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Building Better Business Globally

Editorial

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The United Nations Committee of Experts on International Co-operation in Tax Matters issued a discussion draft on 1 September 2020 on 'inclusion of software payments in the definition of royalty'. Taxation of software has been a vexed issue, with both taxpayers and tax administrators having forceful arguments in their favour. The draft is out for public comments, which must be sent by 2 October 2020.

The definition of the term 'royalties' in paragraph 3 of article 12 of the UN Model would be amended as follows (the proposed addition appears in ***bold italics***):

The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, ***computer software*** or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

The reasons put forth by the members of the committee to change the definition, and reasons given for opposing the change, are summarised below.

Major reasons for change

- The global importance of software justifies allocation of taxing rights
- Remove the blurred distinction between copyright and copyrighted software
- Source state protection, given that computer software is easily and cheaply reproducible
- Domestic laws of various states include 'software' in the royalty definition.

Major reasons against the change

- For taxation of sale, software should be treated just like other goods
- The argument for source rule taxation is itself not a justification for change, because this argument could be extended to other categories of products such as natural resources
- 'Software' is already covered as royalty in some existing treaties, so there is no need for a change
- Practical difficulties may be encountered when software is purchased by an individual, and in cases where it is embedded in other products.

The comments received will be discussed at the next meeting, which will take place between 26 October and 2 November 2020. The OECD is already working on a consensus on the taxation of digital payments, and it will be interesting for tax professionals to see how these issues finally pan out.

When this Q3 edition is circulated, we will be completing 8 years of publication of this newsletter. I would like to say a big 'thank you' to all member firms who have regularly contributed over the years, as without their support this journey would not have been possible.

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Capital gains tax update

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These 'anti-avoidance' measures could impact transactions that occurred between 6 April 2019 and 11 March 2020, and may subject these transactions to the new £1m lifetime limit

After much speculation about the abolition of Entrepreneurs' Relief (ER) in the run-up to the Budget announcement in March this year, the UK government decided to retain the relief in order to encourage genuine entrepreneurial risk-taking.

ER (now known as Business Asset Disposal Relief [BADR]) is a relief from UK chargeable capital gains tax (CGT) on qualifying disposals of business assets. Where BADR applies, the rate of CGT payable reduces from 20% to 10%.

However, the relief has been significantly curtailed by reducing the lifetime limit for qualifying gains from £10m to £1m, the level it was at when first introduced in 2008.

The changes

For disposals on or after 11 March 2020, BADR claims will be limited to the first £1m of lifetime gains – meaning any individual who has already claimed Entrepreneurs' Relief on gains of £1m or more will no longer qualify for the relief on any future disposals.

Furthermore, anti-forestalling provisions were also introduced which may apply the new £1m limit to arrangements/transactions entered into before 11 March 2020. The new Finance Bill makes these anti-forestalling measures even more wide-ranging, such that they now also apply to share reorganisations that may have taken place more than 11 months before the Budget.

In particular, these 'anti-avoidance' measures could impact transactions that occurred between 6 April 2019 and 11 March 2020, and may subject these transactions to the new £1m lifetime limit. The measures are also wide-reaching and may, perhaps unintentionally, catch commercial and non-tax motivated transactions and company restructurings that happened as far back as April 2019.

Other reliefs

Investors' Relief, which permits qualifying shareholders to benefit from a 10% rate of CGT on the first £10m of capital gains, is to continue unchanged. Investors' Relief is available to investors in qualifying shares of an unlisted trading company (or the holding company of a trading group) but, unlike BADR, is only available to investors who are not employees involved in the running of the business.

Shareholders may also want to consider whether they could introduce an 'employee ownership trust' to their company. Where a shareholder sells a controlling interest in their company to such a trust, and various conditions are met, a 0% tax rate is available on any gain that arises on the sale.

Review of capital gains tax

On 14 July 2020, the Chancellor sent a letter to the Office of Tax Simplification requesting it to 'undertake a review of capital gains tax and the aspects of the taxation of chargeable gains in relation to individuals and smaller businesses'.

The following day, the scope of the review was published and a call for evidence was opened, Part 1 (high-level principles) running until 10 August 2020 and Part 2 (technical detail and practical operation) running until 12 October 2020.

There is again much speculation around the likely changes or cuts to CGT, but most advisors consider an increase in rates likely. There are currently four rates of CGT: 10%, 20%, 18% and 28%. These depend on the level of the taxpayer's income for the tax year and the type of asset the gain has arisen from. As such, one option would be to align CGT with income tax rates, which can be as high as 45%.

continued over

Clients with UK chargeable assets who are considering a disposal in the near future should seek advice and revisit these decisions, and perhaps accelerate the disposals to secure what is currently a BADR rate of 10% where available or CGT rates no higher than 28%.

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The Canada Revenue Agency is now auditing US real estate transactions of Canadians – going back 6 years

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Information that will be verified includes municipal addresses, square footage, names of the owners, sales histories, and property tax assessments

The Canada Revenue Agency (CRA)'s audit programmes continue to be updated. On 25 June 2020, the CRA announced one of its newest programmes: they will now audit the US real estate transactions of Canadians, looking back as many as 6 years.

Property records in the United States will be reviewed by CRA for any record of Canadian ownership. Information that will be verified includes municipal addresses, square footage, names of the owners, sales histories, and property tax assessments. This represents an extensive search of a foreign database to uncover taxable transactions involving Canadians – a very rare step indeed, without a specific prior indication and in a specific case.

The exposure for Canadian taxpayers is extensive, as outlined below.

Unreported foreign property

All Canadian residents are required to disclose their holdings of foreign income producing assets when the aggregate amount of those assets exceeds (Can) $100,000. Most real property will qualify.

This is true regardless of whether the owner is an individual, a corporation, or a trust: all three forms of ownership require this disclosure. CRA has communicated that they will be reviewing deeds and other evidence of ownership in US real estate transactions – it should be assumed that hiding ownership will be extremely difficult, if not impossible.

The penalties for not reporting ownership of foreign property are automatic and significant. The penalty is calculated at $25/day, to a maximum of $2,500 per instance. The penalty could increase to as much as 5% of the cost of the foreign property if more than 24 months have passed.

Unreported rental income

Airbnb, VRBO, and other online platforms nowadays make it extremely easy to arrange the casual rental of property. Renting your real estate through such channels can look like an easy way to make money. For Canadian residents, income from US real estate is taxable in Canada as well as in the United States, whether it is one rental day or 365.

The CRA will be looking into these activities in detail. Unreported rental activity that has taken place on any portal or posted online could be easy to verify by the Canadian tax authorities. Through the mutual assistance agreement in the Canada–US Tax Treaty, the CRA has the authority to request records from the IRS, verify if rental income was withheld by renting agents and remitted directly to the IRS, or request any returns that were filed with the IRS. The CRA can also review and deny deductions of rental expenditures, and has the ability to make sweeping assumptions and assess tax when records are not available. Taxpayers are advised to get their records in order as soon as possible.

Unreported property sales

Each year, thousands of Canadians and Americans change their residence between Canada and the United States. In Canada, taxpayers receive an exemption for the sale of their principal residence. However, the sale must still be *reported* to the CRA, and there is a penalty of up to $8,000 for not reporting the disposition of a principal residence. Canadians moving from the United States to Canada may simply have forgotten, or not known how, to report the sale on their Canadian tax returns before taking up US residence.

Sales of non-principal residences are also on CRA's radar. This could include transfers that may often be considered non-taxable, such as a 'quitclaim' transfer. The quitclaim deed is a non-warranty deed used to transfer property interest without any guarantees. It is often used between related parties, or between owners and entities they control, because the documentation required is minimal. In Canada, however, transfers between any related party, individual or otherwise, are deemed to take place at fair-market value. (Special elections are available for transfers between owners and entities). These transactions are *taxable*. This fact may not be appreciated by owners transferring property using a quitclaim deed.

Inadequate or inappropriate documentation

Many taxpayers enter into real estate transactions using alternative legal entities to hold the assets (trusts, bare trusts, partnerships, etc.) but fail to go through the formalities to document the transfer or purchase of the real estate by these legal entities . Either the entity has not filed the proper annual tax and information returns with the CRA, or perhaps the entity was never even constituted in the first place (i.e. registering title as a 'trust' without creating the trust agreement). Any of these pitfalls can spell big trouble when the transactions are audited. Income that taxpayers may have thought was sheltered from tax, or deferred, in fact may not be. Title to property, which taxpayers thought was hold by a particular entity or person, may in fact not be. Transfers, which owners *thought* had occurred, may not legally have occurred. Property could be exposed to creditors when in fact it was thought to be protected. This can be particularly problematic in cases where the original owner has died, or where the property is part of an estate plan. Years of overdue taxes, penalties, and interest could be the result.

Impacts – and what to do?

With Canada's very close ties to the United States, the number of Canadians purchasing real estate in the United States is bound to keep growing. Experts estimate that in 2018, Canadians purchased 27,400 properties, valued at (US) $10.5B in total.[1] The average purchase price is estimated to have been $383,900. In 2017, the number of homes was over 30,000, with an average price over $500,000.[2]

Any taxpayer with US real estate is advised to review their documentation. Ensure that you have properly documented title and beneficial ownership. Review your tax filings in both countries. Review your holdings structure, ensure that all entities are properly documented and that a professional has commented on any estate tax implications.

This latest CRA audit programme could turn out to net a great deal in unpaid taxes. The implications for Canadian holders of US real estate is clear: it is time to get your houses in order.

> *Experts estimate that in 2018, Canadians purchased 27,400 properties, valued at (US) $10.5B in total*

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Extending the Instant Asset Write-Off

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Under the instant asset write-off provision, eligible businesses can claim an immediate tax deduction for the business portion of the cost of an asset below the instant asset write-off threshold amount in the year the asset is first used or installed ready for use.

Eligibility to use instant asset write-off on an asset depends on:

- The business aggregated turnover (the total ordinary income of the business and that of any associated businesses)
- The asset purchase date and when it was first used or installed ready for use
- The cost of the asset being less than the instant asset write-off threshold.

The Australian government has enacted the Coronavirus Economic Response Package Omnibus Act, 2020 (Act No. 22 of 2020), which received Royal Assent on 24 March 2020, in response to the economic conditions caused by COVID-19. Schedule 1 of this Act has amended the instant asset write-off provision as follows:

- Expands the eligible businesses with aggregated turnover of less than $500m (up from $50m)
- Increases the instant asset write-off threshold to $150,000 (up from $30,000) for assets first used or installed ready for use for taxable purposes from 12 March 2020 to 30 June 2020.

On 19 June 2020, The Treasury Laws Amendment (2020 Measures No 3) Act, 2020 (Act No. 61 of 2020) received Royal Assent. Schedule 4 of this Act has amended the income tax law to extend the instant asset write-off for an additional 6 months to allow eligible businesses with aggregated turnover for the income year of less than $500m to immediately deduct the cost of a depreciating asset less than the $150,000 threshold and be first used or installed ready for use for taxable purposes on or after 12 March 2020 to 31 December 2020. (*Note:* Without this amendment, the $150,000 instant asset write-off would end on 30 June 2020.)

Changes to the instant asset write-off thresholds and aggregated turnover for eligible businesses over the last few years are summarised in the table.

Extending the previous end date of 30 June 2020 to 31 December 2020 has given businesses additional time to access this $150,000 instant asset write-off on their investments that may have been delayed by the supply chain disruptions during the coronavirus outbreak. Additionally, the amendments will further strengthen cashflow support to businesses and encourage a stronger economic recovery following the pandemic.

Eligible businesses aggregated turnover	Date range for first use or installed ready for use	Threshold
Less than $2 million	1 January 2014 to 7.30 pm on 12 May 2015	$1,000
Less than $2 million	7.30 pm on 12 May 2015 to 30 June 2016	$20,000
Less than $10 million	1 July 2016 to 28 January 2019	$20,000
Less than $10 million	29 January 2019 to 7.30 pm on 2 April 2019	$25,000
Less than $50 million	7.30 pm on 2 April 2019 to 11 March 2020	$30,000
Less than $500 million	12 March 2020 to **31 December 2020**	$150,000

Cameco Corporation (Federal Court of Appeal, Canada)

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Federal Court of Appeal of Canada decides in favour of Cameco Corporation affirming the principle that the 'commercial rationale' arrangement should be respected as structured by the taxpayer

In a decade-old tax litigation on applicability of the re-characterisation provision[1] prescribed in Canadian transfer pricing regulation, Canada's Federal Court of Appeal (FCA) decided in favour of the taxpayer, Cameco Corporation[2], affirming the principle that the 'commercial rationale' arrangement should be respected as structured by the taxpayer. This is the first ever case to interpret the re-characterisation provision under the Canadian transfer pricing rules.

Facts of the case

Cameco group, headquartered in Canada, is an integrated uranium producer and supplier to nuclear power plants across the globe. Cameco Corporation ('Cameco Canada') is the group parent company, based in Canada. Since 1993, Cameco Canada had been negotiating with a Russian government company, Tanex, and another uranium enricher, Urenco, for supply of uranium of Russian origin. In pursuance of the operational restructuring, during 1999, instead of directly entering into a contract of buying uranium with Tanex and Urenco, Cameco Canada allowed its Switzerland-based subsidiary company to purchase uranium from Tanex and Urenco. Besides buying uranium from Urenco and Tanex, Cameco Switzerland would also buy uranium from Cameco Canada for reselling. The market price of uranium in 1999, at the time contract for supply of uranium was entered into between Cameco Switzerland with Urenco and Tanex, was low. However, after 2002 and at the time of reselling the uranium by Cameco Switzerland, the price increased substantially, resulting in substantial profits earned by Cameco Switzerland.

The Canadian Revenue Agency (CRA) was of the view that the profit arising to Cameco Switzerland belonged to Cameco Canada. CRA reassessed the income of Cameco Corporation for tax years 2003, 2005 and 2006 and made an aggregated transfer pricing adjustment amounting to (Ca)$480m on the basis that Cameco Canada, and not Cameco Switzerland, was entitled to supernormal profit.

Arguments by the parties

CRA argued that the arrangement of having Switzerland for trading was a 'sham' and was not commercially rational. The CRA argued that a third party would not have let go a potentially profitable business opportunity. CRA further argued that Cameco Switzerland did not perform valuable functions to earn the significant profit from resale of uranium. Cameco Switzerland continued to avail contract administrative services from Cameco Canada. The whole affair was arranged principally with the objective of taking tax benefit arising from lower tax rates in Switzerland as compared to Canada. Therefore, the arrangement structured by Cameco Canada should be completely disregarded and the transaction be re-characterised as if Cameco Canada had directly entered into uranium purchase agreements with Tanex and Urenco.

Cameco Canada argued that there was no incongruity in the form and substance of the transaction, so the question of the transaction being 'sham' does not arise. Cameco Canada also argued that a person would be willing to give up a business opportunity for an appropriate price and there was no significant economic value when the uranium supply contract was first entered into by Cameco Europe with Tanex and Urenco. It was only after 2002 that the price of uranium spiked, and this spike in the price could not have been foreseen at the time the supply contract was entered into with Tanex and Urenco.

Federal Court of Appeal decision

Aggrieved by the order of the CRA, Cameco Canada litigated the transfer pricing additions before the Tax Court of Canada (TCC). The TCC agreed with Cameco Canada's argument that there was no evidence of any deception or deceit on the part of Cameco Canada to render the arrangement 'sham'. In regard to 're-characterisation', TCC opined that there is nothing commercially irrational in giving up a business opportunity and that a commercially rational arrangement should be looked at from a pricing adjustment perspective, not from the structural adjustment/re-characterisation perspective.

Aggrieved by the order of the TCC, CRA appealed before the FCA. However, CRA did not pursue the 'sham' argument before the FCA and merely argued on 're-characterisation' and 'pricing adjustment' grounds, which were also negated by the TCC. The FCA analysed the re-characterisation provision in the Canadian transfer pricing regulation.

Section 247(2) of the Canadian Income Tax Act deals with transfer pricing provisions and has four paragraphs. Simply put, paragraphs (a) and (c) of section 247(2) permits CRA to make an adjustment when the terms and conditions in respect of a transaction entered into between non-arm's length parties are different from terms and conditions in respect of a transaction entered into between arm's length parties under similar circumstances. This adjustment is done through a 'comparative' analysis.

However, under paragraphs (b) and (d) of section 247(2), an adjustment arises when twin pre-conditions of triggering re-characterisations are met:

- The transactions entered into between non-arm's length parties would not have been entered into by any arm's length parties, even with changed terms and conditions.
- The non-arm's length parties have entered such transactions primarily for the purpose of tax benefit.

The adjustment in such cases is made by presuming that an alternative (hypothetical) transaction would have been entered into between arm's length parties under arm's length conditions and then 'substituting' the terms and conditions of this alternative transactions to actual transaction entered into between non-arm's length parties primarily for tax benefit purpose. Here, the adjustment is done through a 'substitution' analysis.

In order to adjudicate the issue whether there was a need to recast the transaction entered into by Cameco Canada with non-arm's length parties, the question at stake was whether the twin pre-conditions mentioned in para (b) of section 247(2) were met in the given facts and circumstances. In respect of condition (1), the FCA remarked that instead of asking whether Cameco Canada would have entered into the arrangement it actually entered into with an arm's length party, the question that needed to be answered was whether any party would have entered into such a transaction with arm's length party at arm's length conditions. The FCA also observed that the commercial rationality of the transaction was established by witnesses from both sides: if a transaction is commercially rational, then it was reasonable to assume that arm's length persons would enter into it.

> *CRA did not pursue the 'sham' argument before the FCA and merely argued on 're-characterisation' and 'pricing adjustment' grounds, which were also negated by the TCC*

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> *The FCA held that the CRA's proposition of replacing the transaction with nothing was against the mandate of para (d) of section 247(2)*

The FCA held that the first condition of para (b) of section 247(2) is not fulfilled, so there was no need to adjudicate on adjustment proposed by the CRA under para (d) of section 247(2) of the Canadian IT Act. However, for the sake of completeness, the FCA did analyse the adjustment proposed by the CRA, and observed that once the twin conditions of recasting of transactions are met, para (d) requires replacing of the transactions entered by the taxpayer with a non-arm's length party by an alternative arm's length transaction. The FCA held that the CRA's proposition of disregarding the purchase contract between Cameco Switzerland and Tanex and Urenco – as if the said purchase contracts were entered into directly between Cameco Canada and Tanex and Urenco – would virtually mean amalgamation of separate legal entities with Cameco Canada.

The FCA held that the CRA's proposition of replacing the transaction with nothing was against the mandate of para (d) of section 247(2), which requires replacement of the transaction with an alternative transaction having arm's length characteristics. Consequently, the FCA dismissed the CRA's appeal and decided in favour of Cameco Canada.

Interplay of OECD TP Guidelines and Canadian TP regulation on re-characterisation

The earlier OECD TP Guidelines (released in 1995 and 2010) listed two circumstances where a transaction could be re-characterised:

- Where the form of transaction is different from the 'commercial substance' (by analysing the conduct of the parties)
- Where form and substance are the same but the transaction/arrangement, viewed in totality, lacks 'commercial rationality' and the transaction is structured such that it would impede the determination of arm's length price.

It is worth noting that re-characterisation and disregarding should be resorted to only rarely; the OECD Guidelines (2010) also clarified that a transaction should not be re-characterised or disregarded just because a transaction/arrangement similar to one entered into by the taxpayer with its group companies are not found in the open market between third parties. The guidance on re-characterisation and disregarding a transaction created significant disputes between taxpayers and revenue authorities.

The revised guidance on re-characterisation and disregarding of transaction in the OECD TP Guidelines, 2017[3] does not specifically mention the word 're-characterisation' and simply focuses on 'disregarding' or 'non-recognition'. Furthermore, instead of two circumstances mentioned in earlier versions of the OECD TP Guidelines, the current OECD TP Guidelines only mentions one circumstance: a transaction/arrangement lacking commercial rationality, which may qualify for non-recognition or disregarding.

Though not clearly reflected in the current OECD TP Guidelines, the only explanation for such a change seems to be that current OECD TP Guidelines focus on 'delineation' of a controlled transaction. Put simply, delineation means 'going behind the transaction' to understand the 'real deal' involved. The delineation process not only considers the form of the transaction as represented in inter-company contract, but also focuses on 'commercial substance'. Therefore, the 'substance over form' test is already subsumed during the delineation process. The implication of subsuming the 'substance over form' test in the delineation process is that it allows the revenue authority significant discretionary power and latitude to re-characterise the transaction structure under the guise of delineation.

Key takeaways and way forward

Whether this decade-long transfer pricing issue is finally laid to rest by this decision, or the CRA will appeal before the Supreme Court, is not yet in the public domain. It is expected that the subtle difference in interpretation of 're-characterisation' in the pre- and post-2017 versions of the OECD TP Guidelines will keep the litigation ground busy in near future on the issue. On 26 February 2020, the CRA issued a draft notice informing tax professionals that Circular IC87-2R containing guidance on transfer pricing provisions contained in section 247 stands cancelled. In respect of re-characterisation, this circular relied on interpretation of 're-characterisation' based on the 1995 OECD TP Guidelines. The CRA has stated that IC87-2R was cancelled due to its inconsistency with the CRA's current interpretation and application of Canadian transfer pricing legislation, and does not reflect updated OECD TP Guidelines.

More importantly, the CRA also mentioned in the draft notice that the practice of resorting to re-characterisation only in exceptional circumstances is outdated – a clear indication that in future, it may apply re-characterisation provisions more freely as compared to current practice. However, whether such a broad application of re-characterisation would prevail in the courts would depend upon the facts and circumstances of each individual case.

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1. Sections 247(2)(b) and 247(2)(d) of the Canadian Income Tax Act.
2. *Her Majesty The Queen v Cameco Corporation* [2020 FCA 112].
3. Paragraphs 1.119–1.128 of the OECD Transfer Pricing Guidelines, 2017.

Germany's temporary VAT cut: Rates of 19% and 7% reduced to 16% and 5% from 1 July to 31 December 2020

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The new VAT rates are applicable to supplies, services and intra-Community acquisitions rendered between 1 July and 31 December 2020

On 12 June 2020, the German government decided to lower VAT rates in an effort to contain COVID-19's economic hit. The higher rate was reduced from 19% to 16%, and the lower rate from 7% to 5%. This temporary measure applies from 1 July to 31 December 2020, after which the original rates will be reinstated. Problems related to the measure's application are to be expected, and it will require clarification. This contribution is based on a letter from the German Federal Ministry of Finance dated 30 June 2020.

The new VAT rates are applicable to supplies, services and intra-Community acquisitions rendered between 1 July and 31 December 2020. This applies irrespective of whether the services are taxed according to agreed or collected payments. The point in time of the contract agreement is just as irrelevant as the point in time of the receipt of the payment or the issuing of the invoice. The new tax rates also apply to imports made from 1 July to 31 December 2020.

As the VAT rate depends on the time of performance, this must be determined in each individual case. The tax authorities allow simplifications through temporary regulations.

Supplies are carried out at the time when the power of disposal over the supplied goods is transferred. In the case of transport or shipment supplies, the supply is deemed to be carried out at the beginning of the transport or shipment. A service is always carried out at the time of its completion. If a supply is cancelled, such as by exchanging the supply item, the original supply is substituted by a new one with a new supply date. These principles also apply to work supplies and work services.

In this context, 'partial services' require special consideration – that is, where there is an economically identifiable part of a work or a work service that is accepted or completed separately and for which partial payments are agreed and invoiced separately. For partial services rendered before 1 July 2020, the VAT rates applicable until 30 June 2020 are to be applied.

The reduction in VAT rates has a particular impact on services that extend for a long time (permanent services). Permanent services are performed on the day on which the agreed service period ends. Recurring supplies (except for supplies of electricity, gas, heat and water) are carried out on the day of each individual supply. Reduced turnover tax rates already apply to permanent services rendered after 30 June 2020. When billing additional services, the application of the VAT rate depends on the time the main service is performed (e.g. for rent and additional costs). Caveat: in case of a contract for permanent service that itself constitutes an invoice, it must contain every legally mandatory information of an invoice in order to be valid (including new applying VAT rates, which can be implied by a simple reference to 'plus VAT at the statutory rates'). Otherwise, it won't guarantee the input tax deduction of the service recipient.

If a permanent service is not invoiced for the whole service period, but for a shorter period, it is considered a partial service; application of the correct VAT rate depends on when the relevant partial service was performed.

The change of tax rate is also problematic if the tax base changed after the initial turnover was carried out. In this case, it depends on the form into which the tax base was changed. If the change occurs due to a discount, rebate or non-payment, the applicable tax rate depends on the date the initial turnover was made, before or after 1 July 2020.

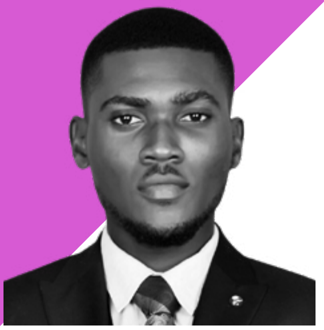
If the tax base is reduced by issuing vouchers, the company can apply a tax adjustment of 19% if the vouchers were issued between 1 July and 31 August 2020. However, for vouchers issued after 31 August 2020, VAT is to be corrected at 16%.

If the tax base changes due to the granting of annual bonuses or annual refunds, the tax rate at which the initial turnover was taxed is also relevant. To simplify matters, the respective annual turnover can be divided *pro rata temporis*. Understandably, however, the tax authorities do not object if the company makes the tax adjustment at 19% without exception.

The tax administration allows a further simplification in the taxation of the hotel and restaurant sector.

An important part of the letter from German Ministry of Finance is the non-compliant rule in the business chain. The Ministry first clarifies that an excessive tax display leads to a tax liability for the additional amount. However, 'for reasons of practicability' no objection is raised if the company does not correct the VAT display in the invoices for services rendered in July 2020. On the other hand, a service recipient who is entitled to deduct input tax can deduct the VAT shown in the invoice. In cases of reverse-charge procedure, this regulation applies accordingly.

Taxation of digital economic activities: The ‘Significant Economic Presence’ rule in Nigeria



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Introduction

Over recent years, the global business space has evolved faster than existing international tax laws. As a result, the risk of double or non-taxation of income has arisen, threatening to undermine the fairness of the international tax system. Among the recommendations of the committee set up by the Organisation for Economic Co-operation and Development (OECD) under Action Plan 1 of Base Erosion and Profit Shifting (BEPS), is finding a solution to the taxation mismatch caused via digital economic activities. Consequently, the concept of ‘Significant Economic Presence’ was devised.

The Finance Act 2019, which became operational in Nigeria in February 2020, has made provision for the taxation of digital activities, thus putting an end to the erstwhile controversy around the taxation of companies digitally operating and deriving income from the country without a physical presence.

Taxation of digital activities before the Finance Act

Until February 2020, a non-resident company was subject to income tax in Nigeria if it had a fixed base in the country and the profit is attributable to that fixed base. Other than operating through a fixed base, where a company habitually operates its business through a person in Nigeria or where the business activities involve a single contract for surveys, deliveries, installation or construction, such company was also subject to income tax. Accordingly, businesses conducted strictly via the digital space eluded the tax net because of the phrasing of the law, which did not consider income from digital activities as taxable income.

Similarly, the Value Added Tax Act mandates a non-resident company that carries on business in Nigeria to register for tax, using the address of the person with whom it has a subsisting contract, as its address for purposes of correspondence relating to the tax. Such a non-resident company is expected to include VAT in its invoice and the person to whom the goods or services are supplied in Nigeria is obligated to remit the tax in the currency of the transaction.

Emergence of the ‘Significant Economic Presence’ rule

The Finance Act has now recognised the profits of a non-resident company from any trade or business that transmits, emits or receives signals, sounds, messages, images or data of any kind by cables, radio, electromagnetic systems or any other electronic or wireless apparatus to Nigeria. This business may be in respect of any activity, including electronic commerce, app store, online advertising, participative network platform, online payments and so on, to the extent that the company carrying on the business has a significant economic presence in Nigeria and profit can be attributable to such activity. Where this is the case, such profits are to be subject to income tax in Nigeria as provided in the amended Companies Income Tax Act.

In furtherance of the powers bestowed on the Minister of Finance, Budget and Planning, the Companies Income Tax (Significant Economic Presence) Order, 2020 (‘SEP Order’) was promulgated to determine what constitutes ‘significant economic presence’ in Nigeria. The SEP Order specifies the conditions under which non-resident companies that generate revenue from Nigeria via digital means will be liable to income tax. These are:

- Deriving a gross turnover or income in excess of 25 million Naira, or its

The introduction of the concept of significant economic presence into Nigerian tax laws is laudable, as it aligns with current business realities

equivalent in other currencies, in any accounting year from any or a combination of the following in Nigeria:

  - Streaming or downloading services of digital content, including but not limited to movies, videos, music, apps, games and e-books to any person in Nigeria
  - Transmission of data collected about Nigerian users that has been generated from such users' activities on a digital interface, including website or mobile apps
  - Provision of goods or services directly or indirectly through a digital platform to Nigeria
  - Provision of intermediate services through a digital platform, website or other online apps that link.

- In determining the threshold, activities carried out by connected persons in that accounting year are considered.
- Using a Nigerian domain name (.ng) or registering a website address in Nigeria.
- Having a purposeful and sustained interaction with persons in Nigeria by customising its digital platform to target persons in Nigeria, including reflecting the prices of its products or services in Nigerian currency or providing options for billing or payment in Nigerian currency.

In addition, a non-resident company carrying on a trade or business comprising the furnishing of technical, professional, management or consultancy services shall be deemed to have significant economic presence in Nigeria where it receives or earns any payment or income from a person resident in Nigeria or a fixed base of a foreign company.

However, a company will not have significant economic presence in Nigeria in relation to a payment, if it is made to an employee of the person making the payment under a contract of employment, for teaching in or by an educational institution, or by a foreign fixed base of a Nigerian company.

Conclusion

The introduction of the concept of significant economic presence into Nigerian tax laws is laudable, as it aligns with current business realities. Foreign companies that qualify under the SEP Order are now required to file tax returns in Nigeria, while Nigerian residents transacting with the foreign companies must deduct withholding tax on payments made to such companies.

To avoid penalties for default, non-resident companies carrying on business in Nigeria that previously had no tax obligations are expected to comply with the new tax rules.

Double taxation cases and information exchange between Taiwan and Indonesia

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Taiwan court case 1: Incorrect withholding and double taxation

In this case, Taiwan's Administrative Supreme Court (Docket No. 109-Pan-101) ruled that the commission payment remitted by an Indonesian company to the Taiwanese taxpayer was deemed as a business profit – which taxing right, according to the Taiwan–Indonesia bilateral treaty, belongs exclusively to Taiwan even though the payment was being incorrectly withheld in Indonesia.

Company A is a company incorporated and operating in Taiwan. From 2011 to 2013, Company A had received several commission payments totalling US$1 million from Company B in Indonesia. Company S withheld 20% tax while remitting the commission to Company A. Because the commission payments had been taxed by 20% withholding before remitting to Taiwan, Company A considered the tax liabilities arising from that commission payment resolved and did not disclose them in the annual corporate tax returns in Taiwan. However, the Indonesian Ministry of Finance informed the Taiwan's tax department of such commission and withholding facts. The Taiwan tax bureau then penalised Company A for deficient tax payables.

Company A argued that the corresponding tax liability had been satisfied because of that 20% withholding payment in Indonesia. The Taiwan tax bureau contended that the withholding was wrongfully made, and Taiwan had the exclusive right to tax the commission as a business profit, which means Company A must pay again in Taiwan.

The Tax Senate of the Supreme Court dismissed Company A's argument and ruled that the commission was business profit in nature and should be taxed only by Taiwan according to article 7 of the Taiwan–Indonesia tax treaty. As for the wrongfully withheld payment to the Indonesian tax bureau, Company A cannot deduct it in Taiwan but may claim a refund in Indonesia.

Taiwan court case 2: Dealing through a shell company registered in BVI

The second case also concerns commission payments. The Taipei Administrative High Court (Docket No. 108-Su-328) ruled that commission paid through a British Virgin Islands (BVI) account controlled by a Taiwanese company should be exclusively taxed by Taiwan under the Taiwan–Indonesia tax treaty.

Company C is registered and operating in Taiwan. It performed a mediating role in coal supply transactions between Chinese buyers and Indonesian suppliers. Three Indonesian companies had paid Company C a substantial commission of US$12 million in 2011. That commission was remitted to an Offshore Banking Unit account owned by a shell company registered in BVI. The BVI shell company further applied for business profits non-taxation in Indonesia with reference to the Taiwan–Indonesia tax treaty by claiming to be a nominee of Taiwanese Company C. Taiwan's tax department was later informed by the Indonesian tax bureau and began a tax investigation. It found that the registered directors and business place of both Company C and the BVI shell company were identical. As a result, the commission should be attributed to Company C, along with deficient taxes and administrative penalty for concealing taxable foreign income. However, the whole case was being processed as merely a tax avoidance rather than tax evasion or illicit money laundering, which might result in criminal charges.

Company C argued that the commission was the receiver's (i.e. BVI company's) income. The Taiwan tax bureau contended that, according to the facts, Company C was the real beneficiary behind the shell company.

The Taipei Administrative High Court decided in favour of the tax bureau by applying the principle of 'substance over form', which penetrates the veil of the BVI company and attributes the taxable commission directly to Company C.

Taiwan has implemented Common Reporting Standards (CRS) and starts automatic exchange of tax information, first with Japan and Australia, in September 2020

Tax information exchange between Taiwan treaty partners

Taiwan has implemented Common Reporting Standards (CRS) and starts automatic exchange of tax information, first with Japan and Australia, in September 2020. According to the Taiwan Ministry of Finance, Taiwan has maintained a functional spontaneous exchange of information (SEOI) with treaty partners, especially with the Netherlands, Luxembourg and Germany. The two commission payment cases described above are clear examples of SEOI conducted in accordance with the Information Exchange clause of the Taiwan–Indonesia tax treaty.

PILCOM (PAK-INDO-LANKA Joint Management Committee) v Commissioner of Income tax

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PILCOM had opened two bank accounts in London and made various payments to foreign cricket boards without deducting tax

Tax to be deducted at source, even if amount is not chargeable to tax by virtue of tax treaty

Recently, the Supreme Court of India in the case of *PILCOM (PAK-INDO-LANKA Joint Management Committee) v Commissioner of Income Tax* [2020] 116 taxmann.com 394, in examining the provisions of section 194E[1] (tax deduction in respect of payments made to non-resident sportsmen or sport association) of the Income Tax Act, 1961 ('the Act'), held that, once income has accrued or arisen or deemed to have accrued or arisen in India, tax at source is liable to be deducted under specific sections of law irrespective of whether a beneficial rate in a tax treaty has been provided. This decision is explained in detail below.

Facts of the case

The appellant, PILCOM, was a committee formed by the cricket boards of India, Pakistan and Sri Lanka for jointly hosting the 1996 ICC Cricket World Cup. It had opened two bank accounts in London and made various payments to foreign cricket boards without deducting tax. These payments were held as liable to tax withholding by the lower authorities under the provisions of section 194E read with section 115BBA of the Act (tax on non-resident sportsmen or sports association). The Calcutta High Court affirmed the view taken by the Calcutta Tribunal and upheld that, in respect of payments made for matches played in India, obligation to deduct tax would arise and had to be discharged irrespective of the existence of a concessional rate as per treaty. The appellant preferred appeal before the Supreme Court of India against the High Court's order.

Arguments before the Supreme Court of India

PILCOM's contentions

The payments made to non-resident sports associations (NRSAs) were for grant of privilege and not towards matches. The bid amount was payable irrespective of the games being played or not. Since the payments were made in England, no income accrued or arose in India.

Revenue's contentions

The Revenue pressed for the acceptance of the High Court judgement under appeal and added that, for attracting the provisions of section 115BBA of the Act, participation would not be material; instead, what would be relevant is that the payment was for the matches held in India and therefore, in the present case, the income was deemed to accrue or arise in India.

Decision of the Supreme Court of India

The Supreme Court of India held as under:

- **Regarding the source of income:** Applying the ratio of the Supreme Court of India in *Performing Right Society Ltd v CIT* [1977] 106 ITR 11 to the present facts of the case, it held that though the payments were described as guarantee money, they were intricately connected with the event where various cricket teams were scheduled to play and did participate in the event. The source of income, as rightly contended by the Revenue, was the playing of the matches in India.
- **Regarding the consequent liability of PILCOM:** The expression 'in relation to' under section 115BBA(1)(b)[2] of the Act emphasises the connection between the game or sport played in India on one

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PILCOM had opened two bank accounts in London and made various payments to foreign cricket boards without deducting tax

hand and the guarantee money paid or payable to the NRSA on the other. Once this connection is established, liability under the provision must arise.

- **Distinguished judgements relied upon by PILCOM:**
  - Supreme Court in *CIT v Eli Lilly & Co.* [2009] 178 Taxman 505 and *GE India Technology Centre Private Ltd v CIT* [2010] 197 Taxman 110
  - It was held that these decisions had no application to the payments in question. In these decisions, the payer was held liable to deduct tax only on the income that was chargeable to tax under the Act; in the present case, only the income attributable to India was held to be liable to tax and hence no further relief was to be granted.
  - Patna High Court in *Metallurgical and Engineering Consultants (India) Ltd* [1999] 103 Taxman 548 and Kerala High Court in CIT v Manjoo and Co. [2010] 195 Taxman 39
    Neither case was held to apply to the present controversy: the 'connection' for the income to accrue and arise in India, which was absent in the case of Metallurgical and Engineering Consultants, was very much present in the present case.
- **Applicability of the tax treaty:** The reasoning of the High Court was affirmed, and it was upheld that the obligation to deduct tax at source under section 194E of the Act was not affected by the tax treaty. In case the exigibility to tax was disputed by the assessee on whose account the deduction was made, the benefit of treaty could be pleaded and if the case was made out, the amount in question would always be refunded with interest. However, that alone could not absolve the liability to deduct tax under section 194E of the Act.

Editorial comments

This is a significant judgement in case of NRSAs wherein it was held that these cricket control boards would come within the purview of section 9 of the Act (income deemed to accrue or arise in India) insofar as the income accrued or arose by way of guarantee money, etc., through the playing of matches in India, which constituted their source of income in India.

It is also pertinent to note here that section 195 of the Act (a residuary section for payments made to non-residents) requires the deduction of tax on such payment at the 'rates in force', defined under section 2(37A)(iii) of the Act to mean the beneficial rate of income tax specified in the Finance Act or the rate as per the tax treaty. Hence, in terms of the provisions of section 195 of the Act, if the sum payable to a non-resident is not chargeable to tax under the tax treaty or is exigible to tax at concessional rate under the treaty, then the withholding tax obligation should be determined in consonance with the position under the treaty and either the Tax Deducted at Source (TDS) should not be deducted or it should be deducted at concessional rates, as appropriate.

However, this decision deals with cases where the tax is not to be deducted at the 'rates in force' but at a specific rate provided in the section, the beneficial rate, if any under tax treaty would not be applicable at the time of deduction. If later, the payee disputes exigibility to tax by virtue of the treaty, then the same may be pleaded by filing a return and consequently, the excess tax deducted can be claimed as a refund by the payee.

For instance, section 196D of the Act prescribes the rate of tax deduction at source for payment to foreign institutional investors by way of income (dividend, interest etc.) or from securities at a rate of 20%. Thus, for dividends paid to a foreign institutional investor, no reference can be made to the treaty at the time of withholding tax, even if the treaty prescribes a lower rate of 5%, 10% or 15%.

REFERENCES

1. 'Where any income referred to in section 115BBA of the Act is payable to a non-resident sports association or institution, the person responsible for making the payment shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of 20%.'
2. 'The income-tax payable by the assessee shall be a rate of 20% where the total income of an assessee being a non-resident sports association or institution, includes any amount guaranteed to be paid or payable to such association or institution *in relation* to any game or sport played in India.'

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A liaison office acting within its permitted, statutory scope does not create a PE in India, rules the Supreme Court of India

The liaison office–permanent establishment conundrum

The taxability of a liaison office (LO) of an overseas entity in India and the concept of 'permanent establishment' (PE) has been rather vexed. A plethora of judicial precedents have analysed what constitutes a PE in India and what does not. Although section 9(1) of the Indian Income-tax Act, 1961 ('the Act') enumerates circumstances where income is 'deemed to accrue or arise in India', primarily through a 'business connection' test, the relevant tax treaties provide that the income earned in one contracting state may be taxed in the other contracting state only if it has a PE in that other state. The term 'PE' is duly defined in these treaties, but often exclude entities that only perform 'preparatory or auxiliary activities' in the taxable state.

The Indian Supreme Court recently in the case of *Union of India vs. UAE Exchange Centre* [2020] 116 taxmann.com 379 SC had an occasion to adjudicate upon the scope of activities carried on by a LO as to whether such activities constitute preparatory or auxiliary activities.

Facts of the case

The taxpayer, UAE Exchange Centre, a company incorporated in the United Arab Emirates (UAE), was engaged in a lucrative business opportunity: offering money remittance services to the burgeoning milieu of non-resident Indians (NRIs) who work in the UAE and other Gulf countries, providing a fast, efficient channel for transferring money to their beneficiaries located at various places in India.

Under the extant exchange control norms, a foreign entity can open and maintain a LO in India for certain limited purposes, such as coordinating the foreign head office (HO)'s business activities in India, but is precluded from conducting any commercial/trading/industrial activity in India. Desirous of ensuring a better customer experience and to offer better, faster remittance services, the taxpayer incorporated a LO in India after acquiring the necessary permission from the Reserve Bank of India (RBI) –LOs under the Foreign Exchange Regulation Act, 1973. The sanction accorded by the RBI permitted the LO to carry out only the following activities:

- Responding to fraudulent complaints from the customers/banks
- Reconciliation of bank accounts in India
- Acting as a communication centre via modem receiving advices of mail transfer, telegraphic transfer stop payment messages, payment details, etc., originating from the taxpayer's computer server located in the UAE and transmitting to its Indian correspondent banks
- Printing Indian Rupee drafts with facsimile signature from the HO and countersigned by the authorised signatory of the LO in India
- Following up with the Indian correspondent banks.

The RBI specifically forbade the LO to undertake any trading, commercial or industrial activity and also prohibited the LO from either entering into business contracts in its own name or earning any income in India. The LO was to sustain itself exclusively from remittances made by the foreign HO.

The business model deployed by the taxpayer was such that a contract was entered between the NRI customer and the taxpayer to avail remittance services from UAE to the intended beneficiary in India, for certain agreed commercials. Thereafter, the taxpayer collected the funds from the NRI customer and made an electronic

The AAR provided its ruling in the year 2004, asserting that the taxpayer's income shall be deemed to accrue in India from the activity carried out by its Indian LO

remittance of the said funds on their behalf, in either of the following two ways:

1. Telegraphic transfer through bank channels
2. Physical delivery of cheque/drafts to the beneficiaries in India through the taxpayer's LO in India.

Note that the activities of entering into the contract, collection of the one-time fees, and collection of the intended funds to be transferred were all done in the UAE itself (i.e., outside India).

Given these facts, the taxpayer held a *bona fide* view that no income had accrued or deemed to have accrued to it in India, under the Income-tax Act, 1961 as well as under the Double Taxation Avoidance Agreement entered between India and UAE ('the DTAA'). Thus, the taxpayer filed income returns declaring nil tax in India. However, seeking to put the matter beyond doubt, the taxpayer filed an application before the Authority for Advance Ruling (AAR)[1] in India in the year 2003, seeking a ruling on 'whether any income is accrued/deemed to be accrued in India from the activities carried out by the company in India'.

AAR ruling

The AAR provided its ruling in the year 2004, asserting that the taxpayer's income shall be deemed to accrue in India from the activity carried out by its Indian LO. The AAR observed that the taxpayer had a 'business connection in India' in terms of section 9(1) of the Act concerning activities carried out in mode (2) above (i.e., physical delivery of cheque/drafts via the taxpayer's LO in India).

The AAR considered the crucial role played by the LO in this mode of effecting remittances and held that it could not be considered 'preparatory and auxiliary' in nature to the taxpayer's business activity and thus, shall not be covered by the exception to the fixed-place PE as provided under article 5 of the DTAA. Consequently, it held that the profits to the extent attributable to such operations shall be taxable in India.

High Court ruling

Aggrieved by the AAR's order, the taxpayer filed a writ petition before the Delhi High Court, since the Income-tax Department was now seeking to collect the tax. The High Court observed that the AAR's discussion about the 'business connection' of the taxpayer under section 9(1) of the Indian tax laws was not particularly relevant in a case where a separate DTAA was entered between the two nations that was more beneficial to the taxpayer; thus, the High Court restricted its analysis to the applicability of articles 5 and 7 of the DTAA.

The High Court affirmed that the LO of the taxpayer was covered under article 5(2)(c), which states that 'PE' includes an office. However, referring to the 'negative list', the High Court noted that article 5(3) opens with a *non-obstante* clause that overrides article 5(2) and provides certain exceptions to the meaning of the term 'PE'. Clause (e) of article 5(3) provides that the fixed place of business (i.e., office) shall not constitute a PE if that office is maintained solely for carrying out activities that are 'preparatory and auxiliary' in nature. The High Court observed that the AAR had failed to understand the true meaning of the word 'preparatory and auxiliary' by erroneously considering that it was not possible to complete the impugned remittances of funds without the activities performed by the Indian LO; these were therefore significant activities that could not be termed as 'preparatory and auxiliary' in nature.

Instead, the High Court took inference from *Black's Law Dictionary*[2] to understand the common meaning of the word 'preparatory and auxiliary' in nature – i.e., aiding or supporting activities – and deduced from this that the activities performed by the LO were merely 'preparatory and auxiliary' in nature. Therefore, the High Court concluded that no income shall be deemed to accrue in India.

The Income-tax Department was not satisfied by this judgement provided by the High Court in favour of the taxpayer and therefore, preferred an appeal before the Supreme Court.

Issue posed for the Supreme Court's consideration

The moot dispute arose in respect of the second mode of remittance transaction and the role played in this by the Indian LO, i.e. downloading the particulars of remittances through electronic media and printing cheques/drafts drawn on the banks in India, which in turn, were couriered or despatched to the beneficiaries in India, in accordance with the instruction of the NRI customer. The question considered by the Supreme Court was whether the activities carried out by the LO could be considered 'preparatory and auxiliary' in nature.

Taxpayer's key arguments

The taxpayer contended that, through its six LOs in India, it provided certain 'auxiliary' services to NRI customers in the UAE to remit funds to their intended beneficiaries in India. The following key points were emphasised by the taxpayer to prove its contention that no business/trade was indeed carried out in India;

- The contract between the taxpayer and the NRI was executed in UAE.
- The funds were handed over to the taxpayer in UAE, not in India.
- The funds were then remitted in accordance with the instruction of the NRI customer in either of modes (1) or (2) described above. Notably, no extra commission or fee was charged for the remittances from the Indian beneficiaries.
- The approval for the LO issued by the RBI had imposed a prohibition on the LO to carry out any trading, commercial or industrial activity in India, and this was not disputed by the Income-tax Department.

Thus, the taxpayer's contention was that the activities carried out in India by the LO could not be construed as 'business connection' within the meaning of sections 5(2)(b) or 9(1)(i) of the Act.

The taxpayer further argued that even if it was assumed that the income was deemed to arise or accrue in India, its business profits would be liable to tax only if it had a PE within the meaning of article 7(3) read with articles 5(1) and (3) of the DTAA. In this regard, the taxpayer stated that its facts were squarely covered by the exception provided under article 5(3)(e), as activities of a 'preparatory or auxiliary' character; therefore, in the absence of a PE in India, no income earned by the taxpayer shall be taxable in India.

Income-tax Department's key arguments

The Income-tax Department argued that income shall be deemed to accrue or arise to the taxpayer in UAE from 'business connection' in India, considering the second mode of transaction, since the following points enabled the taxpayer to complete the remittance transaction, in terms of the contract entered into with the NRI customers:

- The downloading of information about the beneficiaries of the NRI customers by the LOs in India
- The act of the cheques or drafts being drawn on banks in India, in the name of the beneficiaries
- Their despatch through couriers to the beneficiaries.

Therefore, a real and intimate business connection existed between the business carried on by the taxpayer in the UAE as well as in India, for which it received commission in UAE. It was further argued that there was a continuity between the business of the taxpayer in UAE and the activities carried on by the LO in India, without which the contract to remit funds could not be completed. Considering the vital role played by the LO especially in effecting the second mode of remittance, the Income-tax Department vehemently contended that the activities carried out by the LO clearly could not be termed as 'preparatory and auxiliary' in character, and that the LO shall constitute a PE for the taxpayer in India. Therefore, the income, to the extent that operations were carried out in India by the LO, shall be taxable in India.

Supreme Court verdict

At the outset, the Supreme Court observed that the 'business connection' test was satisfied by review of sections 2(24), 4 and 5 read with section 9 of the Act; therefore, income could be deemed to accrue or arise in India under the Indian tax laws.

However, the Court crucially discerned that the moot issue in the impugned facts must be decided on the basis of stipulations contained in the DTAA, for which it turned to its well-settled dictum in the landmark case of *Union of India v. Azadi Bachao Andolan* [10 SCC 1], which held that if the terms of the DTAA were more favourable to the taxpayer than the Act, then the DTAA would apply.

The Court crucially discerned that the moot issue in the impugned facts must be decided on the basis of stipulations contained in the DTAA

That said, the Court also noted that the activities carried out by the LO complied with the conditions specified in the RBI approval. It was not disputed that the LO had completely and scrupulously adhered to the constraints imposed by the RBI on the LO not to indulge in commercial or business activities in India and to sustain itself exclusively through the remittances received from the HO alone. Thus, the Supreme Court agreed with the High Court's conclusion that the LO's activities were indeed circumscribed by the permission given by the RBI and were therefore definitely 'preparatory and auxiliary' in nature.

Therefore, the Court affirmed that the activities carried out by the LO in India did not qualify as a PE of the taxpayer under article 5 of the India–UAE tax treaty. Consequently, no income of the taxpayer was exigible to tax in India.

Editorial comments

The terms 'preparatory' and 'auxiliary' have not been defined in either domestic tax law or the DTAA, so it was often difficult to differentiate between activities that are 'preparatory or auxiliary' in character and those that are not. The individual facts of each case are therefore of primary importance. The decisive criterion could be whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

This is a welcome ruling by the Indian Supreme Court, which has shed light on the application of the 'preparatory and auxiliary' test by foreign entities having their LO in India. The decision provides a line of direction that where there is no violation of the RBI guidelines or sanction terms, the activities of the LO shall be treated as being of 'preparatory and auxiliary' character.

Global entities and multinational corporations with business arrangements/ operations in India must now consider the changes introduced by the MLI (Multi-Lateral Instrument) in relation to PE and demonstrate that the specific activity exemption (advertising, storage, etc.) is indeed available to such activity, being preparatory or auxiliary in character.

REFERENCES

1. The AAR is a statutory forum available to all taxpayers who wish to have their doubts clarified or to achieve certainty regarding their tax affairs in India.
2. A practice commonly adopted by the Indian Judiciary when seeking to give literal meaning to legal expressions.

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