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Global Tax Insights

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EDITORIAL

The beautiful city of Copenhagen was the venue for the 2015 Morison International conference. This coincided with MI celebrating its 25th anniversary. Around 190 delegates, including companions, attended the conference. On the second day, the tax group met for members to share the latest developments in their respective jurisdictions; some interesting structures to own real estate were presented. The meeting ended with a panel discussion on the Foreign Account Tax Compliance Act (FATCA) and the panel members expressed their concern on the far-reaching consequences of FATCA law.

Like FATCA, India's crusade against black money has resulted in The Black Money (Undisclosed Foreign Income and Assets) Imposition of Tax Act, 2015 being enacted by the Indian Parliament. The provisions of the new legislation apply to all persons who are residents of India. A separate article in this edition of the newsletter explains the salient features of this new legislation.

On 15 May 2015, the Organisation for Economic Co-operation and Development (OECD) has released its new discussion draft on BEPS Action 7 (Prevent the Artificial Avoidance of PE Status). The draft recommends a proposal for replacing Articles 5(5) and 5(6) of the OECD Model and the Commentary on these paragraphs. As per the recommendation in Article 5, the phrase 'negotiates material elements of the contract' is proposed to be added besides the 'authority to conclude contracts', which at present is a prerequisite for existence of a permanent establishment in the source State. In Article 5(6) of the OECD Model, changes are proposed for defining an independent agent: if one person possesses 50% of another's beneficial interest, then the other party cannot be treated as having independent status.

This edition of the newsletter, besides the updates from various countries, incorporates three judgements: two from the Courts in India and one from Brazil. The decision of the Indian Courts deal with source-based royalty taxation and the applicability of the 'Bright Line Test' in transfer pricing. A new section on international tax headlines is being introduced in this edition. This gives an overview of key changes rather than explaining the issues in detail. I hope that this is useful to our readers.

I express my gratitude to all the member firms that have contributed to this edition of the newsletter. I sincerely hope that the contents are useful to the members and their clients. Feedback and suggestions on the contents are always welcome. You may email your suggestions to sachin@scvasudeva.com.

Happy reading!

Sachin Vasudeva
Senior Partner, S.C. Vasudeva, India

BRAZIL *Contributed by Marcello Karkotli Bertoni and Vinícius Martyins Moura, Madrona Hong Mazzuco-Sociedade de Advogados*

Marcello Karkotli Bertoni

Vinícius Martyins Moura

Stock options plan tax efficiency under review

As a result of Law No. 12,973, dated May 2014, new provisions were introduced in the Law to support Brazilian tax authorities' case for collecting payroll taxes on stock options granted to employees. Stock options are commonly granted to key employees as an incentive for the growth and development of the company. The option to purchase stocks is granted for a certain period, at a pre-set price.

In Brazil, this alternative also has been driven by a tax benefit captured by both employee and company: while the salary is taxed at a 27.5% individual income tax rate plus a 20% social security contribution due by the company, gains arisen from transactions with stocks vested in such plans are solely subject to a 15% income tax rate as capital gain.

This apparent tax arbitrage has been subject to the scrutiny of the tax authorities, who have been trying to characterise capital gains related to employees' stock options as remuneration for payroll taxes purposes. In the past, the case law has been favourable to the taxpayers whenever they were able to evidence that the plan presented market conditions and that the employee was subject to market risks and potential losses.

In this context, Law No. 12,973/2014 came to harmonise some new Brazilian Generally Accepted Accounting Principles rules (based on International Financial Reporting Standards rules) to the tax legislation, including a provision qualifying gains from stock options plans as a form of remuneration.

Turnover taxes upon financial revenues

By means of Federal Decree No. 8,451, dated 19 May 2015, the Brazilian government reactivated turnover taxes (Contribuição para o Programa de Integração Social [PIS] and Contribuição para o Financiamento da Seguridade Social [COFINS])[1] upon financial revenues at a 4.65% combined rate. Prior to such legislation, financial revenues were subject to a 0% PIS/COFINS rate.

This new taxation on financial revenues could impact significantly companies that operate with foreign trade, especially those that make use of hedge to protect against exchange variation and companies funded in foreign currency. Hedge transactions also were impacted as losses could not be offset with gains, causing a 4.65% flat burden only on a gains position.

After discussions between market agents and the government, this new legislation was amended to exclude foreign exchange (FX) variation gains earned by exporters and companies funded in foreign currency, as well as hedge transactions related to the companies' operational activities.

In addition, the government provided that the companies may change on a monthly basis the tax regime for recognition of the FX variation (cash or accrual basis), whenever the US dollar presents a monthly variation higher than 10%.

1 Contribution to Social Integration Program and Contribution to Finance Social Security

INDIA *Contributed by Ashish Gupta, S.C. Vasudeva & Co.*

The Black Money (Undisclosed Foreign Income and Assets) Imposition of Tax Act, 2015

This Act was introduced to Parliament by the Finance Minister on 20 March 2015, to curb the menace of black money, especially to deal with black money concealed abroad. The bill was approved by the President of India on 26 May.

Applicability

As per the income tax return forms, an assessee is required to furnish the details of any foreign assets held – including foreign bank accounts, financial interest held in any entity, any immovable property owned in any foreign country, etc. Before the Act was introduced, there was no penalty or fine in case of an assessee failing to furnish, or furnishing incorrect, particulars in respect of foreign assets held.

Key provisions

- Undisclosed foreign income or assets shall be taxed at the flat rate of 30%. No exemption or deduction or set-off of any carried-forward losses that may be admissible under the existing Income-tax Act, 1961, shall be allowed.
- The Act prescribes various penalties including a penalty equivalent to 90% of the undisclosed income/assets and various other penalties.
- The Act also prescribes a heavy prison sentence in certain cases.

One-time compliance opportunity

The Act prescribes a one-time compliance opportunity for a limited period to the persons who have any undisclosed foreign assets. Such persons may file a declaration before the specified tax authority within a specified period, followed by payment of tax at the rate of 30% and an equal amount by way of penalty. No prosecution shall be launched in these cases.

SWITZERLAND *Contributed by Bernhard Madorin, Artax Fide Consult AG*

Automatic exchange of information

On 19 November 2014, the Federal Council decided that Switzerland will join the multilateral agreement about the automatic exchange of information regarding tax matters. This agreement, developed by the OECD and modelled after the American FATCA model 1 in order to prevent tax evasion across borders, will be crucial for the future introduction of the cross-border automatic exchange of information. However, Switzerland still has to create the legal basis and negotiate further agreements with partnering nations. Should parliament (and, if required, the voters) pass this, then 2017 would see the start of the collection of data, and the first data exchange could then take place in 2018. This ambitious timetable of the Federal Council is due to the pressure of the G20 member states and the EU's introduction of first data transfers in 2017 (with the exception of Austria, to follow in 2018).

As far as financial information to be exchanged is concerned, the standard should be all-encompassing (including trusts). The criteria for registering any person subject to tax should be the national anti-money-laundering regulations, to identify contractual parties and to identify beneficial owners. The model contract is based on mutuality and provides that the information exchanged may be used solely for those purposes agreed by both parties. Confidentiality and data protection are equally included. Uniformity is to be achieved and ensured via a joint reporting standard, a model agreement between two nations, an accompanying commentary on interpretation, and basic data of an IT solution to assist the authorities. A review by the Global Forum, an authority designed and created by the G20 member states, is meant to ensure an efficient implementation of those standards.

Of prime importance for the implementation in Switzerland are the EU and its member states, as well as the USA. Next to this, countries with close economic and political ties will receive priority treatment. The Federal Council has emphasised that regularisation of the past (e.g. voluntary declaration to avoid punishment, final withholding tax) and market entry should be requested and strived for. Negotiations with the EU referring to this will probably supplement the current negotiations about the extension of the bilateral agreement on the taxation of savings income, or even make them redundant. As the USA is relying on the finalised FATCA agreement and therefore sees no necessity for new agreements, Switzerland's only option is to change to FATCA model 1; however, in the case of companies and trusts, the full view of the beneficial owner is not possible, due to the restrictions on reporting about a 'settlor' and for professionally managed trusts. Thus the USA will strengthen its position as a reliable and secure haven for tax evaders the world over. In this realm there are lively discussions in the UK about how to organise trusts in the future so they still provide protection in line with these OECD standards. This must be avoided with more precise definitions. Equally, the minimum levels set for reporting obligations open the doors for abuse through account splitting.

Apart from banks and other credit institutions, financial institutions subject to reporting include asset managers, trustee (custodians), stockbrokers, funds/investment companies and specific insurance companies that offer redeemable insurance policies or annuity contracts. Whether a financial institution is actually subject to reporting needs to be determined by a multitude of criteria, as the authors of the regulations are applying a circular reasoning: 'financial institutions subject to reporting are all those who are not financial institutions not subject to reporting'. This casuistic approach makes the regulations as complicated as the FATCA model.

In principle, financial institutions not subject to reporting (with the exception of payments connected to commercial financial activities) are national entities, international organisations and central banks, listed companies, pension funds, other legal entities with reduced risks of abuse leading to tax evasion and all those that are explicitly exempt from the duty to report, exempt organisms for the joint investment of securities. When determining the financial institutions or the accounts that are not subject to reporting, the national legislators have some leeway; added to which there is a catalogue listing criteria for exemption (provisions up to a limit of annual contributions of US$ 50,000, tax reliefs, reporting requirements to tax authorities,

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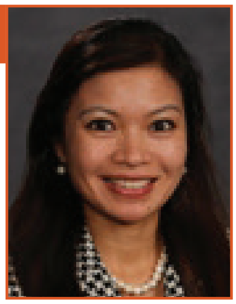
withdrawals attached to certain conditions, accounts are subject to supervision for other purposes than retirement plans, rental deposit accounts, etc.). In these cases, the question arises as to which national tax law should be adhered to.

The following data will be reported by financial institutions subject to reporting to the Federal Tax Administration, who passes the data on automatically to the equivalent authority abroad (as opposed to the present exchange of information on request):

- Name, address, country of residence, tax identification number, date of birth and birthplace
- Where a legal entity is the account holder: name, address, tax identification number of the legal entity, plus data of all persons subject to reporting
- Account number, name and, if applicable, identification number of reporting financial institution
- Account balance or account value (including cash or surrender value) in case of redeemable insurance policies or pension insurances at the end of the calendar year or at the time of the closing of the account
- Total gross earnings of interests, dividends and other revenue
- Total gross earnings of divesting or redemption of tangible or intangible assets.

UNITED STATES *Contributed by Angela Sadang, Marks Paneth LLP*



Finding an intersection between intangibles valuation and transfer pricing

Valuation of intangibles for financial reporting and transfer pricing are prominent and challenging areas in the entire M&A transaction process. The objective of this article is to dissect the differences and find the intersection that can turn the divergence into opportunities for convergence.

Cross-border mergers and acquisitions (M&A) are at their hottest pace since before the financial crisis, and a large proportion of transactions has increasingly involved intangible assets or intellectual property (IP) as the dominant acquired asset. As multinational companies shift ownership of intangible assets between legal entities and across jurisdictions for various strategic purposes, the most critical considerations in cross-border M&A, therefore, are the identification and valuation of intangible assets and transfer pricing. Simultaneously and of equal importance are valuations for financial reporting that involve the allocation of purchase price among the target company's tangible and intangible assets and the resulting annual goodwill impairment testing.

The initial perception is that the value of any transaction and the largely acquired intangible assets is driven by financial reporting valuation rather than by transfer pricing valuation. However, it is important to ask in such transactions whether the valuation of intangible assets in purchase price allocations can be used for transfer pricing purposes, or whether the same can be tweaked to address transfer pricing requirements for intangible assets.

Differences: The devil is in the detail

In recently published papers, the US Internal Revenue Service (IRS) as well as many tax authorities in many countries drew the distinction between valuations for financial reporting purposes and valuations for transfer pricing purposes, stating that financial reporting valuations, specifically purchase price allocations, should only be used as a 'starting-point' for transfer pricing purposes and may not be probative. The recent US Tax Court cases involving Veritas[1] and Xilinx[2] sharply demonstrate the divergence of the two perspectives.

The OECD is moving in a direction similar to the IRS in tightening controls, making sure that OECD member countries do not assign a low value to intangible assets for purposes of transferring them out of one jurisdiction into a more favourable tax jurisdiction.

The scepticism and hesitancy of the IRS and OECD stem from intangible asset values determined within the context of financial reporting, being notably different from (and often lower than) the values determined for transfer pricing purposes. To better understand the dynamic between valuations for transfer pricing and financial reporting, we highlight some of the key differences underlying each framework in Table 1.

Table 1. Valuations for transfer pricing and financial reporting: key differences.

	Transfer pricing	Financial reporting
Regulatory standards	OECD, local transfer pricing regulations, and in the US Section 482 of the Internal Revenue Code	IVSC, IASB, IFRS, ASC 805-Business Combinations, ASC 350 – Goodwill and Other, ASC 820 – Fair Value Measurement
Standard and premise of value	Arm's length standard	Fair value
Reporting unit versus legal entity	Legal entity level analysis	Fair Value measured in aggregate and allocated to RUs
Definition of intangible asset and goodwill	Goodwill is subsumed in the value of intangible asset. Buyer-specific synergies are included in arm's length value	Goodwill is a residual concept, and projections used to value intangible assets include market participant assumptions
Valuation methodologies	Valuation is performed on a pre-tax basis	Valuation is performed on a post-tax basis
Useful lives	Considers fixed term and longer useful lives	Considers perpetual term

ASC, Accounting Standards Committee; IASB, International Accounting Standards Board; IFRS, International Financial Reporting Standards; IVSC, International Valuation Standards Council; OECD, Organisation for Economic Co-operation and Development; RU, reporting unit.

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Most important to note among the differences is that in financial reporting, goodwill is a residual concept as projections used to value intangible assets only include market participant assumptions and exclude buyer-specific synergies. In transfer pricing, goodwill is embedded in the intangible value and consists of buyer-specific synergies, future customer relationships, future technology and all future opportunities that are part of residual goodwill value in financial reporting and are not considered goodwill in transfer pricing. In transfer pricing, there is a broader view of the definition and what comprises intangible asset value.

The difference in the treatments of goodwill and the definition of an intangible asset from the perspective of a specific buyer (transfer pricing) versus a market participant buyer (financial reporting) leads to higher valuations done for transfer pricing than those performed for financial reporting.

Similarities: Shall the twain ever meet?

Given all the differences, financial reporting valuations share general concepts with transfer pricing valuation such as the concept of comparables in a Market Approach, use of present value and discounting under an Income Approach, and the fact-finding process – i.e. the industry analysis and functional analysis in transfer pricing are conducted and performed in a similar fashion as part of due diligence in financial reporting. In addition, the documentation process is very similar: transfer pricing contemporaneous documentation requirements (Treas. Reg. 1.6662) mirror the standards set by the American Society of Appraisers (ASA) and the American Institute of Certified Public Accountants (AICPA) on the requirements of a comprehensive valuation report.

Finding an intersection

It is clear that valuations done for financial reporting purposes should not be fully relied upon for transfer pricing purposes. Relying on the valuation from a purchase price allocation results in undervaluation of transferred intangibles for transfer pricing purposes because of different treatment, including definitions of intangibles, goodwill, intangible life, buyer-specific synergies, pre-tax versus post-tax analyses, etc. as mentioned above.

However, aligning the two disciplines, especially in the context of M&A, presents opportunities for practitioners to become value-added service providers. This presents tax risks due to differences in value between the two frameworks and misalignment of the placement of intangible assets when setting a company's global transfer pricing policy. In addition, and more importantly, audit risks are higher due to inconsistent values of IP and challenges to post-acquisition transfers.

Coalescing the two disciplines early in the process saves time and cost rather than having to justify different methodologies later when potentially material tax consequences may arise. For instance, fact-finding and due diligence meetings can be conducted as one, and both disciplines leverage from the same information using the same set of projections and one similar set of market comparables. In addition, analytical models from both frameworks can be aligned to have similar inputs and assumptions. The documentation requirements of both can also be synchronised and performed jointly as there are many intersecting portions between the reporting requirements of transfer pricing and financial reporting valuation. This leads to a more enhanced ability to support tax positions and reduce audit risks.

Synchronised project teams and advisers with the skills, knowledge and experience from both disciplines enable both transfer pricing and financial reporting frameworks to be supported more consistently, with fewer discrepancies and potential disputes between all tax, accounting and corporate stakeholders.

References

1 Veritas Software Corp. & Subs. v. Commissioner, 133 T.C. No. 14 (2009).

2 Xilinx v. Commissioner, 125 T.C. 37 (2005) and Xilinx v. Commissioner, 598 F.3d 1191 (2010).

International Tax Headlines

Contributed by Saurabh Jain, S.C. Vasudeva & Co.

Australia

Investment Manager Regime bill introduced into Parliament: On 27 May 2015, a bill for the third and final element of the investment manager regime (IMR3) was introduced in the Australian Parliament. These IMR reforms remove tax impediments to investing in Australia in order to attract foreign investment into Australia and promote the use of Australian fund managers. The objective of the IMR bill is to encourage investment in relation to portfolio interests in equities and interests in other financial interests (e.g. certain debts) made by certain non-Australian residents either directly or through Australian fund managers. This would be achieved by providing non-Australian residents with an Australian income-tax exemption for income or gains in respect of the disposal of their investments.

China

The State Administration of Taxation (SAT) has issued a public notice 16 clarifying certain aspects on transfer pricing: On 18 March 2015, the SAT of China released Public Notice [2015] No. 16, which states that outbound payments to overseas related parties should follow the arm's length principle; it also specifies various circumstances where payments, service fees or royalties paid to overseas related parties would not be deductible for corporate income tax (CIT) purposes. Also, the taxpayers will be expected to provide relevant documentation upon request, such as intercompany agreements, documentation that verifies the authenticity of the transaction and transfer pricing documentation.

Russia

Amnesty scheme for disclosure of foreign assets: The Lower House of the Russian Parliament has approved the Amnesty Scheme for Offshore Capital: under the Capital Amnesty Bill, businesses and citizens who declare their foreign assets to the Russian tax authorities between 1 July and 31 December 2015 will get a free pass on a range of criminal, administrative and tax violations they may have perpetrated in relation to those assets.

UK

Introduction of a diverted profit tax: A key UK development related to the OECD BEPS initiative has taken place in the form of an anti-avoidance proposal for a new diverted profits tax at 25% from April 2015. The main objective of the diverted profits tax is to counteract avoidance of a UK taxable presence and/or contrived arrangements between connected entities, used by large groups (typically multinational enterprises) that result in the erosion of the UK tax base.

Hong Kong

Bill on profits tax exemption for offshore private equity funds: A bill that proposes to extend Hong Kong's profits tax exemption for offshore funds to private equity (PE) has been introduced to the Legislative Council. It is aimed at attracting certain overseas PE funds to Hong Kong by giving exemption to certain PE transactions (generally those that do not have many Hong Kong ties or connections). It is hoped that these funds would be able to set up their management business (i.e. the fund managers) in Hong Kong, which would further strengthen Hong Kong's position as the premier management centre in Asia.

Direct Action of Unconstitutionality [2013] 2588 STF

Contributed by Marcello Karkotli Bertoni and Laura Diniz Silva Santos, Madrona Hong Mazzuco-Sociedade de Advogados

Marcello Karkotli Bertoni

Laura Diniz Silva Santos

The Brazilian Supreme Court overruled the application of controlled foreign company (CFC) rules when the Brazilian company has no effective power over the invested company. The reasons of this decision were embodied in the Brazilian new CFC rules, which became effective in January 2015.

Facts in brief

Profits from CFCs and affiliate companies are taxed in Brazil by income tax and social contribution on net profit since 1995. Before 2001, foreign-source profits of CFCs and affiliate companies were taxed only at the time they were considered available to the Brazilian controlling company.

In late 2001, controversial changes were introduced by Provisional Measure No. 2158-35, causing foreign-source profits of CFCs and affiliate companies to be taxed in Brazil at the time the profit is shown on their balance sheets, regardless of whether the income is actually made available to the shareholders.

The constitutionality of these rules was challenged by the National Confederation of Industry, which filed the Declaratory Action of Unconstitutionality No. 2588 before the Brazilian Supreme Court.

The National Confederation of Industry contended that non-distributed profits of an invested entity could not be considered legally or economically vested income for Brazilian taxation purposes.

Besides, it was argued that when the Brazilian company is not the controlling shareholder, the payment of Brazilian corporate income taxes could occur even when the investor has no power to approve an effective distribution of profits.

Decision of the Brazilian Supreme Court

In 2013, after more than ten years of discussion, the Brazilian Supreme Court ruled partially in favour of the National Confederation of Industry.

It was stated that it is not possible to tax with CFC rules the profit of invested companies when the Brazilian entity has no control and effective power to vote for a distribution of dividends.

On the other hand, in regard to the parent companies, it was ruled that former CFC rules could be applicable in the case of invested companies based in low tax jurisdictions. Only a few months after the rendition of the above mentioned precedent, Provisional Measure No. 627/2013, converted into Federal Law No. 12,973/2014, was enacted, bringing several changes to the corporate income tax legislation, including new CFC rules.

In summary, the arguments of the decision were reflected in the new rules, under which:

i. the profits of controlled companies and equivalents will be taxed in Brazil when shown on their balance sheets; and

ii. the profits of affiliated companies will be taxed in Brazil only when the income is actually distributed, unless they are based in low tax jurisdictions, in which case the profits will be taxed in Brazil upon their booking in balance sheets.

Additionally, unlike former CFC rules, Federal Law No. 12,973/2014 foresees the possibility of consolidation of CFC profits and losses until 2022, provided certain conditions are met.

Qualcomm Inc. v. ADIT [2015] TS-70-ITAT-2015 Delhi

Contributed by Padmini Khare Kaicker and Karthik Natrajan, B.K. Khare & Co.

Padmini Khare Kaicker

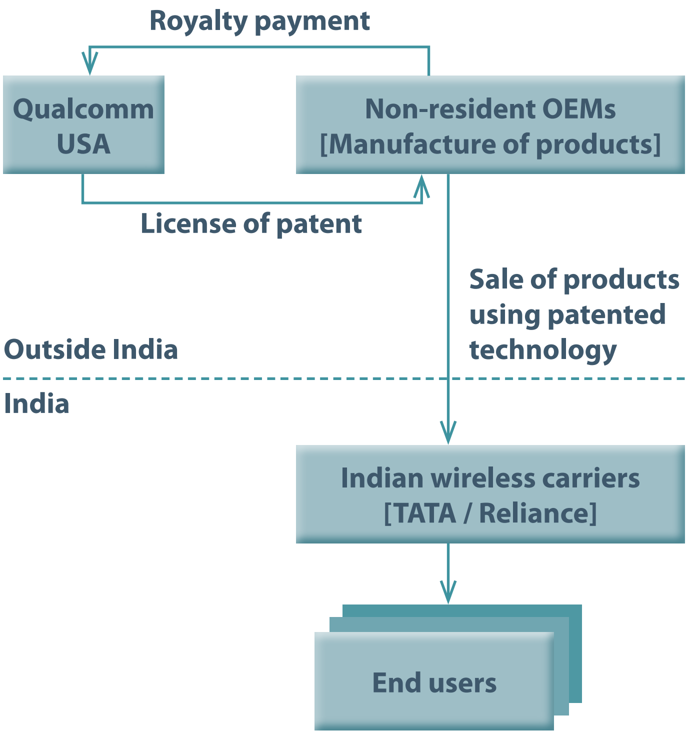
Karthik Natrajan

In a recent judgement, the Delhi Tribunal has ruled that if a patent is used by an end consumer and the manufacturer of a product is only a conduit for collection of such a consideration, the taxation would be warranted in the end-use jurisdiction. This judgement could have far-reaching ramifications for intellectual property (IP) holders whose eventual products end up being consumed in India. Of course, this judgement comes on the back of certain specific and highly technical facts which have led to the conclusion that the royalties were deemed to accrue or arise in India.

Facts in brief

The appellant in this case was M/s Qualcomm Inc. (Qualcomm), a US tax resident, engaged in the business of design, development, manufacture, marketing and licensing of digital wireless telecommunication products/services based on code division multiple access (CDMA) technology (see Figure 1).

Figure 1. Diagrammatic representation of the facts



- Qualcomm licensed certain patents (patented technology) for manufacture of CDMA handsets to original equipment manufacturers (OEMs) situated outside India, in countries such as Korea and China
- The OEMs used the patents to manufacture the products in their manufacturing bases, again outside India
- These handsets were sold to wireless carriers worldwide – including to Indian players in the CDMA space, such as TATA Indicomm, Reliance Infocomm – and the title to these handsets passed on to these Indian players outside India
- Royalty was paid by OEMs to Qualcomm only upon sale of the handsets
- These handsets were sold eventually to end-customers subscribing to the mobile communication network operated by these Indian players.

Assessing Officer's contentions

The Assessing Officer noted the provisions of the domestic tax law and the applicable Tax Treaty viz. Income-tax Act, 1961 (the Act) and India–USA Tax Treaty (Tax Treaty), respectively. Under Section 9(1)(vi)(c) of the Act, income by way of royalty payable by non-residents was deemed to accrue or arise in India so long as it was relatable to a business carried on in India or to any source in India. Per Article 12(7)(b) of the Tax Treaty, where royalties do not arise in one of the contracting states and relate to the use of, or the right to use, the right or property in one of the contracting states, the royalties shall be deemed to arise in that contracting state.

After a perusal of the fact pattern and available documentation, the Assessing Officer noted that it was not a case where royalty has been paid a lump sum for the use of CDMA technology, but rather an ongoing payment dependent on the volume of sales. He concluded that royalty arose to Qualcomm only

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when the OEMs sold the handsets to wireless carriers; and since TATA Indicomm & Reliance Infocomm were based in India, relatable royalty was deemed to accrue or arise in India for Qualcomm and hence taxable in India, both under the provisions of the Act as well as the Tax Treaty. He observed that there were specific features incorporated in the phones to be sold in India, thereby creating a strong Indian nexus for source-based taxation. To further cement his stand, the Assessing Officer concluded that if the handsets were not made compatible with the Indian network specifics, then they cannot be used in India.

Qualcomm's contentions

Qualcomm contended that its royalty earnings were not taxable in India, *inter alia* based on following arguments:

- Royalty received from the OEMs is independent of whether the handsets are sold or not
- Qualcomm is not involved, in any manner, in the sale of handsets between the OEMs and Indian wireless carriers and also has no role in determining their pricing *inter se*
- Technically, it was contended that the patented technology was used outside India for manufacturing the handsets, i.e. before they are sold to Indian wireless carriers
- There was no customisation of handset qua the CDMA connectivity, and the handsets manufactured by the OEMs using the patented technology could be sold anywhere in the world and the use of patents was not India-specific; hence, activities done by Qualcomm could not be said to be a source of income in India.

Thus, it was contended by Qualcomm that the ultimate use of a product manufactured by the OEMs using the patents licensed by Qualcomm, in India, cannot be said to be a source in India. Hence, royalties received by Qualcomm abroad were not taxable in India.

Appeal before Tax Tribunal

Aggrieved by the assessment order and not finding support before first appellate authority, Qualcomm took the matter before the Income-tax Appellate Tribunal. In India, the Tax Tribunal is the final fact-finding body whose findings are, by and large, considered to be well reasoned and balanced.

It may be pertinent to note that this judgement relates to tax years 2005–06 to 2008–09. Qualcomm sought to invoke the favourable ruling it had obtained before the same Tribunal, on same facts, relating to tax years 2001–02 to 2004–05. At that time, the Tribunal had observed that the Indian wireless carriers did not constitute a source of income for the OEMs in India and that the OEMs have not used the patented technology for the purpose of carrying on business in India or for earning income from a source in India. The role of Qualcomm ended when it licensed its patents on intellectual property rights pertaining to CDMA handsets for manufacture and when it collects royalty from OEMs on these handsets, when they are shipped out of the country of manufacture. It was also concluded that the CDMA handsets were not India-specific: mere customisation, such as locking the handset to enable operation only with a specific operator, inclusion of Hindi or regional languages, and so on were in no way connected with the patented technology. Accordingly, it had held that the royalties earned by Qualcomm were not taxable in India under the Act and hence, did not go into the question of taxability under the Tax Treaty. The Tribunal was also influenced by the fact that the OEMs did not have any income from business in India.

Earlier ruling distinguished

The matter was examined by a coordinate bench of the same Tribunal. It raised doubts on the conclusion that the CDMA handsets were not India-specific and remanded the matter back to the Assessing Officer for recording categorical findings by obtaining expert technical opinion and by recording witnesses of experts.

Drawing an analogy from the US Internal Revenue Code and examining Section 9 of the Act, the Tribunal upheld the validity of source-based taxation of royalties in India when the products, in respect of which the royalty is paid, are used in India. The emphasis is on the *situs* of use of the patent rather than the *situs* of the entity making payment for the royalty. It clarified that if the patent is used in the manufacturing process, then the taxation of royalty should be in the tax jurisdiction in which manufacturing activity is carried on rather in the tax jurisdiction in which ultimate consumer of product is located. However, if the patent is used by an end

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consumer and the manufacturer of a product is only a conduit for collection of such a consideration for use by the end consumer, the taxation would be warranted in the end-use jurisdiction.

The earlier finding of the coordinate bench was distinguished also on the fact that the OEMs did have taxable business income in India and hence, the royalty could be attributed to right used for business carried on in India and thus, the source of income was established.

EDITORIAL COMMENT

This decision seeks to distinguish between the situs of use of a technology in manufacturing and use of a technology in functioning of the product so manufactured. The finding that in the latter case, royalty was taxable where usage of the product ordinarily takes place, would create practical difficulties – especially for non-residents owning IP; therefore, one could expect protracted litigation on this topic.

This judgement also highlights another important aspect: the role of press briefings. The Qualcomm case was influenced heavily by the press briefings issued by Qualcomm and press clippings around the visit of one of its senior executives to India, including his meetings with the Indian government and important customers. The Assessing Officer had in fact reopened the case on the strength of these clippings. This highlights the importance of ensuring the correct and appropriate representation of facts, as any careless quote or unreflected soundbite could seriously mar the prospects of unsuspecting assessees.

Sony Ericsson Mobile Communications India Pvt. Ltd v. CIT [2015] 55 taxmann.com 240 Delhi

Contributed by Aditi Gupta, S.C. Vasudeva & Co.

This article summarises a recent ruling of the Hon'ble Delhi High Court in the case of various companies on the issue of a transfer pricing adjustment for excessive advertising, marketing and promotional (AMP) expenses incurred by the assessees.

The Hon'ble Delhi High Court, while deciding this case, has addressed the controversies surrounding the transfer pricing adjustments for AMP expenses, arising out of the ruling of the Special Bench of the Income tax Appellate Tribunal, Delhi in the case of LG Electronics India Pvt. Ltd v. ACIT (2013) 152 TTJ 273.

Background and brief facts of the case

- The assessees were several Indian subsidiaries of multinational enterprises including subsidiaries of Sony, Reebok, Canon, etc.
- During the relevant period they were engaged in import, distribution and marketing of branded products manufactured by their foreign associated enterprises (AE).
- The functions performed by the assessees were to promote and develop the market for selling and distributing the branded products in India, and to support and cooperate in execution of global marketing plans and strategies.
- The intangible rights in the brand name were owned and controlled by the foreign AEs.
- The assessees used transactional net margin method/resale price method (TNMM/RPM) as the most appropriate method to justify the arm's length price in respect of their international transaction of import of finished goods.
- The Transfer Pricing Officer (TPO) accepted the methods so applied by the assessees; however, he alleged that by incurring excess AMP, the assessee was engaged in brand-building development or enhancing marketing tangibles, although no corresponding reimbursement of expenses from AEs was made.
- The TPO used the bright line test – i.e. the arithmetic mean of the AMP – sales ratio of comparable companies – to determine the excess AMP. Thereafter, TP adjustment to the extent of the excess so ascertained was made, along with a mark-up of 15%.
- The Dispute Resolution Panel upheld the TPO's approach, but reduced the mark-up from 15% to 12%.
- The assessee was not successful at the Income-tax Appellate Tribunal and therefore the matter travelled to the High Court.

Issues before the Hon'ble Delhi High Court

- Whether AMP expenses can be treated and characterised as a separate international transaction under section 92B of the Act?
- Whether TP adjustments can be made in respect of AMP expenses, and if so, under what circumstances?
- Whether the Tribunal was right in directing that selling expenses – such as trade discount, rebates, and commission – cannot be included in the AMP expenses?

In order to appreciate the decision of the Court, it is imperative to go through the findings of the Special Bench in the case of LG Electronics.

Special Bench ruling in the case of LG Electronics

The Special Bench in the case of LG Electronics, by largely holding in favour of the Revenue, had held the following:

- Incurring of higher AMP expenses than the comparable companies would be classified as a separate international transaction of provisions of brand-building/brand-promotion services supplied by the Indian Assessee to its foreign AE.
- The amount of excess AMP expenses were computed having regard to the bright line test. Anything in excess of the bright line was designated

Continued over

'non-routine expenses', which should have been recovered from the foreign AE by applying an appropriate mark-up.

- The Special Bench summarised a set of 14 principles for undertaking benchmarking; expenses such as discount, sale commissions, etc. should not be considered as a part of the value/cost of the international transaction.

Decision of the Hon'ble Delhi High Court

- ***AMP expense is an international transaction:*** The Court held that incurrence of AMP expense by the assessee in relation to marketing intangibles owned by the foreign AE is an international transaction under Section 92B of the Act. Differentiating the provisions of Chapter X (i.e. TP provisions) of the Act from Section 37(1) of the Act, the Court observed that the Revenue is not questioning the reasonableness of the AMP expenses incurred by the assessee towards third parties in India. The issue was adequacy of compensation received by the assessee towards marketing and distribution functions.
- ***Aggregation of transactions and application of TNMM:*** The Court observed that the expression 'class of transaction' and 'functions performed by the parties' under Section 92C(1) of the Act implies that the word 'transaction' includes a bundle or group of connected transactions. The Court also observed that AMP is an expense related to distribution and under a bundled approach, it would be illogical to treat the same as a separate international transaction. Clubbing of closely linked transactions, including continuous transactions, may be permissible under the Act and the assessee can aggregate the controlled transactions if the transactions meet the specific parameter. While giving such ruling, the Court also held that one of the primary rules of statutory construction is that singular includes plural and vice versa, and that there cannot be any contrary presumption.

  It was further held that if the TPO accepts the method applied by the assessee for computing the ALP in respect of its international transaction, then AMP expenses must not be treated as a separate international transaction. This is because AMP expense is a cost that is factored into the net profit of the interlinked transaction. Thus, when the comparables pass the functional analysis test and the profit margin matches with the comparables, the conclusion is reached that the transfer price is the arm's length price of the international transaction and that the AMP expense is already factored into the analysis.

  However, in the case of manufacturing, distribution and marketing activities, where the transactions cannot be benchmarked together, the appropriate approach would be to benchmark manufacturing and distribution/marketing separately.
- ***Aggregation of transactions and provisions of set-off:*** In LG's case, the assessee was of the view that the additional profits earned due to excessive AMP, as segregated by the Revenue, had not been segregated. The Revenue, however, contended that such a set-off is prohibited under Section 92(3) of the Act.

  The assessee's stand was rejected; however, the Court held that the concept of set-off or adjustments is well recognised and accepted internationally. Section 92(3) of the Act does not *per se* prohibit set-off.

  Subsection (3) of Section 92 does not incorporate a bar or prohibit set-off or adjustments. The effect of the subsection is that the profit or loss declared (i.e. computed by the assessee on the basis of entries in the books of account) shall not be enhanced or reduced because of TP adjustments under subsection (2) or (2A) to Section 92. The concept of set-off or adjustments was/ is widely recognised internationally, including by the tax experts/ commentators. Had the legislative intention behind subsection (3) to Section 92 been to deny set-off, it would have been worded to make this absolutely clear. **Legislative intent to the contrary should not be assumed.**
- ***AMP expenses vis-à-vis brand and brand building:*** The Court, on the issue of whether AMP expenses lead to brand creation, held that it would be erroneous to consider brand commensurate with AMP expenses. The Court observed that there could be situations where a brand name is developed without incurring huge advertisement expenses, and there could also be situations where brand value is not created even after incurring huge AMP expenses. Brand reflects the reputation of the brand owner; it is earned over a period of time, on the basis of the nature and quality of goods and services and various other factors. Thus, it would be inappropriate

to state that AMP expenses are a major contributing factor to brand building, or that the only reason for incurring AMP expenses is to build the brand.

- ***Bright line test lacks acceptability:*** The Court did not accept the universal bright line test of computing excess AMP expenses by bifurcating the AMP expenses between routine and non-routine expenses, the latter being attributed towards brand building. Assessees do not undertake advertisement to increase the value of brand, but with the intention of increasing sales, and thus profits. The Court observed that applying the bright line test, on the basis of 14 parameters prescribed in the LG Electronics Special Bench Ruling (para 17.4 of the Special Bench order) would be adding text to the statute and the rules, and by doing so introducing a new concept that has not been recognised and accepted in any of the international commentaries or as per the general principles of international taxation accepted and applied universally. There is nothing in the Act or the rules to hold that it is obligatory for AMP expenses to be subjected to the bright line test or for the non-routine AMP expenses as a separate transaction to be computed in the manner as stipulated.

  The Court concurred with the view adopted under the UN Model. As per para 10.4.8.15 of the said model, determination of arm's length price in cases of marketing intangibles would involve functional assets analysis of the profile of the Indian entity and the parent company. The question, therefore, of when a subsidiary entity engaged in distribution and marketing incurs AMP expenses, can only be answered by ascertaining whether the subsidiary AE entity has been adequately and properly compensated for undertaking the said expenditure. Such compensation could be in the form of low purchase price or reduced royalty, or even by payment of direct compensation/reimbursement to the assessee.

- ***Economic ownership versus legal ownership:*** The assessee had argued that they were economic owners of the brand in India. The Special Bench in the LG case, however, rejected this argument and held that the Income-tax Act only recognised legal ownership and that economic ownership exists only in a commercial sense.

  The Court, however, recognised that economic ownership of a brand is an intangible asset and that this is an internationally accepted factor in determining transfer prices. The Court also stated that economic ownership will only arise in case of long-term contracts and where there is no stipulation of denying economic ownership. It further observed that valuation of economic ownership of a brand could be required when the Indian assessee is deprived of, or transfers its economic ownership in, the brand – i.e. upon termination of the distribution/marketing agreement or when economic ownership gets transferred to a third party.

- ***Direct marketing expenses:*** The Revenue authorities had added direct marketing and selling expenses – including discounts, incentives, sales commission, etc. – to the AMP expenses. The Special Bench in the LG case had held that such expenses should be excluded from the AMP expenditure by stating that these do not create any marketing intangible. The Hon'ble Court upheld the decision of the Special Bench and held that marketing or selling expenses like trade discounts, volume discounts, etc. offered to sub-distributors or retailers are not in the nature and character of brand promotion. The expenses being in the nature of selling expenses have an immediate connect with price/consideration payable for the goods sold. They are not incurred for publicity or advertisement.

EDITORIAL COMMENT

The Delhi High Court has substantially overruled the Special Bench Ruling in the case of LG Electronics. This judgement broadly rejects application of the bright line test by holding that it has no statutory mandate. It permits clubbing of closely linked transactions and benchmarking of a bundle of transactions applying entity-wide TNMM. Importantly, the Court has upheld the argument that economic ownership of a brand is an intangible asset, just like legal ownership.

This ruling is welcome, as it lays down some very significant (albeit broad) principles of law to be applied to the facts of each case. The decision is likely to have a far-reaching impact for Indian distributors and MNEs. Going forward, taxpayers should ensure that appropriate functional and economic analysis is captured in the TP documentation itself.

The Next Step

Contact Morison International to discuss your needs

www.morisoninternational.com

Morison International
193 Praed Street
Paddington
London, W2 1RH
United Kingdom

T: +44 (0)20 7638 4005
E: info@morisoninternational.com