Morison KSi

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Global Tax Insights

Morison KSi

Editorial

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The year 2017 will be the year of achieving greater tax transparency at a global level. Automatic exchange of information (AEOI) enters into a critical phase, with the first exchanges scheduled to commence in September 2017. Most countries have changed their domestic laws to require financial institutions to report comprehensive information on the financial accounts and assets they hold for non-residents. Altogether, 53 jurisdictions will be undertaking first exchanges in 2017, and 47 countries in 2018.

Implementation of the various BEPS Action Plans will be high on the agenda for 2017. In March, even the British Virgin Islands joined as a participant on an equal footing in the BEPS project as an associate member. India, being an active member of the BEPS project, implemented Action Plan 1 by introducing an equalisation levy tax (popularly known as the 'Google tax'), and Action Plan 13 by introducing country-by-country reporting. Budget 2017 has implemented Action Plan 4 by restricting deductions for interest payments where such payment is to a non-resident.

On the indirect tax front, as mentioned in my previous editorial, India inches closer to a full-fledged GST regime. Four new legislations have been passed by the Lower House of Parliament. Draft rules have also been placed in public domain, inviting comments from the stakeholders. It looks as though GST should be implemented in India by 1 July.

Other than country updates, this edition of the newsletter covers OECD updates on BEPS Action Plan 8–10, relating to application of the profit split method. We also have two important articles regarding new employee share option plan concessions for SME start-ups and USA–Canada cross-border investments using an unlimited liability company. One international tax case law from Indian tax authorities on transfer pricing provisions has also been included.

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

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Country Focus

Australia

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Australian transfer pricing developments

1. Simplified transfer pricing options

Back in December 2014, the Australian Taxation Office (ATO) released a number of simplified options that certain smaller businesses could use to minimise the costs of complying with the transfer pricing provisions. The ATO has now released a Practical Compliance Guideline (PCG 2017/2), which provides more detail on these options.

Under the Australian transfer pricing provisions, all taxpayers who have dealings with international related parties are expected to ensure that these transactions are undertaken on arm's length terms, in accordance with OECD guidelines. Transfer pricing principles also apply when determining the profits that are attributable to a permanent establishment in Australia or in a foreign country.

There is also an expectation that taxpayers produce and maintain contemporaneous documentation to explain the nature of the transactions, the transfer pricing method that is being adopted and to prove that the transaction is consistent with arm's length business dealings. If appropriate documentation is not kept by the business, then higher penalties can apply if a transfer pricing adjustment is made by the ATO.

Complying with the documentation requirements can be an onerous task, especially for smaller businesses. The ATO's simplified transfer pricing options are an attempt by the ATO to reduce the compliance burden faced by these businesses and to provide them with a greater level of comfort in relation to their position under the transfer pricing provisions. This also allows the ATO to focus its resources on higher-risk transactions and taxpayers. The ATO makes the following comments:

If you apply one or more of the options in this Guideline, we will not allocate compliance resources to review the covered transactions or arrangements specified in that option for transfer pricing purposes, beyond reviewing your eligibility to use the option you have applied.

The eight simplified options cover the following areas:

- Small taxpayers
- Distributors
- Intra-group services
- Low-level inbound loans
- Materiality
- Management and administration services
- Technical services
- Low-level outbound loans.

By way of example, taxpayers can use the simplified option relating to inbound loans if the following conditions are met:

- The taxpayer has a cross-border loan balance of up to Au$50 million across the Australian economic group throughout the financial year
- The interest rate on inbound loans is no more than a specific rate published by the Reserve Bank of Australia (6.4% per annum in January 2017)
- The funds provided under the loan are Australian dollar funds and this is reflected in loan agreements

- Associated expenses are paid in Australian dollars
- The taxpayer has not made sustained losses (i.e., losses incurred for three consecutive years including the year in question)
- The taxpayer does not have related party dealings in certain specified countries
- The taxpayer has not undergone a restructure in the year.

Taxpayers who qualify for one of the simplified options and choose to use that option must disclose this on the International Dealings Schedule that is lodged with their income tax return. These taxpayers still need to retain documentation to demonstrate that the eligibility criteria were satisfied, but should not need to create more substantial transfer pricing documentation (e.g., benchmarking analysis).

2. Centralised operating hubs

The ATO has also released a Practical Compliance Guideline (PCG 2017/1) setting out its compliance approach to transfer pricing issues that arise when a business group centralises certain business activities and operating risks. This would commonly involve the centralisation of marketing, sales and distribution functions. These centralised models are often referred to as 'hubs'.

The aim of this guidance document is to assist businesses with the following:

- Determine the risk profile associated with a hub under the Australian transfer pricing rules
- Understand the compliance approach that the ATO is likely to adopt, given that risk profile
- Understand how the business can mitigate its transfer pricing risks
- Understand the type of analysis and evidence the ATO would require when testing the outcomes of a hub from a transfer pricing perspective.

The ATO intends to concentrate its compliance and review efforts on international related party dealings that pose the highest risk of not complying with the transfer pricing rules.

This document sets out a risk rating system based on six risk zones and explains the factors that should be taken into account when determining which risk rating applies to a particular hub.

For example, the risk assessment framework starts by looking at whether hub profits are ≤100% mark-up of hub costs. If so, the hub will be classified as low risk. If the hub profit is >100% mark-up of hub costs, then it is necessary to calculate the tax impact of the hub using a formula set out in the PCG. For example, if the tax impact is above Au$50 million per year, then the hub will be classified as high risk. These hubs could be pushed into a very high-risk zone if they do not meet certain transfer pricing documentation requirements.

The ATO notes that it would not generally devote compliance resources to businesses in the low-risk zone. However, as businesses move outside the low-risk zone they can expect the ATO to monitor, test and/or verify the transfer pricing outcomes of the hub. The higher the risk rating the higher the ATO's expectations will be when it comes to the level and detail of transfer pricing documentation and supporting evidence.

Businesses that utilise centralised operating hubs where there is some level of exposure to the Australian tax system should work through the process of identifying their current risk rating, as well as the steps that can be taken to move to a lower-risk zone.

Country Focus

Canada

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Impact of new principal residence exemption rules on non-residents purchasing Canadian real estate

On 3 October 2016, the Canadian Department of Finance introduced some significant changes to the principal residence exemption (PRE) rules. The Department of Finance stated that the purpose of these changes was to improve tax fairness by preventing perceived inequities connected to the capital gains exemption on the sale of a principal residence.

The main change to the PRE rules will limit the ability of certain taxpayers to reduce or eliminate the capital gain on the sale of their home.

A principal residence of a taxpayer means a property that the taxpayer (including their spouse or common-law partner or child) has 'ordinarily inhabited'. The amount of exemption available to a taxpayer is determined by a formula that prorates the amount of gain by the number of years in which the property was designated as the taxpayer's principal residence (the numerator) compared to the total number of years that the taxpayer owned the property (the denominator).

While the PRE rules only allow one property to be designated as a taxpayer's principal residence for a particular tax year, the rules do recognise that a taxpayer can have two residences in the same year – such as when one residence is sold and another is bought in the same year. In such cases, the formula adds 1 year (the '1+ rule') to the designated principal residence years (the numerator) to allow both properties to be treated as a principal residence for the 1 year that both are owned.

The 1+ rule will apply after 3 October 2016 only when the taxpayer is a resident in Canada during the year in which they acquired the property. Thus, for sales after 2 October 2016, an individual who was not a resident of Canada in the year they acquired the residence will not be able to add the additional year to the designated principal residence years in the year of sale. This measure has been put in place to ensure that permanent non-residents are not eligible for the PRE on any part of the gain from the sale of a residence. However, it appears that the PRE rules do not provide relief to a non-resident taxpayer who acquires a residence and then immigrates to Canada in a subsequent year and resides in that property. Furthermore, the rules do not penalise a taxpayer who emigrates from Canada and continues to own the property that was acquired while being a resident of Canada.

Reporting requirements for sales of principal residences

The new PRE rules will apply to taxation years ending after 2 October 2016. Accordingly, starting with the 2016 taxation year, vendors who sell their principal residence including deemed dispositions on or after 1 January 2016 are now required to report the sale on their income tax return and make an appropriate principal residence designation to claim their PRE on their 2016 return.

This rule replaces Canada Revenue Agency (CRA)'s administrative policy, which stated that an individual is not required to report the sale of their residence nor file Form T2091 when the PRE eliminates the entire taxable gain.

Penalties relating to the reporting requirements

Finally, when the sale of a home has been reported but a principal residence designation was not made in the taxpayer's tax return, the CRA will be able to accept a late-filed principal residence designation subject to a penalty of $100 per month to a maximum $8,000.

Under normal circumstances, CRA may only assess tax paid by a taxpayer for a taxation year during the 'normal reassessment period'. The normal reassessment period for individuals is 3 years from the date of the original notice of assessment issued by CRA. However, the PRE rules indicate that CRA has now the ability to reassess tax beyond the normal reassessment period if the taxpayer does not report a disposition of a real estate property on the appropriate tax return. This change is much broader since it applies to all unreported disposition of a real estate property and not just the disposition of a principal residence.

This reassessment beyond the normal reassessment period would only be limited to the unreported disposition of a real estate property. If the return is amended to include a previously unreported disposition of a real estate property, then the normal reassessment period for that disposition would begin on the date of the notice of reassessment issued by CRA.

The two major changes to the PRE rules that affect non-residents will be the loss of the 1+ rule for non-residents acquiring a principal residence and the requirement to report the disposition of a principal residence. These changes were brought about by concerns with maintaining the stability in the Canadian housing markets. Furthermore, the Department of Finance has stated that they wish to have a tax system that is not only fair, but perceived by taxpayers to be fair; thus, they want the PRE to be available only where appropriate. Furthermore, earlier in the year the British Columbia Ministry of Finance placed an additional property transfer tax on residential property transfers to foreign entities in the Greater Vancouver Regional District.

Country Focus

India

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Amendment in Budget 2017 relating to thin capitalisation

India, being a member of G20, is very proactive in adopting the recommendations of Base Erosion and Profit Shifting (BEPS). Earlier, some Action Points in the BEPS reports – such as equalisation levy, country-by-country reporting, lower rate of taxation for income from patents – was introduced into the statute through the Finance Act 2016. Budget 2017 has taken another step towards implementation of BEPS recommendations, this time under BEPS Action Plan 4, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments'.

The Finance Bill 2017 has inserted a new section 94B in the Income-tax Act 1961 ('the Act') in line with the recommendations of OECD BEPS Action Plan 4, to provide that:

1. Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, pays interest or similar consideration exceeding one crore rupees which is deductible in computing income chargeable under the head 'Profits and gains of business or profession' in respect of any debt issued by a non-resident, being an associated enterprise of such borrower, the interest shall not be deductible in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2).

   Provided that where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise.

2. For the purposes of sub-section (1), the excess interest shall mean an amount of total interest paid or payable in excess of thirty per cent. of earnings before interest, taxes, depreciation and amortisation of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less.

3. Nothing contained in sub-section (1) shall apply to an Indian company or a permanent establishment of a foreign company which is engaged in the business of banking or insurance.

4. Where for any assessment year, the interest expenditure is not wholly deducted against income under the head 'Profits and gains of business or profession', so much of the interest expenditure as has not been so deducted, shall be carried forward to the following assessment year or assessment years, and it shall be allowed as a deduction against the profits and gains, if any, of any business or profession carried on by it and assessable for that assessment year to the extent of maximum allowable interest expenditure in accordance with sub-section (2):

Provided that no interest expenditure shall be carried forward under this sub-section for more than eight assessment years immediately succeeding the assessment year for which the excess interest expenditure was first computed.

In view of the above, interest expense claimed by an assessee that is paid to its associated enterprise(s) shall be restricted to 30% of EBITDA or interest paid or payable to associated enterprise, whichever is less.

Example: ABC Ltd, a tax resident in Country A, borrows an amount from XYZ Ltd, a tax resident of Country X. The corporate tax rate in Country A is 35% and in Country X is 15%. On the interest expenditure, ABC Ltd would be able to claim deduction and reduce tax liability at a rate of 35%; however, XYZ Ltd shall pay tax at the rate of 15% on the interest income. Hence, the group will be able to save tax of 20% on the interest income, thus shifting profits and eroding the base in the form of reduction of tax base in country A.

The rationale behind the amendment is that the companies are typically financed through a mix of debt and capital. Dividend paid on equity is not tax deductible, unlike interest on debt. Therefore, debt is often a more tax-efficient method to finance than equity, and multinational groups are often able to structure their financing arrangements to maximise this benefit. Thus, this amendment aims to control this cross-border shifting of profit through excessive interest payments.

Though the amendment is proposed to protect the country's tax base, the section is not very well drafted and could result in litigation and undue disadvantage to the assessees. Some observations in this regard are:

- From the reading of this section, any payment of interest or similar consideration that is deductible under the head 'Profits and gains of business or profession' shall be included for determining the interest claim. The term 'similar consideration' has not been defined. Hence, it is not clear what expenses are covered by these provisions.

- The section does not give grandfathering provisions for existing debts.

- The provisions include both implicit and explicit guarantees, although insisting on implicit guarantees would unfairly burden a taxpayer's genuine business transactions.

- Allowable interest expenditure based on EBIDTA would impact industries that are cyclical in nature, as well as loss-making start-ups in their initial years.

While these new provisions have been introduced as a first step in tackling the challenge of BEPS, the amendment will result in litigation, thus defeating the entire purpose of the amendment. The rule for 'limitation on interest deduction' has already been implemented by developed countries such as Australia, China, France, Germany, Japan, the Netherlands, New Zealand, Russia, Sweden, the UK and the USA. Imposing the same rules on a developing nation like India at this stage may be an impediment to growth. Further, it does not take account of certain industries that are financed through debt, such as large infrastructure projects. A distinction should be made between cases where there is an element of profit shifting as compared to genuine cases.

Country Focus

UK

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Embracing our digital future

The digitalisation of tax is a major trend that will have a significant impact on tax professionals and their clients as it continues to spread globally.

Digitalisation is viewed as attractive for its potential to drive down costs and increase efficiency. It is a less labour-intensive way of helping governments gain insight into their economies and, if efficiently implemented, provides an excellent return on investment for the front-end costs. Tax digitalisation also aims to offer a better service for business owners and citizens through the pre-population of tax returns. The role of the accountant will move from preparer of tax returns to being more of a reviewer and checker.

The UK is a leader in this field: nearly all business returns and 90% of personal tax are now filed online. Recent years have seen increasing levels of tax return information filed electronically and, from 2018, there will be a step change as the government's 'Making Tax Digital' (MTD) agenda begins to be implemented.

The intention is for the system to be fully in place by April 2020, with the changes phased in. Business income tax reporting will go digital from April 2018, VAT from April 2019, and corporation tax the following year.

In practice, this means that UK businesses will need to acquire software or applications that allow their digital tax accounts with HM Revenue & Customs (HMRC) to be updated with details of their business accounting figures. Taxpayers will be required to update their digital tax accounts quarterly, with accounting and tax adjustments being made either quarterly or annually. HMRC believes this will save costs, while helping taxpayers monitor their likely tax liabilities more accurately. The programme will be linked to a new enforcement regime and will introduce the ability to make voluntary tax payments on account – 'pay as you go'.

All individuals – not just those in business on their own account – will have a digital tax account and the intention is that, where possible, information will be automatically populated by HMRC based on data it already receives, such as salary data, which is collected through the Real Time Information (RTI) system. Meanwhile, figures from the quarterly reporting will feed into the same account.

As for the accountants, taxpayers' agents will be able to make, say, year-end accounting adjustments or tax adjustments on their clients' behalf.

All of these changes will require taxpayers and their advisers to make fundamental changes to the way they operate and report incomes, profits and gains for tax purposes. It's a major revolution in the tax arena and, needless to say, the digitally savvy among us will cope better with the changes than others.

The MTD scheme is ambitious and has a punishingly short timetable for implementation, which is particularly concerning given the scale of what the government is hoping to achieve and its track record with large IT projects. The accountancy profession has lobbied to delay the implementation timetable, as well as grant further concessions for small businesses, although attempts have largely fallen on deaf ears.

When it comes to the global approach to digitalisation, it's clearly not a case of 'one size fits all' and there are useful lessons to be learned for the UK – and any other countries considering, or actively implementing, digital schemes.

Australia is an interesting example, as it has already developed a comprehensive digitalisation programme. To achieve a similar feat, other jurisdictions would need to ensure that enough time is factored in for pilot schemes and consulting on service delivery options – avoiding a 'more haste, less speed' approach. Australia has also benefited from experimenting with unusual security options, including the AUSkey and voice pattern recognition.

Russia has rolled out digital tax services at a speed that might make other countries sit up and take notice. Robust pilot testing has been key to this, but the rapid transformation has caused a number of issues, including some inconsistencies across government departments and the increase in compliance costs causing issues for taxpayers.

Estonia's strong central vision for transformation to digital over the last 30 years is a shining example for other countries and has driven the programme to fruition through many changes of administration. However, a more ready cultural acceptance of loss of privacy in order to gain the convenience of digitalisation has played a significant role in fast implementation, and this cannot be universally applied.

Ultimately, regardless of the different approaches being taken, tax digitalisation is spreading across the globe. It is hoped that this will bring transparency and that, as more and more global markets go digital, tax systems around the world will become more efficient.

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Country Focus

UK

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Business Tax Roadmap: Recent changes to the UK's business tax landscape

A number of measures have recently been introduced as part of the UK government's 'Business Tax Roadmap' that was first announced in Budget 2016. The guiding principles behind the Roadmap are to:

- Continue to reduce the UK's corporation tax rate
- Tackle avoidance and aggressive tax planning
- Simplify and modernise the business tax regime.

Corporate interest restrictions and the hybrid mismatch rules have been introduced as part of the UK's ongoing commitment to BEPS initiatives. While these measures introduce restrictions and are likely to result in increased tax for affected companies, changes to the rules for loss relief and the substantial shareholding exemption, in addition to the UK's ongoing commitment to reducing the rate of corporation tax to 17% from 1 April 2020, should provide increased flexibility and tax mitigation opportunities.

Corporate interest restriction

The Finance Bill 2017 introduced draft legislation containing rules to restrict the amount of interest expense that companies can deduct with effect from 1 April 2017.

Broadly, the restrictions will allow all groups to deduct up to £2 million of 'aggregate net tax-interest expense'. This is defined as the sum of each group entity's 'net tax interest expense', being tax interest expense less tax interest income.

Beyond the £2 million de minimis, the rules allow for a deduction of net tax-interest expense at a percentage of 'tax EBITDA', capped at the consolidated net interest expense of the group. The percentage is the higher of:

- The 'fixed ratio' percentage of 30%
- The 'group ratio' percentage of [net group interest expense / group EBITDA].

'Tax EBITDA' represents profit chargeable to corporation tax after taking into account most tax adjustments, with the exception of R&D and other qualifying tax reliefs (e.g. creative industries relief). Interest, capital allowances and intangible fixed asset allowances are added back.

The legislation potentially impacts all UK companies or UK permanent establishments, regardless of size, that claim corporation tax relief for interest and other finance expenses, although many smaller companies will fall below the £2 million de minimis threshold. It does not apply to limited liability partnerships.

The rules apply in addition to transfer pricing, but they have the potential to be significantly more restrictive. In particular, where the group overall has no external interest expense, the total UK deduction across the group could be restricted to £2 million regardless of how much debt could have been raised at arm's length.

Highly leveraged groups are likely to have to rely on the group ratio percentage if net interest expense exceeds 30% of tax EBITDA. The intention of the group ratio is to allow interest on external debt where it relates to UK taxable income, making it likely that a deduction should be secured for senior interest.

The above is a high-level summary of the key aspects of the rules – certain exemptions (for example, the public benefit infrastructure exemption) and anti-avoidance provisions also apply. The detailed rules, including the definitions of the various terms, are complex; groups should review them carefully in the context of their financing structures to determine whether significant restrictions are likely.

Hybrid mismatch rules

New legislation was enacted in the Finance Act 2016 containing provisions to remove tax mismatches arising from the use of hybrid financial instruments and hybrid entities. Broadly, a tax mismatch arises where a double deduction is being claimed for the same expense ('double-deduction outcome') or a deduction is being claimed for an expense without the corresponding receipt being fully taxed ('deduction/non-inclusion outcome').

The rules affect all entities subject to UK corporation tax, including UK permanent establishments (PEs), that enter into arrangements involving both of the following:

- A hybrid instrument or hybrid entity
- A tax mismatch caused by the hybrid.

An entity or a financial instrument is a hybrid for these purposes if, generally, two different jurisdictions apply different tax treatments.

The rules will impact a wide range of structures, most typically those involving entities that are treated as opaque in the country of incorporation but transparent for the investor or parent entity – such as US-parented groups where UK subsidiaries have been elected to be disregarded for US tax purposes ('check the box'). Certain arrangements involving PEs and dual-resident entities will also be affected.

Other structures affected will include those where financial instruments have been entered into that may be treated as debt for the payer entity but equity for the payee, thereby generating an interest deduction with no corresponding taxable income for the investor or parent entity.

The rules are complex; however, broadly, for payments and/or quasi-payments made on or after 1 January 2017 that give rise to a tax mismatch, if the conditions relating to the particular kind of mismatch are met, the mismatch will be countered by either:

- Disallowing the excess deduction claimed; or
- Bringing within the charge to tax in the UK an amount of income representing the mismatch amount.

The legislation targets the following hybrid arrangements where they give rise to either a deduction/non-inclusion outcome or a double deduction outcome:

- Hybrid financial instruments
- Hybrid transfers
- Hybrid entity payers
- Hybrid entity payees
- Dual resident companies
- Arrangements involving PEs.

Further rules relating to 'imported mismatches' also apply where there may have been an attempt to circumvent the main hybrid mismatch rules by routing the mismatch outcome to a third non-UK jurisdiction.

Given the complexity of the rules and the fact that they operate mechanically without the need for there to be any tax avoidance motive, groups with cross-border activities should take steps to review their structures for potential exposures.

The 'imported mismatch' rules mean that arrangements entered into by a UK entity not actually involving a hybrid mismatch can still be caught if there a mismatch elsewhere in the group. It may therefore be necessary to look at the wider group in more detail than has previously been necessary, to understand the overarching arrangements.

Changes to loss relief

The stated policy objective driving these changes is to 'modernise the UK's loss relief regime by increasing the flexibility over the profits that future carried-forward losses can be relieved against while ensuring that businesses pay tax in each accounting period that they make substantial profits.'

Under the current rules, trading losses carried forward within a company must be 'streamed' and are therefore only available to be carried forward and offset against trading profits arising within the same company.

Under the new rules however, both trading and non-trading losses arising from 1 April 2017, and carried forward to subsequent accounting periods, will be available for offset against the total taxable profits of the loss-making company and members of the same 75% group (represented by a principal company and its 75% subsidiaries), effectively enabling 'group relief' of losses carried forward.

The *quid pro quo* is that relief for tax losses carried forward will be restricted to 50% of taxable profits arising after 1 April 2017, subject to a £5 million group *de minimis* where 100% can be offset.

Losses accumulated at 31 March 2017 will not benefit from the increased flexibility of set-off; so, for example, 'old' trading losses can only be set against future profits arising from the same trade. Such losses will, however be subject to the £5 million annual 'allowance' described above.

The legislation does not affect the treatment of capital losses.

Anti-avoidance provisions have been included to prevent trading losses from being carried forward against total future income in periods in which the trade becomes small or negligible, where the trade is carried on wholly overseas or on an uncommercial basis. In these cases, provided the trade is continued, then the current loss relief rules will continue to apply, in that any loss may only be offset against future profits of that trade.

The rules also make changes to terminal loss relief claims.

Where a company ceases to trade in an accounting period it will be able to set any unrelieved trading losses, arising from 1 April 2017, against total profits arising in the final three years of trading. Currently only losses arising in the final 12 months of trade can be offset against profits of the same trade in the final 3 years.

Claims for terminal loss relief under these provisions are not subject to the £5 million restriction.

Losses incurred from 1 April 2017 will be available to surrender between group members, which will allow much greater flexibility within 75% groups (represented by a principal company and its 75% subsidiaries, as noted above). Under the old rules, only current-year losses can be surrendered; this should help to avoid the situation where losses become stranded in a particular group company despite the group being profitable overall.

However, this will be subject to restrictions. In particular, a group relief surrender will be restricted as follows:

- To nil, where the company surrendering the losses has no assets capable of producing income at the end of the accounting period (to prevent losses from being 'stored' in dormant companies)
- Losses must be set first against the company's own profits before they can be surrendered
- Where losses relate to an overseas PE and relief for the loss could be obtained in the territory of the PE, relief will not also be available in the UK.

In addition, a claimant company may not make a claim for group relief under these provisions unless it has first utilised its own losses against its total profits.

Changes to the substantial shareholding exemption (participation exemption)

Gains on the disposal of shares by a company are exempt from tax provided the substantial shareholding exemption (SSE) conditions are met.

From April 2017, it is proposed that the SSE rules be amended to relax and remove a number of these conditions, thus enabling more companies to benefit from the exemption. In particular:

- The condition that the investing company is required to be a trading company, or part of a trading group, is being removed.
- The condition that the investment must have been held for a continuous period, at minimum, of 12 months in the 2 years preceding the sale is being extended to a continuous period of 12 months in the 6 years preceding the sale.
- The condition that the company in which the shares are sold continues to be a qualifying company immediately after the sale is being removed, unless the sale is to a connected party.

Stop Press:

Following the announcement of the 8 June General Election, on 25 April 2017 the government announced that the provisions relating to Corporate Interest, Loss Relief and SSE, given their relative complexity, would be removed from the Finance Bill 2017 to allow it to be passed uncontested prior to the dissolution of Parliament on 3 May 2017. It is probable that the rules will be included in a second Finance Bill after the election however it is uncertain whether, given the delay, the original 1 April 2017 commencement date will remain.

Country Focus

USA

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Where is US corporate tax headed under the new administration?

It is anticipated that US Congress will soon revise corporate tax policy.

Among the proposals coming to the fore, and being hotly debated in business and tax journals, is 'destination-based cash-flow tax' (DBCFT).

It is important to recognise that a DBCFT tax regime differs greatly from our current income tax system, and incorporates two distinct elements: a *cash-flow tax system and a destination-based tax system*. Each of these regimes can operate independently – but the proposed DBCFT combines the distinct approaches.

As such, it is imperative that executives understand how corporate taxation may change under a DBCFT tax regime, and how such a regime might benefit or adversely impact their business.

The cash-flow tax regime

Under a 'pure' cash-flow tax regime, the entity structure used would not be material as tax liability would be based on the net of receipts less capital employed. The borrowing of funds would be a taxable receipt and the payment of interest would be a deductible expense. Capital employed would include purchases of inventory, equipment, rent, utilities and other expenses related to assets used or consumed by the business including loan repayments, interest and labour. Assets would be wholly deducted in the year purchased, and depreciation would no longer have to be computed. There would be no difference in tax based on whether an asset is a capital asset. Business income would be taxed at a single rate.

Under this approach, borrowing would not be encouraged by the tax system, while investment in businesses will be encouraged. No net tax benefit is derived when a company makes an investment with borrowed funds, as the borrowing is considered a taxable receipt and is offset by the asset investment. A net tax deduction is received in the year of investment when a company makes an investment with equity funds.

It is probable that modifications to the pure cash-flow tax regime might be required for certain business sectors whose income might not easily fit within the defined receipt and capital employed concepts. If Congress wishes to provide incentives to certain industries, it will consider granting tax credits to reduce taxes payable.

Tax plans presently being considered by Congress are not 'pure' cash-flow regimes, but rather incorporate significant elements of a cash-flow tax. For example, under plans now being considered, interest expense would not be deductible, while net interest income and non-active income earned by businesses would be subject to tax.

The destination-based tax system

Under a destination-based tax regime, transactions sited in the USA would have a tax consequence while foreign-sited activity ('consumption') would not impact US taxation. So far, Congress is considering the destination-based component of taxation solely for businesses, while individuals will continue to be taxed on their global income.

Under a destination-based regime, receipts from foreign buyers of goods or services would not be subject to US business tax. Because taxable business receipts are determined by where a product or service is consumed, exporters are supportive of this tax regime, as their export receipts will not be subject to US tax, while their cost to produce the exported product would not be deductible.

Importers of goods to the USA, however, are not supportive of this regime, as goods being imported would be subject to US taxation at the border upon importation. It is questionable whether this import tax will increase the price paid by US consumers for foreign goods. Proponents of this tax claim that through price adjustments or foreign exchange adjustments, the cost of the import tax on goods would be lessened or eliminated. However, those objecting to the tax claim that there will be an overall cost increase to the US consumer.

Nevertheless, a destination-based tax regime eliminates the need for US businesses to relocate abroad to reduce their overall effective tax rate. US goods exported to foreign jurisdictions will no longer incur the higher of the US or foreign tax – and income earned abroad can be repatriated free of any additional US tax. Net profits will be considered earned where goods or services are consumed.

Goods imported to the USA would bear US tax at the border, while receipts from the sale of exported goods or services will be exempt from US business tax. Businesses, however, will need to accurately determine the cost of manufactured goods, as such costs will not be deductible in calculating US tax liability.

Conclusion

Both Congress and the new administration have unequivocally promised that tax reform will be a top priority in 2017. Regardless of whether the DBCFT is selected as US tax policy for years to come, business leaders operating stateside and abroad should follow the latest discussions around reform, and plan accordingly to manage the resulting impact.

Morison KSi

Tax Advisory

Australia

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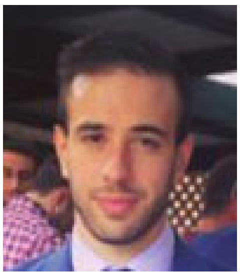

Vincent Scali

New employee share option plan concessions for SME start-ups

Employee share option plans (ESOPs) are a long-standing remuneration practice among many businesses in various jurisdictions around the world. For Australian tax purposes, an ESOP is referred to as an employee share scheme (ESS). Broadly, an ESS involves offering shares, rights, or options in a company to employees generally as an incentive to align the goals of owners and employees and to introduce a shared sense of ownership in the business.

ESS themselves have been an effective means for companies to attract, retain and motivate key employees for many years. However, the Australian tax laws governing ESS have constantly changed and morphed over the last decade, resulting in both favourable and unfavourable outcomes for Australian taxpayers. The ESS tax rules have been convoluted, inconsistent in their application, and a constant source of uncertainty for both Australian and foreign taxpayers. In recent years, these tax rules have been revised yet again.

This article is not intended to cover all aspects of the new ESS rules, but rather to focus on the generous new tax concessions offered to eligible start-up businesses from 1 July 2015. These tax concessions could include deferral of taxing point and generous capital gains tax (CGT) treatment which may also qualify for the general 50% CGT discount.

Generally speaking, ESS interests (i.e. shares, rights or options) issued to employees at a 'discount' to their market value are taxed up-front as income unless they meet the requirements for deferred taxation. However, if employees of certain small to medium enterprise (SME) start-ups are eligible for the new ESS start-up concessions, the employee will not be taxed on grant or vesting of the ESS. Furthermore, in the case of options there is no taxing point on exercise either. Instead, the first taxing point will be on ultimate disposal of the shares which is taxed on capital account and which may also attract the general 50% CGT discount where the shares are held for more than 12 months.

The concessions under new ESS rules and requisite conditions are explained below:

What are the ESS start-up concessions?

For shares to which the concession applies:

- The discount is exempt from tax; and
- Shares will be subject to the CGT rules with a cost base equal to the market value at the time of acquisition.

For rights to which the concession applies:

- The discount is no longer subject to up-front taxation; and
- The share received upon exercise of the right are subject to the CGT rules. The cost base of the shares will be equal to the employee's cost of acquiring the right.

What conditions must be satisfied?

For the ESS start-up concessions to apply, the following conditions must be satisfied by the company (the test company):

- The test company (including any holding companies or subsidiary of a holding company) must *not* be listed on a stock exchange at the end of the most recent income year before the ESS interest is acquired by the employee

- The test company (including any holding companies or subsidiary of a holding company) was incorporated by or under an Australian law or foreign law less than 10 years before the end of the most recent income year before the ESS interest is acquired by the employee
- The test company has an aggregated turnover of less than Au$50 million for the income year before the year in which the employee acquired the ESS interest
- Where the ESS interest is a share – the *discount is less than 15%* of its market value at the time the employee acquired the interest
- Where the ESS interest is a right – the *exercise price of the right is greater than or equal to the market value of an ordinary share* in the company at the time the employee acquired the interest
- The employer of the employee must be an Australian resident
- The employee is an employee of the test company or a subsidiary of the test company when they acquire the ESS interest
- All the ESS interests available for acquisition under the scheme relate to ordinary shares
- The employee is not permitted to dispose of the ESS interest for a period of 3 years starting from when the ESS interest was acquired
- At least 75% of the Australian resident permanent employees of the employer, with at least 3 years of service are, or have at some time been entitled to acquire ESS or ESS interests under the scheme (however, we note that options do not need to satisfy this requirement)
- The employee must not hold a beneficial interest or voting power of more than 10% in the test company immediately after acquiring the ESS interest.

Each of these three requirements are to be satisfied at the end of an income year, therefore it is possible to be eligible for the ESS start-up concessions in the next income year even if those requirements are failed in that next income year.

Eligibility of ESS start-up concessions for foreign companies

As outlined above, a condition of the ESS start-up concessions is that the employer must be an Australian resident. However, this condition does not require that the entity issuing the ESS interests must be an Australian resident. In other words, a foreign company will qualify for the ESS start-up concessions if it has a subsidiary that is both the employer and an Australian resident, provided all other conditions are satisfied.

How are ESS interests taxed under the start-up provisions?

For ease of reference, Table 1 outlines how the ESS interests are taxed under the ESS start-up provisions.

In summary, the introduction of the new ESS start-up concessions are a welcome change for Australian SME businesses. However, the Australian ESS tax rules are complex and there are various traps and pitfalls that companies should be wary of.

Table 1. Taxation of ESS interests under start-up provisions.

Tax features	Shares	Options
No upfront taxing point	✔	✔
The ESS deferred taxing points do not apply (this means no taxing on cessation of employment, exercise of the option or lifting of any sale restrictions on the shares)	✔	✔
No CGT event on exercise of options	✖	✔
CGT cost base	Cost base will equal market value at grant date. That is, if the shares have a market value of $1.00 and are acquired for $0.50, the cost base is $1.00	Cost base of the shares acquired on exercise of the options will equal the exercise price
CGT event	Generally when shares are sold	Generally when shares acquired on exercise are sold or the options themselves are sold
CGT discount	Available if shares sold >12 months from date of grant	Provided that the option or share is sold >12 months from when the option was granted, the participant should be eligible for the CGT discount

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Tax Advisory

Canada

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USA–Canada cross-border investments using an unlimited liability company

Unlimited liability companies (ULCs) have become useful vehicles for investments in Canada by a US investor. This article summarises the advantages of using a ULC, the treatment of a ULC in Canada and in the USA, and the use of the ULC in structuring US investments in Canada.

What is a ULC?

The Canadian provinces of Alberta, British Columbia and Nova Scotia allow for the creation of ULCs under their respective statutes. A ULC is a hybrid entity: it is treated as a corporation for Canadian tax purposes, and can be treated as a flow-through or disregarded entity for US tax purposes.

An ULC may be an attractive investment vehicle for a US investor starting a business or expanding into Canada for many reasons, for example:

- It avoids double taxation in the USA, as, unlike Canada, the USA does not provide full integration between corporate and personal taxation that may arise in corporate structures
- It allows for losses (including start-up losses) to flow through to shareholders to offset a US shareholder's income
- It allows for investment in passive investments in Canada without triggering US anti-avoidance rules for foreign holding companies
- It provides flexibility to defer US income tax on the ULC's income by allowing US shareholders to elect to 'check the box' to treat the ULC as a corporation for US tax purposes, so that the ULC income will not be taxed until it is repatriated
- It has less stringent requirements to have Canadian directors.

Canadian tax treatment of ULCs

As stated, a ULC is treated like any other corporation for Canadian tax purposes. Depending upon its particular features, it could be taxable as a private or public corporation, but practically it will be a private taxable Canadian corporation. Like other Canadian corporations, a ULC is eligible for protection under the Canada–USA tax treaty ('the Treaty').

Since an ULC is considered an ordinary corporation for Canadian tax purposes, interest, dividends, royalties and other payments from a Canadian ULC to a US shareholder are subject to 25% withholding tax under the Canadian Income Tax Act (the 'Tax Act'). The Treaty has historically reduced or eliminated such withholding taxes on many types of payment to US recipients, allowing ULCs to remain tax-efficient for US investors. Under the Treaty, the withholding rates on these types of payment range from 0% to 15%.

US tax treatment of a ULC

For US tax purposes, a ULC is classified as a branch (if there is one shareholder) or a partnership (if there is more than one shareholder). ULC can elect under the 'check the box' regulations to be treated as a corporation. If the ULC is classified as a partnership or branch, then for US purposes it is treated as a flow-through entity.

In the end result, the ULC is a hybrid entity – a corporation for Canadian tax purposes and a flow-through entity for US tax purposes.

As an entity classified as a partnership for US tax purposes, the income or losses of the ULC are directly attributable to the US shareholders. Thus, losses incurred by the ULC would be directly deductible by the US shareholder on the US income tax return. Conversely, income earned by the ULC would be included in the US tax return and any Canadian income taxes incurred on such income would be creditable against US tax.

Exploiting the benefits of the ULC in cross-border investments

As described above, the 'hybrid' character of a Canadian ULC may frequently allow a non- resident investor to simultaneously reap the tax advantages afforded by both the Canadian and US tax systems when structuring cross-border investments. Of particular interest to non-resident investors, acquisition structures utilising Canadian ULCs have been developed to facilitate the purchase of Canadian businesses on a tax-advantaged basis for US tax purposes without triggering significant Canadian income tax liabilities.

The use of ULCs has proven to be a popular means for non-residents of Canada to acquire and hold Canadian assets or businesses. Since ULCs are regarded as corporations for Canadian tax purposes, interest, dividends, rent, and service fees paid to a ULC from a Canadian payer are not generally subject to non-resident withholding tax under Part XIII of the Tax Act, even though the ULC may be treated as a pass-through entity for US federal tax purposes. Accordingly, US-resident investors wishing to lend funds, acquire rental property, or provide services in Canada often undertake such activities through a ULC to avoid having Canadian tax withheld from Canadian-sourced receivables. Effectively, the use of a ULC as an intermediary entity allows a non-resident investor to internally manage its Canadian withholding tax liabilities and potentially employ strategies to reduce its aggregate Canadian withholding tax burden.

In addition, a US resident wishing to acquire a Canadian business may be able to secure certain US tax benefits by structuring the contemplated acquisition through a ULC. In many cases, conflict can arise where a US resident wishes to purchase the assets of a particular Canadian business, while the shareholders of the Canadian business are more inclined to sell the shares of the entity that operates the business. By utilising a ULC to effect the acquisition of the business in question, the conflicting interests of both the Canadian vendor and the US purchaser may be simultaneously satisfied.

Finally, with careful tax planning in the proper circumstances, and in situations where the benefits of a ULC align with a US investor's tax and business objectives, the ULC remains a useful alternative for structuring investment or expansion by US investors and businesses into Canada.

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OECD Update

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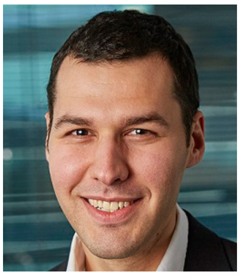

Philip Brudney

Transfer pricing: Re-evaluating profit splits

As part of its BEPS initiative, the OECD identified as one priority 'Aligning Transfer Pricing Outcomes with Value Creation' via Action Plan 8–10. Through a series of discussion drafts, the OECD has promulgated its view of the way forward for transfer pricing for multinationals in the global economy. One of the key drafts addresses the use of the profit split method in transfer pricing, and presents several key issues for multinational companies as they examine their global transfer pricing policies.

Background

The most common transfer pricing method is the transactional net margin method (TNMM). A typical TNMM analysis treats the least complex party to a transaction as the 'tested party.' The TNMM assigns a routine return to the tested party for the functions it performs using financial data for comparable companies. For example, if a German-based manufacturer has a UK subsidiary that distributes its products in the UK, that UK subsidiary would typically be treated as the tested party and would earn a simple distributor's return. The remaining income relative to the transaction would accrue to Germany.

As described below, the profit split requires that both parties make a contribution beyond the routine return ascribed to the tested party under a TNMM. The profit split method aims to divide the combined profit or loss of associated enterprises in accordance with the division of profits that would have been expected in an arm's length agreement. The division of profits is typically in accordance with each company's contribution to the transaction. In the example above, if the UK company creates significant marketing intangibles, then the UK subsidiary would earn an additional return for these intangibles and report more income in the UK.

Analysing the multinational group

In practice, the analysis of whether a profit split method applies begins with a review of a multinational company's global value chain. According to the OECD, a value chain analysis identifies the features of the commercial or financial relationships between parties to a transaction, including where and how value is created in the business operations. A value chain analysis will provide information including:

- The key value drivers in relation to the transaction, including how the associated enterprises differentiate themselves from others in the market
- The nature of the contributions of assets, functions and risks by the associated enterprises to the key value drivers, including consideration of which contributions are unique and valuable
- Which parties can protect and retain value through performance of important functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles
- Which parties assume economically significant risks or perform control functions relating to the economically significant risks associated with value creation
- How parties operate in combination in the value chain, and share functions and assets in parallel integration (as described below).

The OECD guidance elaborates that a profit split reflects a relationship where the parties either share the same economically significant risks associated with the opportunity, or separately assume closely related risks, and consequently should share in the resulting profits or losses. In particular, the sharing of risks may be identified by a high degree of integrated functions or the making of unique and valuable contributions by each of the parties, such that the contributions cannot reliably be evaluated in isolation. Risks might be shared, and a profit split more appropriate, where two parties jointly develop intellectual property or perform marketing activities. This contrasts with a classic value chain, where each party performs a discrete function. Such a case may be evidenced by parallel integration within the value chain such that multiple parties are involved in the same stage, rather than sequential integration where parties perform discrete functions.

Assessing the results

The review of the global value chain will often suggest that certain aspects are highly integrated, and a profit split may be necessary. From a tax perspective, however, the profit split will not be desirable in all cases. Recall that the profit split will result in more income allocated to a jurisdiction that would receive only a routine return under a traditional TNMM. Therefore, depending on tax rates in the various jurisdictions involved, a profit split may or may not be tax advantageous.

Take, for example, a US-based company manufacturing in several offshore jurisdictions. Upon review of the company's functions, it was determined that the offshore manufacturing operations performed significant development activities that could not reliably be evaluated in isolation, and therefore a profit split may be appropriate. The profit split was also tax advantageous because the offshore operations were taxed at a lower rate than the USA's 35% corporate tax rate. Given the current uncertainty regarding US tax rates, changes may be necessary in the future to reassess profit splits involving US operations.

If a change is deemed appropriate, the multinational must actually be able to move the value creation between jurisdictions. The OECD makes clear that a simple contractual adjustment of risk is not sufficient:

[R]isks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. (OECD Discussion Draft on BEPS Actions 8–10)

OECD guidance further explains that a company manages risk (and receives the associated reward) only if it has:

- the capability to make decisions to take on or decline a risk-bearing opportunity;
- the capability *and actual performance* of making decisions on how to respond to risks; and
- the capability to mitigate risk.

Some risk management may be outsourced, provided the enterprise outsourcing the risk has the capacity to decide whether to outsource and also oversees the third party. A company wishing to adjust the risk profile of a group member must ensure that the company is sufficiently capitalised to bear risk and that local employees have the capability and autonomy to actually manage the risk. Similarly, for any function being shifted to another jurisdiction, the employees in that jurisdiction must have the capability to perform that function and must actually perform it.

As tax authorities worldwide implement OECD guidance and reconsider the applicability of profit split methods, maintaining proper transfer pricing documentation remains crucial to avoiding prolonged tax audits or potential double taxation. The documentation should contain a detailed functional analysis to illustrate where value-creating activities are performed and substantiate whether a profit split should be used. Multinational companies should also ensure that their intercompany agreements are updated to reflect their desired transfer pricing outcome. They then must monitor the actual conduct of companies involved to ensure that the division of functions and risks matches the agreements, as tax authorities will generally look to facts and circumstances rather than the form of agreements.

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International Tax Headlines

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Australian Senate passes legislation to impose diverted profits tax (DPT) from 1 July 2017

On 27 March 2017, the Australian Government has successfully legislated a new diverted profits tax, which will prevent multinationals shifting profits made in Australia to avoid paying tax. The diverted profits tax will commence on 1 July 2017. It will reinforce Australia's position as having one of the toughest laws in the world to combat multinational tax avoidance.

Indian government notifies the amended India–Singapore tax treaty

On 23 March, India published a notice in its Official Gazette confirming that a third protocol to the double tax avoidance agreement (DTAA) with Singapore has entered into force. The India–Singapore DTAA at present provides for residence-based taxation of capital gains of shares in a company.

The third protocol amends the DTAA with effect from 1 April 2017 to provide for source-based taxation of capital gains arising on sale of shares in a company. This will curb revenue loss, prevent double non-taxation and streamline the flow of investments. In order to provide certainty to investors, investments in shares made before 1 April 2017 have been grandfathered subject to fulfilment of conditions in a limitation of benefits clause as per the 2005 protocol. Further, a 2-year transition period from 1 April 2017 to 31 March 2019 has been provided during which capital gains on shares will be taxed in the source country at half the normal tax rate, subject to fulfilment of conditions in the limitation of benefits clause.

The third protocol also inserts Article 9(2) in the DTAA, which would facilitate relieving of economic double taxation in transfer pricing cases and also enables application of domestic law and measures concerning prevention of tax avoidance or tax evasion.

The protocol was signed on 30 December 2016, and entered into force on 27 February 2017.

South Africa to exchange tax information with over 50 jurisdictions

On 27 February 2017, the South African Revenue Service (SARS) has committed to the automatic exchange of tax information with the revenue authorities of over 50 other jurisdictions under the OECD Common Reporting Standard (CRS) by September 2017. The adoption of the CRS by South Africa obliges a number of reporting financial institutions to report specific information of clients that are not tax resident in South Africa to SARS by 31 May 2017. Financial information that is required to be reported by financial institutions would include interest, dividends, account balances, income from certain insurance products, sales proceeds from financial assets, and other income generated with respect to assets held in the account or payments made with respect to the account.

UK to expand double tax treaty passport scheme

HM Revenue & Customs (HMRC) is planning to make its double taxation treaty passport (DTTP) scheme available to all UK borrowers following a consultation on a legislative amendment. The DTTP scheme provides for double taxation relief on UK loan interest payments made by a UK corporate borrower to overseas corporate lenders. The scheme will be made available to all UK borrowers that have an obligation to deduct withholding tax, including UK partnerships, individuals, and charities. The terms and conditions and guidance for the scheme will be updated on 6 April 2017.

Singapore updates transfer pricing guidance

On 12 January 2017, the Inland Revenue Authority of Singapore (IRAS) released its 4th edition of their transfer pricing guidelines. In its latest guidance, the IRAS has enhanced the guidance on arm's length principle and functional and risk analysis. Specifically, the IRAS has amended the relevant paragraphs of the guidance to note that profits should be taxed where the real economic activities generating the profits are performed and where value is created.

Italy issues rules for implementation of country-by-country reporting

On 8 March 2017, a ministerial decree was published in the Italian government's Official Gazette for implementing the rules of Law no. 208/2015 with respect to country-by-country (CbC) reporting. The requirements of the Italian CbC reporting rule are generally in line with the relevant OECD guidance and 2016 EU Directive.

India continues to conclude several APAs

On 28 February 2017, India's Central Board of Direct Taxes (CBDT) announced that India has entered into new bilateral advance pricing agreements (APAs) with the UK and Japan. The CBDT also signed seven unilateral APAs pertaining to various sectors of the economy – such as telecoms, pharmaceuticals, banking and finance, steel, retail, and IT – and cover international transactions involving royalties, software development services and interest payments. Some of the APAs include roll-back provisions. With the latest agreements, the total number of APAs entered into by India has reached 140 (including 130 unilateral and 10 bilateral). More are expected to be concluded and signed in the near future.

Morison KSi

International Tax Cases

Judgement of Hon'ble Andhra Pradesh High Court in case of Principal Commissioner of Income Tax-3 v. R.A.K. Ceramics India (P) Ltd [2017] 78 taxmann.com 230 (Andhra Pradesh)

The above judgement pertains to Assessment Year 2010–11

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

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Facts of the case

- The assessee, M/s RAK Ceramics India Pvt. Ltd ('RAK India'), is a wholly owned subsidiary of M/s RAK Ceramics PSC, UAE ('RAK UAE'). Accordingly, RAK India and RAK UAE are associated enterprises.

- RAK India is engaged in manufacturing vitrified tiles and sanitary ware in India for sale in domestic and international markets.

- During AY 2010–11, RAK India entered in to a royalty agreement with RAK UAE. As per the said agreement, RAK UAE was to provide technical assistance on process and product improvement to the assessee along with any other service as specified in the agreement. In consideration, RAK India was to pay royalty equivalent to 3% of the net ex-factory sale price of the products.

- RAK India made payment of the above-mentioned royalty to RAK UAE during AY 2010–11 and while filing the return of income for the relevant year, RAK India claimed deduction of the said payment of royalty.

- Further, RAK India also furnished a transfer pricing (TP) study before the transfer pricing officer (TPO), wherein the said transaction was justified by adopting Transaction Net Margin Method (TNMM).

Contention of assessing officer

The TPO contended that the said payment of royalty should be restricted to 2% of the net ex-factory sale price of the products instead of 3%, due to the following reasons:

- The TPO held that the assessee did not fulfil the conditions of 'benefit test' since there was no perceptible change in the sale or profit that could be attributed to receipt of technical know-how from RAK UAE, to justify payment of royalty at 3% to RAK UAE.

- The TPO further contended that substantial expenditure had been incurred by RAK India on advertising and marketing, and it was these efforts that had yielded increased revenue and profit.

Accordingly, the TPO made a TP adjustment equivalent to 1% of the net ex-factory sale price of the products and the said adjustment was also confirmed by the dispute resolution panel (DRP). The TPO accordingly passed the assessment order.

The TPO also rejected the TP study filed by RAK India (wherein TNMM was applied by RAK India to justify the royalty payment made to RAK UAE), stating that the assessee had clubbed an intangible transaction with tangible transaction. In response, RAK India filed an alternative TP study wherein the royalty payment was justified by using comparable uncontrolled price method (CUP), but the TPO rejected the alternative TP study also, stating that that the database used by the assessee was in relation to US-based companies and copies of their agreements had not been furnished.

Contention of assessee

- Rule 10B of the Income-tax Rules 1962 ('the Rules'), which deals with 'Determination of arm's length price', does not mention applicability of the benefit test for determining the arm's length price. Accordingly, the use of this test by the TPO was not justified.

- It is not for the Revenue to dictate how the assessee should go about running its business or how it should source its technical know-how.

- The assessee placed reliance on the judgement of the Supreme Court in the case of **CIT v. Walchand & Co. (P.) Ltd. [1967] 65 ITR 381**, wherein it was held that for determining the commercial expediency of any expense claimed by the assessee, the assessing officer needs to adjudge the same from the point of view of the businessman and not of the Revenue; that is, it is open to the Revenue to determine whether an expenditure has not been incurred wholly and exclusively for the purpose of business or not, but it is not open to the Revenue to determine the quantum of expenditure that should have been incurred by the assessee.

Contention of Income Tax Appellate Tribunal (ITAT)

On appeal to ITAT, the Tribunal decided the case in the favour of the assessee and deleted the TP adjustment made by the TPO, because:

- No analysis had been undertaken by the TPO in fixing the arm's length price of the royalty payment.

- Further, TPO had not adopted any of the methods prescribed under Section 92CA of the Act for determining the arm's length price. Accordingly, the Tribunal rejected the application of the benefit test adopted by the TPO.

Decision of High Court

The High Court decided the case in favour of the assessee and accordingly deleted the TP adjustment made by the TPO on the following basis:

- Once the comparables were rejected by the TPO, it was for the TPO to come up with other comparables to justify reduction of the royalty payment. However, no such exercise was undertaken by the TPO.

- Once it is admitted by the Revenue that the assessee has entered in to a royalty agreement and the assessee has claimed benefit from such agreement by way of increase in sales with no apparent increase in cost, it was not for the TPO to determine what could be the other reasons for increase in the assessee's sales and profit.

- The TPO decided to reduce the contractual rate of royalty from 3% (as claimed by the assessee) to 2% without explaining how this reduced percentage was calculated.

Editorial Comments:

The High Court has relied upon the judgment of the Supreme Court and has correctly held (1) that there must be reasons for rejecting the comparables and (2) that reducing the percentage of royalty paid cannot be done arbitrarily.

The Next Step

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