursement of brand promotion expenses by the taxpayer were also towards licensing of brands and hence royalty and a separate payment colored as reimbursement was an artificial dissection of an integrated transaction. The RA highlighted that the actual expenditure incurred by the taxpayer had no direct nexus with the individual hotel and was rather towards brand building. The Mumbai ITAT observed that merely because two different agreements were signed within the same group, one for promoting global brand of the taxpayer and the other one for payment of royalty, the true nature of the transaction will not change. It was held that the amounts received towards promotion of brand constituted royalty and thus, liable to tax. [*Marriot International Inc.* v. *DDIT*, ITA No. 1996 &1997/Mum./2011, Order dated 14-1-2015, ITAT Mumbai]

Employee deputation leads to Service PE incidence and salary cost allowed as deductible expense

The taxpayer, a US tax resident was engaged in providing support services to various group companies in India. The support services were provided by deputing employees to group companies wherein such employees worked

under control and supervision of the Indian group companies. The taxpayer was directly making payments to the deputed employees and was receiving reimbursement for the same from the group companies in India. The RA alleged that the payments to the taxpayers were in the nature of fees for technical services. The Mumbai ITAT following the ruling of *Morgan Stanley* (Supreme Court) and *Centrica India* (Delhi High Court) held that the seconded employees constituted Service PE in India as per the India US tax treaty as the employees retained lien on overseas employment and continue to remain on payroll of US company. The Tribunal further held that once Article 7 was applicable the salary paid to deputed employees by the taxpayer was a deductible expense. [*Morgan Stanley International Incorporated* v. *DDIT*, ITA No. 6882/Mum/2011, Order dated 18-12-2014, ITAT Mumbai]

DATA link charges not 'FTS' in the absence of human intervention

The taxpayer, a software development company, made payments against DATA link charges to service provider without deducting tax thereon. The revenue authorities, however, passed an order under Section 201(1)/(1A) for having not deducted tax on such payments alleging the same to be in the nature of 'fees for technical services'. The taxpayer contended that DATA link charges were for allowing the satellite link from one service provider to be carried to the other service provider and usage of technical equipment with no human intervention in such transmission does not make contract towards rendering technical services. On these facts, the Tribunal relying on *Bharti Cellular's* ruling held that in absence of human intervention the payments for such charges are not 'fees for technical services'. [*iGate Computer Systems Ltd. v. DCIT (ITAT Pune)*, ITA 1301/PN/2013, Order dated 30-12-2014]

Domestic Transactions

Claim of depreciation optional while computing 80IA

The taxpayer had not claimed depreciation while computing the profits eligible for deduction under Sections 80HHC and 80IA, however the revenue authorities contended that the claim of depreciation was automatic and has to be claimed by the taxpayer. The High Court relying on *Arun Textiles* case held that there is nothing contained in the provisions of Section 32(1) read with Section 29 to indicate that when no claim is made by taxpayer, the revenue is bound to allow a deduction despite the introduction of block of assets concept. Further, it is not necessary that the depreciation is allowable or not allowable as a whole, the assessee can claim it partly also in respect of certain block of assets and not claim in respect of other block of assets. [*DCIT* v. *Sun Pharmaceuticals India Ltd.*, Tax Appeal 93 of 2000, Judgment dated 17-12-2014, Gujarat High Court] *[Note : The decision pertains to AY 1996-97 and hence prior to the insertion of Explanation 5 to section 32 by the Finance Act 2001 w.e.f. 1-4-2002]*

Amendment to Explanation 2B of Section 43(6) by Finance Act, 2003 is retrospective

The taxpayer, a resulting company from a demerger in the AY 2003-04, increased its block of assets in respect of assets received on demerger by the written down value as appearing in the

'books of accounts' of demerged company and claimed depreciation on such value on the contention that amendment made to Explanation 2B to section 43(6) by Finance Act, 2003 wherein the words *'books of accounts'* were omitted was prospective in nature. On appeal by revenue authorities, the Tribunal held that written down value for *'tax purpose'* of demerged company in respect of assets transferred has to be taken into consideration. It was further observed that the amendment by Finance Act, 2003 was curative and clarificatory and it has neither in any way affected any substantive right already vested in the assessee nor has taken away any such right which was accruing to the assessee before such omission, therefore the same is retrospective in nature. It also referred that the provision relating to demerger were introduced on a principle that demerger should be tax neutral and should not attract tax liability. [*Godrej & Boyce Mfg. Co. Ltd.* v. *ACIT,* ITA No. 4368/M/2011, Order dated 31-12-2014, ITAT Mumbai]

No 'capital gains' on TDRs as 'cost of acquisition' is not ascertainable

The taxpayer acquired right of putting up additional construction through a transferable development right (TDR) as per Development Control Rules, 1991; however, instead of utilizing the right, the taxpayer transferred it to a developer for a consideration and did not pay any capital gains tax thereon on the understanding that since the cost of acquisition of such right is not ascertainable and further in absence of any specific provision in that regard there will no capital gains. On appeal by the revenue authorities, the High Court held that sale of TDR acquired by taxpayer cannot be subject to tax under head capital gains in absence of cost of acquisition by relying on *B.C. Srinivasa Shetty's* case, since TDR was rather generated by the plot itself. Further, even Section 55(2) also doesn't cover this right being a capital asset. [*CIT* v. *Sambhaji Nagar Cooperative Housing Society Ltd.,* ITA 1356 of 2012, Judgment dated 11-12-2014, Bombay High Court]

Each item of a shuttering material an independent unit

The taxpayer, engaged in the business of acquiring shuttering material to be used in construction and leasing the same, claimed 100% depreciation on such shuttering material treating each component as a unit costing less than Rs. 5000 under Section 32(1)(ii) of the Act. The revenue authorities rejected the claim stating that the entire material cost should be considered as one single unit. On these facts, the High Court relied on *Sri Krishna Bottlers* case and snubbed *Raghavendra Constructions* case holding that the same was passed *'sub silento'* to *Sri Krishna Bottlers.* [*CIT* v. *Live Well Home Finance (P) Ltd.,* ITA No. 239/2003, Order dated 27-11-2014, Telagana & AP High Court]