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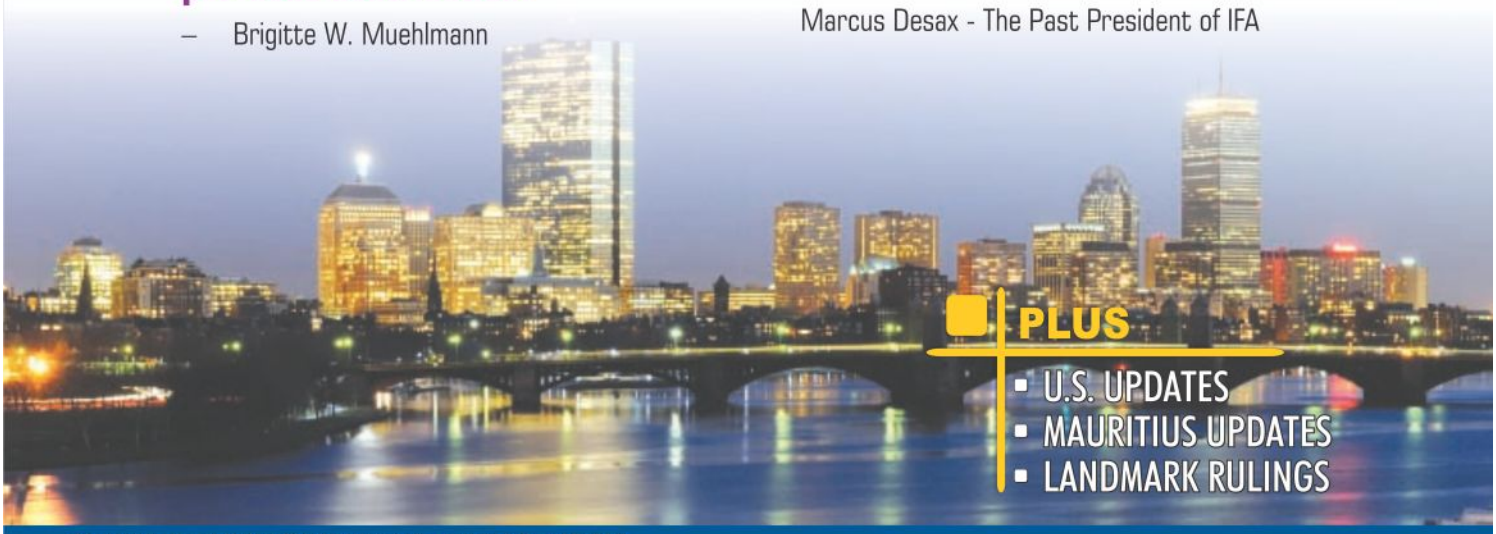
IFA World Congress Boston 2012



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ROGER D. WHEELER

From the Guest Editor

It was a cold and snowy February evening when I first sat down to talk warmly about the Boston IFA Congress with Ken Vacovec, the Congress President. It was then, that Mr. Vacovec told me his objective for the Congress was: "to provide a valuable and entertaining congress... with great scientific (that is, technical) programmes... and top-notch technical content." He also was desirous to show the fabulous city of Boston many of his friends he had made friendship with over the years at IFA Congresses held in other great international cities. Recently, under the crisp air and blue sky of early October at New England, Mr. Vacovec assessed the just finished Congress this way: "The Congress exceeded all our expectations. Attendance was among the highest ever (2233 registered, 2156 attended). Technical programmes were superbly carried out, including those beyond the regular agenda (such as the report on "enhanced relationships," the special conference honouring Hugh Ault, and the international tax research symposium). The social and networking programmes were beyond compare." I think Mr. Vancovec's brief summarized the Congress very well.

IFA Congresses mean many things to many people: for some, the social and business networking and visiting old friends is witnessed only once a year at IFA; for others, it is an opportunity to interact with business and academic professionals or Government officials, and perhaps a chance to accomplish "real work;" and for most of the delegates it means sound IFA technical programmes. Indeed, the backbone

of IFA congresses is technical programmes. These generally consist of comprehensive coverage of two selected subjects (this year's subjects chosen were enterprise services and the debt-equity conundrum) supplemented by a series of topical seminars (as many as twelve this year).

The current issue includes articles addressing many of the topics discussed at the Boston IFA Congress, most of these written by leading professionals who actually participated in the discussions. These articles also include an article on enterprise services, one of the two principle subjects taken up by Ariane Pickering of Australia, who was the General Reporter for enterprise services. She is an international tax consultant and former Chief Tax Treaty Negotiator for Australia. The other article is contributed by Shipra Padhi and Shreya Rao, of the Indian Law firm, Nishith Desai and Associates, which is affiliated with Bijal Ajinkya of Nishith Desai who was India's National Reporter for the debt equity topic.

There are six articles on the IFA Congress seminar programmes: Vijay Mathur from India and a panelist on Seminar C, has written on MAP and international dispute resolution. Shefali Goradia of BMR Advisors from India and also a panelist on Seminar D, has written on the scope of domestic law on treaty negotiations; this article is co-authored by Anubha Mehra of BMR. Professor Brigitte W. Muehlmann, of Suffolk University in the United States and panelist on Seminar H, has written on the subject of cross-border charitable donations. There are two articles contributed by panelists of Seminar I, telecommunications — Mukesh Butani of BMR Advisors from India and Kimberly Tan Majure of KPMG of the United States. Daniel M. Berman of McGladrey LLP and a panelist for Seminar L has contributed on limitation on benefits. This article is co-authored by Natalia Velez Delgado, a tax LLM student at Boston University.

In addition to the established technical programme, this year's Congress included a report on IFA's investigation of the so-called "enhanced relationship" initiative, designed to establish terms of engagement among tax authorities, corporate taxpayers and third-party intermediaries. This investigation was started by IFA's President, Manuel Tron of Mexico. Jerome B. Libin of Sutherland Asbill and Brennan and a former President of IFA prepared an article on the enhanced relationship initiative for this issue.

Although not discussed as an official Congress topic, there was considerable interest generated in the topic of prospects for tax reform in the United States. Therefore, we have included in this issue a timely article by Harry L. Gutman on US tax reform. Mr. Gutman, of KPMG's Washington National Tax Office, is a well known expert on tax reform matters.

I have greatly enjoyed attending the Boston IFA Congress and seeing many friends from around the world. We all look forward eagerly to attend future IFA Congresses — next year in Copenhagen and following that year in Mumbai in 2014.

Best regards - Roger

(ROGER D. WHEELER)

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Mr. Porus Kaka -

The Next President of IFA

Mr. Porus F. Kaka, an eminent senior advocate from India, has been appointed President of the International Fiscal Association (IFA). He will take charge on the conclusion of the Copenhagen Congress in 2013 and will hold office till 2015, subject to further extension till 2017. Mr. Kaka will preside over the IFA Congress in Mumbai in 2014. We take this opportunity to present his views on IFA's international and Indian activities.

Porus Kaka

1. Mr. Kaka, it is the first time that someone from India, if I am not wrong from Asia also, is elected to this coveted post? How you feel?

Yes, it is the first time that the International Fiscal Association has chosen both someone from India as well as someone from Asia.

This is indeed an overwhelming recognition and I feel gratefully humbled and honoured to have been so elected and considered from so many worthy persons across the world. I am looking forward to this challenging assignment with the objective of growing this fine organization in all parts of the world, especially Asia.

2. What is the process of selection?

IFA has a rigorous process of selection and it goes through several Committees / Executive Boards before it reaches the Executive Committee and then the General Council and General Assembly under its constitution. IFA through the Executive Committee has laid down several criteria for selection of the President.

I am pleased that all the committees and now recently the General Council and General Assembly that have so far examined my candidature have been unanimous in their view.

3. What are the main functions of IFA president?

The President represents IFA externally for example at regional conferences, international organizations and other functions when necessary.

The President also presides over the General Assembly as well as over the meetings of the General Council, the Executive Committee, and the Executive Board.

The Executive Board is entrusted with the day-to-day management of the Association.

It takes the decisions necessary for such purpose, draw up the agenda for the Executive Committee and submits to the Executive Committee all suggestions which it considers useful.

4. What would be your agenda as IFA President?

I am still in the process of examining the same but certainly I would look to expanding the footprint of IFA in Asia and growing the same rapidly also in India. We must look to expand and include more of our fine Judges and also Government Representatives. I think it is essentially important that all sides of the International Tax Community are involved in this scientific organization which would mutually benefit everyone whether they are in judiciary or in Government or in the Corporate Sector or private practice. IFA as a forum for scientific debate could play a unique role in the more complex International Tax debates and disputes.

5. India is hosting IFA World Congress in 2014 in Mumbai. How the work is going on? What will be your priorities?

The work for the 2014 Congress is going well under the leadership of the Conference Chairman Mr T.P. Ostwal and Mr. Pranav Sayta and our IFA India Chairman, MrSushilLakhani. We have already had several round of meetings and though I am no longer on the Organizing Committee I am supporting them with all my efforts. We had a stall at the upcoming Congress in Boston in September which was received with great enthusiasm and interest. The priorities undoubtedly would be to have a good technical Congress with great depth of discussions and also make an entertaining and lively experience for the participants and accompanying persons so that they take back warm and fond memories of Mumbai and of India.

6. IFA has a branch in India which is one of the largest Branches in IFA Worldwide. Would you like to strengthen it?

Yes, we are now the 4th largest Branch of IFA and growing IFA in India would be one of my priorities and I intend now post the Boston Congress to tour its various Regions to strengthen and grow the organization well in time for 2014. I am starting with going to Chennai in the first week of November for the Southern Region's International Tax Conference.

Mr. Marcus Desax -

The Past President of IFA

Dr. Marcus Desax is a tax partner at Swiss Law Firm of Walder Wyss Ltd., Zurich, Switzerland. Presently he is Honorary President of the International Fiscal Association (IFA), after having presided over IFA from 2005 to 2009. From 1998 to 2001 he was President of the Swiss Association of Tax Law. It is our proud privilege to present his views on IFA's activities.

Marcus Desax

1. What do you perceive as IFA's most important current initiative or objective?

It is implementation of the enhanced relationship project at branch level.

2. What is the biggest challenge facing the tax community these days and in a near future?

The current state of public fiances in many countries and the perceived need of the governments to raise revenue.

3. Personally, what do you consider as the major accomplishment during your term as IFAs President, in other words, what was your most cherished moment?

In cooperation with the then Secretary General, Maarten Ellis: The successful launch of the young IFA network (YIN) project.

4. In shaping your career, who was the person who acted as your mentor during your early involvement with (or got you into) IFA?

Paul Gmuer, President of IFA from 1973 to 1997, my senior Partner, who 1985 introduced me to the Swiss IFA branch and encouraged me to propose, together with Pierre Gillioz, to the Swiss Executive Committee to submit invitations for an IFA Congress in Switzerland (1996 in Geneva).

How well are you being served?

Ariane Pickering*

The concept of services has been around as long as mankind, and taxation of income from the provision of services has existed almost as long. Yet the rules for taxing income from services vary widely from country to country, and are often far from certain. The tax treatment of income derived by enterprises from the provision of cross-border services was one of the main topics considered during the 66th annual Congress of the International Fiscal Association which was held in Boston, MA, from 30 September to 4 October 2012.

The General Report on Enterprise Services[1] looks at how income from services is dealt with under the domestic law of 38 jurisdictions[2] that submitted reports on this topic. After noting that there are different rules for determining the source of services income, and widely differing views as to what constitutes an appropriate nexus for source taxation of such income, the Report examines whether tax treaties resolve these differences in a way that removes tax barriers to cross-border provision of services while providing acceptable revenue outcomes to tax administrations. Leaving aside the treaty provisions dealing with specific types of services, such as international transport, employment services, directors' fees, entertainment, etc., the Report found that there were 3 broad tax treaty approaches to taxation of income from services:

1. The OECD Model Tax Convention approach, where such income is treated in the same way as any other business profits under Article 7 and is subject to source tax only where the usual permanent establishment (PE) threshold is met;
2. The UN Model approach, where source taxation is also permitted where a time threshold is met, either under a deemed PE provision in the case of income that falls within Article 7, or, in the case of independent personal services, under Article 14; or
3. Royalty treatment, which permits source taxation on a gross basis of income from services, especially technical services, where the payment is made by a resident or a PE situated in a jurisdiction.

* Ariane Pickering, International Tax Consultant and former Chief tax treaty negotiator for Australia.

A Panel of experts, chaired by Porus Kaka from India and with representatives from government (Liselott Kana from Chile), from academia (Brian Arnold from Canada and Akiyuki Asatsuma from Japan) and from business (Christian Kaeser from Germany and Gary Sprague from USA) as well as General Reporter Ariane Pickering from Australia, considered a number of issues that these three tax treaty approaches raise. The Panel concluded that there is much work yet to be done to ensure clear, consistent and appropriate taxation of income from cross-border services.

Domestic law

Source taxation of income derived by a non-resident service provider varies considerably from country to country.

The most common approach, found in nearly half of the reporting jurisdictions, is to treat services income as ordinary income and subject it to the usual rules for determination of taxable income. As with other business income, expenses are deductible, and the resulting profits are subject to tax at ordinary rates applicable to the type of enterprise that derives the income.

Even in countries where services income is generally treated as ordinary income, there are frequently exceptions. Many countries have, for example, special rules for taxation of income of shipping or air transport enterprises engaged in international traffic, or different treatment for entertainers or insurance enterprises.

Some countries generally treat services income as business profits, but treat professional or independent personal services income as a separate category of income to which different tax treatment applies. Such different treatment may affect rates of taxation, source of income, threshold for source taxation or even method of taxation (e.g. the income may be subject to withholding).

A significant number of countries, including many South American countries, do not treat services income in the same way as other business profits. In these countries, income from the provision of services generally is regarded as a separate category of income and is subject to a withholding tax on the gross amount of the payment unless, in most countries at least, the income is attributable to a PE in that country.

Irrespective of the basic approach to taxation of services income under domestic laws, the Report noted that there was little consistency between countries as to determination of the source of income or the threshold for source taxation. While all countries will treat income from services physically performed in their jurisdiction as having a source in their country, many would also see other factors as giving rise to income sourced in their country, e.g. where the services are 'used' in that country, or benefit a resident or PE of that country, or where the contract is made in the country, or the services are paid for by a resident or PE in that country.

Approaches are also varied under domestic law as to what constitutes a sufficient nexus between the income and jurisdiction to warrant source taxation by that country. In many countries, the mere fact that income from services has its source in that country under domestic law is sufficient to create a liability to source taxation. In other countries, income that has a certain nexus with the jurisdiction may be subject to tax therein, irrespective of whether it would otherwise be considered to have a source in that country, e.g. where the activities are carried on through a PE in that country, or are part of a business carried on or managed in that country. In yet other countries, income from services will only be taxed if they have a source in that country and meet a certain threshold (such as a PE or time requirement).

Tax treaty provisions

So how effective are tax treaties in resolving these differences? As noted above, the Report describes 3 main approaches to allocating taxing rights over income from cross-border services. Each is very different, and provides different outcomes from revenue, compliance and administrative perspectives. The policy and practical implications of these three approaches were the focus of the seminar on this topic.

The treaties of just over half of the reporting jurisdictions generally follow the OECD Model approach. Under this approach, services income

(other than income dealt with under the specific articles) falls for consideration under Article 7. In the absence of a fixed place of business or a dependant agent PE, the income may be taxed only in the country of which the enterprise is a resident. Where the income is attributable to a PE of the enterprise in the other country, the income may be taxed in that other country on a net (profits) basis.

This approach was understandably the one most favoured by the business panellists. It ensures that a resident of one jurisdiction will be taxed in another jurisdiction only when the enterprise establishes a significant physical and economic presence in that other jurisdiction. It also ensures that expenses are taken into account in applying taxation. It was noted however that there can be classification difficulties, particularly in determining whether an amount is a business profit or a royalty, and that different countries apply different interpretations to these provisions, resulting in considerable uncertainty in borderline cases. Some of the difficulties in determining whether a place of business is 'at the disposal' of a service provider were also discussed. Some panellists suggested that further clarification on both of these issues is necessary to provide business and tax administrations with greater certainty.

Other panellists did not agree that the OECD Model approach provided the best policy outcomes for taxation of services income. The *Dudney case*[3] was cited as an example of where a service provider may perform services in one place over an extended period without being found to have a PE under the OECD approach. Some panellists considered that the Dudney decision was wrong, from either a legal or a policy perspective. These panellists generally preferred an approach which allows source taxation of services income in a broader range of circumstances.

The UN Model approach is the one most commonly found in treaties that do not follow the OECD Model on this issue. The UN is currently reviewing how income from services should be dealt with under treaties, but its current approach is to include an additional time threshold that can lead, in certain circumstances, to a deemed services PE or taxing rights under Article 14 where services are provided in a jurisdiction for more than 183 days. A similar, though not identical, approach is reflected in the OECD's alternative services PE provision, that was added to the Commentary on Article 7 in 2008. Given the mobility of many services provided cross-border these days, this additional time threshold is regarded by many countries, especially capital importing countries, as resulting in a more appropriate balance between source and residence taxation of services income than an approach which relies primarily on the existence of a fixed place of business in the source country.

Like the OECD Model approach, the UN Model approach ensures that income derived through a deemed services PE is taxed on a net (profits) basis. While most countries also tax income from independent personal services on a net basis, this is not always the case. There may also be uncertainty as to whether Article 14 is limited to services provided by individuals, or whether it also applies to corporate entities. A number of difficulties arise with respect to the interpretation of the deemed services PE provision, e.g. what constitutes the 'furnishing' of services. It will be interesting to see what changes, if any, will result from the review by the UN Committee of Experts[4] on the deemed services PE provision.

One option being considered by the UN Committee is whether to provide for royalty-type treatment of income from technical and other services. While the OECD Model provides for taxation of royalties only in the country of residence, the majority of existing treaties allow limited source taxation on the gross amount of royalties paid by a resident or a PE situated in a jurisdiction. The General Report notes that a number of countries, especially South American countries and developing countries, extend this treatment to fees for technical services. This approach attracted a good deal of attention from the Panel. Panellists noted that the difficulties of determining whether a service is 'technical' or not, in particular whether the services need to involve, or be related to, a transfer of know-how or other intellectual property. On the other hand, one panellist questioned the policy rationale for distinguishing between technical services and other services.

A major concern was that the royalty approach, in providing for taxation of the gross amount of the payment, does not take account of the often high level of expenses incurred in the performance of services. One panellist commented that, if gross taxation at a limited rate is intended to be a proxy for ordinary taxation, rates of 10 or 15% which are commonly found in treaties that adopt royalty-type treatment assume an unrealistically high profit margin for service providers who are subject to the withholding tax. It was also noted that the royalty-type approach may permit taxation in a country even where the services are not performed within that jurisdiction. On the other hand, the royalty approach is relatively certain and simple to administer. Importantly, especially in the case of developing countries, it may be the only way in which the tax administration is able to effectively collect tax on services income of non-resident service providers.

Each of the 3 main treaty approaches has its problems, and each represents a different policy approach to source taxation of services income. While there seems little prospect, at least in the short term, of reconciling 3 fundamentally different approaches, there certainly seems to be scope for removing some of the uncertainties and inconsistencies within each of the approaches. For example, further clarification under the OECD approach on when services will give rise to a fixed place of business would be welcome, as would increased certainty with respect to the border between services and other categories of income such as royalties, rents etc. The UN approach could clarify what is meant by 'furnishing' of services, and the royalty approach needs to be much clearer on what services it is intended to cover and what rate of withholding would be appropriate.

There may also be scope for improving consistency across the 3 approaches. For example, should the term 'services' be defined for treaty purposes? Could international agreement be reached that source taxation should only be permitted under treaties where services are physically performed in that country?

There is much work left for the international tax community to do on this topic. In a world where cross-border services constitute an ever-increasing proportion of the global economy, taxation issues are not going to go away.

1. Cahiers de Droit Fiscal International, Vol 97a, 2012
2. Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Chinese Taipei, Colombia, the Czech Republic, Denmark, Finland, France, Germany, Hungary, India, Israel, Italy, Japan, Republic of Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Peru, Portugal, Russia, South Africa, Spain, Sri Lanka, Sweden Switzerland, Ukraine, the United Kingdom, the United States, Uruguay and Venezuela
3. *Dudney* v. *The Queen* [2000] DTC 6169 (FCA)
4. Committee of Experts on International Co-operation on Tax Matters

The Debt-Equity Conundrum

Shipra Padhi*

Shreya Rao **

Introduction

In India, there are different regimes applicable to inbound and outbound investments, with stricter restrictions on the latter. Equally, there are various tax implications affecting these investments that might affect the decisions of smaller as well as institutional investors. One of the frequent issues under consideration is the debate surrounding the nature of treatment meted out to 'interest' *vis-à-vis* 'debt' (which is restricted by the regulatory regime, and deductible in the hands of the payer but taxed at higher rates in the hands of the recipient), *versus* returns on equity i.e. dividends (which have a unique tax treatment in India and which are subject to various corporate law requirements).

This paper examines the application of these issues to Indian capital markets. It begins with a description of the existing paradigm of legal provisions that govern such financial instruments, and the regulatory framework that exists today. In the next section, the paper attempts to examine specific issues related to the taxation of equity and debt as under Indian taxation laws including controversies and areas where there is a lack of clarity in the law. The conclusion will examine the impact of these on investment into financial instruments in India.

SECTION 1 - OVERVIEW OF CORPORATE AND REGULATORY REGIME

Prior to 1991, there were strict restrictions in India on the inflow and outflow of capital from the country. Therefore, although Indian capital markets have a history spanning over 150 years,[1] it was only post liberalization (around 20 years ago) that the regulatory and tax regime began to move towards the form it has currently adopted today. The Indian equity market comprises of two main national level stock exchanges and several regional level bourses which draw participation of domestic and international institutional and individual investors. In comparison, the debt market is smaller[2] and less active. In the next section, we provide a brief overview of the manner in which corporations and financial instruments function in India to enable the treatment of debt and equity in the Indian capital markets.

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- Authors thank Bijal Ajinkya for her valuable contributions.

Types of entity

Businesses in India can be set up as: (a) companies set up and governed by the Indian Companies Act, 1956: "Companies Act"); (b) partnership firms (set up under and governed by the Partnership Act, 1932); (c) limited liability partnerships (set up under and governed by the Limited Liability Partnership Act, 2008 ("LLP")); and (d) unincorporated entities like proprietorship concerns and association of persons. As companies enable investors to scale up easily, ring fence their liability while at the same time pool resources from a large number of shareholders, large businesses prefer this form of organization. However, this involves detailed compliances and more onerous tax consequences for the investor. Therefore, smaller businesses sometimes prefer to opt for the partnership model. This is typically preferred in a situation where the partners are known to each other as a general partnership involves joint and several liability amongst the partners which is unlimited. India does not have too many hybrid entities. One of the few exceptions is the LLP which was recently introduced and which is gradually being used more frequently.

Types of Equity and Debt Instruments

Under the Companies Act, Indian companies can issue shares in the nature of equity, which are common stock, or preference shares, which have preferential distribution rights.[3] Preference shares can also be convertible into equity shares on a compulsory or optional basis. However, in the event that they are redeemable, the condition is that this should take place subject to a maximum tenure of 20 years. Debt instruments are typically called debentures or bonds. Debentures of longer duration (up to 15 years) are generally referred to as bonds whereas the short term securities with maturity of 7 to 365 days are called commercial paper and are generally issued at a discount on the face value. Debentures may be secured (against property) or unsecured. Additionally, like preference shares, debentures can also be redeemable, non-redeemable, convertible or non-convertible into equity.Under the Companies Act, companies can, subject to applicable rules, accept deposits from the public and issue certificates of deposit[4] for the same, in addition to issuing convertible instruments.

Overview of Regulatory Framework

As mentioned above, the Indian regulatory regime opened in 1991 and the regime governing inbound investments is more permissive than the regime relating to outbound investments. Foreign companies can (subject to satisfaction of certain conditions) generally subscribe to all types of securities - equity, preference, debt and convertible debt depending upon their needs. Where these investments are in the nature of debt, the Reserve Bank of India ("RBI") has prescribed guidelines relating to external commercial borrowings ("ECB") which prescribe requirements in terms of maturity period, interest coupon, end use restrictions etc. Under these rules, optionally convertible debt is treated as debt as against compulsorily convertible debt which is treated as equity and is accordingly subject to several restrictions applicable to ECBs.

This classification is also relevant for investments made under the foreign direct investment ("FDI") route, which considers equity, compulsorily convertible preference shares ("CCPS") and compulsorily convertible debentures ("CCD") issued by an Indian company as equity for the purpose of FDI and applicable sectoral caps. A large number of institutional investors including foreign pension funds and other tax exempt entities (like university funds, endowment funds etc.) also make portfolio investments in the Indian capital market as registered Foreign Institutional Investors ("FII") or as a sub-account to such FIIs. A separate set of investment rules that mandate investment restrictions, reporting and compliance apply to FIIs and their sub accounts. A large number of FIIs have invested in India through tax efficient jurisdictions such as Mauritius. India and Mauritius have entered into a tax treaty ("Treaty") which *inter alia* provides for the beneficial tax treatment of capital gains whereby, any capital gains earned by Mauritian entities are taxable only in Mauritius (it should be noted that capital gains are exempt from tax under Mauritian tax law). It is also relevant to mention that debt investments are typically not made under this route but through an entity set up in Cyprus, which has a beneficial Treaty with India for interest payments.

Very recently, the Indian government has introduced a new regime for Qualified Foreign Investors ("QFIs"), primarily to facilitate foreign

investment. QFIs can invest into Mutual Funds ("MFs"), the Equity Market and the Corporate Bond Market. Earlier, QFIs were only permitted to invest in Indian equity MF schemes and in debt MF schemes that invest in infrastructure. Basic requirements for QFIs to invest in India include compliance with anti-money laundering regulations, KYC requirements, etc. Restrictions placed on QFIs include restrictions on aggregate and individual shareholding of QFIs, restrictions on off market security transfers etc. As of now, there are no specific provisions for taxation of QFIs, unlike FIIs, so the provisions for non-residents shall be applicable.

Overview of Tax Framework

As per the provisions of the ITA[5], a resident of India is taxable on interest income accruing or arising from India or abroad while a non-resident is only taxable on Indian source interest such as[6]: interest paid by the Government, any interest paid by an Indian resident unless in respect of business or profession outside India / source outside India / any payment by a non-resident if payable in respect of a debt incurred for a business or profession or source in India. The payer of interest / issuer of a debt instrument needs to withhold tax in order to be able to deduct the payment. Currently the rates range between 10% - 42% depending on the residence of recipient and denomination of loan. It is relevant to note that India has entered into Treaties which could bring down this rate of interest. Cyprus and Netherlands have beneficial treaties for debt investments into India. Withholding tax rates on external commercial borrowings have also been reduced to 5% from 20% for three years in certain sectors. These sectors are power, airlines, roads and bridges, ports and shipyards, affordable housing, fertilizer and dams.

Capital gains rates range from 0% on gains from disposition of long term assets on the stock exchange to 42% for short term capital gains from unlisted securities. Long term capital gain on equity shares are only tax exempt and eligible to the 0% rate if the transfer has been subjected to Securities Transaction Tax ("STT").[7] Tax rates also depend upon the residence of the recipient and can be reduced by a beneficial treaty as in the case of interest. India and Mauritius have a beneficial Treaty for the treatment of capital gains, which results in an effective capital gains tax of zero percent in India and Mauritius.

In case of FIIs, there is some ambiguity as to whether their income should be treated as capital gains or business income. However there are beneficial rates on capital gains from investments in stock which are as follows:[8]

a) Dividend income (which has not suffered DDT) at the rate of 21.01%.

b) Short term capital gain at the rate of 15.76% (in the case of a share in an equity-oriented fund) or at the rate of 31.52%.[9]

c) Long term capital gain at the rate of 10.50% (in case of an off-market transaction)[10]

As per the provisions of the ITA, a non-resident is liable to capital gains tax in India if the gain arises from the transfer of any asset situated in India.[11] This income is also liable to withholding tax even where the payer or transferee happens to be another non-resident.[12] The newly introduced retrospective amendments to section 9 of the ITA seek to tax offshore transfers that take place between two non-residents in a situation where the non-resident company derives its value 'substantially' from assets located in India. However, this shall not impact transactions that can take the benefit of the tax treaties of India with a few countries like Mauritius, Singapore, Cyprus and Netherlands which provide for taxation of capital gain arising from the transfer of any Indian security in the country of residence of the non-resident.

SECTION 2 - KEY TAX PRINCIPLES

Tax Treatment of Debt and Equity - General principles

As per the provisions of the Income-tax Act, 1961 ("ITA"), amounts paid as interest on borrowings and debt, in general, qualify for tax deduction as long as it is on account of capital borrowed for the purpose of business or profession.[13] Further, section 37 of the ITA provides that any expenditure (not being capital or personal in nature), incurred wholly and exclusively for the purposes of the business would qualify as an allowable expenditure to be taken into account while computing taxable

business or professional income.[14] Income earned on subscription to a debt instrument is normally taxed as interest income, whereas any gains arising from the sale of the debt, is taxed as capital gains. On the other hand, return on equity in the form of dividends paid, declared or distributed by Indian companies is subject to a Dividend Distribution Tax ("DDT") at the rate of 16.22%[15] and is tax exempt in the hands of the shareholder while gains on sale of such equity is classified as capital gains and is taxed as such. DDT payable by the Indian companies is over and above the normal corporate tax.[16] Dividends paid, declared or distributed by a company are not tax deductible.

Now, Indian taxation laws do not specifically define the terms 'debt' or 'loan'. In the ordinary sense, it means something that is owed and creates an obligation to pay, generally money or money's worth. For a loan there has to be a positive act of lending money coupled with its acceptance[17] and a corresponding obligation of repayment. Therefore, equity contributions without any provision of repayment cannot be classified as a loan.

The term 'interest' however, has been defined[18] in the ITA to mean:

> "interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized"

As the above definition is inclusive and does not indicate the essential attributes of 'debt' or 'interest', the terms have been broadly interpreted by courts to include any amount payable as compensation towards any debt incurred. However, the line is not always clear from a tax perspective and interest needs to be distinguished from payments which are in the form of application of profits, since deduction is only permissible with respect to interest on borrowings. Here, interest is typically seen as an outgoing expenditure to arrive at the taxable profit as compared to any payment which is an application of profit. The line of distinction is not always clear. For example, preferred stock which may carry a fixed rate of return is not considered a loan,[19] even if it has been issued on a redeemable basis. Hence, dividend paid on such stock is not deductible as interest on borrowed capital.

When we come to the issue of deductibility, there are also other issues aside from the classification issues. Under the scheme of the ITA, deductions are typically allowed if the debt is obtained for the purpose of generating income from business or profession. However, the arrangement is perceived restrictively where the lender and the buyer agree that there shall be a loan - it does not cover every nature of liability that may arise in the course of a business. For example, interest paid on borrowings made for the purpose of paying statutory dues has been held to be not eligible for tax deduction, as it does not cover the liability that may arise during the course of business.[20] Further, the ITA provides for a residual clause[21] under which any expenditure incurred wholly and exclusively for the purposes of business, not being capital in nature can be allowed as a tax deductible expense. It is possible to claim a deduction for interest expenditure on items like trade payables, brokerage or commission paid to an agent to procure a loan[22] under this residuary clause. Here it is important to note that there is a strong distinction between capital expenditure and revenue expenditure under the Indian ITA, and a deduction of interest on borrowings is allowable only if it is paid or incurred on account of capital borrowed for business purposes. The interpretation of 'business purpose' is largely a question of fact whereby the borrowed funds should be utilized for the purposes of the existing business[23] and not a new project or independent venture which is unconnected with the business.[24] Further, the commencement of the business at the time when the loan is obtained is important for the deduction to be claimed. Where an entity has borrowed money on interest and subsequently advanced interest free loans to its sister concerns, interest expenditure on such borrowing cannot be said to be for business purpose, and is hence disallowable.[25] Similarly, tax authorities have the discretion to disallow expenses that they consider unreasonable (in the context of domestic transactions) or not on an arm's length basis (for cross border transactions), if the loan is from a related entity.[26] The reasonability

of payment is determined from the perspective of the taxpayer and not the Income Tax Authorities ("Revenue Authorities").[27] Some of the criteria involved are the fair market value of the goods/service, the legitimate needs of the business or profession and the benefit derived by taxpayer. As discussed above, the Indian regime differentiates between revenue and capital expenditure. Therefore if the interest is towards a capital expenditure then it is not deductible from the revenue account. However, it is factored into the cost of capital asset and should be eligible for depreciation benefit. In few cases involving cross-border related party transactions, courts have scrutinized specific instances wherein interest free loans were extended to foreign/Indian subsidiaries by their parent holding companies. For example, in the case of *Perot Systems TSI (India) Limited* v. *Dy. CIT*,[28] the taxpayer, an Indian company advanced interest free loans to its subsidiaries (Bermuda and Hungary), which in turn used those funds to make investments in other subsidiaries. Rejecting the taxpayer's contention that the said loans were in fact 'quasi-equity' advanced in furtherance of commercial expediency, the ITAT (Delhi) held that under the applicable transfer pricing rules, arm's length rate of interest ought to have been charged. Further, in the case of *VVF Ltd.* v. *Dy. CIT*,[29] the ITAT observed that funding assistance by a parent company to its subsidiaries without arm's length interest would not satisfy the arm's length test, irrespective of commercial expediency.

Convertible Instruments - the issue posed

Although the principles for debt and equity are laid down as above, in a situation where the instrument itself is hybrid, there is not significant clarity. This is why the deduction for expense incurred in relation to convertible instruments has been the subject matter of conflicting judicial opinion. In the case of *Banco Products (India) Ltd.* v. *Dy. CIT*[30] it was observed that since convertible debentures have characteristics of equity shares, the convertible portion of such debentures cannot be termed as debt and, therefore, any expenditure to enhance the equity base of the company has to be treated as capital expenditure. Whereas a contrary view was taken in *CIT* v. *Secure Meters Ltd.*[31] in which case it was held that debentures issued are loans and, thus, expenditure incurred in issuing and raising loan by debentures is admissible, notwithstanding the fact that the same is convertible or non-convertible. What are the features of debt or equity one would look for? In case interest payments are made contingent on earning profits or on the value of publicly-traded property or the value of a stock or commodities index, a question may arise whether the amount paid by way of interest is tax deductible. Such loan/interest arrangements are not widely prevalent in India and the ITA does not provide any separate provisions for deduction of interest in such situations and such issues remain largely untested by the Revenue Authorities.

Sale, Redemption & Conversion of Debt Instruments - Important Tax Considerations

The ITA provides that any profits and gains arising from the transfer of a capital asset are chargeable to tax under the head 'capital gains'. 'Transfer', in relation to a capital asset has a wide connotation and is defined to include sale, exchange or relinquishment of an asset or the extinguishment of any rights in an asset. The ITA further provides that any transfer involving the conversion of bonds or debentures, debenture-stock or deposit certificates of a company into shares or debentures of that company is exempt[32]. However, convertible preference shares are not covered by this exemption and to that extent some ambiguity continues to exist.

In cases of sale and redemption of debentures, the debenture holder may be liable to tax on the capital gains arising from the redemption of debentures. For instance, a Foreign Currency Convertible Bond ("FCCB"), for the purpose of taxation is treated as a debt instrument till such time it is converted into equity shares. Nonetheless, since it is considered a debt instrument it would qualify as a capital asset in the hands of a subscriber/purchaser of the FCCB.[33] Further, in the case of redemption of FCCBs, it can be said that the redemption results in the relinquishment of rights in the capital asset, and should hence, give rise to capital gains.[34] Further, the Central Board of Direct Taxes ("CBDT") has issued a Circular[35] discussing the tax treatment of deep discount bonds wherein it has been stated that any payment received on the maturity of such

bonds must be treated as interest income. However, it has been clarified that the aforesaid circular shall not be applicable in respect of zero coupon bonds issued by specified companies that are notified by the Government.[36]

SECTION 3 - CLASSIFICATION AS DEBT OR EQUITY

Debt & Equity - Foreign Investments under Indian Exchange Control laws

From an FDI perspective, only those instruments which are fully and mandatorily convertible into equity are considered as investment. Other instruments, despite their nomenclature (*e.g.* preference shares / debentures, non-convertible, optionally convertible or partially convertible instruments) are considered as debt, mandating compliance with ECB Regulations.

Prior to 2007, many Indian companies raised funds under the FDI route through the issue of hybrid instruments such as optionally / partially convertible debentures and preference shares. However, in June 2007, the RBI has issued circulars[37] clarifying that since these optionally / partially convertible instruments are intrinsically debt-like instruments, routing of debt flows through the FDI route has an effect of circumventing the framework in place for regulating debt flows into the country. It clarified (prospectively) that only instruments which are fully and mandatorily convertible into equity would be reckoned as part of equity under the FDI policy and eligible to be issued to persons resident outside India under the FDI route.

Recently, the RBI has been raising concerns regarding FDI where the non-resident investors have a put option on the Indian company and / or promoters at a fixed return, that is, they have the right to force either the company to buy-back, or the promoters to purchase, the equity / mandatorily convertible instrument from the non-resident at such price which gives the non-resident an exit at predetermined fixed rate of return. A typical example would be where the non-resident subscribes to a CCD of an Indian company at INR 100 and has the right to force the Indian company to buy-back the CCD after three years at 36% interest on the investment of INR 100. Such put option rights, according to RBI, gives the instrument debt like characteristics, as the foreign investor gets fixed returns akin to debt and it becomes indifferent to the profit and loss of the company, thereby defeating the whole intent behind FDI, which is participation in the risk capital of the company.

Though, no formal notification or clarification has been issued by the RBI in this regard, there have been instances where companies issuing such instruments have been issued show cause notices by the RBI to explain as to why such instruments should not be considered as ECB.

Other Regulations

Though not expressly distinguishing debt and equity, there are certain regulatory authorities in India which prescribe norms in respect of entities governed by them that classify these instruments to some extent. For example, the regulations governing Non-Banking Financial Companies ("NBFC") and Core Investment Companies ("CIC") issued by the RBI provide few such instances.

NBFC

A company is treated as an NBFC if its financial assets are more than 50% of its total assets (netted off by intangible assets) and income from those financial assets is more than 50% of the gross income. Under the directions issued by the RBI applicable to NBFCs,[38] it has been mandated that every Systemically Important Non Deposit taking NBFC ("SINBFC"), that is, NBFCs not accepting / holding public deposits and having total assets of INR 100 crores (approximately USD 22.5 million) and above as shown in the last audited balance sheet, maintain a minimum prescribed capital ratio consisting of Tier I and Tier II capital and that the total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

Tier I capital, the more important of the two, largely consists of shareholders equity, whereas Tier II capital consists mainly of other kinds of capital, including hybrid instruments. Preference shares, other than CCPS, are included within the ambit of Tier II capital, whereas CCPS have been brought within the ambit of Tier I capital, indicating

that instruments mandatorily convertible into equity are treated at par with equity. However, at the same time a dichotomy exists here as CCDs are still classified under Tier II capital and not under Tier I capital. Further, perpetual debt instruments,[39] have also been included as a constituent of Tier I capital giving them a flavours of shareholders capital whereas CCDs, still qualify as Tier II capital.

CIC

A CIC is an NBFC which have their net assets predominantly (not less than 90%) in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies. CICs enjoy certain exemptions in terms of registration requirements and credit concentration norms. However, to qualify as a CIC, one of the conditions which have to be satisfied is that the investments in the equity of the group companies should constitute not less than 60% of its net assets. It has been specifically provided under the Core Investment Companies (RBI) Directions, 2011 that financial instruments compulsorily convertible into equity within the period of 10 years would be included for the purposes of computation of the equity investment into group companies. Thus this is one instance where not only the convertibility of an instrument, but the period of convertibility as well, has been taken into account in classifying the instrument as equity or debt.

Tax Perspective

Indian taxation laws do not have a thin capitalization regime. The Revenue Authorities in general respect the form of an instrument and do not attempt to characterize debt as equity based on substance over form doctrine or under the general anti-abuse provision. In one reported case involving extraordinarily high debt equity ratio, the Revenue Authorities attempted to classify debt as equity. However, on appeal the ITAT struck down this approach as being impermissible.[40] The Tribunal held that in the absence of thin capitalization rules, the Revenue Authorities did not have the power to re-classify debt as equity. Accordingly, it would be fair to state that for tax purposes it is common to treat classification of instruments and the consequent income flowing from such instruments as an exercise that is independent of the classification criteria adopted for other purposes such as foreign investment regulations, accounting standards etc.

In this regard it is pertinent to note that the ITA envisages a separate authority - "the Authority for Advance Rulings" ("AAR")to make such an authoritative and binding determination of taxability of a particular ongoing on proposed transaction. An advance ruling pronounced by the AAR is binding with respect to transaction(s) in relation to which ruling has been sought, on the Revenue Authorities and the applicant i.e. taxpayer who seeks such a ruling.

SECTION 4 - OTHER MEANS OF PROVIDING CAPITAL

Raising capital domestically is fairly unregulated in India. Mortgage of property of the company, pledge of promoter shares, and promoter guarantees, individual as well as corporate, is a common phenomenon. The situation however, changes drastically, when capital is sought to be raised from abroad, or using foreign collateral. Though, equity can be raised under the FDI regime fairly easily, as most of the sectors are now open to foreign investment,[41] raising offshore debt is still a challenge. Debt can be raised from abroad under the ECB regime, however, there are various onerous limitations imposed such as end use restrictions, eligible borrowers, recognized lenders, amount, maturity period etc. which need to be complied with, prior to raising such debt as well as during tenure of such debt. Further, creation of security on immovable property or pledge of shares in favour of non-residents, for the purpose of securing the ECB raised by the borrowing company in India is also subject to certain conditions.

To work around the restrictions imposed under the ECB regime, and in certain cases the sector specific restrictions imposed under the FDI regime, another route for raising capital abroad which has gained popularity in the recent past is the Non-Convertible Debentures ("NCD") route.

Under this route, the Indian company first issues NCDs to a domestic lender, acting as a warehousing entity. As debt is being raised from a domestic

lender, the borrower has the flexibility to determine the coupon rate, tenure[42] and end-use of proceeds from NCDs. The NCDs are then listed on any stock exchange in India under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. Subsequent to listing, a SEBI registered Foreign Institutional Investor ("FII") then purchases the NCDs on the floor of the stock exchange from the warehousing entity, subject to the limits prescribed by the RBI and SEBI from time to time.[43] Thus, under this route, a non-resident entity is able to provide capital to an Indian company without being subject to the restrictions imposed under the ECB and the FDI regime.

Another challenge that was faced until recently was that similar to restrictions on creation of mortgage over immovable property and pledge of shares in favour of non-residents, until recently, a non-resident shareholder could not pledge its shares in an Indian company to secure a debt raised by the Indian company, without the prior approval of the RBI. However, the RBI has recently obviated the need for its prior approval by delegating the powers to the Authorized Dealer Category - I banks ("AD"). Thus under the new regime, an important funding channel for raising debt by an Indian company from an Indian bank by leveraging the shares held by non-residents has opened up.

As mentioned in section 5 above, the tax treatment of zero coupon bonds and especially deep discount bonds and FCCBs has been uncertain with differing views on classification of income/gain at the time of redemption. In this regard, it is pertinent to note that numerous tax treaties entered into by India define the term 'interest'. The Treaty (India - Mauritius) for example, unlike the ITA, defines interest to include 'premiums and prizes attaching to such securities, bonds or debentures'. The OECD commentaries also indicate that the premium paid on redemption of a debt instrument has the character of interest on the debt.

Therefore, a view may be taken by the Revenue Authorities that the premium on redemption of a FCCB should be taxed as interest income. However, notwithstanding the classification of FCCBs redemption premium under the Treaty, it should be noted that the ITA would apply to the extent they are more beneficial to the taxpayer. Hence, if the redemption premium is treated as capital gains under the ITA, then the taxpayer should be able to claim the benefit of the definition under the ITA and apply the Treaty for the purpose of determining which country has the right to tax the capital gains.

Basis the above, a possible structuring alternative may be to consider an instrument which may be treated as tax deductible in the hands of the issuer (being interest income) and taxed at an optimal rate in the hands of the recipient. For instance, the payout can be a redemption premium which may be tax deductible in the hands of the issuer as interest payments and taxable as long-term capital gain in the hands of the recipient (subject to the satisfaction of the holding period). However, given the ongoing debate on the classification of redemption premium, care would need to be taken during structuring exercise since the Revenue Authorities may classify the entire amount as interest income.

SECTION 5 - GOVERNMENT APPROACHES TO ADDRESS ISSUES

The Indian Government has proposed to introduce an anti-avoidance measure by way of General Anti Avoidance Rules ("GAAR") which will empower the Revenue Authorities to re-characterize equity as debt or *vice versa* in a case where the arrangement entered into by a person (with the sole or predominant objective of obtaining a tax advantage) is declared to be an impermissible avoidance arrangement. However, the recently released Shome Committee Report on GAAR has recognized the choice of funding through debt or equity to be a method of acceptable tax mitigation as it is an option available to the taxpayer under law and should be left generally to commercial judgment of a taxpayer. The Committee has proposed that 'funding through debt or equity' should be included under a negative list of transactions to which GAAR should not apply. However, if there is a tainted element present in the transaction i.e. the transaction is being carried out in an abnormal manner and the same result would not be obtained in case of a *bona fide* transaction, in such a scenario GAAR may be invoked. For example (as illustrated in the

Report), when the rate of interest is directly linked to the annual profits of the company. Such a proposal comes as a welcome relief to taxpayers. It is expected that these recommendations made by the Committee shall be accepted in entirety by the government.

Conclusion

Indian capital markets are vibrant and draw wide domestic and international participation. The debt market though is much smaller than the equity market. As discussed in the paper, the term "debt" has not been defined in the Indian tax statute, however, it provides for a definition of the term "interest" which is quite wide and captures within its ambit all payments made for any debt incurred or any other similar obligation. However, the taxability of various hybrid instruments is still ambiguous and clear in cases where there is no clear cut provision provided in the ITA.

In the absence of a thin capitalization regime in place, the characterization and possible re-characterization of debt as equity and *vice versa* is still under question. Although the Shome Committee Report on GAAR has clarified situations in which such re-characterization can be made, one still is yet to see the manner and situations in which this is done to get a clear picture of the same.

Indian taxation law and practice supports the form over substance doctrine in respect of classification of debt and equity. The tax authorities generally do not attempt to alter the form of debt into equity and it is hoped that in future also, the same practice is followed.

1. The Bombay Stock Exchange (BSE), one of the two main stock exchanges, was set up in the 1850s and has a market capitalization of more than US$1.5 trillion
2. India has about US$200 billion of corporate bonds outstanding compared with China's corporate bond market of $614 billion, according to Asian Development Bank figures.
3. Section 85 of the Companies Act.
4. Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.
5. Section 5 of ITA
6. Section 9(1)(*v*) of ITA
7. Section 10(*38*) of the ITA
8. Section 115AD of the ITA
9. Base rate 30% plus surcharge of 2% (in case of corporate recipients where income exceeds INR 10 million) and education cess of 3%]
10. Base rate 10% plus surcharge of 2% (in case of corporate recipients where income exceeds INR 10 million) and education cess of 3%]
11. Section 9(1)(*i*) of the ITA; securities of an Indian entity are considered as assets situate in India.
12. Section 195 of the ITA.
13. Section 36(1)(*iii*) of the ITA.
14. India follows a scheduler system of taxation and there are five heads of income: "salaries", "house property", "capital gains", "business or profession" and "other sources": Section 14 of the ITA.
15. Base rate of 15% plus surcharge @ 5% and cess @3% on tax and surcharge. Surcharge is applicable if the total income of the company exceeds Rs. 10 m.

16. Base rate of 30% plus surcharge of 7.5% and cess of 3% on tax and surcharge. Surcharge is applicable if the total income of the company exceeds Rs. 10m.
17. *CEPT* v. *Bhartia Electric Steel Co Ltd.,* [1954] 25 ITR 192 (Cal.)
18. Section 2(28A) of the ITA
19. *Kirloskar Electric Co Ltd* v. *CIT. (No.1)* [1997] 228 ITR 674 (Kar.).
20. *L.M. Thapar* v. *CIT* [1988] 173 ITR 577/37 Taxman 95 (Cal.).
21. Section 37 of ITA.
22. *C. Moolchand* v. *CIT* [1956] 29 ITR 449 (Hyd.).
23. *Ritz Continental Hotels Ltd.* v. *CIT* (1978) 114 ITR 554 (Cal.).
24. *Dey's Medical Stores Mfg. (P.) Ltd.* v. *CIT* [1986] 162 ITR 630/26 Taxman 390 (Cal.).
25. *Triveni Engg. Works Ltd.* v. *CIT* [1987] 167 ITR 742/31 Taxman 128 (All).
26. Section 92 of the ITA provides for determination of arm's length price in international transactions whereas Section 40A(2)(*b*) of the ITA provides for disallowance of any excessive expenditure incurred in favour of a related party in the domestic scenario.
27. *S.A. Builders Ltd. v. CIT (Appeals),* [2007] 288 ITR 1/158 Taxman 74 (SC).
28. [2010] 37 SOT 358
29. [IT Appeal No. 373 (Mum.) of 2006, dated 8-1-2010]
30. [1997] 63 ITD 370 (Ahd.); See also, *Sona Steering Systems Ltd. v. Dy. CIT* [2003] 129 Taxman 152 (Delhi) (Mag.).
31. [2008] 175 Taxman 567.
32. Section 47(x) of the ITA.
33. This assumes that the debt instruments are not in held as stock-in-trade in which case it would be treated as a revenue receipt. There are a number of judicial precedents stating that even a debt instrument such as a fixed deposit in a bank or foreign currency by itself should qualify as a capital asset
34. *Mrs. Perviz Wang Chuk Basi* v. *Jt. CIT* [2006] 102 ITD 123 (Mum). The ITAT held that "*Thus after the date of redemption, there was an extinguishment of right by operation of contract and also a relinquishment of right in the asset in lieu of which, the assessee received cash from the competent authority. In either of the situations, the case is covered within the definition of Section 2(47) i.e. transfer*". See Also, *Madhya Pradesh Financial Corporation* v. *CIT* [1981] 132 ITR 884 (MP).
35. Circular No. 2/2002, dated 15-2-2002. However, it may be noted that Circulars issued by the Authorities are not binding on the taxpayer.
36. Circular No. 3/2006 dated 27th February, 2006. Further, in the case of a zero coupon FCCB (bonds that are convertible into equity shares after a certain period but no interest is payable till such conversion), an option is provided to the bond holder to either convert the bond into equity shares or redeem the same at a premium. Since, there is only an extinguishment and relinquishment of rights in the capital asset, and not a payment representing interest, the same should be regarded as capital gains.
37. A.P. (DIR Series) Circular No.73 and A.P. (DIR Series) Circular No.74
38. Notification as amended upto June 30, 2011– "Non-Banking Financial (Non - Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007"
39. PDIs may be issued as bonds or debentures by SINBFC subject to certain terms and conditions as prescribed under RBI Circular DNBS (PD) CC. No.131/03.05.002/2008-2009. The maturity period of PDIs shall be perpetual and the instrument shall be plain vanilla instrument; however, PDIs with call option may be issued subject to compliance with each of the following: (a) the instrument has run for a minimum period of 10 years from the date of issue; and (b) call option shall be exercised only with the prior approval of the RBI.
40. *Besix Kier Dabhol, SA v. Dy. DIT (International Taxation)* [2011] 131 ITD 299/[2010] 8 taxmann.com 37 (Mum.)
41. Pricing restrictions and certain sector specific restrictions are still applicable.
42. For NCD with maturity period of up to one year, separate directions have been issued by the RBI.
43. Under Regulation 5(4) read with Schedule 5 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**").

Mutual Agreement Procedures and Resolution of Cross Border Disputes

Vijay Mathur*

Tax controversies and disputes seem to be the order of the day. In the international arena the increase has come from the exponential growth in cross border transactions and investments. This in turn has given rise to use of resources, markets and employment of persons overseas and their taxation in different jurisdictions. Instances of double taxation therefore are on the increase and the real problem is when they remain unresolved. The friction with tax departments emanates across the globe, particularly in developing countries from the interpretation and application of domestic law and its interface with the treaty. Countries also target base erosion and profit shifting. The result is an increase in tax disputes. The need therefore for an expeditious Competent Authority (CA) process has never been felt to be greater.

In most jurisdictions the final resolution of cross-border disputes through the domestic appeal system, is both time consuming and expensive. From the appeals filed before officials of the department to the Tribunal and then the higher Courts is a long journey. The expectation from the Mutual Agreement Procedure (MAP) is therefore high as it provides a one stop in-expensive resolution to international tax disputes. The time taken in resolving disputes under MAP has however been increasing first due to the increased workload and maybe more important because of the bench strength of the Competent Authority team not increasing commensurately. It is learnt that in respect of OECD countries alone (figures for other countries are not available) the end of the year MAP case inventories have increased nearly 20% from 2006 to 2011. During the same period the average number of months taken for completion of MAP has gone up from 22 to a little over 26 months. Globally the time taken is reported between 3 to 5 years. It is also known that there are cases which have been pending resolution for more than eight or ten years. The figures of pendency at the beginning of the year, addition during the year and the closing stock at the close of a year should be published by countries. This may inspire CAs into action where there has been limited progress in MAP cases.

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To be fair there are some inhibiting factors which do come in the way of successful resolution of MAP cases. Usually CAs are drawn from the revenue service of the country and consequently would be averse to forgo any tax in an agreement under MAP. This is not to suggest that CAs should be appointed from the private sector as few Governments would feel comfortable in parting with this function. Further, some countries have a system of review and approval which slows down the CA process and weighs on its independence. Then the words used in Paragraph 2 of the Article on MAP, that "the Competent Authority shall endeavour ... to resolve the case by mutual agreement" gives the effort a non-mandatory status. Also, though there is time within which a MAP may be invoked, there is no limitation for disposal of a case. The procedures are also cumbersome in that they begin with country invoking MAP to give details of why the process is being initiated followed by the other country sending its position paper in the case. Both these processes involve interaction of the CAs with the relevant tax offices of their country and the subsequent examination of the case. In addition the secrecy of the proceeding in MAP and the absence of the taxpayer from the deliberations in the furnishing of the position papers and the face-to-face meetings, limits to some extent the efficiency of the process. The office of the CA carries with it other functions associated with international taxation and at times this is also a reason for the delay in dispatching position papers, fixing face-to-face meetings and even at times adhering to the appointed dates.

Most countries recognize that the CA office has institutional limitations in the form of inadequate resources. Staffing is an issue. The number of personnel trained in international taxation has not kept pace with the increase in work-load. Training therefore becomes an important function for the personnel selected to work in the CA office. Other capacity issues like space and budget at times become irritants in the proper functioning of the CA office.

In addition to the institutional, it is seen that limitations are also caused by many country CAs insisting on following provisions of their domestic statutory law or administrative guidance. The provisions of the treaty which actually is the starting point for the resolution may lead to the provisions of the treaty itself being ignored. There is an apparent mismatch at times in transfer pricing disputes as the regulations specified in arriving at the arms length price of a transaction may differ between countries. In spite of this there is no reason why agreements cannot be arrived at on the basis of analysis of only facts pertaining to a transaction. Basically agreements have to be understood as resolving an issue rather than adoption of a purely legal stance. There are cases where an audit results in the tax department holding that a PE is constituted. The CA of the other country is not in agreement as according to him the provisions of Article 5 & 7 are not satisfied. In close cases an agreement could be reached if an attempt is made by both parties to determine the income that could be attributed to the PE on a Transfer Pricing analysis. Settlements have been reached on this basis.

Agreement however would be difficult if it is negotiated in terms of the current tax policy of the country. The CA outcomes should be based on the provisions of the applicable bilateral treaty. If this is not followed the impression that the agreements are reached on the basis of *ad hoc* resolutions and on the basis of "horse trading" would unnecessarily gain credence. Further there are instances where CAs may not be too willing to reach agreements if the cross-border trade between countries is imbalanced or more adjustments are invoked by one of the treaty partners. MAP consideration should be for all issues covered by the treaty but some countries do not do so on specific issues. Canada excludes thin capitalization. Japan does not accept applications involving "contributions" or "donations" between related parties and India excludes transfer pricing adjustments where there is no Article 9 (2), from the ambit of the MAP process. Exclusions based on anti-avoidance or penalties also seem to be on the rise. Many treaties however specifically exclude penalties from the scope of the "taxes covered". In this circumstance they may be justified in not entertaining such MAP applications.

The Article on MAP should be considered in a liberal way so that most disputes could be considered. The introduction of a transfer pricing provision in Article 9 (1), itself accepts the fact that the two countries recognize economic double taxation and not only juridical double taxation. Alternatively it could be argued that in the absence of article 9 (2), transfer pricing adjustments can be invoked under the MAP Article as the CAs are empowered to do so, by virtue of the following words found in Paragraph 3 of the Article, namely, - "They may also consult together for the elimination of double taxation in cases not provided for in this Agreement."Countries which do not entertain MAP cases where Article 9(2) does not exist however must make public their position on this issue.

Paragraph 1 of the Article on MAP provides that the "case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Agreement."Normally this would mean three years from the date when the notice of demand or assessment for the collection of tax is received by the taxpayer. However the phrase in the same paragraph, namely that "actions of one or both of the Contracting States result or will result" in taxation not in accordance with the Agreement allows the interpretation, that the trigger date could be earlier than the date of receipt of the demand notice or assessment order by the taxpayer. This could be in the form of a 'show cause' notice received by a taxpayer from the tax department proposing an action in respect of an issue not in accordance with the provisions of the Convention. The proposed action may already have been applied in the case of other taxpayers. In such a circumstance an application could be filed under MAP after the receipt of the show cause notice and before the completion of assessment. If there is a tax withholding order in respect of a cross-border transaction, then the recipient may possibly come to know of the same at a point of time which is later than the date of deduction of tax. In such case the CAs may have to allow the time from the date when the recipient of income becomes aware of the withholding. This obviously should be on the basis of evidence filed. In many bilateral treaties the limitation of three years is not provided for. In such cases the CA should accept the application under MAP even after three years, if the limitation under the domestic law has not expired. Limitation under domestic law here would mean that there is still time to file an appeal under the domestic law before any appellate authority.

Internationally the domestic appeal process stands suspended in many jurisdictions with the acceptance of MAP filing by a CA of one of the countries. In others the processes are allowed to run in parallel. The former rule presumably is to avoid a multiplicity of proceedings and further in case the CA resolution is accepted by the taxpayer any other appeal would become infructuous. The other method is probably with the intent to save time in case the taxpayer does not accept the MAP resolution, in which case, the entire process of domestic appeals would commence only after two to three years. Some countries require a taxpayer to deposit the full amount of tax and interest assessed or a substantial part of it as part of their appellate procedure. This is extended to the MAP cases too. In the latter cases the tax may have to be paid in both the countries thus creating cash flow problem for the taxpayers. It is therefore advisable if collection of tax is suspended during the time when the MAP is in progress. Stay of collection may however be allowed only if adequate safeguards/guarantees have been taken by the tax department for a possible collection of the assessed tax. If the entire taxes are collected as per the assessed tax, there is a concern that the CAs may not want to resolve the case as it may result in a refund.

Delays in the MAP proceedings are a hardship to the taxpayer as it may result in interest charges, currency fluctuations and the difficulty faced in financial reporting. Towards this end both the OECD and the UN have incorporated procedures of arbitration where the CAs have not been able to come to an agreement after a specified period of time from the invocation of MAP. The OECD Model provides that if CAs do not reach an agreement to resolve the case within two years from the presentation of the case to the CA of the other State, any unresolved issue shall be submitted for arbitration if the taxpayer makes such a request. According to this Model the

unresolved issues would not be the subject of arbitration if decisions on these have been rendered by a Court or Tribunal.

The UN Model provides for arbitration after a period of three years as against the two years stated in the OECD Model. The other significant difference is that instead of the taxpayer making a request for arbitration after the specified period in which the MAP remained unresolved, the arbitration can be initiated only by one of the CAs. The arbitration decision is binding in both States and will be implemented notwithstanding the domestic law time limits.

Some countries have already entered into their treaties such a provision. However others are bidding their time and watching how successful this process develops into. In any case once this arbitration provision is adopted it would put pressure on the CAs to resolve cases before the time of two or three years specified, for the possible initiation of this process. While it is understood that the arbitrator would be nominated by Government and could be a person serving in Government, there may be countries which may not legally or constitutionally be able to offer for arbitration, a sovereign function like taxation. This may be so in spite of the fact that it is only an extension of the Competent Authority process.

Successful tax administrations place great emphasis on providing an efficient dispute resolution mechanism. Domestic appeal procedures take long and are costly too, for both the tax department as also the taxpayer. Governments must therefore recognize the importance of the mutual agreement procedure provided in all double tax avoidance agreements. Adequate and trained manpower is a basic requirement for each Competent Authority office. The expenditure incurred for this office would be more than made up by the relatively inexpensive way of resolving disputes through MAP. If the MAP process also takes a shorter time than today, taxpayers and tax administrations would benefit greatly and trade and investment would flow more smoothly.

Interpretation of Article 3(2) of tax treaties – India's perspective

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Tax treaties, under paragraph 2 of Article 3, provide that undefined terms under the treaty should derive their meaning from the domestic laws of the respective countries. Article 3(2) is gaining significance in today's times as more and more countries are trying to place reliance on it to unilaterally define terms in their domestic laws and use the same to override tax treaties, so as to increase their tax base and tax revenues.

While applying tax treaties, it becomes necessary that the various terms used therein are aptly interpreted in good faith, keeping in mind their ordinary meaning and the context in the tax treaty, so that the tax treaties are able to meet their purpose. This principle is also supported by the Vienna Convention on Law of Treaties ('VCLT') which codifies the existing norms of customary international law on treaties[1]. While some countries (such as Mexico) give primary importance to the VCLT in interpreting terms used in tax treaties, Indian courts have not explicitly referred to VCLT for interpretation of tax treaties, except in a few instances where VCLT has been referred to[2]. However, the broad principles laid down by the VCLT are universally respected. This article discusses some important issues with respect to the applicability of Article 3(2).

Which state's laws will be applicable?

If each treaty partner applies its own respective definition, it could lead to double taxation or non–taxation of income for both countries. It is pertinent to determine the contracting state that will apply the definition. The general view is to apply the laws of the source state *i.e.* where the treaty is being applied. It is expected that the resident state should confirm the applicability of the laws by the source state, so as to avoid any double taxation of income.

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Which domestic law would be applicable?

Article 3(2) of tax treaties generally provides that the meaning defined under the domestic law should be adopted. The question arises as to whether only meaning assigned in the domestic tax law or any other domestic law should be referred to. Also, where a term is defined under two or more domestic laws, the question arises as to which law should then be given preference. The general principle followed in this case is that the domestic tax law should be first referred to and any meaning under the domestic tax law has to be given preference. For instance, the India-Luxembourg tax treaty has the following provision in this regard:

> *"As regards the application of the Agreement at any time by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Agreement applies,* ***any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.****"*

Where a term is not defined under the domestic tax law, any other domestic law can be referred to and the term should be accorded the meaning under that law which best suits the context in which it has to be interpreted. The above principle is also supported by the OECD Commentary on tax treaties. India's treaties with various countries such as Luxembourg, South Africa, Hungary, Armenia, Mexico, etc expressly incorporate the above principle in Article 3(2).

The Indian domestic tax law has been recently amended to provide that any term used but not defined in the Indian Income-tax Act, 1961 ('the Act') or the tax treaty shall, unless the context otherwise requires and is not inconsistent with the provisions of the Act or the tax treaty, have such meaning as is assigned to it under any notification issued by Indian Government in this regard[3]. Thus, the Indian tax law empowers the Government to assign meaning to an undefined term by way of a notification and in case such a meaning is assigned, the same should then prevail rather than meaning under any other domestic law.

Indian courts in several rulings on characterisation of software payments have placed reliance on other domestic laws where a term has neither been defined under the tax treaty nor under the Act[4]. Software payments were not specifically covered within the meaning of 'royalty' either in India's domestic tax law or its tax treaties. The definition of the term 'royalty' under both *inter alia* included payment for transfer of all or any rights in relation to a 'copyright'. The term 'copyright' has not been defined under either the domestic tax law or tax treaties. The Courts placed reliance on the definition of 'copyright' under the Indian Copyright Act, 1957 to determine whether the software payments could qualify as payments for transfer of copyright and hence, get covered within the meaning of royalty.

Similarly, in India, for the meaning of the word 'securities' which is neither defined under the domestic tax law nor India's tax treaties, the domestic tax law itself makes reference to the definition under the Indian securities laws.

In certain cases, if there is no definition in the domestic law as well, Courts have placed reliance on the interpretation accorded to the relevant terms in previous Court rulings.

In a French case[5], interest payment was made by a French company to its Swiss parent for late payment of commercial debt and the question was whether such payment is taxable as interest or business profits under the tax treaty. Tax withholding would have been required in France if the payment qualified as interest. The term 'interest' was defined under the treaty as 'income from debt claims of every kind'; however, the expression 'income from debt claims of every kind' was not defined either in the treaty or in the domestic tax or non-tax legislation. The Court then relied on interpretation adopted in a prior domestic tax case law, thereby holding that interest for late payment of commercial debt would belong to the same category for the recipient as the main income *i.e.* business income.

In India, the term 'fees for technical services' is defined in the domestic tax law as well as most tax treaties to mean consideration for rendering of 'technical, consultancy or managerial services'. The terms 'technical', 'consultancy',

or 'managerial' have not been defined in either the domestic tax law or tax treaties. In such a case, meanings given in the legal dictionaries and interpretation given by Courts in past rulings are commonly referred to.

Context to be given importance

Article 3(2) of tax treaties states that the domestic law meaning is to be used *'unless the context otherwise requires'*. This would mean that before applying the domestic law meaning for a term which is undefined in the treaty, it is necessary to see whether such meaning is consistent with the context in which the term is used in the tax treaty, so that the purpose of the relevant provision of the tax treaty is not frustrated.

The above principle is supported by the OECD Commentary as well as the VCLT, which are used as guides for interpreting tax treaties throughout the world. The OECD Commentary further states that the context needs to be determined by the intention of the treaty partners when signing the tax treaty as well as the meaning given to the term in question in the domestic tax law of the other treaty partner.

In India, the Court upheld the above principle in the ruling pronounced in the case of ***CIT* v. *Siemens Aktiongesellschaft* [2009] 177 Taxman 81 (Bom.)**, which is discussed in greater detail later in this article. In this ruling, the context in which the term 'royalty' was used in the tax treaty was given importance rather than the definition of the term in the domestic tax law. Similarly, in another ruling in the case of James Mackintosh[6], the Court observed that to determine the meaning of words used in tax treaties, their ordinary meanings need to be seen in the context and in light of the objects and purpose of the tax treaty, so that the treaty is interpreted in good faith and it is workable rather than redundant.

The significance of 'context' was also discussed in one of the Danish cases[7], where the interpretation of the term 'paid to' used in the article on taxability of dividends in the relevant tax treaty was under debate. In this case, a Swiss company was entirely held by a Danish company, which was in turn held by a Guernsey company. The question was whether the dividend paid by the Swiss company should be considered to have been 'paid to' the Danish company or the Guernsey company under the tax treaty. The expression 'paid to' was not defined in the tax treaty. The Swiss domestic tax law provided for interpretation of the phrase 'paid to' in the context of beneficial ownership, thereby implying that the dividend payment be considered to have been made to the ultimate holding company in Guernsey. The Court held that the context of the tax treaty needs to be given precedence over the domestic tax law meaning; the context of the treaty was to prevent double taxation of income and hence, rather than adopting the broader concept of beneficial ownership, the decisive criterion for determining whether the Danish company be considered as the recipient of income or not would be whether the recipient's country (*i.e.* Denmark) allocated the income to the Danish company for tax purposes.

Similarly, 'context' was given precedence in a Swiss case law, where it was to be determined whether the ultimate parent company in the US which held a Swiss company through a chain of subsidiaries in the US and Switzerland, would be eligible for the preferential withholding tax rate of 5 percent (under the treaty) on hidden dividend distribution by the Swiss company. Here, while the US parent could not qualify as 'shareholder' as per the definition of 'shareholder' under the Swiss company law, the definition of dividend under the Swiss tax law was given a much broader interpretation to include hidden dividends. The Court relied on such broader definition of dividend as well as the context/purpose of the treaty in providing lower tax withholding rate and held that if dividend has to be interpreted economically, even the term shareholder should be interpreted in that sense and not in the narrow sense as per the domestic company law.

Static v. Ambulatory interpretation

With passage of time, the definitions and interpretations of terms change. A question arises as to whether the terms used in tax treaties should be interpreted in accordance with the *Static Approach* or the *Ambulatory Approach.*

The argument in favour of the 'Static Approach' is that a tax treaty represents an agreement of

mutual understanding between the two countries reached at the time of finalization of the treaty and hence, the interpretation of a tax treaty should be based on the provisions relevant at the time of finalization of the tax treaty. On the other hand, the rationale for applying the 'Ambulatory Approach' is that the ever changing times and commercial scenarios demand that the tax treaty is interpreted on the basis of meanings prevalent in the current world, *i.e.* at the time of application of the tax treaty. The OECD Model Convention and its Commentary support the ambulatory approach for interpretation.

Article 3(2) of certain Indian treaties is worded in a manner to provide for ambulatory approach by use of the words 'at that time', 'from time to time', etc, such as treaties signed with South Africa, Australia, Mexico, Hungary, Saudi Arabia and Kazakstan.

The question that arises is that in the absence of the above language in other tax treaties, can one adopt a static approach while interpreting terms under such other treaties.

The static approach was upheld by the Indian Court in the case of Siemens[8] to give purposive interpretation to the treaty. In this case, a German company had entered into agreements with Indian companies for provision of certain patents, patent applications, utility models, relevant written material etc. and the question was whether payments for the same qualified as 'royalty'. The term 'royalty' was not defined in the applicable tax treaty (the erstwhile India-Germany tax treaty). For interpretation of an undefined term, the relevant tax treaty gave reference to the meaning of the term under the 'laws in force' of the respective country. The term 'royalty' was not defined in the Indian domestic tax law as well at the time of entering into the tax treaty, though the same had been subsequently defined in the domestic tax law. The Revenue contended that given the expression 'laws in force' in the India–Germany tax treaty, the Court should consider the ambulatory approach of interpretation and not static interpretation and apply the royalty definition existing in the domestic tax law as on the date of application of the treaty, thereby, taxing the payments as royalty. On behalf of the taxpayer, it was submitted that the clauses of the tax treaty and the meaning at the point of time when such treaty was entered into should be considered, thereby ignoring the subsequent amendments. The Court finally held that despite there being a subsequent meaning assigned to the term 'royalty' in the Indian domestic tax law, what was important for determining taxability under the tax treaty was the context in which the term 'royalty' was used in the tax treaty (which was used in a narrow sense with regard to income from operation of a mine, quarry or any other extraction of natural resources) and hence, it did not apply the meaning which was subsequently assigned to 'royalty' in the Act (after the execution of the tax treaty) while interpreting the term under the tax treaty.

Recent trends in India

The above issue gains importance with the recent amendment introduced in the Indian domestic tax law by Finance Act, 2012, by an Explanation inserted in the provision which empowers the Indian Government to assign meanings to undefined terms by issuing notifications. The new Explanation (inserted with retrospective effect from October 1, 2009) provides that the meaning assigned to any term by way of the above-mentioned notification shall be deemed to have effect from the date on which the respective tax treaty came into force. This amendment seeks to clearly lay down adoption of ambulatory approach as the rule for interpreting the Indian tax treaties, as it provides that a meaning assigned to a term today should be applied retrospectively even to earlier years during which a tax treaty was applicable, when no such meaning existed under the Act in those years. The question arises whether by such a unilateral amendment, the Indian Government has the power to assign an interpretation to a tax treaty retrospectively, despite the basic principle that a tax treaty is a bilateral document.

Retrospective amendment in meaning of 'royalty' under domestic tax law

Before the introduction of Finance Act 2012, the term 'royalty' in the domestic tax law was defined to include *inter-alia* payments for transfer of all or any rights in respect of any copyright as well as payments for transfer of all or any rights/

use of a secret process. The Finance Act 2012 has inserted an Explanation with effect from 1976 which states that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

The question that arises from the above amendment is whether the extended meaning of 'royalty' under the domestic tax law now should also be considered while interpreting the meaning of this term in applying tax treaties, since the term 'royalty' carries a specific definition of its own in the tax treaties. As this explanation adds to the meaning of a term already defined, reliance on domestic law may not be permissible under Article 3(2). The recent Court rulings[9] have also upheld this view.

Similarly, though the definition of 'royalty' in the domestic tax law as well as tax treaties includes payment for use or transfer of 'process', the term 'process' was not defined in either of the two. As a result, there has been controversy on taxability of payments for use of transponder/ satellite transmission services rendered by offshore service providers, the issue being whether such payments qualify as payments for use of a 'secret process'. The Finance Act 2012 has inserted an Explanation to the royalty definition with effect from 1976, stating that 'process' includes and shall be deemed to have always included transmission by satellite (including up-linking) or by any other similar technology, whether or not the process is secret. The question would arise whether such meaning of the term 'process' assigned in the domestic tax law now can be applied to tax treaties at all and if yes, whether the same should apply prospectively or retrospectively.

A similar scenario arose in South Korea[10] when its domestic tax law with regard to taxability of royalty payments for patents was amended in a manner which was inconsistent with the way taxability under the South Korea-US tax treaties ought to work. Royalty earned by a US resident was, as per the domestic law as well as the tax treaty, taxable in South Korea only if the same was in respect of patents 'used' in South Korea. The term 'used' was not defined in either the domestic law or the tax treaty and had always been interpreted by Courts to mean that the patent would be considered used in South Korea only if the same is registered in South Korea. However, the Korean Government unilaterally amended the domestic tax law to tax such royalty payments irrespective of whether the patents were registered in South Korea. When the question arose whether such extended meaning can be applied to the tax treaty as well, a South Korean Court ruled against the same. However, in another instance, the South Korean authorities, during the MAP process under the South Korea-US tax treaty, denied to accept this interpretation and maintained the stand that the extended meaning ought to apply under the treaty as well.

The application of Article 3(2) in the Indian context is an evolving concept and presently, there is limited jurisprudence in India on this matter. However, given the recent retrospective amendments introduced in the Indian domestic tax laws, Article 3(2) is likely to gain greater importance and interesting litigation on this matter can be expected in the forthcoming times, as both the taxpayers and the Government are likely to try and apply this article to their advantage.

1. India is currently not a signatory to the VCLT and so the provisions of VCLT are non-binding on India and may be used only as a guiding principle in India

2. *British Airways Plc* v. *Dy. CIT* [2002] 80 ITD 90, *James Mackintosh & Co. P. Ltd.* v. *Asstt. CIT* [2004] 93 ITD 466 and P. No. 28 of 1999, In re [1999] 105 Taxman 218 (AAR-New Delhi)

3. Section 90(3) of the Act
4. *Motorola Inc* v. *Dy. CIT* [2005] 95 ITD 269, *CIT, International Taxation* v. *Samsung Electronics Co Ltd.* [2011] 203 Taxman 477/ 16 taxmann.com 141 (Kar.)
5. Golay Buchel 27 July, 2001 (RJF 11/01 No. 1428)
6. *James Mackintosh & Co (P) Ltd (supra)*
7. Swiss Federal Tax Appeal Commission 3 March 2005 (SRK 203-159)
8. *CIT.* v. *Siemens Aktiongesellschaft* [2008] 177 Taxman 81 (Mum.)
9. *B4U International Holdings Ltd* v. *Dy. CIT* (IT) [2012] 52 SOT 545/21 taxmann.com 529 (Mum.), *DIT* v. *Nokia Networks OY* [2012] 25 taxmann.com 225 (Delhi)
10. 2011 Guhap 3891; Article titled 'The Korean Position on Royalty Sourcing' by Philip R West and Brian R Symington in the publication 'Tax Analysts 2012'

Standards for International Activities and Grants of U.S. Charitable Organizations

Brigitte W. Muehlmann*

U.S. immigrants often have the desire to give back in order to promote welfare in their countries of origin. The U.S. income tax law may permit a deduction for their contributions (IRC Sec. 170). A deduction is available when contributions are made to certain U.S. non-profit entities. These organizations may conduct part or all of their activities in a foreign country or make grants to another qualifying organization without geographic limitation. The following chapters discuss the standards that govern the aspects of international activities and grant making by U.S. charitable organizations.

1. Allowance of the deduction

A deduction is available for contributions to organizations that have been created or organized in the U.S. or in any of its possessions ("domestic organizations, entities or charities") and are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, for the prevention of cruelty to children or animals, or to foster national or international amateur sports competition to the extent that no part of its activities involve the provision of athletic facilities or equipment ("qualifying organizations, entities or charities"). The contribution may not benefit a private shareholder or individual and may not be used for an attempt to influence legislation or for a participation or intervention in any political campaign in support or in opposition of a candidate for public office. Further, no recipient may appear on the master list of Specially Designated Nationals, which is maintained by the Office of Foreign Assets Control at *http://www.treas.gov/offices/enforcement/ofac/sdn/*.

The deduction of contributions to qualifying organizations is allowed under the theory that they compensate Government for the loss of revenue by relieving it from financial burden, which would otherwise have to be met by appropriations from public funds, and by the benefits

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ensuing from the promotion of the common good. If money or property is devoted to foreign institutions, the deduction is disallowed because the U.S. does not derive such benefits (H.R. Rep. No. 75-1860, at 19-20, 1938). However, Congress permitted domestic recipients to use some unspecified portion of its funds for authorized purposes in other countries without affecting the deductibility of the contribution. The Government affirmed that a qualifying organization may conduct part of its activities in foreign countries and stated that the same conclusion applies if all of its activities are carried on in foreign countries (Reg. Sec. 1.170A-8).

2. Qualifying Organizations

In determining whether a contribution to or for the use of a qualifying organization is deductible, it must first be determined that the recipient was validly created or organized as a domestic organization. The contributions to a qualifying organization were deductible in *Bilingual Montessori School of Paris* v. *Commissioner* (75 T.C. 480) even though it had no U.S. activities. In this case, the taxpayer made contributions to a domestic entity that operated a school in Paris, France. The IRS urged the Court to ignore the existence of the domestic entity and to determine whether deductions were allowable for contributions made to the school. The Court found that the qualifying entity wasn't a mere shell, even though contributions were routed abroad to the French school.

To the contrary, in *Dora F. Welti* v. *Commissioner (1 T.C. 905)* the taxpayer, a citizen of Switzerland, resided in Boston, Massachusetts. She claimed her contribution to the First Church of Christ, Scientist, Berne, Switzerland, of which she was a member. The contribution was paid out of funds on deposit in a Swiss bank. The sources of the funds were outside the United States. Dora Welti was also a member of The First Church of Christ, Scientist, in Boston, Massachusetts ("The Mother Church"), a corporation organized under the laws of Massachusetts. The First Church of Christ, Scientist, Berne, a corporation organized under the laws of Switzerland, was a branch of The Mother Church and had its own form of government. The taxpayer argued that the contribution, although promoting the welfare of a Swiss organization, also was of direct or indirect benefit to a qualifying organization within the United States. The theory of the taxpayer's argument was that her contribution should be considered as having been made to the Christian Science Church generally, whose mother church is located in Boston, Massachusetts. The church manual and the by-laws of the Swiss church gave the impression that the Swiss branch was heavily depended on The Mother Church to provide spiritual guidance in the Christian Science religion, but that the Berne branch was a separate legal entity. The court held that the contribution was not deductible.

Similarly, the U.S. Tax Court held in *Anonymous* v. *Commissioner* (T.C. Memo 2010-87) that a couple was not entitled to charitable contribution deductions for donations that the taxpayer made to the Catholic Church in her native country, because they did not prove that they contributed to a qualifying domestic organization. The petitioner wife also became a member of a qualifying domestic charity that supports the work of missionaries in her native country. Contributions to or for the use of that entity may be deductible provided the charity satisfies the requirements of the requisite degree of control.

3. Control Rules

Contributions to a qualifying organization that transmits funds to a foreign charitable organization are deductible if it can be shown that the contribution is in fact to or for the use of the domestic organization, and that the domestic organization is not serving as an agent for, or conduit of, a foreign charitable entity. While a domestic organization can use the contributions abroad, it cannot merely transfer them to a foreign entity. Rev. Rul. 63-252 and 66-79 provide examples to demonstrate the control rules. In Examples 1 through 3, the real donee is the foreign recipient and thus the earmarked contributions are not deductible. Examples 4 to 6 present arrangements in which the domestic control requirements are in place.

Example 1

Facts - In pursuance of a plan to solicit funds in the U.S., a foreign organization caused a domestic organization to be formed. At the time

of formation, it was proposed that the domestic organization would conduct a fund-raising campaign, pay the administrative expenses from the collected fund and remit any balance to the foreign organization.

Discussion - Special earmarking of the use or destination of funds paid to a qualifying charitable organization may deprive the donor of a deduction. An inquiry as to the deductibility of a contribution need not stop once it is determined that an amount has been paid to a qualifying organization; if the amount is earmarked, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution. Accordingly, the Service holds that contributions to the domestic organization are not deductible.

Example 2

Facts - Certain persons in the U.S., desirous of furthering a foreign organization's work, formed a domestic charitable organization. The charter provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

Discussion - If an organization is required for reasons, such as a specific provision in its charter, to turn contributions, or any particular contribution it receives, over to another organization, then in determining whether such contributions are deductible it is appropriate to determine whether the ultimate recipient of the contribution is a qualifying organization. The requirements of deductibility would be nullified if contributions simply passed through the qualifying domestic organization. In this case, the domestic organization is only nominally the donee; the real donee is the ultimate foreign recipient.

Example 3

Facts - A foreign organization entered into an agreement with a domestic organization, which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

Discussion - The contributions to the domestic organization, which are given for the specific purpose of being turned over to the foreign organization, are held to be non-deductible.

Example 4

Facts - A domestic organization conducts a variety of charitable activities in a foreign country. The domestic organization makes grants to charitable groups organized in the foreign country to further its purposes which it has reviewed and approved. The grants are paid from its general funds and although the organization solicits from the public, no special funds are raised by a solicitation on behalf of particular foreign organizations.

Discussion - Contributions received by the domestic organization will not be earmarked in any manner, and use of such contributions will be subject to control by the domestic organization. Consequently, the domestic organization is considered to be the recipient of such contributions.

Example 5

Facts - A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for purposes of administrative convenience and the domestic organization controls every facet of its operations. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.

Discussion - The domestic organization is considered to be the real beneficiary of contributions it receives for transmission to the foreign organization. Since the foreign organization is merely an administrative arm of the domestic organization, the fact that contributions are ultimately paid over to the foreign organization does not require a conclusion that the domestic organization is not the real recipient of those contributions. Accordingly, contributions by individuals to the domestic organization are considered to be deductible.

Example 6

Facts - X corporation is a domestic charitable organization. The bylaws provide that after the board of directors has approved a grant to another organization for a specific project or purpose, the corporation may solicit funds for the grant to the specifically approved project or purpose of the other organization. However, the board of directors shall at all times have the right to withdraw approval of the grant and use the funds for other charitable, scientific or educational purposes. In contrast to the broad generality of the purposes stated in its charter, the name X corporation suggests a purpose to assist a named foreign organization. The individuals who organized X corporation, are United States citizens not acting on behalf of the foreign organization. They did not wish X corporation to function simply as a fund raising medium for the foreign organization. Instead, they were interested in raising funds for specific projects, such as scientific research projects, to be carried out by the foreign organization, or individuals connected with the foreign organization, pursuant to grants previously reviewed and approved by the board of directors of X corporation.

In accordance with the provisions of its charter and bylaws, X corporation at times solicits contributions which are to be used to provide grants to a foreign organization, or to individuals connected with such foreign organization, for specific purposes approved by X corporation's board of directors in accordance with its bylaws. The corporation refuses to accept contributions so earmarked that they must in any event go to the foreign organization.

Discussion - The domestic corporation may only solicit for specific grants when it has reviewed and approved them as being in furtherance of its purposes. Furthermore, under the terms of its bylaws the domestic corporation may make such solicitations only on the condition that it shall have control and discretion as to the use of the contributions received by it. Therefore, contributions received by the domestic organization from such solicitations are regarded as for the use of the domestic corporation and not for the organization receiving the grant from the domestic organization. The contributions paid to the domestic organization under the circumstances described above are deductible.

4. Summary

Immigrants to the U.S. may give to their countries of origin or elsewhere and obtain an income tax deduction in the U.S. provided they satisfy the requirements under the law. A deduction is available if they make their contributions to domestic qualified organizations that exercise the established domestic control requirements.

Taxation of Cross-border Telecommunication Income - A persistent dilemma!

Mukesh Butani*

Telecommunications is a term of wide import and signifies a range of services entailing use of communication technologies viz. satellite, servers, fibre-optic cables etc. Omnipresent network and communication channels have blurred geographical boundaries and often resulted in challenges with respect totaxability of income from cross-border transactions,under 'source-based'and 'residence-based'rules. A fundamental challenge that taxpayers and tax administration have grappled with is allocation of taxing rights amongst nations, existence of Permanent establishment, ascertaining economic nexus etc. In the past decade, with advent of multifarious new technologies, an inherent challenges in characterisation of telecommunication income and distribution of taxing right coupled with arm's length standard rules have come in even sharper focus.

Income characterisation debate continues

Characterization of income from provision of telecommunication services continues to be at the centre of debate. Examples of such services could be use of high-end telecommunication equipment; provision of bandwidth capacity through cables; broadcasting through satellites, etc. Whist payment for the use of technology, equipment etc. as such is taxable as royalty income; payment attributable to provision of standardized services may be classified as business profits.

Considering the complexity of transactions,commentaries on Model Conventions (e.g., OECD MC) seek to illustrate taxability by way of specific examples. The OECD MC endorses the view that from a service recipient perspective, availing satellite broadcasting services or roaming facilities from telecommunication network provider,etc suggests receipt of standardized services. The service recipient is neither concerned with the technology nor the equipment utilized for provision of services. However, The Indian Revenue's views don't necessarily coincide with

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- Views expressed are entirely personal.

OECD's view and the characterisation debate becomes even more complex in light of India's specific reservations to OECD's 2010 MC.

Disparity in tax treatment accorded by OECD MC and India's position can be gauged by the synopsis of tax positions mentioned in Table 1 below:

Table 1: Characterization of income – Comparative analysis

Nature of income/activity	OECD MC	India's reservations
Transmission through satellites - Payments under transponder leasing agreements	• Not considered as leasing of equipment - no physical possession by the lessor; • Not considered as payment for a right to use a "secret process"; thus not taxable as royalty	• Represents payments for use of process in transponder • Payments also qualify as being made for leasing equipment, hence royalty
Payment for leasing/ purchasing capacity of undersea cables and pipelines	• Should not qualify as royalties	• Undersea cables qualify as industrial, commercial or scientific equipment; thus, payment for their use constitute equipment royalties
Payment by tele-communication network operator for roaming	• Should not qualify as royalties	• Roaming call constitutes use of process, thus taxable as royalty
Payment for use of spectrum	• Does not constitute use of property or information; thus not taxable as royalty	• Taxable as royalty

Indian courts in recent instance of judicial examination have concurred with OECD's view deviating from India's reservations. Recently, in the case of *Asia Satellite Telecommunications*[1], the Delhi High Court held that payments received for leasing of transponder's capacity in a satellite is not taxable as 'royalty', as it was in the nature of services. In another landmark decision, in the case of *eBay International*[2], the Mumbai Tribunal has held that payments received for provision of website as a platform for selling goods is taxable as business income and not as technical or consultancy services; the Tribunal relied on view contained in OECD Technical Advisory Group report and the Indian High Powered Committee (on ecommerce) report. The Tribunal however, did not rule on the question of whether or not provision of services through website could constitute a PE.

Permanent establishment ("PE") – A real concern!

Besides 'income characterization', growing footprint of telecommunication businesses have left MNCs to deal with PE and PE income attribution issues given nexus between the service provider with the source jurisdiction. Ordinarily, the service provider may not have physical presence in the form of footprint, undersea cables, satellite etc. in the source location. Determining the presence and the degree of nexus that the service provider's business model could cause to be established in the host/source country is critical to ascertaining whether income could become taxable. Such nexus would need to be defined either under Indian domestic law 'business connection' rules and/or PE rules under the applicable tax treaty. For example, in case of a satellite having footprint area (where waves are beamed) across multiple

countries, would it be plausible to view that the footprint area in each country is adistinct source of income for the satellite owner or the cable service provider due to PE? Views adopted by Indian Revenue authorities conflict with the views espoused by OECD; key differences have been outlined in Table 2 below:

Table 2: Conflict in PE determination – Comparative analysis

Nature of income/activity	OECD MC	India's reservations
Footprint area of a satellite	• Location of satellite not a part of territory of other state; footprint area cannot be considered at disposal of service recipient. Thus, no place of business constituted in other country	• Footprint has a fixed location and value for commercial purposes; source country contributes its customer base. Thus fixed place of business constituted
Transportation/transmission through cables and pipelines	• Cable/pipeline not at disposal of customer and thus not a PE	• Undersea cables and pipelines lying in territorial jurisdiction of a source country can be construed as PE
Hosting of internet website	• Internet website does not in itself constitute a tangible property, hence not a place of business	• Place of business said to be acquired by virtue of hosting website on a particular server at a particular location
Roaming facilities by foreign network owner	• Foreign operator's network not at disposal of home network operator; thus no PE	• Roaming call is a composite process – entails use of equipments in source and residence countries; distinction under OECD not logical

Courts have had occasion to examine the question ON determination of a satellite PE; the Delhi High Court in the case of *Asia Satellite Telecommunications Co. Ltd.* (*supra*) made a specific observation that merely footprint of a satellite does not constitute business connection of the satellite owner in India. Relying principles enunciated by Delhi High Court, the Income tax Appellate Tribunal (Mumbai), in the case of *Dy. DIT (IT)* v. *Satellite Television Asia Region Ltd.* [2012] 23 taxmann.com 100 observed that telecasting of signals by satellite companies and location of ultimate viewership in India does not constitute a source/business connection in India. On the question of 'source of income', the Delhi High Court made an interesting observation in the case of *CIT* v. *Havells India Limited* [2012] 208 Taxman 114/21 taxmann.com 476. To make a fine distinction between 'source of income' and 'source of monies received' in the context of export sales concluded from India, the Court observed that mere location of customers outside India should not be construed as constitution of source outside India. A reverse analogy of ratio of Court's ruling could non-residents engaged in provision of transmission services through satellite that have footprint in various countries including India, may be inclined to argue that their customer base should not constitute a source of income in India. However, the tenability of this argument would need to be tested in the context of cross border telecommunications income.

Emerging landscape

Finance Act, 2012 has broadened the scope and definition of term 'Royalty' by inserting three explanations with retrospective effect, suggesting Indian policy maker's strictest form of source based rules. Such retrospective clarifications have widened the definition of royalty to include within its ambit payments made for acquiring license to use computer software, transmission

by satellite and cables (whether the process qualifies as secret or not) etc. Whilst the amendments to domestic law provisions would put to rest the controversy on characterization of income, provisions of applicable tax treaty, to the extent beneficial shall continue to supersede the domestic tax provisions. This view has recently been upheld by the Delhi High Court in the case of *Nokia Networks*[3].

Recent legislative amendments are bound to lead to spate of disputes until India's federal court steps in or the policy makers losses their stance with objections to the OECD MC. Only time will prove what balance India strikes.

1. *Asia Satellite Telecommunications Co. Ltd.* v. *DIT* [2011] 197 Taxman 263/9 taxmann.com 168
2. *eBay International AG* v *Asstt. DIT* [2012] 25 taxmann.com 500
3. *DIT* v. *Nokia Networks OY* [2012] 25 taxmann.com 225

Crossed Wires - Taxing International Communications Income

Kimberly Tan Majure*[1]

It's no secret that the United States has a fairly complicated tax system. But as complicated as the U.S. tax system is, it still retains some traditional aspects. The U.S. tax rules, like the rules of many other countries, were built in a very physical world, where it was easy to determine if property is transferred from one person to another, where title passes, and how and where services are performed. The reality is that modern technology has evolved beyond the tangible world, enabling U.S. industry to reach quickly and easily beyond U.S. borders. That's great from a global commercial perspective, but global tax systems are struggling to keep up with the technological explosion.

International communications income ("ICI") is just one example of technology outpacing tax systems. Many people envision telecommunications working on a variant of the "two cups and a string" principle, with a phone receiver on each end of the call connected by a set of phone lines. In that paradigm, communications are easily traceable along a physical path, and the receivers as well as the call path are potential factors for determining where the call occurs and, consequently, income arises.

But cellular and satellite phone technology, and an interconnected network of telecom providers throughout the world, have enabled fast and wide-ranging communications that few outside the communications industry may grasp. A single call may still have a one identifiable origin (*i.e.*, location of the dialed phone) and one destination (*i.e.*, the location of the answered phone). In an era where, in a given country, as many or more people may use a mobile phone than a land line, origin and destination may not only be more and more difficult to track, they are becoming much less commercially significant. At base, customers are buying a service. Sheer connectivity is the key factor for purchasing decisions; the physical process is invisible and largely irrelevant.

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In addition, it is impossible for any one telecommunications ("telecom") company to earn ICI by itself. The telecom industry is heavily regulated, with significant licensing, infrastructure and capital challenges that must be met in each different country of operations. A telecom company could satisfy these requirements in its own country, with respect to local phone services, but direct overseas expansion would quickly become cost prohibitive. No single company can reach into every country in which its customers expect phone services. Telecom companies in each country are forced to work together, to provide global telecom coverage.

An international call gets routed through a global network of telecom companies, each owning a small piece of the network infrastructure and all linked to each other *via* thousands of bilateral roaming agreements. During the nanoseconds between one phone dialing and another one ringing, a call could be routed through several different locations – each one in a different country, through international waters or even into space. Theoretically, each country represents a technological link in the communications chain, and a "but-for" cause of the ICI arising from the call. But predicting the exact path of that call (as well as millions of others) up-front, or identifying it afterwards, is a practical impossibility.

How does this translate into an administrable income tax base?

The U.S. tax rules take a unique approach to ICI, defined as the transmission of communications or data between the United States and a foreign country (including a U.S. possession), or the provision of capacity to transmit communications.[2]

Communications income is generally sourced under a "paid to do" principle. Here, the key question is "What is the telecom company paid to do?" and, as discussed above, the key answer is "To transmit communications (and bear the risk of such transmission) from point A to point B."[3] Neither the customer nor, consequently, the U.S. tax rules focus on the physical path of the call. Accordingly, under U.S. tax rules, 50 per cent of a telecom company's income based on the location of point A (origin of the call) and the other 50 per cent based on the location of point B (its destination).[4] Wholly domestic calls generate U.S. source income;[5] foreign-to- foreign calls generate foreign source income.[6] If the taxpayer cannot establish the origin and destination of a call, however, the related ICI is treated as wholly U.S. source income.[7]

When it comes to ICI (*i.e.*, on calls inbound to or outbound from the United States), U.S. telecom companies continue to follow the 50/50 approach, earning 50 percent U.S. source, 50 per cent foreign source income.[8] The rules for foreign telecoms, however, take more of a residence-based approach. Foreign telecoms with no significant economic connection to the United States are treated as having solely foreign source income.[9] On the other hand, foreign telecom companies having a U.S. trade or business or U.S. fixed office or place of business (either one, a "U.S. taxable nexus") are viewed as deriving U.S. source ICI to the extent the income is attributable to such U.S. taxable nexus.[10] The regulations attribute ICI to a U.S taxable nexus to the extent of functions performed, resources employed, or risks assumed by such taxable nexus.[11]

What is the overall significance of these rules? For "purely" foreign persons who, as a general matter, are taxed only on their U.S. source income, the rules effectively define ICI to fall outside the scope of U.S. taxation.[12] Even if foreign persons have a significant U.S. economic connection (*i.e.*, they are or are treated as U.S.-shareholder controlled subsidiaries or have a U.S. taxable nexus), some portion of their income can be treated as foreign source, and therefore can avoid U.S. income taxation. Moreover, ICI is treated as services income/business profits for treaty purposes; absent attribution to a U.S. permanent establishment, even U.S. source ICI may be non-taxable for treaty-qualified foreign persons.

The stakes are a little different for U.S. telecom companies. Unlike foreign persons, U.S. persons are taxable on their worldwide income, *i.e.*, on all income, wherever earned. The big question for the U.S. telecoms, therefore, is not *whether* their income will be taxed, but how many times. That is, if income is exposed to foreign income tax when earned, then again subject to U.S. income tax as repatriated, it is double taxed unless and to the extent foreign tax credits are available.[13] The credit is not refundable, and is

subject to the limitation rules of section 904. In essence, a U.S. telecom company's foreign tax credit limitation varies directly with the amount of foreign source income earned; the greater the foreign source income, the greater the amount of current credits. Thus, by treating ICI as only 50 per cent foreign source, the rules automatically constrain a U.S. telecom's foreign tax credits, especially in cases where a foreign country taxes the entire income stream. Excess credits may be carried back, then forward, into other taxable years,[14] though this may offer limited comfort to U.S. telecom companies who are perpetually carrying over credits (and who are, in the meantime, suffering current double taxation).

Nor is this a purely theoretical problem. Few foreign countries, if any, have special rules that address the tax treatment of ICI; most leave characterization to a case-by-case determination distinguishing between services, leasing, and royalty income. Some countries treat ICI as royalty income, under an expansive definition of "royalties" that goes beyond payments for exploitation of intellectual property or information, and includes payments for use of scientific equipment. China, for example, takes the view that such royalties should be sourced in-country even if the scientific equipment is not physically located there and no Chinese person has physical possession and control of the equipment. This conclusion was reached by the Chinese courts, for example, when characterizing income from the satellite broadcast of television shows into China.[15]

India took a similar step in its Finance Act, 2012, by amending its definition of royalty to include consideration paid for any right, property or information, regardless of whether

(*i*) The payor has possession or control of such right, property or information,

(*ii*) The payor uses the right, property or information directly, or

(*iii*) The location of the right, property or information is in India.[16]

The amendment has retroactive effect, back to June 1, 1976.[17]

Such an expansive concept of royalties can significantly increase a source country's income tax base, and very much favours jurisdictions with large consumer populations. Countries having a robust telecom industry may prefer to maintain a more traditional approach that focuses on the physical location of equipment, personnel, or active business activities.[18] Such uncoordinated efforts related to ICI taxation may have serious drawbacks. The one that tax administrators seem to fear most is that, with so few physical (*i.e.*, easily audited) features, portions of ICI threaten to escape taxation altogether. Yet, in the rush to capture their fair shares of the ICI tax base, countries should consider whether double taxation is an acceptable risk, in light of their current as well as evolving balance of consumer and industry interests.

The best, perhaps the only realistic, approach may be to address ICI taxation as a matter of bilateral treaty. Contracting states could adopt a uniform definition of ICI and implement a clear mechanism for allocating income between them. Such allocation need not be purely residence based (which is often the case, e.g., with interest payments). Contracting states could use, for example, a 50/50 split of the income between the countries, along the lines of section 863(*e*), discussed above with respect to the United States. Such an allocation would give countries with evolving telecom industries a better platform for growth. Contracting states could also agree on a sourcing convention that would facilitate double tax mitigation for their resident telecom companies. Finally, countries should discuss and determine the magnitude of ICI activities conducted or equipment located in a contracting state that could give rise to a permanent establishment.[19] The communications network is getting bigger and faster, and reaching all parts of the world. It's about time that the countries start to talk.

1. I would like to thank Jinyan Li, Bernard Bacci, Mukesh Butani, Wei Xiong, and Pedro Corona de la Fuente, for sharing their views on ICI taxation at the 2012 Boston IFA Congress. Any misunderstandings of foreign law in this article are entirely my own; they did their best to educate me.
2. Section 863(e)(2); Treas. Reg. § 1.863-9(h)(2). Note, this does not include non-de minimis provision of content or services (e.g., streaming sports or entertainment programs). Treas. Reg. § 1.863-9(h)(1).
3. See Treas. Reg. § 1.863-9(h)(3)(i). Moreover, the regulations state that it is irrelevant whether a taxpayer contracts out part or all of the transmission functions. Id.
4. See section 863(e) and the regulations thereunder.
5. Treas. Reg. § 1.863-9(c).
6. Treas. Reg. § 1.863-9(d).
7. Treas. Reg. § 1.863-9(f).
8. Treas. Reg. § 1.863-9(b)(1). The same rule applies to communications income earned by foreign corporations that qualify as "controlled foreign corporations," as defined in section 957. See Treas. Reg. § 1.863-9(b)(2)(ii).
9. Section 863(e)(1)(B)(i).
10. Section 863(e)(1)(B)(ii).
11. Treas. Reg. § 1.863-9(b)(2)(iii) (regarding ICI attributable to a U.S. office or fixed place of business); Treas. Reg. § 1.863-9(b)(2)(iv) (regarding ICI attributable to a U.S. trade or business).
12. See section 881 (imposing withholding tax on U.S. source, fixed or determinable annual or periodical income of foreign corporations); section 882 (imposing income tax on income effectively connected with the conduct of a U.S. trade or business).
13. See section 901 (regarding the "direct" foreign tax credit); section 902 (regarding the "indirect" foreign tax credit).
14. Section 904(c).
15. See, e.g., Guoshuihan [1999] No. 566 (concluding that payments for satellite transmissions of television programs into China were payments for the rights to use bandwidth – deemed part of the satellite equipment – inside China, and therefore constitute China sourced rental payments and are subject to withholding tax under the U.S.-China Tax Treaty); *aff'd, PanAmSat International Systems, Inc.* v. *Beijing State Tax Bureau* (2001). This stands in stark contrast to the U.S. precedent established in *Piedras Negras Broadcasting Co.* v. *Commissioner*, 43 B.T.A. 297 (1941) (characterizing a Mexican radio station broadcasting into the United States as engaged in foreign source services based on the location of the broadcasting equipment and personnel).
16. Finance Act, 2012, amending section 9 of the Income-Tax Act.
17. Id.
18. See U.S. Department of the Treasury, Selected Tax Policy Implications of Global Electronic Commerce (1996) ("The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance.").
19. Some consideration could also be given to whether ICI, for these purposes, should be expanded beyond mere transmission of communications to include non-de minimis provision of content. The taxation of "e-commerce" generally falls outside the scope of this article. However, e-commerce and ICI present related issues, and resolutions in one area may positively influence developments in the other.

Limitation on Benefits Clauses in U.S. Income Tax Treaties

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Natalia Vélez Delgado**

I. INTRODUCTION

The United States has increasingly shown its commitment towards broadening its bilateral tax treaty network by vigorously pursuing negotiations with numerous trading partners,[1] recognizing the importance of reducing tax impediments to inbound foreign investment. However, reaching an appropriate balance between allowing cross-border activity to rise to its full potential and avoiding abuse by third-country residents of benefits of bilateral income tax treaties remains a hurdle that attracts as much creative and high level attention as no other aspect of the United States tax treaty policy. The United States has made significant progress in its battle to shut down treaty shopping techniques, and the principal weapon in its arsenal continues to be the limitation on benefits ("LOB") clause in treaties and protocols. At least since the 1989 U.S.-Germany treaty, LOB clauses have been central to the negotiations of every income tax treaty signed by the United States.[2]

As a result of ongoing efforts to solve outstanding issues that provided treaty shopping opportunities, a new U.S. Model income tax treaty was published in 2006 ("USA Model Income Tax Convention (2006)" or "2006 Model"), which included important developments to the LOB clause. This article examines the elements of the latest LOB clause, featuring the principal modifications to the 1996 U.S. Model income tax treaty ("1996 Model"), while outlining key LOB provisions negotiated in the years leading up to the 2006 Model as well as the years since. This should aid the understanding of current and future measures against treaty shopping.

Treaty shopping has been defined as "the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State."[3] For the sake of clarity, the authors will use throughout this Article the shorthand provided by the following treaty-shopping scenario.

X Co, which is based in Country X, derives income from Country S (source country) and pays a 30 percent withholding tax on that income. Country X has no tax treaty with Country S but Country S has a favourable tax treaty with Country R. X Co therefore establishes a

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subsidiary, R Co, in Country R (residence country) and routes its investments in Country S through R Co. The effect is to reduce the Country S withholding tax on the income of X Co. even though X Co. was not an intended beneficiary of the treaty between Country R and Country S.[4]

Legitimate operations can look quite similar to this treaty shopping scenario, however. Suppose, for example, that X Co. established its subsidiary R Co. in Country R for legitimate business reasons. Suppose further that after some time, R Co. had prospered and was seeking suitable investments for its profits. Finally, suppose that the best investment, from a business standpoint, happened to be in Country S. The resulting structure is exactly the same as in the previous paragraph, yet X Co. is not engaged in treaty shopping. Limitation on benefits clauses must attempt to distinguish between these two basic scenarios and all their variations. Moreover, as LOB clauses have developed in U.S. tax treaties, they have focused less on the subjective differences between these two basic scenarios and more on an analysis of objective factors.

II. THE 2006 U.S. MODEL

Article 22 of the 2006 Model, attached hereto as Appendix A, is representative of the modern Limitation on Benefits clause. It provides three principal tests for whether a resident taxpayer is entitled to treaty benefits: (l) an ownership/base erosion test; (2) a public company test; and (3) an active-business test.[5] Treasury has explained the common rationale behind these tests:

The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting State (*e.g.*, a resident individual) to warrant benefits even in the absence of a business connection, and that this business purpose or connection outweighs any purpose to obtain the benefits of the Treaty.[6]

For taxpayers who fail to meet any of these safe harbor tests, the competent authorities of the contracting states may determine eligibility on a case by case basis and elect to grant general treaty benefits or benefits for a specific item of income. The operation and application of each of these tests as well as the competent authority safety valve are examined below, uncovering significant differences between the 1996 and 2006 Models.

A. Public Company Test

A publicly traded company is presumed to be sufficiently connected to the country in which its shares are traded to merit that country's treaty benefits. The Treasury Department assumes that most of the shareholders likely will be residents of that country.[7] In reality, many if not most of the shareholders may not be resident in the country where the trading takes place. Nevertheless, publicly traded companies are not a preferred means of diverting income to third country residents. The chief reason is that publicly listed companies are subject to securities laws. Both the burden of securities regulation and the attendant glare of public scrutiny make publicly traded companies a poor choice for treaty shopping. Since the likelihood of abuse is relatively low, the residence of the shareholders is not particularly important.

Paragraph 2(c) of Article 22 applies to publicly traded companies and subsidiaries of publicly traded companies. There are substantial modifications introduced by the 2006 Model with respect to the public company test of the 1996 Model that broaden the restrictions to qualify for treaty benefits. The 2006 Model deems a company to be publicly traded if (1) the principal class of the company's shares (and any disproportionate class of shares) is (2) regularly traded (3) on a recognized stock exchange, and either (4) the principal class of its shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or (5) the company's primary place of management and control is in the Contracting State of which it is a resident.

Part of the first requirement is for the "principal class [or classes] of shares" to be regularly traded. This phrase was not used in Paragraph 2(c) of the 1996 Model, but it reflects the original intent of the drafters. Treasury explained that the phrasing it used in the 1996 Model was meant to be more precise:

> This provision differs from corresponding provisions in earlier treaties in that it states that "all of the shares" in the principal class of shares must be regularly traded

> on a recognized stock exchange. This language was added to make it clear that all shares in the principal class or classes of shares (as opposed to only a portion of such shares) must satisfy the requirements of this subparagraph.[8]

If the company has multiple classes of shares, it is necessary to identify the "principal class of shares," defined in subparagraph (b) of paragraph 5 of the 2006 Model as the ordinary or common shares of the company, which as a single class or a combination of classes, represent the majority of the voting power and value of the company. It is further explained by Treasury that in the event that more than one group of classes is identified to account for more than 50 percent of the shares, it would be necessary only for one of such groups to fulfil the requirements; the benefits would not be denied to a company even if a second, non-qualifying, group of shares is identified.[9] Each class of shares within the qualifying group must, however, meet the "regularly traded on a recognized stock exchange" test.

Treasury's shift in wording is understandable. Without this requirement, one possible interpretation could allow a company to meet the publicly traded test by listing only a small fraction of its principal class of shares, so long as there is substantial and regular trading in that small listing.

However, as part of the first requirement of the public company test, the 2006 Model also precludes a company from qualifying for treaty benefits if it has a "disproportionate class of shares" that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph (c) of paragraph 5 as any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company. The Technical Explanation provides the following example to illustrate the concept:

> OCo is a corporation resident in the other Contracting State. OCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on the principal stock exchange of the other Contracting State. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that OCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of OCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S. source interest income earned by OCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not regularly traded on a recognized stock exchange, OCo will not qualify for benefits under subparagraph (c) of paragraph 2.[10]

The phrase "regularly traded" is, according to the Technical Explanation, to be defined under the domestic law of the contracting state from which treaty benefits are sought (the source state). The U.S. definition is found in Treasury Regulation section 1.884-5(d)(4)(i)(B),[11] which sets out two requirements. First, the class of shares must be traded in more than *de minimis* quantities on at least 60 days of the taxable year. Second, the aggregate number of shares traded must be at least 10 percent of the average number of shares outstanding during the year. The trading may take place on more than one stock exchange, but each exchange must be "recognized."

The term "recognized stock exchange" is defined in subparagraph (a) of paragraph 5 of the Model treaty to include the NASDAQ System and any exchange registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. The 2006 Model does not attempt to define the criteria for recognizing stock exchanges in the other contracting state. The text of the 1989 U.S.-Germany treaty recognized "any German Stock exchange on which registered dealings in shares take place."[12] The text of the 1992 U.S.-Netherlands treaty recognized only "the Amsterdam Stock Exchange,"[13] but the contemporaneous Memorandum of Understanding accompanying the treaty effectively added the stock exchanges of Frankfurt, London and Paris.[14] Moreover, the letters of understanding to the

1993 U.S.-Netherlands protocol recognized, in addition to the Amsterdam Stock Exchange, the principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo, and Toronto.[15] The revised Limitation on Benefits provision, as replaced by Article 7 of the 2004 U.S.-Netherlands protocol, includes a longer list of stock exchanges in the treaty text itself: the Amsterdam Stock Exchange, *plus* "the Irish Stock Exchange, the Swiss Stock Exchange and the stock exchanges of Brussels, Frankfurt, Hamburg, Johannesburg, London, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto and Vienna."[16] The 2006 Model, however, provides only that the competent authorities can agree on other exchanges that merit recognition.

Furthermore, the 2006 Model sets as a new requirement for either of the following conditions to be met: (*i*) the principal class of shares of the company must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or (*ii*) the company's primary place of management and control must be in the Contracting State of which it is a resident.

The Technical Explanation explicitly identifies the term "primarily traded" to be defined in Treasury Regulation section 1.884-5(d)(3). Accordingly, the stock of a corporation will be deemed "primarily traded" if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the amount traded during that year on established securities markets in any other single foreign country.[17]

As an alternative to the event in which the "primarily traded test" cannot be satisfied, the 2006 Model establishes a "primary place of management and control test." This is different from a "place of effective management test" in the sense that it does not merely look to the place where the board of directors meets, but rather the place where day-to-day responsibility regarding strategic, financial and operational management of the company (and its subsidiaries) is predominantly exercised by executive officers and senior management employees. This term is defined in subparagraph (d) of paragraph 5.

Subsidiaries of publicly traded companies are eligible for a variation on the publicly traded test set out in paragraph 2(c)(i). Under the 2006 Model, a subsidiary qualifies if (1) at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by five or fewer companies entitled to benefits under paragraph 2(c)(i), and (2) every intermediate owner (in the case of indirect ownership) is "is a resident of either Contracting State."

The first of these two requirements no longer applies to *each class* of shares of the subsidiary, as provided in the 1996 Model. The analysis at the subsidiary level currently focuses on the aggregate vote and value. The second requirement is further restricted by limiting intermediate owners to publicly traded companies, in addition to the need to qualify as residents of either Contracting State in the case of indirect ownership.

In this sense, the public company test gained complexity. As a corollary of including a subjective primary place of management and control test, it is no longer limited to definitions of what shares need to be traded, where, and how often. This potentially impacts the analysis of a publicly traded company down to its subsidiary level.

B. Ownership/Base Erosion Test

The ownership/base-erosion test is designed to ensure that if R Co enjoys treaty benefits as a resident of Country R, the ultimate beneficiaries of R Co's success are also residents of Country R. Normally one thinks of the beneficiaries of a company as its equity owners, and the "ownership" aspect of the ownership/base-erosion test focuses on equity or beneficial ownership. Lenders and others in a non-equity relationship can just as surely enjoy the fruits of a successful enterprise, however, and the "base erosion" aspect of the test focuses on that issue. The 2006 Model LOB clause requires at least 50 percent of equity holders to be qualified residents and *more than* 50 percent of deductible payments to be paid to qualified residents.

1. Ownership Test

Paragraph 2(e)(i) of Article 22 sets out the ownership test in the 2006 Model. It provides that an entity[18] resident in one of the contracting states meets the ownership test if (1) at least

50 percent of the aggregate voting power and value represented in shares or other beneficial interests (and at least 50 percent of any disproportionate class of shares) (2) is owned directly or indirectly, (3) for "at least half the days of the taxable year" (4) by residents of either contacting state who are (5) individuals, governments,[19] publicly traded companies,[20] exempt entities, or pension funds.

Ownership or beneficial ownership is determined with the assistance of "domestic anti-abuse provisions" such as the business purpose doctrine, the step transaction and substance over-form doctrines, and conduit principles.[21] In this regard, the LOB provision is the second step in the process. The first step is to determine beneficial ownership under these domestic principles. In the second step, "Article 22 [is] applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income."[22]

Government eligibility is described in Article 4 of the 2006 Model. Tax exempt organizations are defined in Article 4 subparagraph (2)(b).[23] The 2006 Model also includes in this definition organizations that serve artistic or cultural purposes, reflecting the U.S. internal law definition of educational organizations.[24] Pension funds qualify under a more stringent rule: More than 50 percent of a fund's beneficiaries, members, or participants must be individual residents of either contracting state. Pension fund organizations are defined in Article 4, subparagraph 2(a).

Indirect ownership is permitted provided that each intermediate owner is a resident of either Contracting State. A company owned by a pension fund qualifies for treaty benefits so long as the pension fund itself qualifies. However, subsidiaries of companies that satisfy the public-trading test can no longer satisfy the ownership test, as it was permitted under the 1996 Model. Moreover, trusts will be considered to be owned by entities entitled to treaty benefits based on the actuarial interest of its beneficiaries.[25] Of course, the ultimate owners must own at least 50 percent of the aggregate voting power and value of the company seeking treaty benefits (and at least 50 percent of any disproportionate class of the entity's shares). Suppose Company A is 50-percent owned by resident individuals and 50-percent owned by third-country individuals, and Company B is 50-percent owned by Company A and 50-percent owned by a third-country individual. Although Company B is 50-percent owned by an entity that qualifies for treaty benefits, 75 percent of its ultimate beneficial owners are third-country residents so therefore Company B does not qualify for treaty benefits. The ultimate owners must be "persons who are residents of [either] Contracting State and that are entitled to the benefits of [the] Convention under subparagraphs (a), (b), (d) or clause (i) of subparagraph (c),"[26] meaning resident individuals, governments, publicly traded companies, exempt entities, or pension funds. Further, it is worth noting that while a company may enjoy treaty benefits with regard to specific items of income if it meets the active business test (discussed below), being owned by a company meeting the active business test is not a qualification for treaty benefits under the ownership test.

2. Base Erosion

Paragraph 2(e)(ii) of Article 22 sets out the base-erosion test in the 2006 Model. An entity meets the base-erosion test if it does not make payments that are (1) deductible for income tax purposes in the entity's state of residence; (2) paid or accrued, directly or indirectly, to persons other than residents of either contracting state entitled to benefits under subparagraphs (a), (b), (d) or clause (i) of subparagraph (c) of paragraph 2; (3) in the amount of 50-percent or more of the entity's gross income for the taxable year. The purpose of the base-erosion test is to determine whether income derived from the source State is in fact subject to tax in that State.[27]

Although there is no longer an exception for payments attributable to permanent establishments, as was provided in the 1996 Model, the new model excludes arm's length payments in the ordinary course of business for services or tangible property from the 50-percent limitation. The 2006 Model sets forth rules to define gross income by referring to the laws of the entity's country of residence. Treasury further specifies that to the extent trust distributions are deductible from the taxable base they will be considered deductible payments; while depreciation and amortization deductions are disregarded for this purpose, as they do not represent payments or accruals to other entities.[28]

In sum, the ownership/base-erosion provision of the LOB clause adds additional dimensions

to the issue of residency. In terms of ownership, the question is whether R Co is really a Country R entity and the answer depends on whether Country R residents are its beneficial owners. In terms of base erosion, the same question is being asked, and the answer depends on whether R Co's income is subject to taxation in Country R.

C. Active Business Test

The essence of the active business test is whether the company seeking treaty benefits, despite failing to meet the ownership/base-erosion test, has significant substantive ties to Country R (an active business) and the income in question (from Country S) is sufficiently related to the Country R activity. In short, the active business test is one proxy for determining whether there is a good business purpose behind the taxpayer's structure with regard to particular items of income.

The active trade or business test is set out in paragraph 3 of the 2006 Model. There are three prongs to the test: (1) the entity or related person must be engaged in the active conduct of a trade or business in Country R; (2) the Country S income must be "derived in connection with" or "incidental to" that trade or business, and (3) if R Co derives the income in question from its own trade or business activity in Country R or that of a related person, the business activity in Country R must be "substantial in relation to" the activity generating the income in Country S. A company meeting all three prongs of the test will enjoy treaty benefits, but only with respect to the item(s) of income in question. The active business test must be applied item by item, with qualification for treaty benefits always being restricted to the particular item of income that has met the test. For this reason, it is clearly preferable to qualify for full treaty benefits under the public company or ownership/base-erosion test.

The threshold test is whether the Country R operations amount to an active trade or business. The term "trade or business," however, is not defined in the Convention. For the purpose of obtaining treaty benefits with respect to items of income derived from sources within the United States, paragraph 2 of Article 3 of the 2006 Model ascribes to any undefined term the meaning it has under the law of the United States. Although this term is not defined in the Internal Revenue Code, regulations state that "whether or not [the entity in Country R] is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case."[29] The Treasury Technical Explanation refers specifically to the regulations under section 367(a) of the Code for the definition of "trade or business," and continues, "In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities."[30]

The 2006 Model restricts the definition of trade or business by stating that "the business of making or managing investments for the resident's own account"[31] will not be considered an active trade or business, unless the activity is banking, insurance, or securities activity conducted by a bank, insurance company or registered securities dealer.[32] Relatedly, the 2006 Model excludes headquarters companies from satisfying the active business test, reasoning that inasmuch as "a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business."[33]

After meeting the threshold test, a taxpayer must establish a sufficient connection between the active trade or business in Country R and the income in Country S. There are two types of connections that suffice: the income earning activities in Country S must either be carried out "in connection with" or be "incidental to" the Country R active business. These tests are applied to each separate item of income, so a company may qualify for treaty benefits with regard to some items of income but not others.

The "in connection with" test can, in turn, be satisfied in either of two ways. The Country S income-producing activity must be a line of business that "forms a part of" or is "complementary to" the Country R business. The Country S operations form a part of the Country R business "if the two activities involve the design, manufacture or sale of the same

products or types of products, or the provision of similar services."[34] Activities are complementary if they are "part of the same overall industry and [are] related in the sense that the success or failure of one activity will tend to result in success or failure for the other."[35]

The "incidental to" test is an alternative provided for taxpayers who cannot meet the definition of "in connection with" as discussed above. Income is "incidental to" when "it facilitates the conduct of the trade or business in the State of residence." As an example, the Treasury Technical Explanation cites the investment of working capital derived from the active conduct of a trade or business in Country R.[36]

Finally, in cases where the trade or business in Country S that generates the income is carried on either by the R Co or by a related or associated person, the taxpayer also must meet the substantiality requirement: the Country R operations must be "substantial in relation to" the Country S income producing activity.[37] In the Model Treaty, the substantiality test applies equally to "in connection with" income and to "incidental to" income.

The substantiality determination must be based on all the facts and circumstances.[38] The Treasury Department provides some guidance in this respect, stating that substantiality "takes into account the comparative sizes of the trades or businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State."[39] One of the main modifications included in the 2006 Model is the elimination of the safe harbor under subparagraph 3(c) of Article 22 of the 1996 Model. Consequently, there is no longer an objective test to determine the substantiality requirement.

The safe harbor of the 1996 Model used to provide an arithmetic formula to establish substantiality, pursuant to which the size of the active business in Country R had to be at least 7.5 percent of the size of the Country S income producing activity by each of three measures: asset value, gross income, and payroll expenses, and the average of the three calculations had to place the Country R business at more than 10 percent of the size of the Country S activity.

The safe harbor is included in many U.S. tax treaties but was excluded from the 2006 model. As a safe harbor, of course, it was intended to be difficult to satisfy. But like many safe harbors in the tax law, it was subject to misinterpretation as the applicable rule. Thus, perversely, eliminating the safe harbor can be more favourable to taxpayers. One of the few new treaties that still includes the substantiality safe harbor is the pending treaty with Hungary, of which paragraph 10 of a contemporaneous exchange of diplomatic notes not only sets forth the safe harbor but also provides an example of failing to meet the safe harbor yet qualifying for treaty benefits under the active business test.[40]

In addition, paragraph 3(c) of the 2006 Model provides a new rule that defines the meaning of "related person" in furtherance of attributing to a person X activities conducted in Country R by a person Y "connected" to such person X. Y is considered to be connected to X if it owns 50 percent or more of the beneficial interest in X or *vice versa*. This will also be the case if a third person owns at least 50 percent of the beneficial interest in X and Y. In respect of companies, the 50-percent requirement refers to the aggregate vote and value of the company's shares or of the beneficial equity interest in the company. In summary, the 2006 Model treats a person as connected to another if, based on all relevant facts and circumstances, one has control of the other or both are under the common control of the same person or persons.[41]

The active business provision in the LOB clause focuses on items of income rather than on residency. The contracting states to an income tax treaty recognize legitimate business presence in a country. The active business test provides a mechanical test with the same underlying objective as the competent authority safety valve: non-residents engaging in legitimate business operations and not treaty shopping should not be disadvantaged by the LOB provisions.

D. Competent Authority Discretion

Recognizing the three mechanical tests just discussed are neither comprehensive nor perfect, the 2006 Model provides the possibility for competent authorities to exercise discretion in the case of taxpayers who fail the mechanical tests, but nevertheless may deserve to enjoy treaty benefits. The Treasury Department has indicated that, while less structured and more subjective, a determination by the competent authorities has the same objective as the mechanical

tests: "to identify investors whose residence in the other State can be justified by factors other than a purpose to derive treaty benefits."[42]

The mechanical tests can be viewed as safe harbors; taxpayers who meet them can be confident of their tax treatment and need not seek approval of the taxing authorities. However, taxpayers unable to meet any of the safe harbors but hoping to enjoy treaty benefits under the competent authority discretion provision must seek a ruling to that effect.

Paragraph 4 of Article 22 provides such discretion to the competent authorities of the contracting states. This discretion is quite broad, as authorities may decide to grant all substantive treaty benefits or certain treaty benefits for some items of income and not others. Further, the competent authority may establish conditions regarding any granted benefit, such as setting time limits on their duration. The only criterion provided by the 2006 Model for competent authorities to make their determinations instructs them to base their determinations on whether "the establishment, acquisition or maintenance of [the person seeking benefits under the Convention] and the conduct of [such person's] operations did not have as one of its principal purposes the obtaining of benefits under [the] Convention."[43] In practice, however, the U.S. competent authority and the competent authorities of many other countries pay little attention to the stated standard. Instead, they tend to examine in detail how close the taxpayer's facts are to qualifying under any of the treaty's objective tests. Thus, the opportunity to apply a subjective standard is used only to smooth the edges of the mechanical tests.[44]

III. BACKGROUND OF THE 2006 MODEL

The United States did not place LOB provisions among its top priorities until the 1980s. Although the 1977 U.S. Model Treaty contained an LOB provision, it was relatively narrow in scope and, in any case, it was not included in all treaties based on that Model. But the U.S.-Hungary treaty, signed in 1979, was the last U.S. treaty negotiated without an LOB provision.[45] In the past years, the United States has aggressively renegotiated treaties that did not contain LOB provisions.[46] This section discusses the major events leading to the 2006 U.S. Model, with particular focus on the 1989 treaty with Germany[47] and the 1992 treaty with the Netherlands, as amended by protocol in 2004.

A. Early LOB Clauses

The LOB clause of the 1977 U.S. Model Treaty was narrow in scope. It applied only to certain types of income (interest, dividends, royalties), and only if the taxpayer received favourable treatment on such income in the residence state. In addition, the 1977 Model contained no base-erosion test. The ownership requirement, however, was particularly strict: the applicable percentage was more than 75-percent resident ownership, rather than the 50-percent level that has prevailed since the late 1980s. The 1977 Model provision is generally reflected in five U.S. tax treaties.[48]

The 1981 U.S. Model took two major steps toward the modern LOB clause: it added the base-erosion test to prevent avoidance of the ownership test through non-equity channels, and it shifted emphasis away from the 1977 Model's requirement that the taxpayer receive favourable tax treatment in order to trigger the LOB provisions. The 1981 Model, however, contained neither an active business provision nor a competent authority relief provision. The 1981 Model is generally reflected in two U.S. tax treaties.[49]

In 1986, the United States enacted a branch profits tax to be imposed on foreign corporations operating directly in the United States.[50] The United States had been lagging behind other countries in adopting a branch profits tax and previously implemented a treaty policy of precluding the application of branch profits taxes to residents of either treaty country. So the new U.S. branch profits tax was not permitted by many U.S. tax treaties. As enacted, the branch profits tax yields to tax treaty limitations or restrictions only in the case of "qualified residents" of the country with which the United States has an income tax treaty, overriding treaty protection otherwise. Qualified residents are defined as those meeting tests very similar to the ownership/base-erosion and public company tests discussed above in the treaty context.[51] This limited "treaty override" and other efforts by Congress placed limitations on treaty shopping at the top of U.S. tax treaty priorities. The chief U.S. negotiators of the U.S. Netherlands treaty cited the enactment of section 884(e) as a crucial spur toward development of that treaty: "This Congressional willingness to deny treaty benefits, by legislative fiat, to persons who were 'abusing' treaties turned desultory and fitful talks with the Netherlands into real negotiations."[52]

The branch profits tax also provided a model for the substantive development of the LOB clause. "The U.S.-German limitation on benefits article is a refinement and reasoned liberalization of the branch tax qualified resident rules of section 884(e)."[53] As the authors of a leading treatise have noted, "Limitation on Benefits articles came to be both more uniform and more sophisticated" during the 1980s.[54] The most significant step toward sophistication in this period came in the 1989 U.S.-Germany treaty.

B. Germany (1989 Treaty and 2006 Protocol): Expanding the Scope

The United States and Germany signed a treaty on August 29, 1989 that would supersede the treaty of 1954. This new treaty entered into force on August 21, 1991. The LOB provision was found in Article 28 of the treaty, and was supplemented by a memorandum of understanding.[55]

The two key innovations of the Germany treaty were the active business provision and the competent authority relief provision. The Germany treaty thus added the final elements of the modern LOB clause (as represented by the 2006 Model) that had been missing from the 1981 Model. In addition, although the public company and ownership/base-erosion tests appeared in the 1981 Model, the Germany treaty made refinements to these provisions. In short, the Germany treaty brought together all the elements of the modern LOB clause for the first time.[56]

The active business test is set out in subparagraph 1(c) of Article 28, providing a test very similar to the one described in the 1996 Model, with the exception that there is no mention of a substantiality requirement (*i.e.*, that the Country R active business be substantial in relation to the Country S income producing activity). Substantiality is explicitly discussed in the examples included in the MOU, however, clearly reflecting the intent to establish the requirement. Between the treaty text and the MOU, the Germany treaty established all the elements of the modern active business test.

The other major innovation of the Germany treaty was paragraph 2 of Article 28, providing the competent authorities discretion to grant treaty benefits to taxpayers failing to meet any of the mechanical tests. The Senate Foreign Relations Committee described this provision as a "safety valve."

In 2006 the Germany treaty was amended by Protocol in order to reflect the latest developments included in the 2006 Model. The new LOB clause also added provisions on derivative benefits, triangular cases and German investment funds, the first two of which will be discussed below.

C. The Netherlands (1992 Treaty with 1993 Protocol, and 2004 Protocol): Detail, Complexity and New LOB

In 1992, after more than 10 years of negotiation,[57] the United States and the Netherlands signed a new treaty to replace the treaty of 1948. The new treaty entered into force on December 31, 1993. Although this treaty followed the treaty with Germany by just three years, the limitation on benefits provision, Article 26, was dramatically longer and more complex than Article 28 of the treaty with Germany.

In its Technical Explanation, the Treasury Department explained the complexity of the U.S. Netherlands treaty this way:

> The Netherlands delegation was concerned that a provision modeled after the provisions in such recent agreements as the U.S. Germany convention would be too general to provide sufficient certainty to legitimate Dutch investors in the United States. The Netherlands therefore asked that more precise guidance be provided under the provision. In addition, the United States was willing to agree to somewhat looser standards for entitlement to benefits than the analogous provisions of other recent conventions only if there were adequate safeguards that the beneficiaries of these provisions had sufficient nexus to the Netherlands to be entitled to treaty benefits from a policy perspective.[58]

Beyond the complexity it added to the basic LOB provisions, the Netherlands treaty reflected innovation with regard to headquarters companies, derivative benefits, and triangular cases, which will be discussed below.

Major developments to previous LOB elements included (1) in the ownership/base-erosion test, expanding the base-erosion qualification to accommodate payments to non-Dutch residents of the E.U.; (2) in the public company test, requiring listing on a stock exchange in the United States or the Netherlands but permitting the regular trading to occur on other identified exchanges, and including subsidiaries of public

companies; and (3) in the active business test, permitting active business activities to be attributed to the residence country company from related persons, and including the E.U. beyond the Netherlands in testing substantiality.

In 2004, the United States and the Netherlands signed a Protocol, including a new and less complex LOB clause following the latest developments in U.S. tax treaty policy and recent treaties negotiated with other countries.[59]

D. Switzerland (1996): The Predominant Interest Test

The next major development in the evolution of the LOB clause came in 1996, with the signing of the U.S. Switzerland Treaty. The Switzerland Treaty was signed on October 2, 1996 together with a protocol. Although it was signed two weeks after the 1996 Model was issued, negotiations with the Swiss took place over the course of 17 years and were completed before the U.S. Model was issued. Nevertheless, "prior drafts of the U.S. Model were available and taken into account in the course of negotiations."[60]

Article 22 of the Switzerland treaty sets forth the LOB clause. Article 22 is supplemented by an extensive discussion of the LOB provisions in a Memorandum of Understanding ("MOU"). In most respects, the Switzerland treaty follows the Germany and Netherlands treaties. In terms of headquarters companies and derivative benefits, for example, the Switzerland treaty follows closely if not precisely in the footsteps of the Netherlands treaty, as will be discussed below. The active trade or business test is quite similar, but the substantiality prong of the test differs in that the treaty does not provide a safe harbor. In this sense, the Switzerland substantiality test resembles the Germany version and not the Netherlands version. This trend in the substantiality prong of the test was followed in the 2006 Model.

The major innovation of the Switzerland treaty was the so called "predominant interest test." As the Treasury Technical Explanation described it, the predominant interest test "looks to whether those that benefit from the Convention, whether through equity ownership or by receiving payments that erode the recipient's tax base, are qualified residents of one of the Contracting States." The predominant interest test is thus a variation on the ownership/base-erosion test. It looks to whether non-residents and non-publicly traded companies of the contracting states enjoy an "interest" of more than 50 percent ("a predominant interest") in the company. "The predominant interest test was used in this context in order to blend certain principles found in Swiss domestic law with U.S. ownership/base erosion concepts."[61]

The predominant interest test appears deceptively simple in the language of the treaty itself. It is phrased in the negative: All resident companies are eligible for treaty benefits unless "the ultimate beneficial owners of a predominant interest in the form of a participation, or otherwise," in the company are not themselves eligible for treaty benefits under the residency, headquarters, and publicly traded tests.

Paragraph 8 of the Protocol and Paragraph 6 of the Memorandum of Understanding, as well as the Treasury Technical Explanation, fill out the scope of the predominant interest test. Although the test appears to collapse the distinction between ownership and base erosion in the traditional test, the predominant interest analysis must immediately split into two prongs. The first prong is "the ownership test," and the second prong is "the combined test."

The ownership test focuses on identifying the beneficial owners of the equity interest in the company. Here a line is drawn: regardless of the extent of non-equity interests, non-residents are not permitted to be "the ultimate beneficial owners of a predominant equity interest in the entity."[62] The phrase "predominant interest" is given an easy, universal, and quantifiable definition: a direct or indirect interest of more than 50 percent. Thus there appears to be no difference between this prong of the predominant interest test and the ownership prong of the traditional ownership/base erosion test.

The combined test is identical to the ownership test except that, in addition to equity interests, the analysis includes debt and contractual interests as well. The Protocol accompanying the 1996 Treaty clarifies the types of non-equity interests that are to be taken into account. They include the right to receive and the actual receipt of payments that reduce the company's taxable income. Interest and royalties always fall within this definition, payments for tangible property and services fall within the definition only if they are not at arm's length.[63] Depreciation and amortization deductions always fall outside because they are not payments.[64]

The MOU provides several examples to illustrate the predominant interest test. Example I illustrates the basic notion that the predominant interest need not be equity. A U.S. company is 100 percent owned (in terms of stock) by a U.S. individual. However, third country residents hold the company's debt, which is worth ten times more than its stock. The U.S. individual does not hold the predominant interest. Other examples explore the boundaries of "interest" by considering an individual who owns 49 percent of the equity but also receives additional compensation from the company. The predominant interest determination depends on whether the compensation reflects arm's length arrangements or a disguised interest.

Beyond the predominant interest test, the Switzerland Treaty contains a triangular arrangements provision very similar to the Netherlands provision, which will be discussed further on.

E. Italy and Slovenia (1999): The Main Purpose Test

Since the 1996 U.S. Model and the Luxembourg and Switzerland treaties, the most significant LOB clause developments took place in 1999 in the U.S.-Italy and U.S.-Slovenia treaties. On June 21, 1999, the United States and Slovenia signed their first tax treaty. Article 22 sets out the LOB clause. The treaty has no MOU and no Protocol. The United States and Italy signed a new tax treaty on August 25, 1999, to replace the 1984 treaty between the two countries. The LOB provision in the treaty is found in a protocol rather than in the treaty itself. In both the Italy and Slovenia treaties, the LOB clause is identical to Article 22 of the 1996 Model. It is notable that these new treaties contain no derivative benefits provisions and no headquarters company tests.

The innovation of the Italy and Slovenia treaties is the "main purpose" test, an LOB feature placed in specific articles of the treaty rather than in the LOB article proper. For example, paragraph 10 of Article 10 (Dividends) of the Italy treaty reads as follows:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

Identical language appears in Article 11 (Interest), Article 12 (Royalties) and Article 22 (Other Income) of the Italy treaty, and in Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties) and Article 21 (Other Income) of the Slovenia treaty.

The main purpose test focuses on subjective rather than objective factors. The existence of the main purpose test reflects the traditional understanding that mechanical, objective tests are unable to eliminate all treaty shopping scenarios. Of course, subjective tests have their own problems. In its Technical Explanation to the 1996 Model, the Treasury addressed these problems and openly endorsed objective over subjective tests:

> If [a] third country resident had substantial reasons for establishing [an entity in a U.S. treaty partner] that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty shopping set forth above. Of course, the fundamental problem presented by this approach is that it is based on the taxpayer's intent, which a tax administration is normally ill equipped to identify. In order to avoid the necessity of making this subjective determination, Article 22 sets forth a series of objective tests.[65]

By 1999 the Treasury apparently had had a change of heart. But the Senate, on the recommendation of the Joint Committee on Taxation, gave its advice and consent to ratification of both treaties subject to a reservation on the main purpose test, effectively killing it.[66]

The Treasury Department cited an increase in "aggressive abuse" of tax treaties to justify its inclusion of the "main purpose" test—in addition to the standard elements of the limitation on benefits clause—in the Italy and Slovenia treaties. Treasury observed that this increased abuse inspired two statutory enactments: sections 894(c)[67] and 7701(*l*)[68] of the Code. Another inspiration, said Treasury, was the fact that certain other countries have anti-abuse rules "generally consistent with" the main purpose test.

In its Technical Explanation to the U.S. Italy treaty, the Treasury cited "dividend washing"

as a particular target of the main purpose test. Treasury provided the following illustration: Bank is a resident of Italy that easily qualifies for treaty benefits under a modern LOB clause (*e.g.*, the 1996 U.S. Model). Bank purchases shares of U.S. Co from a Bank customer who resides in Country X and does not qualify for U.S. Italy Treaty benefits. Bank makes its purchase immediately before U.S. Co's dividend record date, and at the same time enters a repurchase agreement with Customer to resell the shares to Customer on a date certain and for a price certain. In this fashion, Bank qualifies for a reduced withholding tax on the dividend under the U.S.-Italy Treaty, as Customer could not, and it does so with no exposure to market risk.[69]

The Joint Committee on Taxation objected to the main purpose test on the grounds that it is "subjective and vague" and therefore "inject[s] considerable uncertainty" into the treaties. Such uncertainty can cause difficulties for legitimate business transactions and can "hinder a taxpayer's ability to rely on the treaty."[70] The JCT also questioned whether the test could be administered fairly.[71]

The Joint Committee on Taxation was not the only voice of dissent on the main purpose test. The National Foreign Trade Council expressed strong concerns in testimony before the Senate Foreign Relations Committee.[72] The NFTC expanded on its testimony in a lengthy letter to the Treasury objecting to the main purpose clauses. Among the Council's objections is the inherent difficulty in accurately weighing a taxpayer's tax versus non-tax motivations in a particular transaction.

Treasury responded to the charge that the main purpose test will create uncertainty by arguing that the uncertainly is no greater than that created by domestic anti-abuse rules such as the business purpose and step transaction doctrines. Furthermore, a very similar provision is found in some 50 treaties around the world and in the principal purpose test that appears repeatedly in the Code.[73]

Slovenia accepted the deletion of the main purpose test, and ratified the treaty subject to that modification.[74] Italy, however, did not.

Nevertheless, on December 16, 2009, more than a decade after the U.S. Italy Treaty was signed, instruments of ratification were exchanged with the condition that the treaty would only enter into force subject to the deletion of all of the main purpose test language included in the treaty's provisions. Objections to this type of test seem to have had an impact on Treasury, and it is unlikely that the main purpose test will ever become a standard treaty provision under U.S. tax treaty policy.

F. Headquarters Companies

As mentioned above, the 2006 Model excludes headquarters companies from the benefits of the treaty because they generally do not engage in substantial operational activities. But the 1992 Netherlands treaty contains a special provision for headquarters companies, the first such provision to appear in any U.S. tax treaty. The Dutch negotiators were especially concerned that the treaty provides for headquarters companies because the Netherlands is home to so many such companies.[75]

A company with its headquarters in either of the contracting states is deemed "a headquarter company for a multinational corporate group," and therefore qualifies for treaty benefits if it meets an extensive list of requirements. The chief requirements are: (1) the headquarters company must have discretionary authority to provide, and does provide, a substantial portion of the overall supervision and administration of the group; (2) the group must include corporations resident and engaged in active business in at least five countries, with each business in each of those countries generating at least 10 percent of the gross income of the group (and if there are more than five countries, then the 10-percent requirement can be met through grouping of countries); (3) no country operations, except the resident country of headquarters, can generate 50 percent or more of the gross income of the group; (4) no more than 25 percent of the headquarters company's income is generated in the other contracting state; and (5) the income derived from that other contracting state (Country S) is derived in connection with or be incidental to the active businesses carried on in at least five countries.

Some of these requirements are elucidated in the MOU and each is the subject of extensive discussion in the Technical Explanation. "Supervision and administration" is defined in the MOU to mean group financing, pricing,

marketing, internal auditing, internal communications, management, and/or other activities of the same kind. It is notable that corporations (and not other business forms) must carry on the active businesses in the five or more countries.

The treaties with Austria (1996), Australia (2001), Belgium (2006), and Switzerland (1996) follow closely in the footsteps of the Netherlands treaty, providing the possibility of granting treaty benefits to headquarters companies, notwithstanding the fact that the US Model does not include these rules.

G. Derivative Benefits

The purpose of the derivative benefits provision is to place non-resident taxpayers in a position no worse than if the income had flowed directly to them, rather than flowing through a treaty-resident entity subject to an LOB provision. In general, a derivative benefits provision allows treaty benefits to resident company R Co, which does not otherwise qualify under the LOB rules, if its shareholders would have been entitled to at least the same treaty-based reduction in source-country taxation had they earned the same income directly, rather than through R Co. The 1992 Netherlands Treaty (Article 26(4)) extended derivative benefits to residents of the other European Union states, requiring more than 30-percent ownership by qualified persons resident in the Netherlands and less than 70-percent erosion of gross income through deductible payments to third-country residents, but restricting its application to dividends, branch tax, interest, and royalties.[76] This provision also was included in similar terms in the treaties with Switzerland (1996) and Luxembourg (1996). The Switzerland derivative benefits provision is broader in scope both geographically (it adds NAFTA and the European Economic Area to the E.U.) and in terms of ownership (owners need not be publicly traded). Perhaps the most interesting and significant aspect of the Luxembourg treaty is found in paragraph 4, pursuant to which the derivative benefits provision applies to "all the benefits of this Convention," and not just to certain articles.

Subparagraph 4(a) of the Luxembourg treaty provides that a company resident in Country R but owned by non-Country R residents qualifies for treaty benefits long as (i) it is 95-percent owned by seven or fewer residents of E.U. or NAFTA[77] states that have a comprehensive tax treaty with Country S, and (ii) the company can meet a base erosion test. The ownership restriction (no more than seven owners for the 95-percent test) should not be a problem in practice because these companies commonly will be subsidiaries with one owner or joint ventures with only two or three owners. [78]

The base-erosion test provides that a company may not make deductible payments to non-E.U. and non-NAFTA residents of more than 50 percent of gross income. Arm's length payments in the ordinary course of business for services or tangible property are not included in the calculation.[79] Again, residents of E.U. and NAFTA states qualify only if their state has a comprehensive income tax treaty with Country S.[80] A comprehensive income tax treaty with Country S means, generally, that the treaty must contain an LOB clause with an ownership/base-erosion test, a public company provision, and an active trade or business test.[81] Alternatively, an E.U. or NAFTA resident whose country lacks a comprehensive treaty nevertheless will qualify if that taxpayer could meet the basic ownership/base-erosion, publicly traded, or active business test of the Luxembourg treaty were it a resident of either Luxembourg or the United States. In effect, the LOB clause of the U.S. Luxembourg treaty is applied as if it were a part of the U.S. tax treaty with the E.U. or NAFTA resident's actual country of residence.[82]

There is one final restriction on derivative benefits in the Luxembourg treaty. In the case of dividends, branch tax, interest, and royalties, the tax convention between Country S and the (E.U. or NAFTA) third country must provide a withholding tax rate "equal to or less than the rate provided under this Convention."[83] The Technical Explanation provides this example: U.S. Co pays a dividend to LuxCo. LuxCo has two equal shareholders, an individual and a corporation, each resident in the United Kingdom. The test is applied by asking what the withholding tax would have been for each shareholder had U.S. Co paid the dividend directly to the U.K. shareholders, and then comparing those rates to the withholding that would apply were those recipients residents of Luxembourg. In this example, both the individual and the corporation would have paid the same withholding under either scenario, and therefore LuxCo would qualify for the treaty benefits.[84]

It should be noted that the derivative benefits test applies neither on a proportional basis nor on a pass-through basis. Rather, it either permits or denies the benefits of the residence-country treaty as provided in that treaty. For example, assume that LuxCo is owned 50 percent by a company resident in Portugal and 50 percent by a company resident in Spain, each eligible in full for the benefits of the U.S. tax treaty with its respective country of residence. For a direct-investment dividend, LuxCo would be eligible for a 5-percent rate should the treaty apply and the corporate shareholder resident in Portugal would be eligible for the same 5-percent rate under the U.S.-Portugal treaty, but the corporate shareholder resident in Spain would be eligible only for a 10-percent rate under the U.S.-Spain treaty. In this example derivative benefits would not be available, so LuxCo would be subject to U.S. withholding tax at the full statutory rate of 30 percent. The impact of this effect is lessened by the degree to which U.S. treaty withholding rates are similar across countries. But the advent of limited withholding tax exemptions for dividends, as discussed below, exacerbates this problem significantly.

The Luxembourg derivative benefits test is considerably broader than the Netherlands and Switzerland versions because there is no requirement (*e.g.*, 30 percent) of Luxembourg ownership or Luxembourg deductible payments. As a result, a French company with a wholly owned Luxembourg subsidiary and a wholly owned Dutch subsidiary will enjoy treaty benefits with the United States only in the case of the Luxembourg subsidiary. Similarly, a 95-percent E.U. owned Luxembourg company could make deductible payments totalling 100 percent of its gross income to non-Luxembourg residents, so long as at least 50 percent of those payments went to qualifying E.U. and NAFTA residents. Finally, it is noteworthy that a Luxembourg company could enjoy treaty benefits even if it remits the U.S. income it receives to a tax haven. For example, assume Lux Sub is a second-tier subsidiary, owned directly by first-tier subsidiary Bermuda Co but ultimately by parent France Co. The income that Lux Sub receives from the United States qualifies under the derivative benefits provision (assuming the base-erosion requirements are met) in that Lux Sub is ultimately 100 percent E.U. owned, but Lux Sub may distribute this U.S. source income to accumulate in Bermuda Co rather than pay it directly to France Co.

To catch up with later developments, the derivative benefits provision in the Netherlands treaty was later modified by means of the 2004 Protocol, following some of the key elements included in the Luxembourg treaty. The scope of the provision was broadened to allow its application to any item of income, as long as 95 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons qualified as beneficiaries and the base-erosion test is satisfied.

Other treaties, such as the ones signed with Belgium (1970 Treaty and 2006 Protocol), Malta (2008), Mexico (1992 Treaty and 2003 Protocol), Sweden (1994 Treaty and 2005 Protocol), and the United Kingdom (1975 Treaty and 2001 Protocol), also include a derivative benefits provision.

H. Triangular Cases

A triangular arrangement arises when R Co has a permanent establishment in low-tax Country Y and derives income from Country S through that permanent establishment. As a resident of country R, all of R Co's income generally would be eligible for the benefits of the S-R tax treaty. But when Country R exempts from taxation the profits of R Co attributable to a foreign permanent establishment in Country S, this triangular arrangement would seem to thwart the intent of the tax treaty.[85] Inasmuch as the United States does not exempt foreign permanent establishment income, the triangular arrangement provisions in U.S. tax treaties only apply when the United States is "Country S." Nevertheless, the triangular provisions are drafted bilaterally.

Triangular cases are not addressed in the text of the Netherlands treaty, but in the Protocol in 1993.[86] The Protocol applies to two types of income: royalties and interest. The United States will impose a 15-percent withholding tax on interest and royalties paid to a Dutch permanent establishment in a third country if that third country's tax on the interest and royalties, combined with any Dutch tax due on the same income, is less than 60-percent of the corporate tax rate applicable in the Netherlands.[87] There is an exception, however, for certain interest

and for certain royalties. Interest will be excepted if it is derived in connection with or incidental to an active trade or business carried on by the permanent establishment in the third country.[88] Royalties will be excepted if they are received as compensation for the use or right to use intangible property produced or developed by the permanent establishment.[89]

Paragraph 5 of the Luxembourg treaty LOB clause sets forth a triangular arrangements provision very similar to the Netherlands provision. The chief difference is that the Luxembourg provision applies to dividends as well as interest and royalties. A further difference is that Country S can impose a 15-percent withholding tax if the third-country permanent establishment is subject to a tax rate (in the third country) that is less than 50 percent of the normal Country R rate, while the post-1997 cutoff in the Netherlands context is 60 percent. Hence a third country effecively could be a low-tax jurisdiction in relation to the Netherlands but not in relation to Luxembourg if they each imposed the same basic corporate tax rate. In addition, the Luxembourg treaty specifically requires that the Country R business be exempt from tax on profits attributable to the permanent establishment. Although a classic triangular arrangement does not arise without such exemption, it is possible for Country R to impose a very modest tax on those profits. If this modest tax *plus* the modest tax imposed on the permanent establishment by the third country falls below 50 percent of the normal Country R rate, the Netherlands treaty would permit Country S to withhold a higher rate of tax while the Luxembourg treaty would not.

The Switzerland Treaty also contains a triangular provision very similar to the Netherlands provision. In paragraph 4 of Article 22, the Switzerland treaty defeats triangular arrangements by providing that the Swiss company is ineligible for treaty benefits (for the income at issue) if the actual combined tax imposed by Switzerland and the third country amounts to less than 60 percent of the tax that would have been due had the income simply been earned by the Swiss company in Switzerland. Triangular arrangements do not include royalties received for the right to use or the use of intangible property produced or developed by the permanent establishment itself.[90] They also do not include income that is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country.

The new treaties and protocols with Belgium (2006), Iceland (2007), New Zealand (2008) and Malta (2008) also include a similar triangular arrangement provision, with the exception that the provision in the Iceland treaty covers all items of income rather than just interest and royalties.

I. Zero Withholding Rate on Direct Dividends

A *nil* tax rate on dividends is a recent development in U.S. tax treaty policy. Until 2003, a complete exemption from dividend withholding tax was not included in any U.S. income tax treaty. Since then, a *nil*-rate provision has been included in revised treaties and protocols with Australia, Belgium, Denmark, France, Japan, Mexico, New Zealand, Sweden, the Netherlands and the United Kingdom, where the tax on certain intercompany dividends was excepted from withholding at source and left presumably to be imposed by the taxpayer's country of residence. The ownership percentage required to enable zero withholding is ordinarily 80 percent but varies from treaty to treaty, as does the holding period requirement. The 2006 Model does not provide a *nil*-rate dividend provision; rather it includes the traditional 5-percent minimum rate on dividends.

In 2006 testimony before the Senate Foreign Relations Committee Treasury explained its position on the *nil*-rate dividend provision, stating that the decision to include it had to be "made independently with respect to every treaty negotiation,"[91] based on the overall balance of benefits under the respective treaty.[92] Treasury has further indicated that U.S. *nil*-rate dividend provisions require the inclusion of restrictive LOB rules and comprehensive exchange of information provisions, following the highest standards.[93]

Treasury's perspective towards this type of provision seems to be positive, as they have pointed out it gives way to the following benefits: (*i*) strengthening provisions to prevent treaty shopping, including the introduction of rules that prevent the use of tax treaties after a corporate inversion transaction; (*ii*) significantly improving information exchange provisions, allowing access to information even when the treaty partner

does not need the information for its own tax purposes; (*iii*) reducing withholding taxes on interest and royalties to levels lower than those to which those treaty partners had ever previously agreed; (*iv*) eliminating withholding taxes on dividends paid to pension funds, a tax that otherwise would inevitably lead to double taxation; and (*v*) protecting U.S. companies against the retaliatory re-imposition of withholding taxes on inter-company dividends.[94]

A significant negative of a *nil*-rate provision on dividends is its interaction with derivative benefits provisions. As noted above, derivative benefits provisions operate on an all-or-nothing basis, which can be problematic where withholding tax rates vary across treaties. The U.S. model rate on direct-investment dividends remains 5 percent, which had been standard across most U.S. and OECD-based treaties. But if a company seeking derivative benefits on a direct-investment dividend would be eligible for the new, limited nil rate under its residence-country treaty, it would be denied derivative benefits entirely if any tested shareholder were eligible only for the standard rate of 5 percent. Perhaps the derivate benefits provisions should be restructured to apply a highest-tested-rate rule rather than a match-or-nothing rule. The goals and concerns of the derivative benefits concept would seem to be satisfied by allowing derivative benefits at the rate of 5 percent in this example, and at the rate of 10 percent in the Luxembourg-Portugal-Spain example discussed earlier.

IV. POST 2006 MODEL DEVELOPMENTS

Since the 2006 U.S. Model, additional steps were taken against treaty shopping by continuing to re-negotiate existing treaties with no or inadequate LOB provisions. A major step was the inclusion of an LOB clause in the 2007 U.S. Iceland treaty, replacing one of the few remaining treaties with no LOB provision, which had made it target of income stripping strategies by third countries.[95]

The need to obtain information from tax haven countries has also driven the United States to enter into income tax treaties with such countries. Hence, on August 8, 2008, the United States signed a new tax treaty with Malta, which entered into force on November 23, 2010. The 1980 treaty with Malta had been formally terminated in 1997 by the United States because of concerns that Maltese tax law provided incentives for treaty shopping while not enabling satisfactory exchange of tax information.[96] Upon the modification of its tax laws to address these concerns, and given the accession of Malta to the E.U., the United States was willing to enter into a new tax treaty with Malta.

The new treaty, however, includes stricter provisions than the 2006 U.S. Model in order to deter treaty shopping practices. Such provisions increase the difficulty of meeting the thresholds established in the objective tests. The ownership / base-erosion test is mainly the same, except that a person other than an individual is considered a qualified person only if 75 percent of each class of shares or other beneficial interests is owned by qualified residents and less than 25 percent of the gross income for the year is paid or accrued to persons other than qualified residents of either contracting country. The active business test is also similar, but it includes a substantiality safe harbor that requires at least 10 percent for each asset value, gross income, and payroll expenses, as well as a greater than 15-percent average of the three rates. The treaty also includes a derivative benefits test requiring that at least 95 percent of each class of shares be owned by seven or fewer equivalent beneficiaries and for less than 25 percent of the yearly gross income to be paid to persons other than equivalent beneficiaries.[97]

There is an active trend in U.S. tax treaty policy towards the expansion of bilateral agreements for the exchange of information, consistent with an IRS focus on undisclosed foreign accounts. We can foresee more tax agreements with tax haven or tax secrecy countries.

V. CONCLUSION

The basic elements of the modern LOB provision have settled into place, and further development likely will be in the details rather than in fundamental concepts. Nonetheless, the environment will continue to be dynamic as a consequence of constant global business developments, domestic tax law changes and aggressive international tax planning. We can expect that there will be significant further efforts towards precluding treaty shopping activities, led by both the United States and the OECD.

APPENDIX A

United States Model Income Tax Convention of September 20, 1996

Article 22 – Limitation on Benefits

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2.

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:

   (*a*) an individual;

   (*b*) a Contracting State, or a political subdivision or local authority thereof;

   (*c*) a company, if:

   (*i*) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either:

   A) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or

   B) the company's primary place of management and control is in the Contracting State of which it is a resident; or

   (*ii*) at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under clause (i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

   (*d*) a person described in paragraph 2 of Article 4 of this Convention, provided that, in the case of a person described in subparagraph (a) of that paragraph, more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or

   (*e*) a person other than an individual, if:

   (*i*) on at least half the days of the taxable year, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph (*a*), subparagraph (*b*), clause (*i*) of subparagraph (*c*), or subparagraph (*d*) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State, and

   (*ii*) less than 50 percent of the person's gross income for the taxable year, as determined in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (*a*), subparagraph (*b*), clause (*i*) of subparagraph (*c*), or subparagraph (*d*) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

3. (*a*) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income derived from the other State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.

   (*b*) If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a related person, the conditions described in subparagraph (a) shall be

considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or such person in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

(*c*) For purposes of applying this paragraph, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

4. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, if it determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.

5. For purposes of this Article:

(*a*) the term "recognized stock exchange" means:

(*i*) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934;

(*ii*) stock exchanges of; and

(*iii*) any other stock exchange agreed upon by the competent authorities;

(*b*) the term "principal class of shares" means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company

(*c*) the term "disproportionate class of shares" means any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company; and

(*d*) a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other State and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other State.

1. According to the Tax Management International Journal, the United States currently has a total of 68 income tax treaties in full force and effect, 2 income tax treaties (Chile and Hungary) and 2 protocols (Luxembourg and Switzerland) signed and awaiting Senate approval and 26 tax treaties under various stages of negotiation. *Tax Management International Journal* Vol. 41, No. 10 (October 12, 2012).
2. An LOB clause of some sort has been standard in U.S. treaties since the late 1970s, but the modern era of LOB clauses, in terms of structure and scope as well as high level attention from Treasury, began in the late 1980s.
3. Under State Department of the Treasury, *Technical Explanation of United States Model Income Tax Convention of September 20, 1996*, Art. 22, "Purpose of Limitation on Benefits Provisions."
4. From the U.S. perspective, Country S is the United States and the concern is that non-treaty residents will derive income from the United States but pay no (or little) withholding tax.
5. These are the tests that apply to companies that might be considered to be treaty shopping. *See* Appendix A for the full text of Article 22, including the qualification rules that do not need to be discussed in this article.
6. Treasury Department Technical Explanation, 1996 Model, Art. 22, "Purpose of Limitation on Benefits Provisions."
7. "In crafting the public company exception, Treasury reasoned that companies traded on a recognized exchange are probably owned by residents of the country in which the stock is listed." John Turro, "U.S. Eager to Limit Benefits in Dutch Treaty Negotiation," 91 *Tax Notes Int'l* 2 16 (Dec. 1, 1990).
8. Treasury Department Technical Explanation, 1996 Model, Art. 22, para. 2, "Publicly Traded Corporations—Sub-paragraph 2(c)(i)."
9. Treasury Department Technical Explanation, 2006 Model, Art. 22, para. 2, "Publicly Traded Corporations—Sub-paragraph 2(c)(i)."
10. *Id.*
11. *Id.* The Technical Explanation explicitly identifies this regulation as the definition for "regularly traded."
12. U.S.-Germany Treaty, Art. 28, sub-para. 3(b), prior to replacement by 2006 Protocol.
13. U.S.-Netherlands Treaty, Art. 26, sub-para. 8(d)(ii), prior to replacement by 2004 Protocol.
14. Article XXII of the Memorandum of Understanding accompanying the 1992 U.S.-Netherlands Tax Treaty.
15. Letters of Understanding to 1993 U.S.-Netherlands Protocol (October 13, 1993), Para. VI.
16. U.S.-Netherlands Treaty, Art. 26, sub-para. 8(a)(iii).
17. Technical Explanation, 2006 US Model, Art. 22, clause 2(c)(*i*).
18. The treaty uses the phrase "a person other than an individual."
19. The Treaty no longer makes reference to the concept of qualified government entities, referring only to Contracting States, political sub-divisions and local authorities of the two States, thereby excluding certain quasi-governmental entities that used to be included in the 1996 Model. Joint Committee Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006 (May 8, 2007).
20. For these purposes, subsidiaries of companies that satisfy the publicly traded test are excluded. 2006 Model, Art. 22, para. 2(e)(i).
21. 2006 Model Technical Explanation, Art. 22, para. 1.
22. *Id.*
23. "A tax-exempt organization other than a pension fund automatically qualifies for benefits, without regard to the residence of its beneficiaries or members." Technical Explanation, 2006 US Model, Art. 22, sub-para. 2(d).
24. Joint Committee Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006 (May 8, 2007).
25. Technical Explanation, 2006 US Model, Art. 22, sub-para. 2(e).
26. 2006 Model, Art. 22, clause 2(e)(i).
27. Technical Explanation, 2006 US Model, Art. 22, clause 2(e)(*ii*).
28. Technical Explanation, 2006 US Model, Art. 22, sub-para. 2(e).
29. Treasury Regulation §1.864-2(e).
30. Technical Explanation, 2006 US Model, Art. 22, para. 3.
31. 2006 Model, Art. 22, sub-para. 3(a).
32. *Id*.
33. Technical Explanation, 2006 US Model, Art. 22, para. 3.

34. *Id.*.
35. *Id.*
36. *Id.*
37. 2006 Model, Art. 22, sub-para. 3(b).
38. *Id*.
39. Technical Explanation, 2006 US Model, Art. 22, para. 3.
40. Example 3 under paragraph 10 of Diplomatic Notes, dated February 4, 2010, to the proposed U.S.-Hungary Tax Treaty (signed February 4, 2010).
41. 2006 Model, Art. 22, sub-para. 3(c).
42. Treasury Department Technical Explanation to the 1996 Model, Art. 22, "Purpose of Limitation on Benefits Provisions."
43. 2006 Model, Art. 22, para. 4
44. D.M. Berman, personal conversations with Internal Revenue Service officials and leading international tax lawyers, September-October 2012; *also* "Seminar L–Limitation on Benefits Articles in Income Tax Treaties: The Current State of Play," 66th Congress of the International Fiscal Association, Boston, MA (October 4, 2012).
45. The remaining U.S. tax treaties without an LOB provision are with Hungary (1979), Poland (1974), Greece (1950), Pakistan (1957), the Philippines (1976), Romania (1973), and the USSR (1973; the provisions of which remain in effect with Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan).
46. Among these countries only the treaties with Hungary and Poland offer a withholding tax exemption on interest. A new treaty with Hungary is awaiting approval on the floor of the U.S. Senate, and Treasury has completed negotiations with Poland on the text of a new treaty.
47. The LOB provision in the 1989 treaty with Germany was replaced in a 2006 protocol.
48. The treaties are with Egypt (1980), Korea (1976), Morocco (1977), Norway (Protocol, 1980), and Trinidad and Tobago (1970).
49. Cyprus (1984) and Jamaica (Protocol, 1981).
50. Code § 884(e).
51. *See* § 884(e)(4).
52. *See* Mary C. Bennett, et. al., "A Commentary to the United States-Netherlands Tax Convention," in Baker & McKenzie, *The 1992 United States Netherlands Tax Convention* 51 (1993) [hereinafter Bennett, *Commentary*]. This book is an "offprint" of a special issue (April/May 1993) of *Intertax* that focused exclusively on the U.S.- Netherlands treaty. Authors Philip Morrison and Mary Bennett are identified in the Introduction as the "U.S. head negotiators" for the Netherlands treaty. *Id*. at 2.
53. *Id.* at 51.
54. Peter H. Blessing & Carol A. Dunahoo, *Income Tax Treaties of the United States* ¶ 22.02[1][b] at p. 22 20 (1996).
55. Article 28 of the 1989 treaty was replaced in a 2006 protocol.
56. Leonard Terr, the U.S. Treasury International Tax Counsel who negotiated the 1989 U.S. Germany Treaty, said at the time that the treaty "contains what is certainly the most finely tuned limitations article, and which may well be a model for future negotiations." Kathleen Rosen Matthews, "Terr Discusses Tax Treaty Developments," 42 *Tax Notes* 157 (Jan. 9, 1989). While this development was good news in the United States, Germans may see things differently: "German influence on the working of article 28 appears to be limited primarily to clarification with regard to channeling companies and relief in the foreign ownership test." Stephan Eilers and Maureen Watkins Brugmann, "Article 28 of the German--U.S. Double Taxation Treaty of 1989: An Appropriate Solution to the Treaty Shopping Problem?" 20 *Tax Planning Int'l Rev.* 15 (Sept. 1993).
57. *See* Bennett, *Commentary*, *supra* note 38, at 3.
58. *Id.* A more trenchant explanation was offered elsewhere: "The length and detail is due in large part to the United States' interest in preventing 'treaty shopping' ... and the Netherlands' competing desire to retain its status as an attractive location for holding companies and finance subsidiaries for international groups." Philip H. Spector, "Limitation on Benefits under the New US-Netherlands Income Tax Treaty," 47 *Bull. For Int'l Fiscal Doc*. 159 (1993).
59. The Protocol ("2004 Protocol") broadened the requirements of the publicly traded test, extending its application not only to a company's principal class of shares, but also to any "disproportionate class of its shares", and introducing a new limitation which disallows companies from qualifying for treaty benefits when they do not have substantial presence in the country of which they are residents. This new substantial presence requirement implies a company will fail the publicly traded test if (i) its primary place of management and control is not in the country of which it is a resident, and (ii) the aggregate volume of trading is not primarily carried out in a recognized stock exchange within the company's "primary economic zone", subject to certain thresholds.

The trading requirements to meet the publicly traded test for a class of shares were also modified, demanding the aggregate number of shares traded on a recognized exchange in the "12-month period" preceding the current taxable year to be at least six per cent of the average number of shares outstanding (of the class or classes in question) during that year.

Regarding the public company subsidiary test, the 2004 Protocol reduced the minimum amount of ownership to at least 50% and extended it to cover any disproportionate class of shares, providing that in the case of indirect ownership, each intermediate owner would have to be a resident of either Contracting State. The Protocol further established that the ownership test also had to be satisfied with respect to any disproportionate class of shares. Although the Protocol eliminated the active business test substantiality safe harbor, pursuant to the 2006 Model, the Memorandum of Understanding accompanying the Protocol describes the same safe harbor that used to be included in the 1992 version of the Netherlands treaty and 1996 U.S. Model. In particular, the 2004 Protocol provided the basis of the main modifications included in the 2006 Model.

60. Treasury Department Technical Explanation to the U.S.-Switzerland Treaty, Introduction.

61. Technical Explanation, Art. 22, sub-para. 1(*f*), "Predominant interest test." Treasury does not identify the domestic law at issue. Commentators suggest that it is the 1962 Anti Abuse Decree, which has been relied upon previously as a sort of LOB provision. *See* W. Warren Crowdus, "U.S.-Switzerland Sign Income Tax Treaty," 13 *Tax Notes Int'l* 1983, 1989 (Dec. 16, 1996), and Howard R.Hull,"Switzerland: Limitation on Benefits in the New U.S.-Switzerland Treaty," 51 *Bull. for Int'l Fiscal Doc.* 2, 6 (Jan. 1997).

62. Technical Explanation, Art. 22, sub-para. 1(*f*).

63. Protocol, para. 8.

64. Technical Explanation, Art. 22, para. 1, "Predominant interest test."

65. 1996 U.S. Model, Technical Explanation, Art. 22, "Purpose of Limitation on Benefits Provisions."

66. The Senate held a hearing on the Italy and Slovenia treaties, among others, on October 27, 1999. *See Bilateral Tax Treaties and Protocol: Hearing Before the Committee on Foreign Relations, United States Senate*, 106th Cong. (1999) [hereinafter *Hearing*].

67. Added by the Taxpayer Relief Act of 1997 (P.L. 105-34), Code section 894(c) denies the withholding tax reduction of U.S. income tax treaties to foreign taxpayers using a hybrid entity (*i.e.*, an entity having a different tax status under foreign law than under U.S. law) if the entity is classified as a corporation under foreign law and the owner is not subject to tax on distributions from the entity.

68. Section 7701(L), added to the Code by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), is a grant of regulatory authority to limit conduit arrangements by recharacterizing multiple party financing transactions. The IRS promulgated final regulations under this section in August 1995: Reg. Secs. 1.881-3 and 1.881-4.

69. *See* Technical Explanation to U.S.-Italy Treaty, Art. 10, para. 10.

70. *Hearing*, *supra* note 97, at 37 (testimony of Lindy Paull, Chief of Staff, Joint Committee on Taxation).

71. *Explanation of the Proposed Income Tax Treaty Between the United States and the Republic of Slovenia* 48 49 (JCS 11 99, Oct. 8, 1999).

72. "Although NFTC does not support inappropriate use of such treaties, the wording of these tests are vague and unclear. The tests must be applied in a subjective way under treaty language that may be difficult to change if they do not work as intended. The rules may cause considerable uncertainty to taxpayers in the application of otherwise available provisions of the treaties. The NFTC would hope that the Treasury would not use its franchise to negotiate treaties as a way to achieve new authority under new and untested general anti avoidance rules, particularly where the need for such rules has not been vetted in the public discourse or has been refused by the Congress in other contexts. NFTC strongly supports the immediate ratification of both treaties, but finds the inclusion of these test provisions to be troubling." *Hearing*, *supra* note 97, at 61 (testimony of Fred F. Murray, Vice-President for Tax Policy, National Foreign Trade Council).

73. *Id.* at 41 (testimony of Philip R. West, International Tax Counsel).

74. The U.S.-Slovenia tax treaty entered into force on June 22, 2001.

75. *See* Joseph DeCarlo, Jr., et. al., "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Management Int'l J.* 271 (June 11, 1993), and Ian K. Sugarman, "The U.S.-Netherlands Income Tax Treaty: Closing the Doors on the Treaty Shoppers," 17 *Fordham Int'l L.J.* 776, 821 (1994).

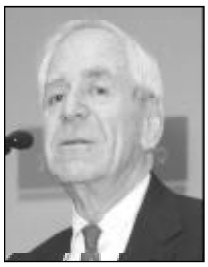
76. These are articles 10 through 13, respectively. *See* U.S.-Netherlands Treaty, Art. 26, sub-para. 4(a).

77. North American Free Trade Agreement.

78. "The ownership percentage requirement is less than 100 percent to avoid denying benefits simply because there is a small non-qualified shareholder, while the limitation on the number of shareholders is set at seven in recognition of the fact that most of the companies that would want to use this provision will be subsidiaries of EU owners, *i.e.*, in most cases there will be a single owner." Technical Explanation to U.S.-Luxembourg Treaty, Art. 24, para. 4.

79. There is no specific requirement that these payments be made to unrelated parties. As noted by the Joint Committee on Taxation, the arm's length payment exception to the base-erosion test is a new and pro-taxpayer development. *See* Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Luxembourg," JCS-14-97 (Oct. 6, 1997).
80. While the United States had at one point completed its tax treaty network with E.U. and NAFTA countries, this situation is in flux with the ongoing enlargement of the E.U. Moreover, not all current U.S. tax treaties with E.U. countries would qualify as "comprehensive."
81. U.S.-Luxembourg Treaty, Art. 24, clause 4(d)(*i*) (regarding the European Union) and clause 4(d)(*ii*) (regarding NAFTA).
82. See *id.*
83. *Id.* at sub-para. 4(c).
84. *See* Technical Explanation to U.S.-Luxembourg Treaty, Art. 24, sub-para. 4(c).
85. This statement assumes that the reduction in withholding tax should be reserved for income that is subject to full taxation in the other State. Although this assumption underlies the U.S. tax system, other Contracting States may not share the view.
86. U.S.-Netherlands Tax Treaty, Art. 24, para. 4 (deleted by the Protocol) provided that triangular cases would be addressed in a Protocol if, by the time the Senate Foreign Relations Committee considered the treaty, the Dutch had not already addressed triangular cases through legislation. They had not.
87. The 60-percent rule is in effect for interest and royalties arising on or after January 1, 1998. Those arising earlier were subject to a 50-percent rule.
88. Protocol Art. 1.
89. *Id.*, Art. 2.
90. U.S.-Switzerland Treaty, Art. 22, sub-para. 4(a).
91. As noted in the testimony of Patricia A. Brown, Deputy International Tax Counsel (Treaty Affairs), United States Department of the Treasury, before the Senate Committee on Foreign Relations on "Pending Income Tax Agreements" (U.S. Treasury Press Report JS-4001, February 2, 2006).
92. See Joint Committee on Taxation, "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria," JCX-60-08 (July 10, 2008).
93. *Id*.
94. Also noted in the testimony of Patricia A. Brown, Deputy International Tax Counsel (Treaty Affairs), United States Department of the Treasury, before the Senate Committee on Foreign Relations on "Pending Income Tax Agreements" (U.S. Treasury Press Report JS-4001, February 2, 2006).
95. See Department of the Treasury, "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties'" (Nov. 28, 2007).
96. United States Senate, Committee on Foreign Relations, Executive Report, Tax Convention with Malta (06/30/2010).
97. U.S.-Malta Tax Treaty, Article 22.

IFA's "Enhanced Relationship" Initiative



Jerome B. Libin*

Think back a few years, to the period when very aggressive tax planning was considered by some to be the "new normal." In that environment, the well-publicized "Seoul Declaration," issued in 2006 by the Forum of Tax Administrators (FTA) representing some 35 countries, caused a bit of a stir. Essentially, the FTA, which functions under the auspices of the OECD, pointed its collective finger at the international community of tax advisers (so-called "tax intermediaries") and suggested that they accept substantial responsibility for participating in (and perhaps fostering) a culture that emphasized abusive tax planning schemes. ("Our discussions revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements.")

The FTA followed up with a broad study of the situation that led to its Cape Town Communique of January 2008. The Communique shifted the focus of the discussion. It acknowledged that tax intermediaries play a vital role in helping taxpayers comply with the tax laws, and that taxpayers themselves make the ultimate decision on which tax strategies to adopt. The Communique chose to emphasize the need for better cooperation between tax administrators and taxpayers. It suggested that tax administrators could achieve a "more effective and efficient relationship" with taxpayers and tax intermediaries by developing greater commercial awareness and acting more impartially, proportionally, openly and responsively. If tax administrators demonstrated such attributes, the Communique indicated, large corporate taxpayers (if not other taxpayers) would be more likely to engage in a closer working relationship – the so-called "enhanced relationship."

The essence of the "enhanced relationship" concept is that if tax administrators demonstrate a willingness to work more closely and more openly with taxpayers, then taxpayers should be willing to be more forthcoming about their tax planning ideas. Stated another way, if taxpayers would commit to disclosing their tax planning ideas, the tax authorities would commit to being properly prepared to indicate which proposed steps they might approve and which they would not approve. A side benefit

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of such full disclosure would, no doubt, be a sharp reduction in the development of abusive tax planning schemes.

The new concept was certainly worthy of attention, and IFA was quick to respond. It held an introductory seminar on the "enhanced relationship" concept at its 2008 Congress in Brussels. Practitioners on the panel were somewhat divided in their reaction to the proposal, not being exactly sure what it might entail. The participating corporate tax officer saw definite benefits from the idea. One telling point that emerged was that, in certain countries, there was "no relationship" at all between taxpayers and the tax administrators, so the prospect of developing an "enhanced relationship" in those countries was considered nil. Some members of the audience supported the strongly held view that any development of an "enhanced relationship" between taxpayers and tax administrators should not undercut the continued role of legitimate tax planning.

Following the Brussels seminar, IFA decided to undertake a major initiative on the subject. While IFA itself would have a neutral position on the issues raised, its branch structure allowed it to gather country-by-country information regarding the views of the various groups directly impacted by the "enhanced relationship" concept (primarily tax administrators, tax practitioners, and corporate tax officers, but also academics and tax judges). This information allowed all interested parties to develop a sense of what their counterparts in other countries were thinking. The initiative involved both separate discussions on the subject by the participating IFA branches and meetings of the various interested parties at the Rome Congress in 2010 and the Paris Congress in 2011.

In 2012, IFA released its Key Issues Report on the Enhanced Relationship Initiative. The Report, which was a major undertaking and is available on the IFA website, describes the range of views formulated as a result of the numerous meetings that had been held and the input that had been received. One key point that emerges in the Report is that there was no consistent understanding of what the term "enhanced relationship" was actually intended to mean. It clearly means different things to different people. In addition, the Report recognizes that local cultural differences are, in some instances, responsible for differing levels of enthusiasm about the concept and differing views regarding its viability. In short, there is no uniformity of views regarding the scope or wisdom of the concept. One size clearly does not fit all.

A major contribution of the IFA Report is its summary of the specific steps and programs that have actually been undertaken in certain countries to improve the relationship between tax administrators and certain taxpayers (generally large corporate taxpayers considered to be "low risk"). This information should be quite valuable. The positive steps that have been taken in the countries identified in the Report have generally resulted in a win-win situation for all involved.

In conjunction with the release of its Key Issues Report, IFA also assembled a panel at the 2012 Boston Congress to revisit the "enhanced relationship" idea. Interestingly, the OECD Representative on the panel suggested that perhaps the concept was now in need of a new name. The term "cooperative compliance" was put forward. The basis for the suggested name change seems to be that the real focus of the effort has been on transparency and disclosure, making it much more of a compliance effort than might initially have been understood. The underlying assumption seems to be that we are now at a point where taxpayers of any size that are willing to be transparent with the tax authorities by making full disclosure of their tax planning ideas should be anxious to benefit from the certainty gained by having their tax situation reviewed and possibly resolved at an early stage. Conversely, taxpayers not willing to be transparent through full disclosure may well become the subject of a higher degree of scrutiny as a result. It was unclear from the discussion whether the rest of the panel was prepared to accept the OECD suggestion for a name change.

The panel undertook to evaluate various aspects of the "enhanced relationship" concept and seemed generally supportive. Yet, one panelist confirmed the earlier indication that in certain countries, particularly developing countries, there is still "no relationship" between the tax authorities

and taxpayers. Another panelist emphasized that any sort of "enhanced relationship" required a very high level of mutual trust, which might certainly vary from country to country. Without such trust, there would be no chance of success.

One point forcefully made by a third panelist was that "tax optimization" must be preserved as a respected principle. Any sort of "enhanced relationship" or "cooperative compliance" arrangement that might develop should not inhibit taxpayers from planning their affairs in a way that minimizes their overall tax liability. (This, of course, brings to mind the well-known statement by U.S. Judge Learned Hand nearly 80 years ago in the leading case of *Gregory* v. *Helvering* — "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury.")

From listening to the panel discussion, one could readily anticipate the prospect of rising tension between a tax administrator's desire to learn everything about the taxpayer's thinking and the taxpayer's desire to ensure that it can plan its affairs in a way that best minimizes its tax liability. Taxpayers that place great value on their tax planning efforts and that are concerned about the "over-disclosure" of information might ultimately be forced to opt out of any opportunities for an enhanced relationship or a cooperative compliance arrangement and simply take the risk associated with being under greater scrutiny by the tax administrators.

The proper conclusion to be drawn from all of this seems to be that, even if the enhanced relationship effort does not produce a perfect solution for all players in all countries, it nevertheless can improve tax administration by encouraging the taking of certain positive steps that benefit both sides. What particular steps might work best in any given country must, of course, be left to the tax authorities and taxpayers of that country.

And on this point, the new IFA Report should be a valuable reference tool. If that proves to be the case, IFA will have made a major contribution to the conversation.

US Tax reform - Broadening the income-tax base

Harry L. Gutman*

The tax reform debate—and the proposals to cut income tax rates—include discussions concerning broadening the tax base. Most policymakers agree that the same amount of revenue can be raised more efficiently and simply with a low rate on a broad base than by a higher rate on a narrow base.

A snapshot of our current income tax system shows a base as full of holes as Swiss cheese. But how can we identify and quantify the tax provisions that move us away from a comprehensive tax base—provisions that are not necessary to define "income?" The answer is the concept of "tax expenditures."

Tax expenditures

What is a tax expenditure? Tax expenditures are defined in the *Congressional Budget and Impoundment Act of 1974* (the Budget Act) as:

> *...revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.*

Thus, tax expenditures include any reductions in income tax liabilities that result from special tax provisions that provide tax benefits to particular taxpayers.

Special income tax provisions are referred to as tax expenditures because they may be considered analogous to direct spending programs, and the two can be considered as alternative means of accomplishing similar budget objectives.

The exclusion from income for employer-provided health insurance is an example of a tax expenditure. It is a special exclusion available only to taxpayers whose employers subsidized their health insurance. The same benefit could be provided by the government directly to the employee.

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The home mortgage interest deduction is also a tax expenditure—a more complicated case than health insurance. An income tax does not permit the deduction of expenses that produce non-taxed income. The home mortgage interest deduction is an expense related to exempt income—the imputed rental value of the home it finances. The home mortgage interest deduction is only available to taxpayers who itemized their deductions, and the value of the benefit increases as the taxpayer's tax bracket increases. The same benefit could be provided as a direct subsidy, but a government spending program to subsidize housing might not be designed the same way as the mortgage interest deduction with the spotlight shining more brightly on "who benefits" from the program.

The total static revenue loss attributable to tax expenditures in 2011 was $1.3 trillion. The entire federal direct expenditure budget was $3.6 trillion. In other word, 26% of federal spending last year was accomplished through the tax code.

The Joint Committee on Taxation (JCT) and the Office of Management and Budget are required by the Budget Act to publish a list of tax expenditures annually.

The top individual and corporate tax expenditures based on the JCT 2012 report are shown below.

Largest tax expenditures, individual and corporate, 2011-2015

INDIVIDUAL TAX EXPENDITURES		CORPORATE TAX EXPENDITURES	
Individual Tax Expenditure and Function	**Total Amount (2011-2015) (Billions of dollars)**	**Corporate Tax Expenditure and Function**	**Total Amount (2011-2015) (Billions of dollars)**
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	725.0	Deferral of active income of controlled foreign corporations	86.7
Deduction for mortgage interest on owner-occupied residences	464.1	Depreciation of equipment in excess of the alternative depreciation system	75.3
Reduced rates of tax on dividends and long-term capital gains	456.6	Deduction for income attributable to domestic production activities	49
Net exclusion of pension contributions and earnings: Defined contribution plans	375.9	Exclusion of interest on public purpose State and local government bonds	46.8
Earned income credit	294.1	Inventory property sales source rule exception	31.0
Net exclusion of pension contributions and earnings: Defined benefit plans	263.7	Credit for low-income housing	28.1
Exclusions of capital gains at death	230.8	Deferral of gain on non-dealer instalment sales	28.1

Deduction of non-business State and local government income taxes, sales taxes, and personal property taxes	230.3	Expensing of research and experimental expenditures	25.8
Exclusion of benefits provided under cafeteria plans	197.6	Inventory methods and valuation: Last in first out	21
Exclusion of untaxed Social Security and railroad retirement benefits	188.8	Credit for increasing research activities (Code section 41)	18.4

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015* (JCS-1-12), January 17, 2012

Tax expenditures v. revenue estimates

A tax expenditure calculation is not the same as a revenue estimate for reasons including the following:

- Unlike revenue estimates, tax expenditures do not take into account the effects of the behavioural changes that are anticipated to occur in response to the repeal of a tax expenditure provision.
- Tax expenditure calculations are concerned with the changes in the reported tax liabilities of taxpayers. Because tax expenditure analysis focuses on tax liabilities as opposed to federal government tax receipts, the short-term timing of tax payments are not taken into account.
- Some of the tax provisions that provide an exclusion from income also apply to the FICA tax base, and the repeal of the income tax provision would automatically increase FICA tax revenues as well as income tax revenues. This FICA effect would be reflected in revenue estimates, but is not considered in tax expenditure calculations.
- There may also be interactions between income tax provisions and other federal taxes such as excise taxes and the estate and gift tax.

Revenue neutral corporate tax rate reduction

The Joint Committee on Taxation (JCT) responded in October 2011 to a congressional request for:

- Estimates of repealing or modifying tax expenditures claimed by corporations
- An estimate of the lowest possible corporate income tax rate that could be enacted through legislation that is revenue neutral for C corporations in conjunction with the repeal or modification of these provisions

The JCT responded that if all of the provisions that they estimated—including accelerated depreciation, the research credit, and the domestic production deduction—are repealed for corporations, the lowest corporate income tax rate which achieves revenue neutrality for C corporations is estimated to be 28%. The estimates assume that no transition relief is provided.

KPMG observation

Note, however, that more than 70% of business income is earned by businesses that are not subject to the corporate tax. Repeal of corporate tax expenditures only would likely encourage businesses to shift their business activity to entities not subject to tax because the preferences would remain for those entities.

On the other hand, eliminating preferences for all business income would result in a tax increase for those who currently do business in non-corporate form. Resolving this conflict in a neutral way is difficult so long as the separate corporate tax exists.

The Joint Committee on Taxation (JCT) noted that it is not always obvious what tax rules would be applicable when certain tax expenditures

are eliminated, and accordingly made some judgments in its report.

The JCT also noted that the estimates are very preliminary, as they continue to upgrade the models relating to corporate tax reform.

In addition, the estimated revenues attributable to C corporations are based on the then-current division of business entities among sole proprietorships, pass-through entities, and C corporations.

Recent U.S. Tax Developments

Charles W. Cope*

This monthly column provides an overview of recent significant developments in U.S. income tax law that may be of interest to tax advisors in India who have clients with U.S. interests and tax directors of companies in India with U.S. interests.[1-2] The column is intended to cover many aspects of U.S. tax law including legislation, Treasury regulations, Internal Revenue Service ("IRS") rulings, judicial decisions and income tax treaties.

IRS Loses Second Debt-Equity Case This Year

On September 20th the U.S. Tax Court issued a memorandum opinion addressing the characterization of certain instruments issued by two indirect Dutch subsidiaries of PepsiCo, Inc. ("PepsiCo") to certain U.S. subsidiaries of PepsiCo.[3] In finding for PepsiCo, the Tax Court concluded the instruments should be characterized as equity, rather than as debt, for U.S. federal income tax purposes.

Earlier this year, the Tax Court issued a decision in favour of the taxpayer in *NA General Partnership & Subs et al.* v. *C.I.R.*[4] In that case the IRS argued that the instruments in question were equity, rather than debt. Thus, in the last year the government has lost when it has argued either side of the debt-equity issue. Although in both cases the Tax Court issued a memorandum opinion, which may not be cited as precedent, taxpayer seeking to structure cross-border financing transactions, should take note of these cases because they offer insights as to how the Tax Court resolves debt-equity issues.

Background

Pepsi, like many US multinationals in the 1970s and 1980s, formed finance subsidiaries in the Netherlands Antilles to borrow outside the United States and on-lend the funds to the US group. Under the terms of a protocol extending the Netherlands-USA Income Tax Treaty to the Netherlands Antilles, interest payments made by the US group to the Antilles finance subsidiaries were free of US withholding tax. Furthermore, PepsiCo's Antilles finance subsidiaries owned interests in non-US partnerships that generated losses for US tax purposes. These losses effectively sheltered

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the interest income of the Antilles finance subsidiaries from current US taxation under the US subpart F rules. The interest income earned by the finance subsidiaries also was lightly taxed under Antilles law.

The United States terminated the Netherlands Antilles protocol in 1995. About the same time, PepsiCo began to seek business opportunities in Eastern Europe as well as Asia, which required large investments and would initially generate tax losses. For these reasons, PepsiCo began a global restructuring of its international operations. One of the goals of the global restructuring was to maintain a structure that was as tax-efficient as the Antilles structure, which was no longer viable from a US tax perspective.

The Global Restructuring

The Back-to-Back Arrangement

As part of the global restructuring, PepsiCo caused two new Netherlands subsidiaries to be formed: PepsiCo Worldwide Investments (PWI) and PepsiCo Global Investments (PGI). Both PWI and PGI were treated as corporations for US federal income tax purposes. Following their formation, PWI and PGI received as capital contributions interests in various foreign partnerships that operated in areas in which PepsiCo was in the process of developing its brand and a market for its products. At the time of contribution, many of these foreign partnerships were generating losses and were expected to continue to do so.

In connection with the global restructuring, PepsiCo's US subsidiaries refinanced the notes that they had issued to the Antilles finance subsidiaries.[5] The new notes were consolidated in one of the Antilles finance subsidiaries, which then contributed them to a new US company, Kentucky Fried Chicken International Holdings ("KFCIH"). KFCIH then contributed the notes to PWI and PGI in exchange for certain instruments (the "Advance Agreements"). As part of a spinoff transaction, KFCIH transferred the Advance Agreements to one of PepsiCo's US subsidiaries.

Desired US Tax Treatment

Thus, after the global restructuring, PepsiCo's US subsidiaries paid interest to PWI and PGI, which then made payments under the Advance Agreements to one of PepsiCo's US subsidiaries. PepsiCo anticipated that the interest income earned by PWI and PGI would be sheltered from current US tax under subpart F by losses from the foreign partnerships. PepsiCo also treated the Advance Agreements as equity for US federal income tax purposes. The losses in PWI and PGI caused those companies not to have earnings and profits for US federal income tax purposes. Thus, payments made under the Advance Agreements were not treated as dividends in the hands of the PepsiCo US subsidiary that receive them. The global restructuring therefore created a current deduction in the United States as interest was paid, but no inclusion in income when that cash was repatriated to United States as a payment under the Advance Agreements.

The Dutch Tax Ruling

From a Dutch tax perspective, PWI and PGI earned interest income, which was taxable in the Netherlands. However, in drafting the Advance Agreements, PepsiCo obtained a ruling from the Dutch Revenue Service that the Advance Agreements should be treated as debt for Dutch tax purposes. Thus, PWI and PGI paid little or no income tax in the Netherlands.

Terms of the Advance Agreements

The Advance Agreements, which were negotiated with the Dutch Revenue Service generally provided for:

(*i*) Accrual of a preferred return on any unpaid principal amounts on a semi-annual basis, *provided, however*, such preferred return was only payable to the extent that the company's net cash flow during the preceding year exceeded a certain amount stated in the Advance Agreements;[6]

(*ii*) Payments of principal amounts after initial terms of 40 years;

(*iii*) Initial, unrestricted options for PWI and PGI to renew the Advance Agreements for a period of 10 years;[7]

(*iv*) Subordination of amounts owed pursuant to the Advance Agreements (e.g., unpaid principal amount, accrued but unpaid

preferred return, etc.) to all the indebtedness of PWI and PGI, without limitation.

(*v*) Subject to certain limitations (e.g., the subordination provision), the right of the Advance Agreement holders to declare as immediately due any unpaid amounts upon certain events (e.g., dissolution or termination of PWI/PGI's legal existence).

In addition to the above, the Advance Agreements provided additional provisions intended to address issues raised by the Dutch Revenue Service. For example, the Advance Agreements provide a provision stating the Advance Agreements became perpetual to the extent of any uncured defaults on loan receivables held by PWI or PGI from related parties.

The IRS's Position

The IRS issued a notice of tax deficiency to PepsiCo for unpaid tax in the amount of USD$ 363 million for the tax years 1998 through 2002. The IRS determined the substance of the transactions supported characterizing the Advance Agreements as debt. Based on this characterization, the IRS determined payments from PWI and PGI pursuant to the Advance Agreements constituted taxable interest payments on promissory notes for U.S. federal income tax purposes. In reaching this conclusion, the IRS heavily relied on PepsiCo's dialogue with the Dutch Revenue Service during its negotiations to obtain a Dutch tax ruling. The IRS determined this dialogue evidenced PepsiCo's clear intention to structure the Advance Agreements as debt.

The Tax Court's Analysis

Based on the facts provided, the Tax Court determined the Advance Agreements exhibited more qualitative and quantitative indicia of equity rather than debt. In the Tax Court memorandum decision, Judge Goeke states the following test for debt-versus-equity inquiries:

> [T]he focus of a debt-versus-equity inquiry generally narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship.The key to this determination is primarily the taxpayer's actual intent, evinced by the particular circumstances of the transfer.

For purposes of this debt-versus-equity inquiry, the Tax Court considered the following 13 factors as applied to the Advance Agreements:

(1) Names or labels given to the instruments;

(2) Presence or absence of a fixed maturity date;

(3) Source of payments;

(4) Right to enforce payments;

(5) Participation in management as a result of the advances;

(6) Status of the advances in relation to regular corporate creditors;

(7) Intent of the parties;

(8) Identity of interest between creditor and stockholder;

(9) Thinness of capital structure in relation to debt;

(10) Ability of the corporation to obtain credit from outside sources;

(11) Use to which advances were put;

(12) Failure of debtor to repay; and

(13) Risk involved in making advances.

The Tax Court determined the Advance Agreements reflected a number of equity features. For example, the Tax Court stated that it could not conclude that PGI and PWI had an unqualified obligation to pay a sum certain at a reasonable close fixed maturity date given the legitimate possibility that a related party default would render the Advance Agreements' terms perpetual. The Tax Court also concluded that the provisions governing the Advance Agreements lacked any legitimate creditor safeguards since certain provisions in the Advance Agreements significantly diluted the holders' right to enforce payment. In support of this conclusion, the Tax Court noted, among other things, that payments with respect to the Advance Agreements were subject to net cash flow restrictions as well as a subordination provision.

The Tax Court also concludes that PepsiCo did not "intend" to create debt and that its intentions comport with the substance of the transaction. In addressing intent, Judge Goeke states the following:

> Petitioners, *engaging in legitimate tax planning*, designed the advance agreements with an expectation that the instruments would be characterized as equity for U.S. Federal income tax purposes and as debt under Dutch tax law. The negotiations with the Dutch Revenue Service underscore petitioners' efforts to secure this hybrid dynamic. While eventually assuring the Dutch Revenue Service that base pre payments would be made annually, irrespective of provisions in the advance agreements which might provide otherwise, petitioners were uncompromising in their refusal to insert terms in the instruments engendering an obligation for PGI to make such payments. Petitioners' vigilance preserved what amounts to base pre payment discretion, a material feature in the light of both the differing terms of the advance agreements and the Frito-Lay notes, and the limited period the Dutch tax ruling remained effective... Undoubtedly, petitioners' internal commitment to make annual base pre payments that were functionally linked to FRITO-Lay Note interest payments evinces a debt-like characteristic of the instruments. Nonetheless, by retaining judgment on whether to make such future payments, petitioners were free to deviate from their representations to the Dutch Revenue Service without the specter of legal consequence. The benefit of added financial manoeuvrability was desired and sought by petitioners and illuminates a significant equity aspect of the investment. *(Emphasis added).*

Unrebutted expert testimony from a finance expert engaged by PepsiCo also helped persuade the Tax Court that the Advance Agreements should be characterized as equity. According to the expert witness treatment of the Advance Agreements as debt would cause PGI's debt-to-equity ratio to be 14.1 to 1 in 1996 and 26.2 in 1997. PepsiCo's expert testified that, in his experience, "it is highly unlikely that any institution would have extended a loan of similar size to the Advance Agreements if the borrower's overall leverage were at these levels, particularly given the duration of the Advance Agreements and the expected business plans for PGI's subsidiaries." This expert testified further that, due to this level of leverage, it is unlikely that debt could be issued in a capital market transaction.

As noted above, the Tax Court ultimately concluded that the Advance Agreements carried more equity traits than debt traits. From a debt factor perspective, however, the Tax Court agreed with the IRS that the connection between interest payments on the Frito-Lay Notes and payments on the Advance Agreements reflects a debt characteristic of the Advance Agreements. In addressing this connection, the Tax Court notes that each payment on the Advance Agreements was made on the same date interest on the Frito-Lay notes was paid to PGI. The Tax Court further noted that the payment amount on the Frito-Lay Notes and the Advance Agreement was substantially similar in amount and that, except in one case, every interest payment on the Frito-Lay Notes was used to make preferred return payments on the Advance Agreements.

Tax Planning Considerations

The *PepsiCo* case provides valuable guidance for both US and foreign multinationals regarding the parameters for structuring cross-border intercompany financing arrangements that are subject to review by US tax authorities. The *PepsiCo* case, thought not binding precedent, addresses important considerations for US multinationals looking to repatriate cash earned offshore as well as foreign multinationals looking to structure debt push-downs in the United States.

1-2. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

3. *PepsiCo Puerto Rico Inc.* v. *Commissioner*, T.C. Memo. 2012-269. This is a consolidated case before the Tax Court. The petitioners are PepsiCo, Inc. and PepsiCo Puerto Rico, Inc ("PPR"). The Dutch subsidiaries issued the instruments under consideration here to both certain domestic subsidiaries of PepsiCo as well as PPR.

4. T.C. Memo 2012-172

5. These new notes provided the following terms: (*i*) interest accrual (rate determined semi-annually) payable on December 31; (*ii*) initial maturities of 15 years, with an issuer option to extend the maturity for an additional 25 years; and (*iii*) creditor rights if the borrower failed to pay accrued interest when required.

6. Specifically, the Advance Agreements provide accrued preferred return is only payable to the extent that the company's net cash flow during the preceding year exceeded the sum of: (i) the aggregate amount of all accrued but unpaid operating expenses incurred by the company during such year; and (ii) the aggregate amount of all capital expenditures made or approved by the company during such year, including all capital investments made or approved by the company during such year.

7. If PWI and PGI exercised these initial options, PWI and PGI could then exercise a separate option delaying payment of principal for an additional 5 years.

Trusts and civil law: The irreconcilable reconciled in Mauritius

Ashvin Krishna Dwarka*

IFA (Mauritius Branch)

It is generally accepted that reconciling civil law and trusts is attempting to bring together the like poles of two magnets. This supported by the difficulties encountered in France, the very epitome of civil law systems, both with respect to the recognition of foreign trusts and the introduction of an equivalent mechanism under French law. The most common explanation put forward for the incompatibility of trusts with civil law is the so-called fundamental contradiction between common law and Roman law.

Yet this statement needs to be revised in light of the success achieved under Mauritian law.

Often cited as a model of social harmony between cultures and communities, Mauritius also constitutes a surprising nexus of confluence between French and English laws - this co-existence stemming from specific historical circumstances[1].

Mauritian law is based upon a civil law system, although, as in the common-law world, case law also plays an important part. It is derived from French and English sources, and essentially consists of statutes and regulations (as interpreted by the courts). Supreme Court judgments will often contain references to Commonwealth jurisprudence as well as decisions from the French *Cour de cassation*.

Substantive law is modelled on the French Napoleonic Code (now the Civil Code), as the cornerstone of Mauritian law. It governs such areas as capacity, property, matrimonial regimes, successions, contract, tort, security interests (pledges, mortgages, etc.)

The main exceptions to this are company law – now based on the equivalent New Zealand legislation – and financial and business statutes.

These major legal systems are only two of the components of the Mauritian legal system, the third one being Equity, which has paved the way for the co-existence of trusts with civil law.

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This paper proposes **(I)** to review the dichotomy between the concepts of ownership under French and English law, and the manner in which Mauritius has been able to reconcile same, and **(II)** to present the most frequent practical uses to which Mauritian trusts are put.

I.A Divergent concepts of ownership under Equity and civil law: the examples of England and France

(i) The origins of trusts and Equity

To understand the Mauritian trust, one has to remember how its ancestor, the English trust, arose in the first place.

At the time of the Crusades, knights who were preparing to leave England for the Holy Land would transfer title to their landed estate (usually the castle with all attached land and villages) to a trusted friend, on the understanding that the said friend would manage the estate for the benefit of the knight's family, and subsequently transfer the property back to him if he returned from the East, or to his children when they came of age.

Yet, human nature being what it is, it often happened that the trusted "friend" would later refuse to transfer the property to the beneficiaries or yield it up to the returning knight. The traditional courts were powerless to order such a transfer, because from a strictly legal perspective, the friend had become the full and absolute owner of the property.

This triggered the development of a parallel system of norms and rules, known as *Equity*, under which, notwithstanding the legal ownership held by the friend, equitable ownership was vested in the knight or his wife and children.

Thus, to borrow a term from scientific parlance, ownership exhibited *"decoherence"*, with two simultaneous incarnations:

- in the common law world: the trustee owns the property.
- in the world of Equity: the beneficiary owns the property.

It stands to reason that two parallel sets of norms are bound to conflict at some point, for instance where both have an equal claim to governing a given set of facts. In England, this dilemma was resolved in the **Earl of Oxford's case** (1615), where it was held that Equity should prevail in case of conflict with common law. Subsequently, the **Judicature Acts of the late 1800s** merged the Courts of Equity and those of the common law but left the legal systems entirely distinct. Moreover, Section 25 of the Judicature Act of 1873 specifically restated the Earl of Oxford's principle of prevalence of Equity.

In the words of the famous English jurist Maitland, "*the two streams have met and still run in the same channel, but their waters do not mix*".

Civil-law jurisdictions traditionally lack this "decoherence" between common law and Equity: they can separate bare ownership from usufruct, or ownership from possession, but the notion of simultaneous existence of legal ownership and equitable ownership is entirely alien to them.

This, however, has not necessarily precluded the recognition of foreign trusts in France.

(ii) The recognition of trusts in a civil-law environment: The example of France

Firstly, trusts have been recognised in France through the application of private international law principles.

There was an initial period where such recognition took place through "adaptation": i.e. recharacterisation as an existing civil-law mechanism, such as testamentary executorship or agency (this occurred in the *Pyrénées Minerals* case[2]).

Subsequently, recognition proper was afforded to trusts. In the *Zieseness* case[3], the French courts found that the principles of private international law called for application of US law (which had been stipulated by the settlor), and thereby recognised the effects of the trust in France. However, the trust in question was not allowed to circumvent the forced heirship rules applicable in that case.

Secondly, France has signed the Hague Convention on the Law Applicable to Trusts and on their Recognition (1985). It should be noted that the Hague Convention definition of the term "trust" is rather broad:

> *"For the purposes of this Convention, the term "trust" refers to the legal relationships created - inter vivos or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose."*

The report on the Convention expressly acknowledged that this definition extends beyond what they called the "common law trust", to encompass analogous structures (such as foundations, or *stiftungs* and *anstalts* under Romano-Germanic law).

The Convention has therefore had the effect of rendering the trust less "alien" to civil-law jurisdictions. Although this Convention has been signed, but not yet ratified by France, the *Zieseniss* decision saw the application of the Convention principles as to the freedom of choice of applicable law, subject to the forum country's public policy rules.

Finally, France has introduced a trust-like mechanism, named *la fiducie***,** into its Civil Code. The French *fiducie* is a contractual mechanism (i.e. a bilateral manifestation of will, contrary to a trust which can arise by a unilateral act), and has its roots in ancient Roman law. Its closest relative is the Luxembourg *fiducie* and it lends itself to more or less the same uses, and is probably most useful when devised as a security instrument.

As can be gathered from the above, the legendary chasm between civil law and trusts has been narrowed on several occasions already. Consequently, it was only natural that the same phenomenon should occur in the Mauritian hybrid legal environment.

I.B The three sources of trusts under Mauritian law: Equity, statute and the Civil Code

(i) Mauritian trusts under Equity

Although there is no corpus of Mauritian legislation that is specifically devoted to Equity as a separate legal system, the Mauritius Supreme Court has been defined as a court of Equity under the Charter or Judicial Constitution of 1851:

> *"The said Supreme Court shall be a Court of Equity, and is hereby invested with power, authority, and jurisdiction to administer justice, and to do all acts for the due execution of such equitable jurisdiction in all cases where no legal remedy is provided by the written law of Mauritius"*

Pursuant to those powers, the Supreme Court has rendered a number of decisions where it acknowledges the application of Equity in Mauritius. One may cite:

- *De Robillard* v. *Bachet* (1897), where the court held that "*we are an English Court of Equity, and we must act on the equitable doctrine if we can*".
- *Marie* v. *Congrégation des Hindous de Maurice* (1916), where, failing the constitution of a religious society by them, the individual recipients of a donation were characterised as trustees.
- Indirectly, *Austin v Bailey* (1962), the seminal Mauritian decision on private international law, which entrenches the freedom to set up a trust under English law, provided that no rules of Mauritian public policy are breached.

(ii) Statutory provisions on Mauritian trusts: The Trusts Act 2001

With the growth of the global business sector in Mauritius, the need was felt for legislation specifically governing trusts. After a relatively brief period of existence, the inchoate statutes enacted in the early 1990s were repealed and replaced with the more modern and comprehensive Trusts Act 2001.

Section 3 of the Trusts Act defines a trust as follows:

> *"a trust exists where a person (known as a "trustee") holds or has vested in him, or is deemed to hold or have vested in him, property of which he is not the owner in his own right, with a* ***fiduciary*** *obligation to hold, use, deal or dispose of it …for the benefit of any person*

> *(a "beneficiary"), whether or not yet ascertained or in existence… for any purpose, including a charitable purpose, which is not for the benefit only of the trustee."*

Surprisingly enough, this legislation does not contain any express reference to Equity as being the source of existence of trusts.

This is to be contrasted with certain other offshore jurisdictions. For instance, Section 86 of the Cayman Trusts Act provides that "*the rules of law and equity shall apply to every exempted trust as they apply to any other trust, save as expressly provided in this part*". Likewise, the British Virgin Islands Trustee Act refers to a trustee's "*equitable duties*"[4].

Under Mauritian law however, only the "*fiduciary*" nature of the obligation incumbent on the trustee is supposed to prevent him from absconding with the trust property.

This nuance is extremely significant, as the category of fiduciaries is broader than that of trustees. Thus, the courts have attached the fiduciary label to relationships between solicitors and their clients, between testamentary executors and heirs, and agents and principals. Also, one should remember the well-known position of company directors, who are subject to fiduciary duties *vis-à-vis* their company.

More importantly however, the definition set out in Section 3 of the Trusts Act, 2001 is especially consistent with the Hague Convention definition of trusts. As the Convention did in France, the Trusts Act, 2001 rendered the trust concept less alien to civil law.

(iii) Trusts under the Mauritian Civil Code

At the same time as the Trusts Act, 2001 was enacted, the Mauritian Civil Code was amended to incorporate a new mechanism, the *fiducie*. However, contrary to its French counterpart, the Mauritian *fiducie* is defined as follows:

> *"A fiducia – or trust – refers to the set of rights and obligations attaching to an estate (the "fiduciary property") that is appropriated in the interests of beneficiaries or allocated to a specific purpose, and that a person (the "fiduciary") undertakes to hold, manage and administer in accordance with such appropriation or allocation."*[5]

This definition appears in Article 1100-1 of the Mauritian Civil Code in the French language, which we have taken the liberty of translating.

This definition begs the question as to the nature of the set of "rights and obligations" attaching to the fiduciary property under Article 1100-1 of the Mauritian Civil Code. As opposed to the French *fiducie*, the Mauritian one is not a contract (indeed, it is not governed by the Civil Code provisions applicable to contracts). Therefore those rights and obligations cannot by any measure be considered as contractual. The law being silent on their nature, Equity will operate as it always does: to fill a void in written law. Thus, a trust created under the Mauritian Civil Code automatically imports Equity into the plane of civil law, thereby bridging the so-called divide between these legal systems.

Having laid the analytical foundations of the Mauritian trust, we may now examine the practical uses to which Mauritian trusts are put by non-residents **(II.A)**, and then the use of foreign trusts by Mauritians **(II.B)**.

II.A Use of Mauritius trusts by non-residents: estate and tax planning

(i) Trusts and fiscal planning

Under Section 2 (Interpretation) of the Income-tax Act of Mauritius, a "trust" is defined as "*a trust recognised under the laws of Mauritius*". This appears to be based on the premise that one ought to know what a trust is, for the Mauritian fiscal legislation does not set out any other detailed definition.

It is interesting to note that prior to 2001, the Income-tax Act defined a trust as "*any trust constituted under the laws of Mauritius*".

Thus, since 2001, the ambit of the Mauritian income tax statute has been extended to apply both to trusts governed by (*i.e.* constituted under) Mauritian law and to foreign-law trusts recognised under the Mauritius Trusts Act 2001.

This is of particular import in light of the fact that a trust governed by Mauritian law is not

necessarily a Mauritian resident trust. Indeed, a foreign law trust can very well be resident in Mauritius. Naturally, the issue of residence becomes crucial from a fiscal standpoint.

A definition of residence of a trust is set out in Section 73 of the Income-tax Act:

> "*where the trust is administered in Mauritius and a majority of the trustees are resident in Mauritius; or*
>
> *where the settlor of the trust was resident in Mauritius at the time the instrument creating the trust was executed*"

Mauritian tax resident status allows a trust to benefit from tax relief under the country's network of double taxation agreements, and requires a tax residence certificate to be issued by the Commissioner of Income Tax. The fiscal advantages of the Mauritian jurisdiction (no capital gains tax, no withholding tax on payment of dividends, interests or royalties, effective 3% tax rate through the application of a credit for deemed foreign tax, etc.) have been abundantly expounded in widely available legal literature and are outside the scope of this paper.

In the specific case of trusts, in addition to the criterion of residency, the question arises as to the effective regime applicable under Mauritian fiscal law. For instance, taking the example of the France-Mauritius double taxation agreement, trusts are not expressly covered. Yet it does define the term "person" as including a "company" within the meaning of Mauritian legislation. In turn, Section 2 of the Mauritian Income-tax Act defines "company" as including a "trust" and further specifies that the term "person" shall be deemed to include a trust.

The effective tax treatment of trusts in Mauritius for income tax purposes is thus harmonised with that of companies. This means that trust distributions receive the same treatment as dividends: once the trust has borne income tax on its chargeable income, distributions from that income after tax are not subject to double taxation.

Whereas the Income-tax Act provides for certification by the Mauritius Revenue Authority of the resident status of a trust, this is not necessarily so as regards non-resident status. While resident status allows for the application of treaty benefits, non-resident status can also turn out to be advantageous, if one wishes to escape Mauritian taxation altogether.

Indeed, under Section 46 of the Income-tax Act, trusts having a non-resident settlor or holding a Global Business Licence and whose beneficiaries are non-resident or GBL holders or being purpose trusts whose purpose is carried out outside Mauritius, are exempt from income tax for a given year provided that such trusts file a declaration of non-residence for that year. In practice however, this type of structure is a rare occurrence, reserved for the mere accumulation of foreign income or the passive holding of assets (including underlying shares).

(ii) Estate planning: the trust as an anti-forced heirship mechanism

More than for tax planning purposes, practitioners find that Mauritian trusts are set up as an estate planning tool, in particular in the face of forced heirship.

Like France and several other European and Latin countries, Mauritius is a forced heirship jurisdiction, which means that testators are prevented from entirely excluding their children's hereditary entitlements[6]. Testators' freedom to dispose of their assets *mortis causa* is limited to the so-called "available portion" of their estate, *i.e.* 50% where the deceased leaves 1 child, one third where there are 2 children, and 25% if the deceased leaves 3 children or more.

If these rules are breached, whether by way of testamentary provisions or through gifts made during the deceased's lifetime, "reduction" takes place – either in value or in kind. In other words, the assets must be brought back into hotchpot and then distributed equally between the forced heirs.

While Mauritian trusts law specifies that a trust cannot be used to circumvent forced heirship principles, an exception to this rule applies for non-resident foreign settlors. Thus, Article 1100-3 of the Mauritian Civil Code provided that where the settlor of a trust is neither a Mauritian

national nor domiciled in Mauritius at the time of death, and where no Mauritian immovables form part of the settlor's estate, forced heirship claims will not be admissible in Mauritius.

II.B Use of offshore trusts by Mauritian residents

The use of offshore trusts by Mauritians lies in stark contrast with the traditional view of Mauritius as an offshore centre offering trust formation services to foreign clients.

Yet there is no prohibition on the use of foreign trusts by Mauritian nationals and/or residents. This principle was laid down in the Mauritius Supreme Court decision of ***Austin*** v. ***Bailey***: "*a party is free to choose the law by which his transactions will be governed*", provided that there is no breach of "*imperative*" matters;

Better still, Section 60(1) of the Trusts Act contains a legislative blessing to the settlement of trusts abroad: "*a foreign trust shall be governed by, and shall be interpreted in accordance with, the terms of the trust and its proper law*".

The most commonly encountered motives for which Mauritians wish to set up a trust abroad are: tax planning, estate planning, structuring corporate and financing transactions, and finally, resorting to mechanisms unavailable under Mauritian law.

Of the above, tax planning is the least significant motive, as domestic tax rates are relatively low in Mauritius – essentially a 15% flat rate for individuals and companies alike. Either because of fiscal discipline, or due to the hassle involved in setting up a foreign trust to squirrel away Mauritian income (the corollary of which is the near-impossibility of repatriating that income for use in Mauritius), it is extremely rare to encounter clients wishing to set up foreign trusts as tax shields.

By contrast, estate planning is a driving factor in the choice of foreign trusts, in an attempt to mitigate, if not altogether avoid, the impact of Mauritian forced heirship rules. As indicated above, Mauritian trusts legislation is extremely protective of non-resident, foreign settlors wishing to shield their movable assets from their national forced heirship laws. However this protection does not extend to Mauritian citizens or residents, which, paradoxically, leads them to seek equivalent solutions abroad.

However, if such foreign trusts breach imperative public policy, *i.e.* if the reserved portion is not allocated to the reserved heirs, the trust will not be enforceable in Mauritius, although it will remain enforceable in the jurisdiction in which it was set up. This obviously means that such a trust can only apply to movable assets in order to guarantee its practical effectiveness.

The settlement of foreign trusts is also encountered in connection with corporate and financing transactions: this requires an *ad hoc* selection of the best foreign legislation, depending on the transaction being implemented, *e.g.*, Luxembourg law for holding assets by way of security (under a security trust deed), or Jersey law for a purpose trust integrated into multi-jurisdictional structured finance transactions[7]. However it should be noted that this is not so much because those jurisdictions have better trust laws (quite the contrary, in fact, as far as Luxembourg is concerned), but essentially because the remainder of their legal framework, especially in the field of finance, tends to be more sophisticated than Mauritian business law.

Conclusion

In light of the above, it is fair to state that Mauritius has achieved the exploit of reconciling the irreconcilable.

This achievement has not required the impossible feat of merging Equity and civil law. Indeed, there is already much heated debate amongst learned scholars as to whether Equity and common law were even merged at the time of the Judicature Acts *circa* 1875. Thus, a merger of civil law and Equity is simply inconceivable. Instead, Mauritius has rather cleverly solved the problem by superimposing Equity over civil law.

This simultaneous applicability of civil law and Equity, combining the legal certainty of the former with the flexibility of the latter, is what makes the Mauritian trust framework one of the most attractive in the world.

As Europe and Asia set their eyes on Africa with a view to unlocking its untapped potential, Mauritius, which has bridged the oft-maligned gap between common law and civil law, finds itself in a unique and privileged position to service both investors from English-law sphere and investees from and into the former French colonies of the continent. In that regard, Mauritius remains an unrivalled player in the global business sphere.

1. A French dominion since 1710, the island was taken by the British in 1810, *i.e.* shortly after the enactment of the French Civil (Napoleonic) Code of 1804 in the French colonies. However, Article 8 of the treaty of surrender signed between the two countries provided that the inhabitants of Mauritius would be allowed to keep their laws and customs. Over the next centuries, elements of English law introduced in Mauritius supplemented – but did not repeal – the existing civil law system.
2. French Cour de cassation (Supreme Court), 19 February 1908, Kerr v. Société Pyrenees Minerals, Clunet 1912.
3. French Cour de cassation (Supreme Court), 20 February 1996 (n° 423 P, JCP ed. G n° 22, 22647).
4. Incidentally, it is interesting to note that the 2006 version of the Jersey Trusts Law of 1984, which is many respects similar to the Trusts Act of Mauritius, does not even specify that a trustee is under a "fiduciary obligation". However, the trustee's statutory duties (not to profit, to act in good faith, with reasonable prudence, etc.) inevitably lead to an inference that they are fiduciary in nature.
5. Est appelée fiducie - ou trust - l'ensemble de droits et d'obligations dont fait l'objet un patrimoine (le "bien fiduciaire") qui est affecté dans l'intérêt des bénéficiaires ou dans un but déterminé, et qu'une personne (le "fiduciaire") s'oblige à détenir, gérer et administrer suivant cette affectation.
6. See, by this author, issue No. 6 of International Taxation (March 2012): "Cross-border tax planning through Mauritius: avenues and pitfalls".
7. In the securitization context, the most common structure uses an "SPV" or Special Purpose Vehicle, frequently in the form of a trust. A company transfers certain financial assets to a SPV whose credit rating is enhanced (for example through a guarantee granted by a special insurance company (monoline) or another credit enhancer, with the purpose of covering the SPV's insolvency risk). The SVP raises funds by selling securities (in particular commercial paper) on financial markets or through bank loans.

LANDMARK RULINGS

INDIAN COURTS

[2012] 25 taxmann.com 557 (Delhi)

HIGH COURT OF DELHI

Commissioner of Income-tax

v.

Sakakibara Yutaka

S. RAVINDRA BHAT AND R.V. EASWAR, JJ.

IT APPEAL NO. 111 OF 2006

AUGUST 3, 2012

Section 9, read with sections 5 and 6, of the Income-tax Act, 1961 and article 15 of DTAA between India and Japan (Income from employment) - Income - Deemed to accrue or arise in India - Assessee was a permanent resident of Japan - He was employed with a Japanese Company S - By virtue of a collaboration agreement entered into between S and an Indian company M, assessee was deputed to India to offer guidance and technical assistance to M - During relevant previous year, assessee worked in India for 273 days and was not a 'resident' in India in any of nine out of ten previous years - Assessee received salary from S in Japan - Assessing Officer held that assessee was liable to tax in respect of salary received by him in Japan - Tribunal found that provisions of Income-tax Act were more beneficial to assessee, same should have been preferred over DTAA, and, thus income earned by assessee outside India could not be taxed in India - Whether since assessee was a person 'not ordinarily resident' in India, salary earned in Japan for employment under S could not be assessed in India - Held, yes - [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 42 (Gujarat)

HIGH COURT OF GUJARAT

Mardia Chemicals Ltd.

v.

Commissioner of Income-tax & 1

AKIL KURESHI AND MS. HARSHA DEVANI, JJ.

SPECIAL CIVIL APPLICATION NO. 4141 OF 2001

JULY 23, 2012

Section 237 of the Income-tax Act, 1961 - Refund - General - Assessee-company had awarded a contract to a foreign company 'N' of France for erection and commissioning of flanking unit - Assessee deducted tax at source at higher amount as compared to total amount which foreign company was found entitled to upon execution of works - Assessee thus filed application seeking refund of excess amount on strength of Circular No. 769, dated 6-8-1998 - Revenue authorities rejected assessee's claim holding that Circular dated 6-8-1998 was subsequently superseded by a Circular No. 790, dated 20-4-2000 - Whether since both circulars, dated 6-8-1998 and 20-4-2000 gave rise to substantive rights, Circular dated 20-4-2000 could not be applied retrospectively so as to cover those cases where Circular, dated 6-8-1998 held field - Held, yes - Whether, therefore, Assessing Officer was not justified in rejecting assessee's claim on aforesaid ground - Held, yes [In favour of assessee]

Circulars and Notifications : Circular No. 769, dated 6-8-1998, Circular No. 790, dated 20-4-2000, Circular No. 7/2007, dated 23-10-2007

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 122 (Bombay)

HIGH COURT OF BOMBAY

Rabo India Finance Ltd.

v.

Deputy Commissioner of Income-tax, Circle -1(3), Mumbai

S.J. VAZIFDAR AND M.S. SANKLECHA, JJ.

WRIT PETITION NO. 870 OF 2012

JULY 9, 2012

Section 147, read with section 37(1), of the Income-tax Act, 1961 and Article 7 of DTAA between India and Netherlands (Business Profits) - Income escaping assessment - Non-disclosure of primary facts - Assessment year 2004-05 - Assessee-company carried on business relating to investments and financial and strategic advisory services - It entered into several business support agreements with its ultimate parent company - Assessing Officer after considering material on record, allowed assessee's claim for deduction in respect of payment for support service under section 37(1) - During course of assessment proceedings for subsequent assessment year 2007-08, assessee was asked to produce details of business support charges paid to parent company - Thereupon, reassessment proceedings for assessment year in question were initiated on ground that details furnished by assessee showed that no specific and substantial services had been rendered by parent company and, thus, deduction in respect of business support charges was wrongly allowed - It was apparent from records that Assessing Officer had allowed assessee's claim for deduction after considering material available on record in detail - Moreover, while reopening of assessment, revenue could not indicate what actually was alleged inadequency of disclosure by assessee - Whether on facts, initiation of reassessment proceedings was based on change of opinion which was not sustainable - Held, yes [Paras 13 to 27] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 169 (Bombay)

HIGH COURT OF BOMBAY

Director of Income-tax, International Taxation-II, Mumbai

v.

Besix Kier Dabhol SA

S.J. VAZIFDAR AND M.S. SANKLECHA, JJ.

IT APPEAL NO. 776 OF 2011

AUGUST 30, 2012

Section 36(1)(iii) of the Income-tax Act, 1961, read with Article 7 of DTAA between India and Belgium (Business Profit) - Interest on borrowed capital - Assessee-non-resident company had borrowed money from its shareholders in same ratio as equity shareholding resulting in abnormal debt-equity ratio of 248:1 - Revenue's case was that debt was to be re-characterised as equity and interest payment thereon disallowed - Whether since there are no thin capitalization rules in force, interest payment on debt capital to shareholders could not be disallowed - Held, yes [Para 8] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 171 (Madhya Pradesh)

HIGH COURT OF MADHYA PRADESH

Bhatia International Ltd.

v.

Additional Commissioner of Income-tax, Indore

SHANTANU KEMKAR AND S.C. SHARMA, JJ.

WRIT PETITION NOS. 2229 & 2230 OF 2011

MAY 14, 2012

Section 92CA of the Income-tax Act, 1961 - Transfer pricing - Reference to Transfer Pricing Officer - Assessment year 2007-08 - Whether

approval of Commissioner is necessary while making reference under section 92CA - Held, yes - Whether Additional Commissioner is an authority who is jurisdictionally competent to make reference to TPO for computation of arm's length price in relation to international transaction entered into by assessee - Held, yes - Whether where TPO while passing order under section 92CA(3) had given proper opportunity to assessee to put forth its objection, question of interference did not arise - Held, yes [Paras 9 to 12] [In favour of revenue]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 242 (Delhi)

HIGH COURT OF DELHI

Qualcomm Incorporated

v.

Assistant Director of Income-tax

BADAR DURREZ AHMED AND SIDDHARTH MRIDUL, JJ.

W.P. (C) NO. 7959 OF 2010

AUGUST 29, 2012

Section 90, read with sections 9 and 147, of the Income-tax Act, 1961 and article 5 of the Double Taxation Avoidance Agreement between India and USA (Permanent Establishment) - Double Taxation Relief - Where agreement exists - Assessment year 2003-04 - Order under section 143(3)/147 was passed and additional income of assessee/petitioner was assessed as royalty income and taxed at rate of 15 per cent in accordance with provisions of section 9(1)(vi) and article 12(7)(b) of DTAA between India and USA - Submission of assessee that it did not have a permanent establishment in India had been accepted during original assessment and, thus, assessee was taxed at lower rate of 15 per cent - Subsequently, reassessment was made beyond four years on ground that assessee had business connection and PE in various form in India and its income was to be taxed at rate of 20 per cent - Whether assessee had fully and truly disclosed material particulars - Held, yes - Whether notice under section 148 being beyond four years from end of relevant assessment year, was barred by limitation - Held, yes [Paras 11 to 14 [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 24 taxmann.com 390 (Delhi - Trib.)

ITAT DELHI BENCH 'G'

Sedco Forex International Drilling Inc.

v.

Additional Director of Income-tax, International Taxation, Dehradun

G.C. GUPTA, VICE-PRESIDENT AND A.N. PAHUJA, ACCOUNTANT MEMBER

IT APPEAL NO. 5284 (DELHI) OF 2011

JUNE 29, 2012

Section 44BB of the Income-tax Act, 1961 - Non-residents - Mineral Oil, business for prospecting/exploration, etc. in case of - Assessment year 2008-09 - Whether reimbursement of amount on account of fuel charge is liable to be included while computing profits under section 44BB - Held, yes - Whether reimbursement of service tax, being a statutory liability, would not involve any element of profit and, accordingly, same could not be included in total receipts for determining presumptive income under section 44BB - Held, yes [Partly in favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 25 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Channel Guide India Ltd.

v.

Assistant Commissioner of Income-tax, Circle 4(1), Mumbai

P. M. JAGTAP, ACCOUNTANT MEMBER AND AMIT SHUKLA, JUDICIAL MEMBER

IT APPEAL NOS. 579 & 1221 (MUM.) OF 2006

AUGUST 29, 2012

Section 9, read with section 40(a)(i), of the Income-tax Act, 1961 and article 7 of the DTAA between India and Thailand (Business Income) - Income - Deemed to accrue or arise in India - Assessment year 2004-05 - Assessee availed facility of satellite Up-linking and Telecasting programmes from a company of Thailand and made payment in foreign exchange - No tax was deducted at source on pretext that said payment constituted business income of non-resident company and since it had no PE in India, its business income was not taxable as per Article 7 - Assessing Officer, however, disallowed said payment under section 40(a)(i) considering it to be in nature of fees for consultancy charges which attracted TDS provisions - Whether since company of Thailand was licensee of satellites owned by Government of Thailand and for providing facility of broadcasting it merely recovered service charges, amount paid by assessee certainly constituted business income of said company under Article 7 - Held, yes - Whether, therefore, no disallowance could be made under section 40(a)(i) - Held, yes [Para 23] [In favour of assessee]

Section 9, read with section 40(a)(i), of the Income-tax Act, 1961 and article 12 of the DTAA between India and Thailand (Royalty) - Income - Deemed to accrue or arise in India - Assessment year 2004-05 - Whether in absence of control and possession of user over equipment, amount paid to non-resident company cannot be held to be royalty for use or right to use any industrial, commercial or scientific equipment as envisaged in clause (iva) of Explanation 2 to section 9(1)(vi) - Held, yes [Paras 21 to 25] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 125 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'E'

Sonata Information Technology Ltd.

v.

Deputy Commissioner of Income-tax, LTU, Mumbai

D.K. AGARWAL, JUDICIAL MEMBER AND B. RAMAKOTAIAH, ACCOUNTANT MEMBER

IT APPEAL NO. 1507 (MUM.) OF 2012

SEPTEMBER 7, 2012

I. Section 40(a)(ia), read with section 9, of the Income-tax Act, 1961 - Business disallowances - Interest, etc. paid to resident, etc. without deduction of tax at source - Assessment year 2008-09 - Whether since definition of royalty is specifically mentioned in section 40(a)(ia), examination of issue can only be made with reference to Explanation 2 of section 9(1)(vi) alone; Explanation 4 cannot be considered as same was not incorporated in definition of royalty in section 40(a)(ia) - Held, yes - Assessee made a payment for purchase of software from persons who were resident in India - It did not deduct tax at source while making said payments - According to Assessing Officer, payment in question was in nature of royalty because it was for a right to use software and, therefore, assessee ought to have deducted tax at source and since assessee had not so deducted tax at source, sum in question was disallowed under section 40(a)(ia) - Whether matter was to be remanded back to decide case afresh to consider whether amounts paid to Indian suppliers could be considered as royalty keeping in mind latest pronouncements of various higher judicial authorities on issue and nature of purchase and rights involved - Held, yes [Paras 29 to 31] [Matter remanded]

Words and Phrases : Word 'payable' as appearing in section 40(a)(ia) of the Income-tax Act, 1961

Circulars and Notifications : Notification No. 21/2012, dated 13-6-2012

II. Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of - Assessment year 2008-09 - Assessee-company was engaged in business of purchase and sale of software - It had entered into an agreement with SSL for availing common services in areas of finance, accounts, taxation, legal administration, HRD, etc. - Assessing Officer disallowed assessee's claim of expenditure by holding that assessee did not prove with supporting evidence that services were in fact rendered by SSL - However, it was found that assessee had given detailed statement of various expenditure and how same were allocated - Further, service charges recovered from assessee were shown as income in SSL's account - Whether there was no reason to doubt either about services being provided or about amounts being paid by assessee - Held, yes - Whether further issue being similar on facts to earlier years, following same, service charges incurred for services rendered by SSL would be allowable as business expenditure - Held, yes [Para 12] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 383 (Delhi - Trib.)

ITAT DELHI BENCH 'B'

Education Australia Ltd.

v.

Deputy Director of Income-tax, Circle 1(2)International Taxation, New Delhi

K.G. BANSAL, ACCOUNTANT MEMBER AND C.M. GARG, JUDICIAL MEMBER

IT APPEAL NO. 5124 (DELHI) OF 2010

MAY 18, 2012

Section 9, read with section 44C, of the Income-tax Act, 1961, read with Article 7 of the DTAA between India and Australia (Business Profits) - Income - Deemed to accrue or arise in India - Assessment year 2007-08 - Assessee was a non-profit company set up in Australia and was owned by Australian Universities - It was engaged in business of providing services to students who desired to study in Australia - For that purpose, it had set up liaison offices in India to assist students in India for enrolling themselves in Australian educational institutions - Australian Universities had certified that expenses of their representatives incurred in India, were borne by universities themselves - Whether addition could be made to income of assessee regarding profit attributable to expenditure incurred on representatives of Australian educational institution for visiting India for purpose of enrolment of students - Held, no - Whether since expenditure of LOs was met out of remittances received through banking channel and Indian offices had not incurred any expenditure, if any income accrued on account of expenditure incurred by head office, it would be income of head office and not of Indian offices and at same time, if any expenditure was attributed to Indian Offices, deduction of expenditure would have to be allowed - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 290 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

De Beers UK Ltd.

v.

Deputy Director of Income-tax, (International Taxation) 1(2), Mumbai

R.S. SYAL, ACCOUNTANT MEMBER AND I.P. BANSAL, JUDICIAL MEMBER

IT APPEAL NO. 8737 (MUM.) OF 2011

AUGUST 10, 2012

I. Section 9, read with section 115A, of the Income-tax Act, 1961 and article 12 of DTAA between India and UK (Fees for Technical Services) - Income - Deemed to accrue or arise in India - Assessment year 2008-09 - Whether receipts from Marketing Contribution and value

added services (VAS) is to be treated as fees for technical services (FTS) as per section 9(1)(vii) and article 12 of Indo-UK tax treaty - Held, yes - Whether said receipts is to be taxed at rate of 10 per cent under section 115A(1) instead of 15 per cent on gross basis - Held, yes [Partly in favour of assessee]

II. Section 234B of the Income-tax Act, 1961 - Interest, chargeable as - Assessment year 2008-09 - Whether interest under section 234B cannot be charged where tax is deductible at source in relation to royalty and FTS, therefore, interest under section 234B, is to be computed after reducing amount of tax deductible at source in relation to royalty and FTS from advance tax payable - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 382 (Delhi - Trib.)

ITAT DELHI BENCH 'B'

Concerto Software India (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Circle-1, New Delhi

G.D. AGRAWAL, VICE-PRESIDENT

AND RAJPAL YADAV, JUDICIAL MEMBER

IT APPEAL NOS. 3268 & 4354 (DELHI) OF 2010

MAY 18, 2012

I. Section 92C, read with section 144C, of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2006-07 - Assessee a subsidiary of a foreign company had undertaken international transactions in respect of purchase of computer software and rendered support services to its parent company - On reference, TPO observed that there was a difference in PLI reported by assessee in comparison to other two comparables and that difference should be added back - Accordingly, Assessing Officer made addition - Assessee filed objection to selection of comparables before DRP but without success - Whether since DRP had not considered any objections of assessee, said order could not be termed as speaking order and same should be set aside to file of DRP for fresh adjudication - Held, yes [Para 4] [Matter remanded]

II. Section 40A(2) of the Income-tax Act, 1961 - Business disallowance - Excessive or unreasonable payments - Assessment year 2005-06 - On scrutiny of accounts, Assessing Officer found that there was a fall in net profit ratio as compared to earlier year and that though turnover decreased in comparison to last year, but expenses on account of salary and wages, telephone and bonus had increased significantly - He issued notice to assessee to explain situation within period of two days - Assessee failed to file reply within prescribed period - Assessing Officer disallowed said payments and made addition on estimate basis - Whether period of two days for explaining situation was not justified and, therefore, matter be remitted back to Assessing Officer for re-adjudication - Held, yes [Para 10] [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 466 (Delhi - Trib.)

ITAT DELHI BENCH 'B'

Ericsson AB

v.

Deputy Director of Income-tax, International Taxation, Circle 1(2), New Delhi

A.D. JAIN, JUDICIAL MEMBER

AND J. SUDHAKAR REDDY, ACCOUNTANT MEMBER

IT APPEAL NOS. 1735 TO 1740 (DELHI) OF 2011

JULY 20, 2012

Section 9 of the Income-tax Act, 1961, read with articles 12 and 5 of DTAA between India and Sweden (Royalty) - Income - Deemed to accrue or arise in India - Assessment years

1999-2000 to 2004-05 - Assessee a Swedish company derived income from supply of telecom hardware and software - Assessee claimed that they had supplied equipment at port of Sweden and their income was not liable to tax in India as per provisions of Act or relevant DTAA - Assessee contended that issue in question stood covered in assessee's own case for assessment years 1997-98 and 1998-99 by decision of Special Bench of Tribunal in Motorola Inc. v. Dy. CIT [2005] 95 ITD 269/147 Taxman 39 (Delhi) (Mag.) (SB) - Commissioner (Appeals) however, found that adjudicating authority got some additional facts by way of evidence during survey - He held that there was change in facts as compared to facts of earlier year and, accordingly, assessee had fixed place of business in India as well as it had dependent agents in India and that revenue arising to assessee from licensing of software to Indian clients were taxable as royalty in terms of article 12 of DTAA, read with section 9(1)(vi) of Income-tax Act, 1961 - Whether since new facts/evidences gathered by Commissioner (Appeals) during survey were not put before assessee nor explanation were called from assessee to confront same, views of Commissioner (Appeals) that facts of case in relevant years were different from that of earlier years could not be accepted - Held, yes - Whether further since facts and circumstances of relevant years were same as in previous years, matter was to be decided in favour of assessee - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 472 (Delhi - Trib.)

ITAT DELHI BENCH 'B'

Ericsson India (P.) Ltd.

v.

Deputy Commissioner of Income-tax, Circle 10(1), New Delhi

G.D. AGRAWAL, VICE-PRESIDENT

AND I.P. BANSAL, JUDICIAL MEMBER

IT APPEAL NO. 5141 (DELHI) OF 2011

MAY 11, 2012

Section 92C of the Income-tax Act, 1961 - Transfer Pricing - Computation of arm's length price - Assessment year 2007-08 - Assessee was engaged in trading, manufacturing and marketing of telecommunication systems and development of telecommunication software - Assessee entered into agreement with its AE in respect of availing services relating to second line support (SLS) including software related errors - Assessee had shown a provision of ` 31.34 crores pertaining to SLS services - TPO was of view that assessee was not required to pay any SLS charges to its AE - Assessee submitted that to ensure faultless working of equipment, it had entered into annual maintenance contract with its customers - Assessee corrected minor problems on its own and only technical complicated problems were referred to AEs for which it had necessary technical expertise and equipments - Whether on facts, business expediency of expenditure incurred by assessee could not be doubted - Held, yes - Whether, therefore, assessee's claim in respect of SLS charges paid to AE was to be allowed; however, matter was to be remanded back to Assessing Officer for correct computation of said charges - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 520 (Delhi - Trib.)

ITAT DELHI BENCH 'H'

Deputy Commissioner of Income-tax, Circle 17(1), New Delhi

v.

MCI Com India (P.) Ltd.

A.D. JAIN, JUDICIAL MEMBER

AND J. SUDHAKAR REDDY, ACCOUNTANT MEMBER

IT APPEAL NOS. 2766 & 4187 (DELHI) OF 2010

C.O. NOS. 341 (DELHI) OF 2010 & 218 (DELHI) OF 2011

AUGUST 30, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment years 2004-05 and 2005-06 - Whether when in T.P. study, comparables taken were wrong as apparently there is no functional comparability, such TP study, cannot be approved, even if T.P.O. has accepted it - Assessee-company which was carrying on marketing support services had entered into international transaction with its AE's - TP study conducted by assessee was approved by TPO - Before, Commissioner (Appeals) assessee contended that 4 of comparables selected by it and accepted by TPO had to be excluded for reason that they were not functionally comparable with assessee as they were engineering companies providing end-to-end solution - Whether when on facts it was clear that there was no functional comparability of said companies with that of assessee, Commissioner (Appeals) was justified in admitting ground of assessee - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 560 (Cochin - Trib.)

ITAT COCHIN BENCH

Assistant Commissioner of Income-tax, Circle-1(2), Ernakulam

v.

I.A.L. Shipping Agencies (Kochi) Ltd.

N.R.S. GANESAN, JUDICIAL MEMBER AND B.R. BASKARAN, ACCOUNTANT MEMBER

IT APPEAL NO. 79 (COCH.) OF 2011

JULY 20, 2012

Section 5 of the Income-tax Act, 1961, read with Article 8 of the DTAA between India and UK (Shipping) - Income - Accrual of - Assessment year 2002-03 - Assessee-company, engaged in shipping business, claimed that it was acting as an agent of U.K. company and, therefore, entire shipping income belonged to U.K. company and was exempt as per provisions of DTAA between India and UK - Assessing Officer rejected assessee's claim and taxed entire receipt in assessee's hands - Whether relationship between assessee-company and UK company need to be examined by Assessing Officer to find out whether assessee-company was really acting as agent of UK company [In favour of revenue]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 25 taxmann.com 574 (Hyderabad - Trib.)

ITAT HYDERABAD BENCH 'A'

Assistant Commissioner of Income-tax, Circle-16(3)

v.

Priyadarshini Spinning Mills (P.) Ltd.

D. KARUNAKARA RAO, ACCOUNTANT MEMBER AND SAKTIJIT DAY, JUDICIAL MEMBER

IT APPEAL NO. 1776 (HYD.) OF 2011

JULY 6, 2012

Section 195, read with section 40(a)(i), of the Income-tax Act, 1961 - Deduction of tax at source - Payments to non-resident - Assessment year 1998-99 - Whether where foreign agents were appointed to act as a selling agents of assessee outside India, commission earned by them for services rendered by them outside India could not be considered as income chargeable to tax in India - Held, yes - Whether therefore, when commission paid to non-residents were not chargeable to tax under provisions of Act, no deduction of tax was required to be made under section 195(1) warranting disallowance under section 40(a)(i) - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 7 (Bangalore - Trib.)

ITAT BANGALORE BENCH 'A'

Allergan India (P.) Ltd.

v.

Deputy Commissioner of Income-tax, LTU, Bangalore

SMT. P. MADHAVI DEVI, JUDICIAL MEMBER AND JASON P. BAOZ, ACCOUNTANT MEMBER

IT APPEAL NO. 1490 (BANG.) OF 2010

MARCH 16, 2012

I. Section 40(a)(i), read with section 195 of the Income-tax Act, 1961 and Article 12 of the DTAA between India and Ireland (Fees for Technical Services) - Business disallowance - Interest etc., payable outside India to non-resident - Assessment year 2006-07 - Assessee was engaged in business of manufacture and trading of pharmaceutical products and its machines - It paid testing charges to an Irish concern ETC - Testing charges so paid were held to be in nature of fees for technical service, and said payment was disallowed under section 40(a)(i) on ground that no TDS was deducted thereupon under section 195 - Assessee pleaded that tax was deducted and deposited in subsequent years and, hence, deduction be granted in year of remittance of TDS as per proviso to section 40(a)(i) - Whether following order of Tribunal in assessee's own case for earlier assessment years, instant issue was to be remitted to file of Assessing Officer to allow payment to the extent challans were available - Held, yes [Matter remanded]

II. Section 194C, read with section 40(a)(ia), of the Income-tax Act, 1961 - Deduction of tax at source - Contracts/sub-contracts - Assessment year 2006-07 - Assessee entered into a contract with an Indian company, NP by which NP was to manufacture assessee's medicines - NP was under obligation to perform quality control and testing of products from Irish company ETC and for such quality control validation charges were incurred by NP - Assessee reimbursed validation charges to NP without TDS - Assessing Officer treated validation charges as payments made for contract for services which attracted TDS liability under section 194C - As assessee failed to deduct tax at source, validation charges reimbursed by assessee was disallowed under section 40(a)(ia) - Whether following order of Tribunal in assessee's own case in earlier years instant issue was to be remitted to Assessing Officer to verify documents so as to ascertain whether it was liability of NP or assessee to perform test so that nature of validation charges would be ascertained - Held, yes [Matter remanded]

Circulars and Notifications : Circular No. 681, dated 8-3-1994 and Circular No. 13 of 2006, dated 13-12-2006

III. Section 43(3) of the Income-tax Act, 1961 - Written down value - Assessment year 2006-07 - Assessee acquired a plant and machinery during year 1997-98 - Such plant and machinery was put to use in years 1997-98 and 1998-99 - Thereafter, it was written off in books of account as obsolete in financial year 1998-99 - Assessee, however, claimed depreciation for said plant and machinery in instant assessment year - Assessing Officer denied depreciation on such plant and machinery and Commissioner (Appeals) confirmed same on ground that plant and machinery had already been written off in books of account, which amounted to discarding of machinery - Whether following decision of instant Tribunal in assessee's own case wherein it was held that assessee ought to have reduced written down value of plant and machinery which was written off in books from block of assets and ought to have claimed depreciation on balance of block of assets, instant issue was to be decided against assessee - Held, yes [In favour of revenue]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 10 (Delhi - Trib.)

ITAT DELHI BENCH 'A'

Bentley Systems India (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Circle-2(1), New Delhi

A.D. JAIN, JUDICIAL MEMBER
AND A.N. PAHUJA, ACCOUNTANT MEMBER
IT APPEAL NO. 5730 (DELHI) OF 2011
SEPTEMBER 5, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2007-08 - Assessee availed intra-group services from its associated enterprises - TPO determined arm's length price of international transactions of assessee with its AEs applying CUP method - Assessing Officer rejected assessee's objections raised against application of CUP method observing that data provided by assessee was inadequate - Whether since assessee had provided relevant data before TPO and it was not made clear by Assessing Officer as to how assessee's data was inadequate, matter required to be remitted back to Assessing Officer to be decided afresh on considering data provided by assessee - Held, yes [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 14 (Delhi - Trib.)

ITAT DELHI BENCH 'D'

Deputy Director of Income-tax, Circle-3(1), International Taxation

v.

Lucent Technologies International Sales Ltd.

G.D. AGRAWAL, VICE-PRESIDENT
AND I.C. SUDHIR, JUDICIAL MEMBER
IT APPEAL NO. 4054 (DELHI) OF 2011
AUGUST 24, 2012

Section 195, read with section 208, of the Income-tax Act, 1961 - Deduction of tax at source - Payment to non-resident - Assessment year 2002-03 - Whether if a person (payer) makes payment to a non-resident but defaults in deducting tax at source from such payment, in such case non-resident would be liable to pay tax - Held, yes - Whether however, there can be no question of payment of advance tax by non-resident on such default of payer - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 23 (Delhi - Trib.)

ITAT DELHI BENCH 'H'

ADIT, CIR. 1(1) (International Taxation)

v.

Vinod Arora

SHAMIM YAHYA, ACCOUNTANT MEMBER
AND C.M. GARG, JUDICIAL MEMBER
IT APPEAL NO. 827 (DELHI) OF 2012
AUGUST 31, 2012

I. Section 56 of the Income-tax Act, 1961, read with article 11(2)(b) of the DTAA between India and UAE (Interest) - Income from other sources - Chargeable as - Assessment year 2008-09 - Whether interest income earned by an NRI who is, a resident of UAE, was taxable at rate of 12.5 per cent as per article 11(2)(b) of Indo-UAE DTAA and Circular No. 728, issued by CBDT; and not at rate of 40 per cent as provided by Income-tax Act - Held, yes [Para 7] [In favour of assessee]

Circulars and Notifications : Circular No. 728, dated 30-10-1995 and Circular No. 734, dated 24-1-1996, issued by the CBDT

II - Section 111A of the Income-tax Act, 1961, read with article 13 of DTAA between India and UAE (Capital gains) - Capital gains - Tax on short term capital gains - Assessment year 2008-09 - Assessee NRI who was a resident of UAE, earned short term capital gains on sale of shares and securities in India and claimed that same was not taxable as per article 13 of DTAA - Assessing Officer relying upon earlier year's order that benefit of Indo-UAE DTAA was not available to assessee, levied tax as per section 111A - Tribunal in Mustaq Ahmed Vakil [Appeal Nos. 269 of 2006-07, 104 of 2007-08 & 71 of 2008-09, dated 30-3-2010] in identical facts held that benefit of Indo-UAE treaty was available to assessee - Whether following said decision, short term capital gains were not taxable in India as per article 13(3) - Held, yes [Para 13] [In favour of assessee]

III - Section 23 of the Income-tax Act, 1961 - Income from house property - Annual value - Assessment year 2008-09 - Assessee claimed that charges towards common maintenance of building should be excluded from gross amount of rent received by it - Assessing Officer rejected said claim on ground that deemed deduction of 30 per cent of net annual value under section 24 subsumes repair and maintenance expenses of all kinds and no deduction is to be allowed while computing ALV of residential house - Commissioner (Appeals) in assessee's own case earlier had decided said issue in favour of assessee - Whether, therefore, deduction was to be allowed while computing netted ALV of house property - Held, yes [Para 17] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 24 (Pune - Trib.)

ITAT PUNE BENCH 'A'

Emilio Ruiz Berdejo

v.

Deputy Commissioner of Income-tax, Circle-7, Pune

SHAILENDRA KUMAR YADAV, JUDICIAL MEMBER

AND R.K. PANDA, ACCOUNTANT MEMBER

IT APPEAL NOS. 991 (PUNE) OF 2008

JULY 24, 2012

Section 271(1)(c) of the Income-tax Act, 1961 - Penalty - For concealment of income - Assessment years 2000-01 to 2005-06 - Assessee, a non-resident, was an employee of 'T' International S.A. - He deputed to India for working with 'T' India Ltd. - During course of expatriate India deputation, assessee received salary from 'T' International S.A. also which he did not disclose in original return of income - In response to notice issued under section 148, assessee filed a revised return wherein amount received from 'T' International S.A. was also disclosed - Assessing Officer having completed reassessment, levied penalty under section 271(1)(c) - It was noticed that as regards salary income from 'T' International S.A., assessee was entitled to net of taxes salary and Indian taxes were to be borne by said foreign company - It was also apparent that 'T' International S.A. computed salary income of expatriate taxable in India for each of assessment years and taxes thereon were deposited along with interest thereon - Whether in aforesaid circumstances, mistake committed by assessee in not disclosing salary income received from 'T' International S.A. could be regarded as inadvertent due to ignorance of Indian income-tax law and, thus, having regard to Explanation 1 to section 271(1)(c), impugned penalty order was to be set aside - Held, yes [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 60 (Pune - Trib.)

ITAT PUNE BENCH 'A'

Piagio Vehicle (P.) Ltd.

v.

Deputy Commissioner of Income-tax, Cir. 4, Pune

I.C. SUDHIR, JUDICIAL MEMBER

AND G.S. PANNU, ACCOUNTANT MEMBER

IT APPEAL NO. 1480 (PUNE) OF 2010

JULY 23, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2006-07 - Assessee-company was engaged in manufacturing and sale of three-wheeler and light commercial motor vehicles - It also transacted in export of spares, parts and components of two/three/four wheeled vehicles - Assessee entered into three types of international transactions with its AEs - Category 'A' transaction represented sale of spares to both third party non-AE distributors and AEs for purpose of servicing vehicles sold by assessee-company and supply of spares and components to AEs resulted in higher profit margin as compared to supply of said components to third party distributors - Category 'B' and 'C' represented sourcing of components required only by overseas AEs for manufacture of vehicles and there was no internal comparable transaction inasmuch as like transactions had not been carried out with non-AEs - Assessee benchmarked its international transactions to AEs by applying external TNMM - TPO, however, having applied internal TNMM, proposed certain addition to assessee's international transactions - Whether impugned addition was to be set aside and, matter was to be remanded back for disposal afresh - Held, yes [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 61 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'E'

Sanchez Capital Services (P.) Ltd.

v.

Income-tax Officer, 3(3)2

B.R. MITTAL, JUDICIAL MEMBER

AND B. RAMAKOTAIAH, ACCOUNTANT MEMBER

IT APPEAL NO. 8682 (MUM.) OF 2011

AUGUST 22, 2012

Section 92A of the Income-tax Act, 1961 - Transfer pricing - Meaning of associate enterprise - Assessment year 2007-08 - Assessee provided services to FIS and FOS - TPO was of view that entire services were to group entity/entities and, thus, provisions of transfer pricing would apply to assessee - Another reason for considering that transfer pricing provisions were applicable was also on basis that assessee had filed Form No. 3CEB as prescribed in section 92E showing these as AEs and maintained documents as prescribed in section 92D, read with rule 10D of IT Rules, 1962 - TPO, thus, made certain transfer pricing adjustments which were accepted by Assessing Officer - Whether merely because assessee has been filing Form No. 3CEB, it could not be stated that FIS and FOS were associated enterprises unless provisions of section 92A were satisfied - Held, yes - Whether since no finding for relevant assessment year could be recorded as to whether there was any relationship of associated enterprise between parties involved, impugned order passed by authorities below was to be set aside and matter was to be remanded back for disposal afresh - Held, yes [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 72 (Delhi - Trib.)

ITAT DELHI BENCH 'SMC'

ONGC

v.

Deputy Director of Income-tax, International Taxation, Dehradun

SHAMIM YAHYA, ACCOUNTANT MEMBER

IT APPEAL NO. 3907 (DELHI) OF 2011

AUGUST 7, 2012

Section 90, read with sections 9, 44BB and 115A, of the Income-tax Act, 1961 and article 22 of DTAA between India and UAE (Other Income) - Double taxation Agreements - Where agreement exist - Assessment year 2002-03 - During relevant previous year, assessee, a UAE based company, was paid certain amount by ONGC against work order - Assessing Officer held that non-resident company was engaged by ONGC and receipts of said company which were offered for taxation under section 44BB, were assessable as fees for technical services as per provisions of section 44D read with section 115A - Commissioner (Appeals) upheld order of Assessing Officer - On instant appeal, assessee raised a contention that it was entitled to relief under article 22 of India-UAE DTAA - Whether in view of aforesaid contention, matter was to be remanded back to Assessing Officer to look into matter and give a finding as to whether assessee was entitled for relief under article 22 of the DTAA and if so, grant same, as per law - Held, yes [Para 13] [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 77 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Saipem S.A.

v.

Deputy Director of Income-tax, (International Taxation)-2(1), Mumbai

R.S. SYAL, ACCOUNTANT MEMBER

AND I.P. BANSAL, JUDICIAL MEMBER

IT APPEAL NOS. 3223 & 3224 (MUM.) OF 2008

AUGUST 24, 2012

I. Section 9 of the Income-tax Act, 1961, read with article 12 of the OECD Model Tax Convention (Fees for technical services) - Income - Deemed to accrue or arise in India - Assessment years 2003-04 and 2004-05 - Assessee, a non-resident, received ` 54.55 crore as fees for technical services from two Indian companies for providing management and technical services - It also received ` 1.24 crore as reimbursement of travelling expenses incurred by its personnel for rendering such technical services, from Indian companies - Assessee did not offer such reimbursement to tax - Assessing Officer, however, treated reimbursement as fees for technical services and charged same to tax - Whether since ` 1.24 crore was in nature of reimbursement of travelling expenses incurred by assessee without having any element of profit and further since on facts, assessee had no relation with Indian companies, said sum of ` 1.24 crore could not be included in fees for technical services - Held, yes [Para 5] [In favour of assessee]

II. Section 9 of the Income-tax Act, 1961, read with article 12 of the OECD Model Tax Convention (Fees for technical services) - Income - Deemed to accrue or arise in India - Assessment years 2003-04 and 2004-05 - Assessee, a non-resident, entered into an agreement with two Indian companies for providing technical services - It received fees for such services which was offered to tax - Experts of assessee, who were deputed to render technical services to Indian companies, received living allowance from Indian companies - Assessing Officer included such allowance as fees for technical services and charged same to tax - Whether since living allowance had been directly paid by Indian companies to experts and technical fees set out in agreements with Indian companies was independent of such living allowance, it could not be included in fees for technical services - Held, yes [Para 10] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 88 (Delhi - Trib.)

ITAT DELHI BENCH 'F'

Cowi India (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Gurgaon Circle-1

RAJPAL YADAV, JUDICIAL MEMBER
AND K.D. RANJAN, ACCOUNTANT MEMBER
IT APPEAL NO. 5052 (DELHI) OF 2010
APRIL 19, 2012

Section 92C of the Income-tax Act, 1961- Transfer pricing - Computation of arm's length price - Assessment year 2006-07 - Assessee was engaged in production of large mapping which involved digital mapping, photogrammetry, GIS, satellite remote sensing, orthophoto etc. - It entered into international transactions with AEs in respect of digital mapping and CAD/CAM services - Assessee having adopted TNM method, calculated arithmatic mean of average margin of seven comparables at 9.19 per cent - Since assessee's margin was 11.36 per cent, it was contended that assessee's international transactions were at arm's length price - In course of transfer pricing proceedings, TPO excluded one of comparables selected by assessee on ground that its functional area was entirely different - Thereupon, TPO after calculating arithmatic mean of remaining comparables at 17.54 per cent, proposed certain addition to arm's length price determined by assessee - However, while making said addition, working capital adjustment was not granted to assessee even though assessee brought on record all relevant information - Whether in view of above, matter was to be remanded back to Assessing Officer to investigate issue about working capital adjustment afresh - Held, yes [Para 13] [Partly in favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 96 (Chennai - Trib.)

ITAT CHENNAI BENCH 'A'

Siva Industries & Holdings Ltd.

v.

Assistant Commissioner of Income-tax, Co. Circle VI(4), Chennai

N.S. SAINI, ACCOUNTANT MEMBER
AND VIKAS AWASTHY, JUDICIAL MEMBER
IT APPEAL NO. 1917 (MDS.) OF 2011
APRIL 30, 2012

I. Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2007-08 - Assessee-company gave loan to its AE in Mauritius - In transfer pricing proceedings, TPO opined that said transaction was not at arm's length - He, thus, made upward adjustment to assessee's interest income which was confirmed by Assessing Officer and DRP - It was found that in preceding assessment year, while deciding same issue, Tribunal noted that assessee had given loan out of its own funds in US dollars - According to Tribunal, once transaction between assessee and AE was in foreign currency and it was an international transaction, then such a transaction would have to be looked upon by applying commercial principles in regard to international transaction - If this was so, then domestic prime lending rate would have no applicability and international rate fixed being LIBOR would come into play - Tribunal further noticed that average of LIBOR rate was 4.42 per cent whereas assessee had charged interest at 6 per cent which was higher than LIBOR rate and, thus, no addition was liable to be made in hands of assessee - Whether following aforesaid order of Tribunal, impugned addition made in relevant assessment year was also liable to be set aside - Held, yes [Para 10] [In favour of assessee]

II. Section 14A of the Income-tax Act, 1961 - Expenditure incurred in relation to income not includible in total income - Assessment year 2007-08 - Whether even in a year where no exempt income was earned or received by

assessee, disallowance under section 14A can be made - Held, yes [Para 6] [In favour of revenue]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 101 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Assistant Commissioner of Income-tax, 15(2)

v.

Super Diamonds

R. S. SYAL, ACCOUNTANT MEMBER
AND I.P. BANSAL, JUDICIAL MEMBER
IT APPEAL NO. 6399 (MUM.) OF 2007
AUGUST 3, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2004-05 - Whether determination of ALP can be made only with regard to international transactions of assessee with its AE and it cannot be extended to international transaction of assessee with its non-AEs - Held, yes - Assessee entered into international transactions with its AEs in respect of import of rough diamonds - Assessee adopted CUP method to benchmark its transactions - TPO rejected CUP method in view of non-availability of adequate documentary evidence regarding comparability of diamonds purchased from AE and non-AEs - He, thus, made certain adjustments to ALP which were accepted by Assessing Officer - Commissioner (Appeals), however, opined that with application of CUP method ALP of AE fell within range of ±5 per cent - He, thus, set aside impugned adjustment made by Assessing Officer - Whether in view of fact that assessee could not produce details about quality of diamond mentioned with reference to invoices, TPO was right in observing that insufficient details were furnished to prove justification of applicability of CUP Method - Held, yes - Whether, therefore, impugned order of Commissioner (Appeals), was to be set aside and, matter was to be remanded back for disposal afresh - Held, yes [Paras 7 & 8] [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 102 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'H'

Assistant Commissioner of Income-tax, 8(1), Mumbai

v.

Genesys International Corpn. Ltd.

B.R. MITTAL, JUDICIAL MEMBER
AND RAJENDRA, ACCOUNTANT MEMBER
IT APPEAL NOS. 3333 & 3334 (MUM.) OF 2010
AUGUST 31, 2012

I. Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2005-06 - Whether geographical/consideration has to be kept in mind while applying CUP method - Held, yes - Assessee providing GIS service in its TP study selected CUP method - As per said study, rates charged from AEs of assessee were same as rates charged from independent third party who operated in same geographical region and availing similar services - However, TP officer rejected TP study of assessee and adopted TNM method - Accordingly, TP adjustment of ` 4.66 crores was recommended - Commissioner (Appeals) rejected such TP adjustment and upheld TP study of assessee - Whether since revenue had not brought on record any evidence to controvert case of assessee, order of Commissioner (Appeals) was to be upheld - Held, yes [Para 26] [In favour of assessee]

II. Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2004-05 - TP Officer, while determining arm's length price of assessee's international transaction, arrived at average margin of 13.3 per cent for comparable companies

as against 8.85 per cent margin of assessee - Accordingly TP adjustment was recommended - Whether since difference in arm's length margin of 13.3 per cent and actual transaction price (8.85 per cent) did not exceed five per cent, no TP adjustment was required to be made as variation was within 5 per cent range of ALP, as per proviso to section 92C(2) - Held, yes [Para 16] [In favour of assessee]

III. Section 10A of the Income-tax Act, 1961 - Free trade zone - Assessment year 2005-06 - Whether loss incurred in a section 10A unit can be set-off against profit of other section 10A unit and against other normal business incomes - Held, yes [Paras 33 & 34] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 104 (Amritsar - Trib.)

ITAT AMRITSAR BENCH

I.J. Tools & Castings (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Range-II, Jalandhar

H.S. SIDHU, JUDICIAL MEMBER

AND B. P. JAIN, ACCOUNTANT MEMBER

IT APPEAL NOS. 63 & 84 (ASR.) OF 2010 & 65 (ASR.) OF 2012

JULY 26, 2012

I. Section 92CA of the Income-tax Act, 1961 - Transfer pricing - Reference to TPO - Assessment year 2005-06 - Whether Assessing Officer is not required to provide opportunity of hearing to assessee before referring matter to TPO - Held, yes [Para 7] [In favour of revenue]

II. Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of - Assessment year 2005-06 - Whether foreign travel expenses are for exploration of possibility of expansion of business and, they are allowable even though object for such expenditure incurred has not been materialized - Held, yes - Whether where assessee brought evidence on record proving that its agents had in fact gone to foreign countries and had booked orders for company, expenditure incurred on their travel was to be allowed even though these orders were not accepted due to commercial reason - Held, yes [Paras 9 & 10] [In favour of assessee]

III. Section 253 of the Income-tax Act, 1961 - Appellate Tribunal - Appeals to - Assessment year 2005-06 - Whether in view of Instruction No. 3, dated 9-2-2011, where tax effect involved in revenue's appeal was less than ` 3 lakhs, same was to be dismissed being non-maintainable - Held, yes [Para 14] [In favour of assessee]

Circulars & Notifications : Instruction No. 3, dated 9-2-2011

IV. Section 271(1)(c) of the Income-tax Act, 1961 - Penalty - For concealment of income - Assessment year 2005-06 - Whether where addition in respect of foreign travel expenses was deleted in quantum appeal, penalty imposed on basis of aforesaid addition was also liable to be set aside - Held, yes [Para 16] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 106 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

John Wyeth & Brother Ltd.

v.

Assistant Commissioner of Income-tax, Circle 2(3)

DINESH KUMAR AGARWAL, JUDICIAL MEMBER

AND P.M. JAGTAP, ACCOUNTANT MEMBER

IT APPEAL NOS. 6772 & 6773 (MUM.) OF 2002

JULY 25, 2012

Section 44C of the Income-tax Act, 1961 - Non-resident - Head office expenditure in case of - Assessment years 1981-82 and 1982-83 - Assessee was a non-resident company, being only a branch

of a foreign company with Head Office in UK - Its business both in UK and in India was that of manufacturing pharmaceutical products - During assessment proceedings, Assessing Officer examined issue of applicability or otherwise of section 44C in respect of laboratory expenses - Assessing Officer took a view that entire Research and Development activities had been centralized in UK, and expenses were merely in nature of general administrative and executive in nature, and, hence, applicability of section 44C was inevitable - Accordingly, Assessing Officer disallowed assessee's claim in respect of laboratory expenses - On appeal, assessee filed financial statements to show that UK Company had shown executive or general administration expenditure as indicated in different clauses of Explanation (iv) to section 44C separately - Whether in absence of any contrary material placed on record by revenue to show that laboratory expenses claimed by assessee included expenses incurred on executive or general administration as indicated in above Explanation (iv) to section 44C, impugned disallowance was to be deleted - Held, yes [Paras 9 & 10] [In favour of assessee]

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[2012] 26 taxmann.com 120 (Pune - Trib.)

ITAT PUNE BENCH 'A'

Amdocs Business Services (P.) Ltd.

v.

Deputy Commissioner of Income-tax, Circle 1(1), Pune

I.C. SUDHIR, JUDICIAL MEMBER

AND G.S. PANNU, ACCOUNTANT MEMBER

IT APPEAL NO. 1412 (PUNE) OF 2011

JULY 23, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2007-08 - Assessee-company was engaged in business of providing Information Technology enabled services to its parent company, i.e., ADL - For assessment year under consideration, assessee-company filed a return of income declaring a loss - In course of transfer pricing proceedings, TPO proposed certain addition to ALP determined by assessee - It was noted from records that while proposing said adjustment, TPO did not grant benefit of ± 5 per cent variation as given in proviso to section 92C(2) - It was also found that assessee's comparables charged depreciation in accordance with rates prescribed in Schedule XIV to Companies Act, 1956, whereas assessee charged depreciation at higher rates - However, said aspect was not considered while determining assessee's ALP - Further, plea set up by assessee for economic adjustment on account of under capacity utilisation being in start-up phase, was also found to be reasonable - Whether in view of aforesaid, impugned adjustment made by TPO was to be set aside and, matter was to be remanded back for disposal afresh - Held, yes [Paras 6 to 12] [Matter remanded]

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[2012] 26 taxmann.com 121 (Rajkot - Trib.)

ITAT RAJKOT BENCH

Income-tax Officer, (International Taxation)

v.

CMA CGM Agencies (India) (P.) Ltd.

T.K. SHARMA, JUDICIAL MEMBER

AND D.K. SRIVASTAVA, ACCOUNTANT MEMBER

IT APPEAL NOS. 151 TO 190 (RAJ.) OF 2012

AUGUST 31, 2012

Section 172, read with sections 139 and 44B, of the Income-tax Act, 1961 - Non-resident - Shipping business of - Assessment year 2010-11 - Whether where French shipping company undertook a huge number of 40 voyages through Indian agent and had exercised its option under

section 172(7) by filing return of income under section 139(1), summary proceedings of assessment under section 172(4) could not be applied; regular assessment proceeding was required - Held, yes [Para 18] [In favour of assessee]

Section 253, read with section 172, of the Income-tax Act, 1961 - Appellate Tribunal - General - Assessment year 2010-11 - Whether tax effect in a 'case' means overall tax effect in respect of disputed issues in a particular assessment year - Held, yes - During previous year 40 voyages were undertaken by a French shipping company through its Indian agent and 40 returns were filed - Instead of passing 40 orders, a composite assessment order under section 172(4) was passed by Assessing Officer assessing total income at ` 2.72 crore - Whether since tax effect under appeal in instant case was more than stipulated tax effect of ` 3 lakhs, even though 30 out of 40 appeals had tax effects of less than ` 3 lakhs each, all 40 appeals were maintainable before Tribunal - Held, yes [Para 11] [In favour of revenue]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 124 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'C'

Pennzoil Quaker State India Ltd.

v.

Deputy Commissioner of Income-tax, Range 1(2)

D. MANMOHAN, VICE-PRESIDENT

AND RAJENDRA SINGH, ACCOUNTANT MEMBER

IT APPEAL NO. 8885 (MUM.) OF 2010

AUGUST 3, 2012

Section 92C of the Income-tax Act, 1961 - Transfer pricing - Computation of arm's length price - Assessment year 2006-07 - Whether transfer pricing adjustment should be computed with reference to volume of transactions entered into with associate enterprises only and not with respect to gross turnover of assessee - Held, yes [Para 5] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 127 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Apollo Consulting Services Corporation

v.

Director of Income-tax (International Taxation), Mumbai

P.M. JAGTAP, ACCOUNTANT MEMBER

AND AMIT SHUKLA, JUDICIAL MEMBER

IT APPEAL NO. 2983 (MUM.) OF 2010

JULY 27, 2012

Section 9, read with section 263 of the Income-tax Act, 1961 and Article 12 of DTAA between India and USA (Fees for technical services) - Income - Deemed to accrue arise in India - Assessment year 2005-06 - Assessee, a non-resident company, entered into a base Agreement with IBM-USA - In background of said agreement, IBM-India (a subsidiary of IBM-USA) made a deal with assessee through ISPL-India, for procuring software personnel in USA for projects of IBM in USA - In terms of agreement, orders were issued by IBM to ISPL who in turn passed that to assessee - Assessee's case was that its activity was purely recruiting and supplying of skilled personnel to IBM-India through ISPL and these technical personnel were neither employee nor were they working under supervision of assessee and, thus, payment received by assessee was for personnel supplied to IBM for its projects outside India and it had no relationship or nexus with work or services or software developed by said personnel for the IBM's client - Assessing Officer having accepted assessee's explanation, concluded that

amount received by assessee was neither taxable under section 9(1)(vii) nor under article 12 of Indo-US-DTAA - Commissioner passed a revisional order under section 263 setting aside assessment order - Whether since Assessing Officer had accepted assessee's explanation after making detailed enquiries and view taken by him was one of possible views, impugned revisional order was not sustainable - Held, yes [Paras 10 to 12] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 192 (Delhi - Trib.)

ITAT DELHI BENCH 'F'

Panasonic Consumer India (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Circle-14(1), New Delhi

RAJPAL YADAV, JUDICIAL MEMBER

AND T.S. KAPOOR, ACCOUNTANT MEMBER

IT APPEAL NO. 5301 (DELHI) OF 2010

SEPTEMBER 21, 2012

Section 144C, read with section 92C, of the Income-tax Act, 1961 - Dispute Resolution Panel - Assessment year 2006-07 - Assessee entered into international transaction with its AE - TPO made adjustment while computing ALP of said transaction - Assessee approached DRP and raised various objection against said adjustments - Whether where DRP dismissed various objections filed by assessee in a summary manner without proper application of mind, matter needed reconsideration - Held, yes [Para 9] [In favour of assessee]

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[2012] 26 taxmann.com 193 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Deputy Director of Income-tax (International Taxation) - 4(1)

v.

M. Fabricant & Sons Inc.

DINESH KUMAR AGARWAL, JUDICIAL MEMBER

AND P.M. JAGTAP, ACCOUNTANT MEMBER

IT APPEAL NOS. 2760 (MUM.) OF 2009 & 7514 (MUM.) OF 2010

JULY 31, 2012

Section 9 of the Income-tax Act, 1961, read with article 5 of the DTAA between India and USA (Permanent Establishment) - Income - Deemed to accrue or arise in India - Assessment year 2006-07 - Assessee was a non-resident company dealing in cut and polished diamonds - A survey under section 133A was carried out in assessee's case - Assessing Officer on basis of finding recorded by survey party issued a show-cause notice to assessee as to why its Liaison Office should not be treated as Permanent Establishment (PE) in India - In reply, assessee submitted that activities of Liaison Office of co-ordinating purchases were outside purview of section 9(1) - Assessing Officer rejected assessee's explanation - Commissioner (Appeals), however, held that assessee's office in India could not be considered as PE in India and thus, no profits could be attributed to it - Whether following order passed by co-ordinate Bench of Tribunal in assessee's own case in DDIT (IT) v. Fabricant & Sons Inc. [2011] 48 SOT 576/15 taxmann.com 358 (Mum.), impugned order of Commissioner (Appeals) was to be upheld - Held, yes [Para 11] [In favour of assessee]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 229 (Mumbai - Trib.)

ITAT MUMBAI BENCH 'L'

Lingtec Constructors LP

v.

Income-tax Officer, (International Taxation) 1(2), Mumbai

R. S. SYAL, ACCOUNTANT MEMBER

AND I.P. BANSAL, JUDICIAL MEMBER

IT APPEAL NO. 5376 (MUM.) OF 2003

AUGUST 24, 2012

Section 5 of the Income-tax Act, 1961, read with article 7 of the DTAA between India and USA (Business profit) - Income - Accrual of - Assessment year 1999-2000 - Assessee-US company had principal place of business at Enron Department Corporation (EDC) in Texas - Assessee entered into a contract with Indian company Dabhol Power Corporation (DPC) and got onshore construction work and services in connection with a Power Project - Payment was to be received by assessee from EDC in respect of work done - Main contracts were found not effective in relevant year due to terms and condition of contract - Therefore, assessee executed onshore construction initial work agreement on different dates - Question arose as to whether initial works agreement was an independent contract and, thus, while computing percentage of work completion its value should not be added to value of main contract - Whether though both agreement had been entered into on different dates, they had correlation as they were related to one project only and, thus, percentage of completion had to be seen in light of total value of contract - Held, yes - Whether if project was found to have been completed by more that 20 per cent, receipts would be liable to be assessed to that extent during year under consideration - Held, yes [Paras 18 to 20] [Matter remanded]

[*For full details log on to* **www.internationaltaxation.taxmann.com**]

[2012] 26 taxmann.com 247 (Chennai - Trib.)

ITAT CHENNAI BENCH 'B'

Gama Industries Coimbatore Ltd.

v.

Commissioner of Income-tax-III

ABRAHAM P. GEORGE, ACCOUNTANT MEMBER

AND VIKAS AWASTHY, JUDICIAL MEMBER

IT APPEAL NO. 755 (MDS.) OF 2011

JULY 11, 2012

Section 9, read with section 263, of the Income-tax Act, 1961 and article 13 of DTAA between India and UK (Fees for technical services) - Income - Deemed to accrue or arise in India - Assessment year 2006-07 - Assessee-company was engaged in manufacture and export of cotton yarn fabrics and garments - Its assessment was completed - Commissioner noticed that assessee paid market development fee to a UK company which amounted to fee for technical services under section 9(1)(vii) - Since Assessing Officer failed to consider aforesaid aspect, he, thus, passed a revisional order directing Assessing Officer to reframe assessment - It was noted from records that non-resident company was rendering services to assessee in course of their business and, therefore, such payment clearly went out of ambit of section 9(1)(vii) through exclusion specified in clause (b) thereunder - Moreover, even if one considered it as technical services, nothing was made available to assessee in nature of any technical knowledge, experience, skill, know-how or processes and, thus, payment in question could not be considered as fee for technical services in terms of DTAA between India and UK - Whether on facts, amount paid by assessee to non-resident company was not taxable in India and, therefore, impugned revisional order passed by Commissioner was not sustainable - Held, yes [In favour of assessee]

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